

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarter Ended June 30, 2018 Commission File Number: 0-3676

VSE CORPORATION

(Exact Name of Registrant as Specified in its Charter)

DELAWARE
(State or Other Jurisdiction of
Incorporation or Organization)

54-0649263
(I.R.S. Employer
Identification No.)

6348 Walker Lane
Alexandria, Virginia
(Address of Principal Executive Offices)

22310
(Zip Code)

www.vsecorp.com
(Webpage)

Registrant's Telephone Number, Including Area Code: (703) 960-4600

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|--|--|
| Common Stock, par value \$0.05 per share | The NASDAQ Global Select Market |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer
Non-accelerated filer

Accelerated filer
Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.
Yes No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

Number of shares of Common Stock outstanding as of July 20, 2018: 10,881,106

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VSE Corporation and Subsidiaries

Forward Looking Statements

This report contains statements that, to the extent they are not recitations of historical fact, constitute "forward looking statements" under federal securities laws. All such statements are intended to be subject to the safe harbor protection provided by applicable securities laws. For discussions identifying some important factors that could cause actual results of VSE Corporation ("VSE," the "Company," "us," "our," or "we") to differ materially from those anticipated in the forward looking statements contained in this report, see VSE's discussions captioned "Business," "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Notes to Consolidated Financial Statements" contained in VSE's Annual Report on Form 10-K for the fiscal year ended December 31, 2017 filed with the U.S. Securities and Exchange Commission ("SEC") on March 7, 2018 ("2017 Form 10-K").

Readers are cautioned not to place undue reliance on these forward looking statements, which reflect management's analysis only as of the date hereof. We undertake no obligation to revise publicly these forward looking statements to reflect events or circumstances that arise after the date hereof. Readers should carefully review the risk factors described in our 2017 Form 10-K and in the reports and other documents the Company files from time to time with the SEC, including this and other Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K that we have filed or will file with the SEC subsequent to our 2017 Form 10-K.

PART I. Financial Information**Item 1. Financial Statements****VSE Corporation and Subsidiaries****Unaudited Consolidated Balance Sheets**

(in thousands except share and per share amounts)

| | June 30, 2018 | December 31, 2017 |
|--|---------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 624 | \$ 624 |
| Receivables, net | 54,629 | 55,760 |
| Unbilled receivables, net | 37,955 | 42,577 |
| Inventories, net | 164,390 | 132,591 |
| Other current assets | 13,551 | 16,988 |
| Total current assets | 271,149 | 248,540 |
| Property and equipment, net | 52,670 | 55,146 |
| Intangible assets, net | 102,901 | 110,909 |
| Goodwill | 198,622 | 198,622 |
| Other assets | 15,401 | 15,796 |
| Total assets | \$ 640,743 | \$ 629,013 |
| Liabilities and Stockholders' equity | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ 9,468 | \$ 6,960 |
| Accounts payable | 57,648 | 66,015 |
| Accrued expenses and other current liabilities | 32,619 | 40,243 |
| Dividends payable | 870 | 759 |
| Total current liabilities | 100,605 | 113,977 |
| Long-term debt, less current portion | 171,857 | 165,614 |
| Deferred compensation | 18,028 | 16,323 |
| Long-term lease obligations, less current portion | 19,765 | 20,581 |
| Deferred tax liabilities | 19,172 | 19,423 |
| Total liabilities | 329,427 | 335,918 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock, par value \$0.05 per share, authorized 15,000,000 shares; issued and outstanding 10,881,106 and 10,838,747, respectively | 544 | 542 |
| Additional paid-in capital | 26,490 | 24,470 |
| Retained earnings | 283,767 | 267,902 |
| Accumulated other comprehensive income | 515 | 181 |
| Total stockholders' equity | 311,316 | 293,095 |
| Total liabilities and stockholders' equity | \$ 640,743 | \$ 629,013 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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VSE Corporation and Subsidiaries

Unaudited Consolidated Statements of Income

(in thousands except share and per share amounts)

| | For the three months ended June 30, | | For the six months ended June 30, | |
|--|--|------------|--------------------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| Revenues: | | | | |
| Products | \$ 90,119 | \$ 89,254 | \$ 178,792 | \$ 178,271 |
| Services | 80,275 | 104,606 | 168,499 | 212,883 |
| Total revenues | 170,394 | 193,860 | 347,291 | 391,154 |
| Costs and operating expenses: | | | | |
| Products | 75,834 | 74,222 | 150,560 | 148,928 |
| Services | 75,971 | 100,150 | 161,726 | 204,094 |
| Selling, general and administrative expenses | 730 | 479 | 1,549 | 923 |
| Amortization of intangible assets | 4,004 | 4,004 | 8,008 | 8,008 |
| Total costs and operating expenses | 156,539 | 178,855 | 321,843 | 361,953 |
| Operating income | 13,855 | 15,005 | 25,448 | 29,201 |
| Interest expense, net | 2,182 | 2,376 | 4,357 | 4,811 |
| Income before income taxes | 11,673 | 12,629 | 21,091 | 24,390 |
| Provision for income taxes | 2,922 | 4,822 | 5,288 | 9,290 |
| Net income | \$ 8,751 | \$ 7,807 | \$ 15,803 | \$ 15,100 |
| Basic earnings per share | \$ 0.80 | \$ 0.72 | \$ 1.45 | \$ 1.39 |
| Basic weighted average shares outstanding | 10,881,106 | 10,838,435 | 10,870,887 | 10,830,595 |
| Diluted earnings per share | \$ 0.80 | \$ 0.72 | \$ 1.45 | \$ 1.39 |
| Diluted weighted average shares outstanding | 10,918,927 | 10,861,769 | 10,907,777 | 10,855,632 |
| Dividends declared per share | \$ 0.08 | \$ 0.07 | \$ 0.15 | \$ 0.13 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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VSE Corporation and Subsidiaries

Unaudited Consolidated Statements of Comprehensive Income

(in thousands)

| | For the three months ended June 30, | | For the six months ended June 30, | |
|---|--|----------|--------------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| Net income | \$ 8,751 | \$ 7,807 | \$ 15,803 | \$ 15,100 |
| Change in fair value of interest rate swap agreements, net of tax | 123 | (24) | 334 | 69 |
| Other comprehensive income (loss), net of tax | 123 | (24) | 334 | 69 |
| Comprehensive income | \$ 8,874 | \$ 7,783 | \$ 16,137 | \$ 15,169 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

VSE Corporation and Subsidiaries**Unaudited Consolidated Statements of Cash Flows**

(in thousands)

| | For the six months ended June 30, | |
|---|-----------------------------------|-----------|
| | 2018 | 2017 |
| Cash flows from operating activities: | | |
| Net income | \$ 15,803 | \$ 15,100 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 12,723 | 13,204 |
| Deferred taxes | (888) | (974) |
| Stock-based compensation | 1,676 | 1,464 |
| Changes in operating assets and liabilities: | | |
| Receivables, net | 1,131 | 6,412 |
| Unbilled receivables, net | 9,604 | 13,861 |
| Inventories, net | (34,352) | 528 |
| Other current assets and noncurrent assets | 4,227 | 9,725 |
| Accounts payable and deferred compensation | (6,164) | (39,511) |
| Accrued expenses and other current liabilities | (6,568) | (105) |
| Long-term lease obligations | (816) | (667) |
| Net cash (used in) provided by operating activities | (3,624) | 19,037 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (1,880) | (1,252) |
| Proceeds from the sale of property and equipment | 46 | 400 |
| Net cash used in investing activities | (1,834) | (852) |
| Cash flows from financing activities: | | |
| Borrowings on loan agreement | 359,554 | 181,673 |
| Repayments on loan agreement | (349,534) | (197,142) |
| Payment of debt financing costs | (1,692) | — |
| Payments on capital lease obligations | (707) | (627) |
| Payments of taxes for equity transactions | (641) | (500) |
| Dividends paid | (1,522) | (1,300) |
| Net cash provided by (used in) financing activities | 5,458 | (17,896) |
| Net (decrease) increase in cash and cash equivalents | — | 289 |
| Cash and cash equivalents at beginning of period | 624 | 428 |
| Cash and cash equivalents at end of period | \$ 624 | \$ 717 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018

(1) Nature of Business and Basis of Presentation

Our accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to SEC Form 10-Q and Article 10 of SEC Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2018. For further information refer to the consolidated financial statements and footnotes thereto included in our 2017 Form 10-K.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates affecting the financial statements include accruals for contract disallowance reserves, award fee revenues, costs to complete on fixed price contracts, and recoverability of goodwill and intangible assets.

Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* ("ASC 606"), which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. ASC 606 is based on the principle that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the goods or services. ASC 606 also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to fulfill a contract.

On January 1, 2018, we adopted ASC 606 using the modified retrospective method applied to those contracts which were not completed as of January 1, 2018, including the aggregate effect of modifications to such contracts through January 1, 2018. We recognized the cumulative effect of initially applying the new standard through an increase to the opening balance of retained earnings of \$1.7 million. The primary effects of adopting ASC 606 are: (1) the timing of when we recognize revenue on our contracts with award fees, which previously was based on when we received customer authorization, changed to recognition of the award fees to the extent that it is probable that a significant reversal will not occur as the related performance obligation is satisfied, resulting in revenue being recognized earlier in the contract period, (2) the timing of when we recognize revenues and costs on maintenance, repair and overhaul ("MRO") services for aviation clients and certain fixed price delivery contracts, which changed from the date of delivery to recognition over time as control of the good or service transfers to the customer and progress is made to satisfy the performance obligation, and (3) the pattern in which we recognize revenue on certain fixed price services contracts changed from a straight-line basis over the contract period to measuring progress using input measures, such as costs incurred. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods.

The adoption of ASC 606 also resulted in the establishment of "Unbilled receivables, net" as a separate line item on our unaudited consolidated balance sheets and reclassification of balances to this new line item from "Receivables, net". Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications have no effect on our reported financial condition, results of operations, or cash flows.

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018

The cumulative effect of the changes made to our January 1, 2018 unaudited consolidated balance sheet for the adoption of the ASC 606 update was as follows (in thousands):

| | Balance at December 31, 2017 | Adjustment for ASC 606 | Adjusted balance at January 1, 2018 |
|--|---------------------------------|---------------------------|--|
| Assets: | | | |
| Unbilled receivables, net | \$ 42,577 | \$ 4,982 | \$ 47,559 |
| Inventories, net | \$ 132,591 | \$ (2,553) | \$ 130,038 |
| Liabilities: | | | |
| Accounts payable | \$ 66,015 | \$ (498) | \$ 65,517 |
| Accrued expenses and other current liabilities | \$ 40,243 | \$ 655 | \$ 40,898 |
| Deferred tax liabilities | \$ 19,423 | \$ 577 | \$ 20,000 |
| Stockholders' equity: | | | |
| Retained earnings | \$ 267,902 | \$ 1,695 | \$ 269,597 |

In accordance with the new revenue standard requirements for entities adopting ASC 606 using the modified retrospective method, the disclosure of the impact of adoption on our unaudited consolidated balance sheet as of June 30, 2018 and statement of income for the three months and six months ended June 30, 2018 was as follows (in thousands):

Balance Sheet

| | As Reported | Without Adoption of ASC 606 |
|--|-------------|--------------------------------|
| Assets: | | |
| Unbilled receivables, net | \$ 37,955 | \$ 31,294 |
| Inventories, net | \$ 164,390 | \$ 167,958 |
| Other current assets | \$ 13,551 | \$ 13,551 |
| Liabilities: | | |
| Accrued expenses and other current liabilities | \$ 32,619 | \$ 32,619 |
| Deferred tax liabilities | \$ 19,172 | \$ 18,386 |
| Stockholders' equity: | | |
| Retained earnings | \$ 283,767 | \$ 281,460 |

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018

Statement of Income

| | For the three months ended June 30, 2018 | | For the six months ended June 30, 2018 | |
|---|---|-----------------------------------|---|-----------------------------------|
| | As Reported | Without Adoption of ASC 606 | As Reported | Without Adoption of ASC 606 |
| <u>Revenues:</u> | | | | |
| Products | \$ 90,119 | \$ 88,785 | \$ 178,792 | \$ 177,470 |
| Services | \$ 80,275 | \$ 80,120 | \$ 168,499 | \$ 167,986 |
| <u>Costs and operating expenses:</u> | | | | |
| Products | \$ 75,834 | \$ 74,841 | \$ 150,560 | \$ 149,545 |
| Services | \$ 75,971 | \$ 75,971 | \$ 161,726 | \$ 161,726 |
| Provision for income taxes | \$ 2,922 | \$ 2,796 | \$ 5,288 | \$ 5,080 |
| Net income | \$ 8,751 | \$ 8,381 | \$ 15,803 | \$ 15,191 |

Significant Accounting Policies Update

Our significant accounting policies are discussed in "Note 1: Nature of Business and Significant Accounting Policies" of our 2017 Form 10-K. Significant changes to our policies related to revenue recognition as a result of adopting ASC 606 are discussed below:

We account for revenue in accordance with ASC 606. The unit of account in ASC 606 is a performance obligation. At the inception of each contract with a customer, we determine our performance obligations within the contract and the contract's transaction price. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is defined as the unit of account. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when the performance obligation is satisfied. The majority of our contracts have a single performance obligation as the promise to transfer the individual goods or services is not separately identifiable from other promises in the contracts and is, therefore, not distinct. For product sales, each product sold to a customer typically represents a distinct performance obligation. Our performance obligations are satisfied over time as work progresses or at a point in time based on transfer of control of products and services to our customers.

Contract modifications are routine in the performance of our contracts. Contracts are often modified to account for changes in contract specifications or requirements. In most instances, contract modifications are for goods or services that are not distinct, and therefore are accounted for as part of the existing contract.

Substantially all of our Supply Chain Management Group revenue from the sale of vehicle parts to customers is recognized at the point in time of the transfer of control to the customer. Sales returns and allowances for vehicle parts are not significant.

Our Aviation Group revenues result from the sale of aircraft parts and performance of MRO services for private and commercial aircraft owners, other aviation MRO providers, and aviation original equipment manufacturers. Our Aviation Group recognizes revenues at a point in time for the sale of aircraft parts when control is transferred to the customer, which usually occurs when the parts are shipped. Our Aviation Group recognizes revenues for MRO services over time as the services are transferred to the customer. MRO services revenue recognized is measured based on the cost-to-cost input method, as costs incurred reflect the work completed, and therefore the services transferred to date. Sales returns and allowances are not significant.

Our Federal Services Group revenues result from professional and technical services, which we perform for customers on a contract basis. Revenue is recognized for performance obligations over time as we transfer the services to the customer. The three primary types of contracts used are cost-type, fixed-price and time and materials. Revenues result from work performed on these contracts by our employees and our subcontractors and from costs for materials and other work related costs allowed under our contracts.

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018

Revenues on cost-type contracts are recorded as contract allowable costs are incurred and fees are earned. Variable consideration, typically in the form of an award fees, is included in the estimated transaction price, to the extent that it is probable that a significant reversal will not occur, when there is a basis to reasonably estimate the amount of the fee. These estimates are based on historical award experience, anticipated performance and our best judgment based on current facts and circumstances.

Revenues on fixed-price contracts are recorded as work is performed over the period. Revenue is recognized over time using costs incurred to date relative to total estimated costs at completion to measure progress toward satisfying our performance obligations. Incurred cost represents work performed, which corresponds with the transfer of control to the customer. For such contracts, we estimate total costs at the inception of the contract based on our assumptions of the cost elements required to complete the associated tasks of the contract and assess the affects of the risks on our estimates of total costs to complete the contract. Our cost estimates are based on assumptions that include the complexity of the work, our employee labor costs, the cost of materials, and the performance of our subcontractors. These cost estimates are subject to change as we perform under the contract and as a result, the timing of revenues and amount of profit on a contract may change as there are changes in estimated costs to complete the contract. Such adjustments are recognized on a cumulative catch-up basis in the period we identify the changes.

Revenues for time and materials contracts are recorded based on the amount for which we have the right to invoice our customers, because the amount directly reflects the value of our work performed for the customer. Time and materials contracts are recorded on the basis of contract allowable labor hours worked multiplied by the contract defined billing rates, plus the direct costs and indirect cost burdens associated with materials and subcontract work used in performance on the contract. Generally, profits on time and materials contracts result from the difference between the cost of services performed and the contract defined billing rates for these services.

(2) Revenue

Disaggregated Revenue

Our revenues are derived from contract services performed for United States Department of Defense ("DoD") agencies or federal civilian agencies and from the delivery of products to our clients. Our customers also include various other government agencies and commercial entities.

A summary of revenues for our operating groups by customer for the three and six months ended June 30, 2018 is as follows (in thousands):

| Customer | Three months ended June 30, 2018 | | | |
|----------------------|----------------------------------|------------------|------------------|-------------------|
| | Supply Chain Management | Aviation | Federal Services | Total |
| U.S. Postal Services | \$ 43,089 | \$ — | \$ — | \$ 43,089 |
| DoD | 7,525 | 1,025 | 73,637 | 82,187 |
| Commercial | 3,413 | 34,037 | 31 | 37,481 |
| Other Government | 236 | 742 | 6,659 | 7,637 |
| | <u>\$ 54,263</u> | <u>\$ 35,804</u> | <u>\$ 80,327</u> | <u>\$ 170,394</u> |

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018

| Customer | Six months ended June 30, 2018 | | | |
|----------------------|--------------------------------|------------------|-------------------|-------------------|
| | Supply Chain Management | Aviation | Federal Services | Total |
| U.S. Postal Services | \$ 87,120 | \$ — | \$ — | \$ 87,120 |
| DoD | 15,701 | 2,240 | 151,899 | 169,840 |
| Commercial | 6,799 | 65,572 | 233 | 72,604 |
| Other Government | 507 | 742 | 16,478 | 17,727 |
| | <u>\$ 110,127</u> | <u>\$ 68,554</u> | <u>\$ 168,610</u> | <u>\$ 347,291</u> |

A summary of revenues for our operating groups by contract type for the three and six months ended June 30, 2018 is as follows (in thousands):

| Contract Type | Three months ended June 30, 2018 | | | |
|--------------------|----------------------------------|------------------|------------------|-------------------|
| | Supply Chain Management | Aviation | Federal Services | Total |
| Cost-type | \$ — | \$ 701 | \$ 41,801 | \$ 42,502 |
| Fixed-price | 54,263 | 19,869 | 17,204 | 91,336 |
| Time and materials | — | 15,234 | 21,322 | 36,556 |
| Total revenues | <u>\$ 54,263</u> | <u>\$ 35,804</u> | <u>\$ 80,327</u> | <u>\$ 170,394</u> |

| Contract Type | Six months ended June 30, 2018 | | | |
|--------------------|--------------------------------|------------------|-------------------|-------------------|
| | Supply Chain Management | Aviation | Federal Services | Total |
| Cost-type | \$ — | \$ 1,098 | \$ 92,922 | \$ 94,020 |
| Fixed-price | 110,127 | 39,373 | 32,343 | 181,843 |
| Time and materials | — | 28,083 | 43,345 | 71,428 |
| Total revenues | <u>\$ 110,127</u> | <u>\$ 68,554</u> | <u>\$ 168,610</u> | <u>\$ 347,291</u> |

Contract Balances

Billed receivables, unbilled receivables (contract assets), and contract liabilities are the results of revenue recognition, customer billing, and timing of payment receipts. Billed receivables, net, represent unconditional rights to consideration under the terms of the contract and include amounts billed and currently due from our customers. Unbilled receivables represent our right to consideration in exchange for goods or services that we have transferred to the customer prior to us having the right to payment for such goods or services. Contract liabilities are recorded when customers remit contractual cash payments in advance of us satisfying performance obligations under contractual arrangements, including those with performance obligations to be satisfied over a period of time.

We present our unbilled receivables and contract liabilities on a contract-by-contract basis. If a contract liability exists, it is netted against the unbilled receivables balance for that contract. Unbilled receivables decreased from \$47.6 million at adoption of ASC 606 on January 1, 2018 to \$38.0 million at June 30, 2018, primarily due to billings in excess of revenue recognized. Contract liabilities, which are included in accrued expenses and other current liabilities in our consolidated balance sheet, decreased from \$9.8 million at adoption of ASC 606 on January 1, 2018 to \$3.9 million at June 30, 2018, primarily due to revenue recognized in excess of advance payments received. For the three and six months ended June 30, 2018, we recognized revenue of \$1.2 million and \$7.7 million that was previously included in the beginning balance of contract liabilities.

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018

Performance Obligations

Our performance obligations are satisfied over time as work progresses or at a point in time. Revenues from products and services transferred to customers over time accounted for approximately 57% of our revenues for the three and six months ended June 30, 2018, primarily related to revenues in our Federal Services Group and for MRO services in our Aviation Group. Revenues from products and services transferred to customers at a point in time accounted for approximately 43% of our revenues for the three and six months ended June 30, 2018. The majority of our revenue recognized at a point in time is for the sale of vehicle and aircraft parts in our Supply Chain Management and Aviation groups.

As of June 30, 2018, the aggregate amount of transaction prices allocated to unsatisfied or partially unsatisfied performance obligations was \$339 million. Performance obligations expected to be satisfied within one year and greater than one year are 96% and 4%, respectively. We have applied the practical expedient for certain parts sales and MRO services to exclude the amount of remaining performance obligations for (i) contracts with an original expected term of one year or less or (ii) contracts for which we recognize revenue in proportion to the amount we have the right to invoice for services performed.

During the six months ended June 30, 2018, revenue recognized from performance obligations related to prior periods was not material.

(3) Debt

We have a loan agreement with a group of banks to provide working capital support, letters of credit and finance acquisitions. The loan agreement, which was amended in January 2018 and expires in January 2023, has a term loan facility and a revolving loan facility. The revolving loan facility provides for revolving loans and letters of credit. Financing costs associated with the inception of the amended loan agreement of approximately \$1.7 million were capitalized and are being amortized over the five-year life of the loan.

Our required term loan payments after June 30, 2018 are approximately \$5.0 million in 2018, \$10.0 million in 2019, \$11.9 million in 2020, \$14.4 million in 2021, \$15 million in 2022, and \$41.2 million in 2023. The amount of term loan borrowings outstanding as of June 30, 2018 was \$97.5 million.

The maximum amount of credit available to us under the loan agreement for revolving loans and letters of credit as of June 30, 2018 was \$300 million. Subject to the terms of the loan agreement, we may borrow and repay the revolving loan borrowings as our cash flows require or permit. We pay an unused commitment fee and fees on letters of credit that are issued. We had \$86.2 million in revolving loan amounts outstanding and \$22 thousand in letters of credit outstanding as of June 30, 2018. We had approximately \$79.3 million in revolving loan amounts outstanding and no letters of credit outstanding as of December 31, 2017.

Under the loan agreement we may elect to increase the maximum availability of the term loan facility, the revolving loan facility, or both facilities, up to an aggregate additional amount of \$100 million.

Total bank loan borrowed funds outstanding, including term loan borrowings and revolving loan borrowings, were \$183.7 million and \$173.7 million, as of June 30, 2018 and December 31, 2017, respectively. These amounts exclude unamortized deferred financing costs of approximately \$2.4 million and \$1.1 million as of June 30, 2018 and December 31, 2017. The fair value of outstanding debt as of June 30, 2018 under our bank loan facilities approximates its carrying value using Level 2 inputs based on market data on companies with a corporate rating similar to ours that have recently priced credit facilities.

We pay interest on the term loan borrowings and revolving loan borrowings at LIBOR plus a base margin or at a base rate (typically the prime rate) plus a base margin. As of June 30, 2018, the LIBOR base margin was 1.75% and the base rate base margin was 0.50%. The base margins increase or decrease in increments as our Total Funded Debt/EBITDA Ratio increases or decreases.

The loan agreement requires us to have interest rate hedges on a portion of the outstanding term loan for the first three years after the January 2018 amendment date of the agreement. We executed interest rate swap agreements in February 2015 and February 2018. The notional amount of the interest rate swap agreements was \$50 million and \$85 million as of June 30, 2018 and December 31, 2017, respectively.

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After taking into account the impact of interest rate swap agreements, as of June 30, 2018, interest rates on portions of our outstanding debt ranged from 3.00% to 5.50%, and the effective interest rate on our aggregate outstanding debt was 3.77%.

Interest expense incurred on bank loan borrowings and interest rate hedges was approximately \$1.7 million and \$1.9 million for the three months ended June 30, 2018 and 2017, respectively. Interest expense incurred on bank loan borrowings and interest rate hedges was approximately \$3.2 million and \$3.8 million for the six months ended June 30, 2018 and 2017, respectively.

The loan agreement contains collateral requirements to secure our loan agreement obligations, restrictive covenants, a limit on annual dividends, and other affirmative and negative covenants, conditions, and limitations. Restrictive covenants include a maximum Total Funded Debt/EBITDA Ratio, which decreases over time, and a minimum Fixed Charge Coverage Ratio. We were in compliance with required ratios and other terms and conditions at June 30, 2018.

(4) Earnings Per Share

Basic earnings per share ("EPS") has been computed by dividing net income by the weighted average number of shares of common stock outstanding during each period. Shares issued during the period are weighted for the portion of the period that they were outstanding. Our calculation of diluted earnings per common share includes the dilutive effects for an assumed vesting of restricted stock awards.

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|------------|---------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| Basic weighted average common shares outstanding | 10,881,106 | 10,838,435 | 10,870,887 | 10,830,595 |
| Effect of dilutive shares | 37,821 | 23,334 | 36,890 | 25,037 |
| Diluted weighted average common shares outstanding | 10,918,927 | 10,861,769 | 10,907,777 | 10,855,632 |

(5) Commitments and Contingencies

Contingencies

In November 2016, a lawsuit, Arrieta et al vs. Prime Turbines LLC et al, was filed in the District Court of Texas in Dallas County, by Edgar Arrieta, and four other plaintiffs against VSE subsidiaries, Kansas Aviation of Independence, L.L.C. and Prime Turbines LLC, and three other unrelated defendants. The other named defendants are Pratt & Whitney of Canada Corporation, Cessna Aircraft Company and Woodward Inc. The plaintiffs allege that on April 1, 2016, a plane crashed resulting in the death of three plaintiffs and serious injuries to six other plaintiffs and that VSE's subsidiaries were negligent in providing maintenance, service and inspection of the airplane engine prior to the crash. Plaintiffs are seeking monetary relief over \$1.0 million from the defendants. Trial is scheduled for November 2018. VSE together with its insurance carrier, will aggressively defend the proceedings. While the results of legal proceedings cannot be predicted with certainty and the amount of loss, if any, cannot be reasonably estimated at this time, we believe the likelihood that this lawsuit will have a material adverse effect on our results of operation, financial condition, or cash flows is remote.

On or about April 19, 2018 Joseph Waggoner and Clifford Tefteller, on behalf of themselves and all similarly situated individuals, filed a lawsuit against VSE Corporation, XOTECH Solutions, LLC (Tefteller's employer) and White's Paint and Blast (Waggoner's employer) in the United State District Court, Eastern District of Texas, Texarkana Division, alleging overtime compensation entitlement at a rate of one and on-half times their regular rate of pay for all hours worked over 40 hours in a workweek. The plaintiffs are seeking to certify the case as a collective action for similarly situated individuals. The plaintiffs work under a contract between defendants and the United States Army at the Red River Army Depot in Texas. The plaintiffs assert that employees' fifteen minute unpaid work breaks should have been included as "working hours" for the purposes of calculating overtime. While the results of legal proceedings cannot be predicted with certainty and the amount of loss, if any, cannot be reasonably estimated at this time, we believe the likelihood that this lawsuit will have a material adverse effect on our results of operation, financial condition, or cash flows is remote.

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In a letter dated May 21, 2018, Dyncorp International ("Dyncorp") notified VSE's subsidiary Prime Turbines LLC that the U.S. Air Force ("USAF") had filed a claim against Dyncorp for approximately \$27 million in respect of work performed by Dyncorp and Prime Turbines in support of the USAF program for servicing fuel nozzle tips on aircraft engines. Dyncorp's notification also asserts that Dyncorp believes any liability arising from the USAF claim will be borne by Prime Turbines under its agreement dated August 21, 2013, with Dyncorp. As the events leading to the USAF claim against Dyncorp, including the work performed by Prime Turbines as a subcontractor, occurred prior to VSE's acquisition of Prime Turbines in January 2015, VSE notified the sellers of Prime Turbines of the Dyncorp and USAF claims and VSE's intention to seek restitution from the sellers for any damages arising from such claims. While the sellers have not acknowledged any liability in respect of Dyncorp's claim against Prime Turbines, they have assumed the defense of such claim under the acquisition agreement between the sellers and VSE. VSE believes that Dyncorp and Prime Turbines together with its insurance carrier, will appeal the USAF claim against Dyncorp and will otherwise aggressively defend against such claim. While the results of any resulting legal proceedings cannot be predicted with certainty and the amount of loss, if any, cannot be reasonably estimated at this time, we believe the likelihood that this claim will have a material adverse effect on our results of operation, financial condition, or cash flows is remote.

Other Matters

In addition to the above-referenced legal proceedings and Dyncorp claim, we may have certain claims in the normal course of business, including legal proceedings, against us and against other parties. In our opinion, the resolution of these other claims will not have a material adverse effect on our results of operations, financial position, or cash flows. However, because the results of any legal proceedings cannot be predicted with certainty, the amount of loss, if any, cannot be reasonably estimated.

Further, from time-to-time, government agencies investigate whether our operations are being conducted in accordance with applicable contractual and regulatory requirements. Government investigations of us, whether relating to government contracts or conducted for other reasons, could result in administrative, civil or criminal liabilities, including repayments, fines or penalties being imposed upon us, or could lead to suspension or debarment from future government contracting. Government investigations often take years to complete and many result in no adverse action against us. We believe, based upon current information, that the outcome of any such government disputes and investigations will not have a material adverse effect on our results of operations, financial condition, or cash flows.

(6) Business Segments and Customer Information

Business Segments

Management of our business operations is conducted under three reportable operating segments:

Supply Chain Management Group – Our Supply Chain Management Group supplies vehicle parts primarily through a Managed Inventory Program ("MIP") and direct sales to the United States Postal Service ("USPS"), the United States Department of Defense ("DoD") and to other commercial customers.

Aviation Group – Our Aviation Group provides maintenance, repair and overhaul ("MRO") services, parts supply and distribution, and supply chain solutions for commercial aviation and business and general aviation jet aircraft engines and engine accessories.

Federal Services Group – Our Federal Services Group provides engineering, industrial, logistics, foreign military sales, legacy equipment sustainment services, IT and technical and consulting services primarily to DoD and other government agencies.

The operating segments reported below are the segments of the Company for which separate financial information is available and for which segment results are evaluated regularly by our Chief Executive Officer in deciding how to allocate resources and in assessing performance. We evaluate segment performance based on consolidated revenues and operating income. Net sales of our business segments exclude intersegment sales as these activities are eliminated in consolidation.

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Our segment information is as follows (in thousands):

| | Three months ended June 30, | | Six months ended June 30, | |
|--------------------------------|-----------------------------|-------------------|---------------------------|-------------------|
| | 2018 | 2017 | 2018 | 2017 |
| Revenues: | | | | |
| Supply Chain Management Group | \$ 54,263 | \$ 56,404 | \$ 110,127 | \$ 112,489 |
| Aviation Group | 35,804 | 32,590 | 68,554 | 64,944 |
| Federal Services Group | 80,327 | 104,866 | 168,610 | 213,721 |
| Total revenues | <u>\$ 170,394</u> | <u>\$ 193,860</u> | <u>\$ 347,291</u> | <u>\$ 391,154</u> |
| Operating income: | | | | |
| Supply Chain Management Group | \$ 8,168 | \$ 8,950 | \$ 15,764 | \$ 17,433 |
| Aviation Group | 2,846 | 2,579 | 5,107 | 4,915 |
| Federal Services Group | 3,606 | 3,992 | 6,084 | 7,910 |
| Corporate/unallocated expenses | (765) | (516) | (1,507) | (1,057) |
| Operating income | <u>\$ 13,855</u> | <u>\$ 15,005</u> | <u>\$ 25,448</u> | <u>\$ 29,201</u> |

Customer Information

Our revenues by customer is as follows (dollars in thousands):

| Customer | Three months ended June 30, | | | | Six months ended June 30, | | | |
|---------------------|-----------------------------|--------------|-------------------|--------------|---------------------------|--------------|-------------------|--------------|
| | 2018 | % | 2017 | % | 2018 | % | 2017 | % |
| U.S. Postal Service | \$ 43,089 | 25.3% | \$ 45,959 | 23.7% | \$ 87,120 | 25.1% | \$ 92,428 | 23.6% |
| U.S. Navy | 35,696 | 20.9% | 52,030 | 26.8% | 78,281 | 22.5% | 104,526 | 26.7% |
| U.S. Army | 41,548 | 24.4% | 50,399 | 26.1% | 84,335 | 24.3% | 104,500 | 26.7% |
| U.S. Air Force | 4,943 | 2.9% | 1,822 | 0.9% | 7,224 | 2.1% | 2,840 | 0.7% |
| Total - DoD | <u>82,187</u> | <u>48.2%</u> | <u>104,251</u> | <u>53.8%</u> | <u>169,840</u> | <u>48.9%</u> | <u>211,866</u> | <u>54.1%</u> |
| Commercial aviation | 34,037 | 20.0% | 32,265 | 16.6% | 65,572 | 18.9% | 64,069 | 16.4% |
| Other commercial | 3,444 | 2.0% | 3,308 | 1.7% | 7,032 | 2.0% | 6,437 | 1.7% |
| Total - Commercial | <u>37,481</u> | <u>22.0%</u> | <u>35,573</u> | <u>18.3%</u> | <u>72,604</u> | <u>20.9%</u> | <u>70,506</u> | <u>18.1%</u> |
| Other government | 7,637 | 4.5% | 8,077 | 4.2% | 17,727 | 5.1% | 16,354 | 4.2% |
| Total | <u>\$ 170,394</u> | <u>100%</u> | <u>\$ 193,860</u> | <u>100%</u> | <u>\$ 347,291</u> | <u>100%</u> | <u>\$ 391,154</u> | <u>100%</u> |

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(7) Goodwill and Intangible Assets

Changes in goodwill for the six months ended June 30, 2018 are as follows (in thousands):

| | Supply Chain Management | Federal Services | Aviation | Total |
|---------------------------------|----------------------------|------------------|------------|------------|
| Balance as of December 31, 2017 | \$ 63,190 | \$ 30,883 | \$ 104,549 | \$ 198,622 |
| Balance as of June 30, 2018 | \$ 63,190 | \$ 30,883 | \$ 104,549 | \$ 198,622 |

Intangible assets consist of the value of contract and customer-related intangible assets, acquired technologies and trade names. Amortization expense was approximately \$4.0 million and \$8.0 million for the three and six months ended June 30, 2018 and June 30, 2017, respectively.

Intangible assets, net were comprised of the following (in thousands):

| | Cost | Accumulated Amortization | Accumulated Impairment Loss | Net Intangible Assets |
|-------------------------------|------------|-----------------------------|--------------------------------|--------------------------|
| June 30, 2018 | | | | |
| Contract and customer-related | \$ 173,094 | \$ (79,506) | \$ (1,025) | \$ 92,563 |
| Acquired technologies | 12,400 | (7,969) | — | 4,431 |
| Trade names | 16,670 | (10,763) | — | 5,907 |
| Total | \$ 202,164 | \$ (98,238) | \$ (1,025) | \$ 102,901 |
| December 31, 2017 | | | | |
| Contract and customer-related | \$ 173,094 | \$ (72,937) | \$ (1,025) | \$ 99,132 |
| Acquired technologies | 12,400 | (7,406) | — | 4,994 |
| Trade names | 16,670 | (9,887) | — | 6,783 |
| Total | \$ 202,164 | \$ (90,230) | \$ (1,025) | \$ 110,909 |

(8) Fair Value Measurements

The accounting standard for fair value measurements defines fair value, and establishes a market-based framework or hierarchy for measuring fair value. The standard is applicable whenever assets and liabilities are measured at fair value.

The fair value hierarchy established in the standard prioritizes the inputs used in valuation techniques into three levels as follows:

Level 1—Observable inputs—quoted prices in active markets for identical assets and liabilities;

Level 2—Observable inputs—other than the quoted prices in active markets for identical assets and liabilities—includes quoted prices for similar instruments, quoted prices for identical or similar instruments in inactive markets and amounts derived from valuation models where all significant inputs are observable in active markets; and

Level 3—Unobservable inputs—includes amounts derived from valuation models where one or more significant inputs are unobservable and require us to develop relevant assumptions.

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The following table summarizes the financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017 and the level they fall within the fair value hierarchy (in thousands):

| Amounts Recorded at Fair Value | Financial Statement Classification | Fair Value Hierarchy | Fair Value June 30, 2018 | Fair Value December 31, 2017 |
|---|------------------------------------|----------------------|--------------------------|------------------------------|
| Non-COLI assets held in Deferred Supplemental Compensation Plan | Other assets | Level 1 | \$ 409 | \$ 389 |
| Interest rate swap agreements | Other current assets | Level 2 | \$ 689 | \$ 294 |

Non-COLI assets held in our deferred supplemental compensation plan consist of equity funds with fair value based on observable inputs such as quoted prices for identical assets in active markets and changes in fair value are recorded as selling, general and administrative expenses.

We account for our interest rate swap agreements under the provisions of ASC 815, *Derivatives and Hedging*, and have determined that our swap agreements qualify as highly effective cash flow hedges. The fair value of the swap agreements was approximately \$689 thousand and \$294 thousand at June 30, 2018 and December 31, 2017, respectively. The offset, net of an income tax effect of approximately \$174 thousand and \$113 thousand, was included in accumulated other comprehensive income in the accompanying balance sheets as of June 30, 2018 and December 31, 2017, respectively. The amounts paid and received on the swap agreements are recorded in interest expense in the period during which the related floating-rate interest is incurred. We determine the fair value of the swap agreements based on a valuation model using primarily observable market data inputs.

(9) Income Taxes

Our effective tax rate was 25.0% and 25.1% for the three and six months ended June 30, 2018, respectively, and 38.2% and 38.1% for the three and six months ended June 30, 2017, respectively. The decrease in our effective income tax rate was primarily due to the enactment of the Tax Cuts and Jobs Act in December 2017 ("the Tax Act") which reduced the statutory U.S. corporate income tax rate from 35% to 21% effective January 1, 2018. Income tax expense during interim periods is based on our estimated annual effective income tax rate plus any discrete items that are recorded in the period in which they occur. Our tax rate is affected by discrete items that may occur in any given year, but may not be consistent from year to year.

While we substantially completed our provisional analysis of the income tax effects of the Tax Act as of December 31, 2017 and recorded a reasonable estimate in 2017 of such effects, actual effects may differ, possibly materially, due to, among other things, further refinement of our calculations, changes in interpretations and assumptions that we have made, additional guidance that may be issued by the U.S. Government, and actions and related accounting policy decisions we may take as a result of the Tax Act. We will complete our analysis of the impact of the Tax Act for 2017 over a one-year measurement period ending December 22, 2018, and any adjustments during this measurement period will be included in net earnings from continuing operations as an adjustment to income tax expense in the reporting period when such adjustments are determined. During the six months ended June 30, 2018, we did not identify any adjustment to the net one-time charge for the period ending December 31, 2017 related to the Tax Act.

(10) Recently Issued Accounting Pronouncements Not Yet Adopted

In February 2018, the Financial Accounting Standards Board (FASB) issued ASU No. 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, which provides companies with an option to reclassify stranded tax effects resulting from enactment of the Tax Act from accumulated other comprehensive income to retained earnings. The new standard is effective for fiscal years beginning after December 15, 2018 with early adoption permitted. We currently are assessing the impact that this standard will have on our consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, *Targeted Improvements to Accounting for Hedging Activities*, which amends and simplifies existing guidance in order to allow companies to more accurately present the economic effects of risk management activities in the financial statements. The new standard is effective for fiscal years beginning after December 15, 2018 with early adoption permitted. We currently are assessing the impact that this standard will have on our consolidated financial statements.

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In June 2016, the FASB issued ASU No. 2016-13, *Measurement of Credit Losses on Financial Instruments*, which changes the methodology for measuring credit losses on financial instruments and the timing of when such losses are recorded. The new standard is effective for reporting periods beginning after December 15, 2019 with early adoption permitted for reporting periods beginning after December 15, 2018. We currently are assessing the impact that this standard will have on our consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*, to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The new standard is effective for reporting periods beginning after December 15, 2018 with early adoption permitted. We are currently evaluating our lease portfolio to assess the impact on our consolidated financial statements and evaluating our accounting policies and internal controls that would be impacted by the new standard. We expect to adopt the requirements of the new standard effective January 1, 2019.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Executive Overview

We are a diversified products distribution and services company that assists our clients in sustaining, extending the service life and improving the performance of their transportation, equipment and other assets and systems. We provide products distribution and sustainment services for mission critical legacy systems and equipment and professional and technical services to the United States Government (the "government"), including the United States Department of Defense ("DoD"), the United States Postal Service ("USPS"), and other federal civilian agencies, commercial customers and other customers. Our largest customers are the DoD and USPS. Our operations include supply chain management solutions and parts supply for vehicle fleets; parts supply and maintenance, repair, and overhaul ("MRO") services for aviation clients; vehicle and equipment maintenance and refurbishment; logistics; engineering; energy and environmental services; IT and health care IT solutions; and consulting services.

Organization and Segments

Our operations are conducted within three reportable segments aligned with our management groups: 1) Supply Chain Management; 2) Aviation; and 3) Federal Services.

Supply Chain Management Group - Our Supply Chain Management Group provides sourcing, acquisition, scheduling, transportation, shipping, logistics, data management, and other services to assist our clients with supply chain management efforts. Operations of this group are conducted by our wholly owned subsidiary Wheeler Bros., Inc., which supports the USPS, commercial truck fleets, and DoD with fleet management and sustainment solutions, managed inventory services, and other vehicle parts solutions. The primary revenue source for this group is the USPS Managed Inventory Program ("MIP") that supplies vehicle parts and mission critical supply chain support for the USPS truck fleet.

Aviation Group - Our Aviation Group provides parts supply and distribution, supply chain solutions, and MRO services for commercial aviation and business and general aviation jet aircraft engines and engine accessories. This group offers a range of complementary services and supplies to a diversified client base of corporate and private aircraft owners, commercial and regional airlines, aviation manufacturers, other aviation MRO providers, cargo transporters, and agricultural clients.

Federal Services Group - Our Federal Services Group provides foreign military sales services, refurbishment services to extend and enhance the life of existing vehicles and equipment, fleet-wide ship and aircraft support, aircraft sustainment and maintenance, and other technical, management, engineering, logistics, maintenance, configuration management, prototyping, technology, and field support services to the U.S. Navy and Marine Corps, U.S. Army and Army Reserve, U.S. Air Force, and other customers. Significant work efforts for this group include assistance to the U.S. Navy in executing its Foreign Military Sales ("FMS") Program for surface ships sold, leased or granted to foreign countries, our Red River Army Depot Equipment Related Services Program ("RRAD ERS") providing on-site logistics support for Red River Army Depot at Texarkana, Texas, our Fort Benning Logistics Support Services Program supporting base operations and logistics at Fort Benning, Georgia, our U.S. Army Reserve vehicle refurbishment program and various vehicle and equipment refurbishment, maintenance and sustainment programs for U.S. Army commands, and various task orders under the U.S. Air Force Contract Field Teams ("CFT") Program.

Our Federal Services Group also provides energy and environmental consulting services and IT solutions and services with a focus on medical and health related fields for various DoD and federal civilian agencies, including the United States Departments of Energy; the Social Security Administration; the National Institutes of Health; customers in the military health system; and other government agencies and commercial clients.

Concentration of Revenues

(dollars in thousands)

| Source of Revenue | For the six months ended June 30, | | | |
|-------------------|-----------------------------------|------------|-------------------|------------|
| | 2018 Revenues | % | 2017 Revenues | % |
| USPS | \$ 87,120 | 25 | \$ 92,428 | 24 |
| FMS Program * | 69,443 | 20 | 97,632 | 25 |
| Other | 190,728 | 55 | 201,094 | 51 |
| Total revenues | <u>\$ 347,291</u> | <u>100</u> | <u>\$ 391,154</u> | <u>100</u> |

* Our Aviation Group utilizes the Federal Services Group's FMS Program to sell its gas turbine MRO services to the DoD.

Management Outlook

We continued to experience delays in government funding activity and a deferral of work performed on our FMS program in the second quarter resulting from procedural delays in processing delivery orders by our customer due to a change in personnel. This deferral of work, combined with the completion of the transfer of two frigates to Taiwan on this program in 2017, completion of work on two of our U.S. Army programs in 2017, and a reduction in the scope of work on our RRAD ERS contract in May 2018 has resulted in a decline in our Federal Services Group revenues on a year over year basis. The decline in operating income from these programs is less severe than the revenue decline due to the lower profit margins on these contracts.

We have invested in growth initiatives in our Aviation Group and these efforts have produced positive results. Our Singapore operation began generating revenue in the second quarter as we extend new product lines to new geographic and end-user markets. We have extended our agreement for exclusive distribution rights with a key Original Equipment Manufacturer to 2024. We believe these efforts will provide us with sustainable revenue sources with viable growth potential, and that the associated investment in increased inventory will be beneficial to our future results. Additionally, in conjunction with our Federal Services Group, we have taken our gas turbine MRO competency to the maritime market and we are pursuing additional opportunities for this competency. While revenues, operating income, and inventory may experience fluctuations due to market demand and the mix of products sold, we are optimistic about the near term direction for our Aviation Group.

Parts sales and supply chain and inventory management support services to DoD and commercial clients by our Supply Chain Management Group have shown steady increases on a year over year basis as we continue to capture and on-board new commercial customers. Our commercial client base now includes companies in food distribution, oil field services, waste management, linen and uniform, commercial long haul shipping, bus transportation, and other clients that have vehicle fleets required to meet mission critical delivery or service schedules. We also are capturing new customers and increasing revenue using e-commerce solutions. We look forward to further developing these new client relationships and expect them to reflect a more significant portion of our revenue profile in the future.

The USPS appears to have deferred maintenance on their vehicle fleet, and as a result our revenues from parts sales to the USPS for the first six months declined on a year over year basis. We continue to closely monitor the USPS delivery vehicle procurement efforts and are positioning ourselves to support both newly procured vehicles that are placed in service and aging vehicles that remain in service. While it will likely be several years before the planned custom next-generation USPS delivery vehicle is placed in service in significant numbers, the USPS has begun some shorter-term annual vehicle acquisitions through the procurement of commercial off-the-shelf ("COTS") mass-market vehicles and the retirement of some of its aging COTS vehicles. While we cannot predict with certainty the impact of the USPS delivery vehicle procurement and retirement transition cycle on our future revenues, we believe that our years of service and knowledge of this client's needs strategically position us to continue to serve as a key vehicle fleet sustainment partner. We will remain agile and support this client during its complex vehicle transition initiatives.

Although inventory levels associated with supporting our Aviation growth initiatives increased during 2018, our borrowing increases have been modest and we continue to keep our total debt at reasonable levels. We remain well positioned to pursue further strategic initiatives.

Bookings and Funded Backlog

Revenues for federal government contract work performed by our Federal Services Group depend on contract funding ("bookings"), and bookings generally occur when contract funding documentation is received. Funded contract backlog is an indicator of potential future revenue. While bookings and funded contract backlog generally result in revenue, we may occasionally have funded contract backlog that does not generate revenue due to contract expiration, reduction in work levels or de-obligation upon contract completion.

A summary of our bookings and revenues for our Federal Services Group for the six months ended June 30, 2018 and 2017, and funded contract backlog as of June 30, 2018 and 2017 was as follows (in millions):

| | 2018 | 2017 |
|-------------------------|--------|--------|
| Bookings | \$ 189 | \$ 281 |
| Revenues | \$ 169 | \$ 214 |
| Funded Contract Backlog | \$ 339 | \$ 386 |

Recently Issued Accounting Pronouncements

For a description of recently announced accounting standards, including the expected dates of adoption and estimated effects, if any, on our consolidated financial statements, see *Recently Issued Accounting Pronouncements* in Note 10 of the Notes to our Unaudited Consolidated Financial Statements in this report.

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States, which require us to make estimates and assumptions. See our 2017 Form 10-K for a full discussion of our critical accounting policies. Effective January 1, 2018, we adopted ASC 606, which changed the way we recognize revenue for certain contracts. See *Nature of Business and Basis of Presentation* in Note 1 of the Notes to our Unaudited Consolidated Financial Statements in this report for changes to our critical accounting policies as a result of adopting ASC 606.

Revenue by Contract Type

Federal government contract work is performed by our Federal Services Group under three general government contract types. Revenues of our Supply Chain Management and Aviation groups are generated under ordering or sales agreements, and this revenue is not classified by government contract type. Our revenues are classified as follows (dollars in thousands):

| Contract Type | Six months ended June 30, | | | |
|---|---------------------------|-----|------------|-----|
| | 2018 | % | 2017 | % |
| Cost-type | \$ 92,922 | 27 | \$ 117,480 | 30 |
| Fixed-price | 32,343 | 9 | 50,826 | 13 |
| Time and materials | 43,345 | 13 | 45,415 | 12 |
| Total Federal Services revenues | 168,610 | 49 | 213,721 | 55 |
| Supply Chain Management and Aviation revenues | 178,681 | 51 | 177,433 | 45 |
| Total revenues | \$ 347,291 | 100 | \$ 391,154 | 100 |

Goodwill and Intangible Assets

Goodwill is subject to a review for impairment at least annually. We perform an annual review of goodwill for impairment during the fourth quarter and whenever events or other changes in circumstances indicate that the carrying value may not be fully recoverable. We estimate the fair value of our reporting units using a weighting of fair values derived from the income approach and market approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. Cash flow projections are based on our estimates of revenue growth rates and operating margins, taking into consideration industry and market conditions. The discount rate used is based on a weighted average cost of capital adjusted for the relevant risk associated with the characteristics of the business and the projected cash flows.

In the fourth quarter of 2017, we performed our annual goodwill impairment analysis for each of our reporting units utilizing the statutory tax rate in effect at the time of the test. The results of the impairment analysis indicated that our reporting units had fair values substantially in excess of their carrying values with the exception of our VSE Aviation and Akimeka reporting units.

The fair value of our VSE Aviation reporting unit, within our Aviation Group, approximated its carrying value as of our annual goodwill impairment analysis. While there has not been a significant contract or customer loss, VSE Aviation's revenues and operating income for 2017 did not meet our cash flow projections, primarily due to a decreased demand for new parts and slower than anticipated development of new business opportunities. We believe that these conditions are temporary and that the overall outlook for our Aviation business remains consistent with our long-term projections. Because the fair value of our VSE Aviation reporting unit approximated its carrying value, a negative change in the key assumptions used in the annual impairment analysis or an increase in the carrying value may result in a future impairment of this reporting unit's goodwill. For example, keeping all other assumptions the same, an additional 50 basis points increase in the discount rate or an increase in the carrying value would likely result in an impairment in the reporting unit's goodwill.

Due to the lower clearance at the annual impairment test and the increase in the carrying value resulting from the decrease in our deferred tax liabilities as a result of the Tax Act, we performed an interim goodwill impairment analysis as of December 31, 2017. The result of this impairment analysis showed that VSE Aviation's fair value exceeded its carrying value by approximately 2%.

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Consistent with the annual impairment analysis, negative changes in key assumptions or a further increase in the carrying value may result in a future impairment of the VSE Aviation reporting unit's goodwill.

Based on the results of the annual and interim impairment analysis performed, we have determined that VSE Aviation is at risk of a future goodwill impairment if there are future declines in our cash flow projections or if we are unsuccessful in implementing our revenue growth plans. Additionally, the fair value could be adversely affected by other market factors such as an increase in the discount rate used in the income approach or a decrease in the market multiples used in the market approach, or an increase in the carrying value of this reporting unit. As of June 30, 2018 goodwill associated with VSE Aviation was approximately \$104.5 million.

The fair value of our Akimeka reporting unit, within our Federal Services Group, exceeded its carrying value by approximately 12% during our annual impairment test. Akimeka had experienced a reduction in services performed in prior years due to a decline in services ordered by clients on contracts and a loss of work performed on expiring contracts for which the follow-on work was often awarded to small businesses as set-aside contracts. These factors have been considered in the projections used in our impairment analysis. Based on the results of our analysis, our assessment is that we remain at risk of a future goodwill impairment if there is further deterioration of projected cash flows or negative changes in market factors, such as an increase in the discount rate used in the income approach or a decrease in the market multiples used in the market approach, or an increase in carrying value of this reporting unit. The carrying value of Akimeka as of June 30, 2018 included goodwill of approximately \$29.8 million

We also review the recoverability of our long-lived intangible assets with finite lives when an indicator of impairment exists. For the same reasons discussed above, we assessed the recoverability of the long-lived intangible assets with finite lives at our VSE Aviation and Akimeka reporting units as of December 31, 2017. Based on our analysis of estimated undiscounted future cash flows expected to result from the use of these long-lived intangible assets with finite lives, we determined that their carrying values were recoverable.

As of June 30, 2018, we have no intangible assets with indefinite lives and we had an aggregate of approximately \$199 million of goodwill associated with our acquisitions.

Results of Operations

Our results of operations are as follows (dollars in thousands):

| | Three months ended June 30, | | Six months ended June 30, | | Change | |
|------------------------------|--------------------------------|------------|------------------------------|------------|-----------------|---------------|
| | 2018 | 2017 | 2018 | 2017 | Three Months | Six Months |
| Revenues | \$ 170,394 | \$ 193,860 | \$ 347,291 | \$ 391,154 | \$ (23,466) | \$ (43,863) |
| Costs and operating expenses | 156,539 | 178,855 | 321,843 | 361,953 | (22,316) | (40,110) |
| Operating income | 13,855 | 15,005 | 25,448 | 29,201 | (1,150) | (3,753) |
| Interest expense, net | 2,182 | 2,376 | 4,357 | 4,811 | (194) | (454) |
| Income before income taxes | 11,673 | 12,629 | 21,091 | 24,390 | (956) | (3,299) |
| Provision for income taxes | 2,922 | 4,822 | 5,288 | 9,290 | (1,900) | (4,002) |
| Net income | \$ 8,751 | \$ 7,807 | \$ 15,803 | \$ 15,100 | \$ 944 | \$ 703 |

Our revenues decreased approximately \$23 million or 12% for the second quarter of 2018, and approximately \$44 million or 11%, for the first six months of 2018, as compared to the same periods of 2017. The change in revenues resulted primarily from a decrease in our Federal Services Group revenues of approximately \$25 million for the quarter and \$45 million for the six months. Revenues from our Supply Chain Management Group decreased approximately \$2.1 million for the quarter and \$2.4 for the six months. Revenues from our Aviation Group increased approximately \$3.2 million for the quarter and \$3.6 for the six months.

Costs and operating expenses consist primarily of cost of inventory and delivery of our products sold; direct costs including labor, material, and supplies used in the performance of our contract work; indirect costs associated with our direct contract costs; sales, general, and administrative expenses associated with our operating groups and corporate management; and certain costs and charges arising from nonrecurring events outside the ordinary course of business. These costs will generally increase or decrease in conjunction with our level of products sold or contract work performed. Costs and operating expenses also include expense for amortization of intangible assets acquired through our acquisitions. Expense for amortization of acquisition related intangible assets is included in the segment results in which the acquisition is included. Segment results also include expense for an allocation of corporate management costs.

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Our costs and operating expenses decreased approximately \$22 million or 12% for the second quarter of 2018, and approximately \$40 million or 11% for the first six months of 2018, as compared to the same periods of 2017. Costs and operating expenses for our Federal Services Group and our Supply Chain Management Group decreased for the quarter and the six months and costs and operating expenses for our Aviation Group increased for the quarter and the six months, consistent with the revenues for each group.

Our operating income decreased approximately \$1.1 million or 8% for the second quarter of 2018, and approximately \$3.8 million or 13% for the first six months of 2018, as compared to the same periods of 2017. Operating income from our Federal Services Group decreased for the second quarter and for the first six months of 2018. Operating income from our Supply Chain Management Group decreased for the second quarter and first six months of 2018. Operating income from our Aviation Group increased for the second quarter and first six months of 2018.

Changes in revenues, costs and operating expenses, and operating income are further discussed in the summaries of our segment results that follow.

Interest expense decreased approximately \$454 thousand for the first six months of 2018, as compared to the same period of 2017, due primarily to a decrease in our average level of bank borrowing in 2018. Interest expense also includes interest associated with capitalized construction costs related to our executive and administrative headquarters facility lease. The amount of interest expense associated with this financing lease for the three and six months ended June 30, 2018 was approximately \$348 thousand and \$699 thousand, respectively, as compared to \$370 thousand and \$742 thousand for the three and six months ended June 30, 2017, respectively.

Our effective tax rate was 25.0% and 25.1% for the three and six months ended June 30, 2018, respectively, and 38.2% and 38.1% for the three and six months ended June 30, 2017, respectively. The decrease in our effective income tax rate is primarily due to the Tax Act that reduced the statutory U.S. corporate income tax rate from 35% to 21% effective January 1, 2018. Income tax expense during interim periods is based on our estimated annual effective income tax rate plus any discrete items that are recorded in the period in which they occur. Our tax rate is affected by discrete items that may occur in any given year, but may not be consistent from year to year.

Supply Chain Management Group Results

The results of operations for our Supply Chain Management Group are as follows (dollars in thousands):

| | Three months ended June 30, | | Six months ended June 30, | | Change | |
|------------------------------|--------------------------------|-----------|------------------------------|------------|-----------------|---------------|
| | 2018 | 2017 | 2018 | 2017 | Three Months | Six Months |
| Revenues | \$ 54,263 | \$ 56,404 | \$ 110,127 | \$ 112,489 | \$ (2,141) | \$ (2,362) |
| Costs and operating expenses | 46,095 | 47,454 | 94,363 | 95,056 | (1,359) | (693) |
| Operating income | \$ 8,168 | \$ 8,950 | \$ 15,764 | \$ 17,433 | \$ (782) | \$ (1,669) |
| Profit percentage | 15.1% | 15.9% | 14.3% | 15.5% | | |

Revenues for our Supply Chain Management Group decreased approximately \$2.1 million or 4% for the second quarter and approximately \$2.4 million or 2% for the first six months of 2018, as compared to the same periods of 2017. Revenues from sales to the USPS decreased approximately \$2.9 million for the second quarter and approximately \$5.1 million for the six months, as the USPS has appeared to defer maintenance on their vehicle fleet. Revenues from sales to other customers, including sales to government and commercial customers, increased approximately \$743 thousand to \$11.2 million for the second quarter and approximately \$2.7 million to \$23.0 million for the six months. Costs and operating expenses decreased by approximately \$1.4 million or 3% for the second quarter and approximately \$693 thousand or 1% for the first six months, primarily due to the decreased revenues.

Costs and operating expenses include allocated corporate costs, which increased approximately \$200 thousand for the second quarter of 2018, and approximately \$400 thousand for the first six months of 2018.

Operating income decreased by approximately \$782 thousand or 9% for the second quarter and approximately \$1.7 million or 10% for the first six months. The decreases in operating income and profit percentages were attributable to decreased USPS vehicle parts sales and lower margins typically associated with our DoD sales.

[Table of Contents](#)**Aviation Group Results**

The results of operations for our Aviation Group are as follows (dollars in thousands):

| | Three months ended June 30, | | Six months ended June 30, | | Change | |
|------------------------------|--------------------------------|-----------|------------------------------|-----------|-----------------|---------------|
| | 2018 | 2017 | 2018 | 2017 | Three Months | Six Months |
| Revenues | \$ 35,804 | \$ 32,590 | \$ 68,554 | \$ 64,944 | \$ 3,214 | \$ 3,610 |
| Costs and operating expenses | 32,958 | 30,011 | 63,447 | 60,029 | 2,947 | 3,418 |
| Operating income | \$ 2,846 | \$ 2,579 | \$ 5,107 | \$ 4,915 | \$ 267 | \$ 192 |
| Profit percentage | 7.9% | 7.9% | 7.4% | 7.6% | | |

Revenues for our Aviation Group increased approximately \$3.2 million or 10% for the second quarter of 2018 and approximately \$3.6 million or 6% for the six months ended June 30, 2018, as compared to the same periods of 2017. Revenues from the distribution of new parts and work on engine accessories increased and revenues from engine MRO work and the sale of serviceable parts declined. Costs and operating expenses increased approximately \$2.9 million or 10% for the second quarter of 2018 and approximately \$3.4 million or 6% for the six months ended June 30, 2018, in line with the revenue trend.

Costs and operating expenses include allocated corporate costs, which increased approximately \$200 thousand for the second quarter of 2018, and approximately \$300 thousand for the first six months of 2018.

Our operating income increased approximately \$267 thousand or 10% for the second quarter of 2018, and approximately \$192 thousand or 4% for the first six months of 2018, as compared to the same periods of 2017. The increases in operating income resulted primarily from the increases in revenues as profit margins remained consistent.

Federal Services Group Results

The results of operations for our Federal Services Group are as follows (dollars in thousands):

| | Three months ended June 30, | | Six months ended June 30, | | Change | |
|------------------------------|--------------------------------|------------|------------------------------|------------|-----------------|---------------|
| | 2018 | 2017 | 2018 | 2017 | Three Months | Six Months |
| Revenues | \$ 80,327 | \$ 104,866 | \$ 168,610 | \$ 213,721 | \$ (24,539) | \$ (45,111) |
| Costs and operating expenses | 76,721 | 100,874 | 162,526 | 205,811 | (24,153) | (43,285) |
| Operating Income | \$ 3,606 | \$ 3,992 | \$ 6,084 | \$ 7,910 | \$ (386) | \$ (1,826) |
| Profit percentage | 4.5% | 3.8% | 3.6% | 3.7% | | |

Revenues for our Federal Services Group decreased approximately \$25 million or 23% for the second quarter of 2018 and approximately \$45 million or 21% for the six months ended June 30, 2018, as compared to the same periods of 2017.

Significant items affecting our second quarter revenue on a year to year comparative basis include a decrease of approximately \$17 million in revenues on our FMS Program, decreased revenues of approximately \$5 million due to the completion of work on two of our U.S. Army programs in 2017, and decreased revenues of approximately \$2 million on our RRAD ERS Program. Significant items affecting our first six months revenue on a year to year comparative basis include a decrease of approximately \$27 million in revenues on our FMS Program, a net decrease in revenues of approximately \$15 million on the two U.S. Army contracts that were completed, and decreased revenues of approximately \$2 million on our RRAD ERS Program.

Costs and operating expenses decreased approximately \$24 million or 24% for the second quarter of 2018 and approximately \$43 million or 21% for the six months ended June 30, 2018, as compared to the same periods of 2017. The decreases in costs and operating expenses are primarily attributable to the decreased level of work in 2018.

Operating income decreased by approximately \$386 thousand or 10% for the second quarter and approximately \$1.8 million or 23% for the first six months of 2018, compared to the same periods of 2017. The decreases in operating income resulted primarily from a decrease in award fee income on our FMS Program of approximately \$474 thousand for the quarter and \$2.1 million for the six months, and from changes in the level of profits from other programs.

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Award fee evaluations on our FMS program have occurred three times per year. Prior to 2018, we recognized award fee revenue and income in the period we received contractual notification of the award, which typically occurred in the first, second, and fourth quarters. The adoption of ASC 606 in January 2018 required award fees to be recognized as the performance obligation is satisfied, resulting in the recognition of award fee revenue and income for the year over four quarters instead of three times per year. Also, our award fee associated with work performed during the final award fee period of 2017 will not be recognized in our revenue or income in 2018, rather those award fees earned resulted in an increase to our retained earnings as of January 1, 2018 based on the transition guidance of ASC 606. Beginning in September 2017, our FMS contract was modified such that delivery orders issued subsequent to the modification would include a fixed fee instead of an award fee. Fixed fee revenue and income will be recognized as the costs associated with it are incurred.

Financial Condition

There has been no material adverse change in our financial condition in the first six months of 2018. Changes to asset and liability accounts were due primarily to our earnings, our level of business activity, the timing of inventory purchases, contract delivery schedules, subcontractor and vendor payments required to perform our contract work, and the timing of associated billings to and collections from our customers.

Liquidity and Capital Resources

Cash Flows

Cash and cash equivalents did not change during the first six months of 2018.

Cash provided by operating activities decreased approximately \$22.7 million in the first six months of 2018 as compared to the first six months of 2017. The change was primarily attributable to a decrease of approximately \$23.2 million due to changes in the levels of operating assets and liabilities, a decrease of approximately \$183 thousand in non-cash operating activities, and an increase of approximately \$703 thousand in cash provided by net income.

Our levels of inventory, accounts receivable, unbilled receivables, and accounts payable may fluctuate depending on the timing of services ordered and products sold, government funding delays, the timing of billings received from subcontractors and materials vendors, and the timing of payments received for services. Such timing differences have the potential to cause significant increases and decreases in our inventory, accounts receivable, unbilled receivables, and accounts payable balances in short time periods, and accordingly, can cause significant increases or decreases in our cash provided by operations. Our inventory increased by approximately \$34.4 million for the first six months of 2018 primarily due to strategic inventory purchases for our Aviation Group. This increase in inventory was financed in part by cash flows from operating activities and in part by an increase in borrowings on our bank loan facility.

Cash used in investing activities increased approximately \$982 thousand in the first six months of 2018 as compared to the first six months of 2017. Cash used in investing activities in 2018 and 2017 consisted primarily of purchases of property and equipment.

Cash provided by financing activities was approximately \$5.5 million in the first six months of 2018 as compared to cash used in financing activities of approximately \$17.9 million in the first six months of 2017. Cash provided by financing activities in 2018 and used in financing activities in 2017 consisted primarily of bank borrowing activities, debt financing costs associated with our bank loan amendment, and payment of dividends.

We paid cash dividends totaling approximately \$1.5 million or \$0.14 per share in the first six months of 2018. Our payment of cash dividends is subject to restrictions in our loan agreement, including a restriction on the annual aggregate amount of dividends we may pay. We have paid cash dividends each year since 1973 and have increased our dividend each year since 2004.

Liquidity

Our internal sources of liquidity are primarily from operating activities, specifically from changes in our level of revenues and associated inventory, accounts receivable, and accounts payable, and from profitability. Significant increases or decreases in revenues and inventory, accounts receivable, and accounts payable can impact our liquidity. Our inventory and accounts payable levels can be affected by the timing of large strategic inventory purchases. Our accounts receivable and accounts payable levels can be affected

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by changes in the level of contract work we perform, by the timing of large materials purchases and subcontractor efforts used in our contracts, and by delays in the award of contractual coverage and funding and payments. Government funding delays can cause delays in our ability to invoice for revenues earned, presenting a potential negative impact on our days sales outstanding.

We also purchase property and equipment; invest in expansion, improvement, and maintenance of our operational and administrative facilities; and invest in the acquisition of other companies.

Our external financing consists of a loan agreement with a bank group that provides for a term loan, revolving loans, and letters of credit. The loan agreement, which was amended in January 2018 and expires in January 2023, has a term loan facility and a revolving loan facility. The revolving loan facility provides for revolving loans and letters of credit. Our outstanding debt of approximately \$181.3 million as of June 30, 2018 was net of unamortized deferred financing costs of approximately \$2.4 million.

The term loan requires quarterly installment payments. Our required term loan payments after June 30, 2018 are approximately \$5.0 million in 2018, \$10.0 million in 2019, \$11.9 million in 2020, \$14.4 million in 2021, \$15.0 million in 2022, and \$41.2 million in 2023. The amount of term loan borrowings outstanding as of June 30, 2018 was \$97.5 million.

The maximum amount of credit available to us under our loan agreement for revolving loans and letters of credit as of June 30, 2018 was \$300 million. We may borrow and repay the revolving loan borrowings as our cash flows require or permit. We pay an unused commitment fee and fees on letters of credit that are issued. We had \$86.2 million in revolving loan amounts outstanding and \$22 thousand of letters of credit outstanding as of June 30, 2018. The timing of certain payments made and collections received associated with our inventory, subcontractor, and materials requirements and other operating expenses can cause fluctuations in our outstanding revolving loan amounts. Delays in government funding of our work performed can also cause additional borrowing requirements.

Under our loan agreement we may elect to increase the maximum availability of the term loan facility, the revolving loan facility, or a combination of both facilities up to an aggregate additional amount of \$100 million.

We pay interest on the term loan borrowings and revolving loan borrowings at LIBOR plus a base margin or at a base rate (typically the prime rate) plus a base margin. As of June 30, 2018, the LIBOR base margin was 1.75% and the base rate base margin was 0.50%. The base margins increase or decrease in steps as our Total Funded Debt/EBITDA Ratio increases or decreases.

Our loan agreement requires us to have interest rate hedges on a portion of the outstanding term loan for the first three years after the date of the amendment. As a result, we have executed compliant interest rate hedges. As of June 30, 2018, interest rates on portions of our outstanding debt ranged from 3.00% to 5.50% and the effective interest rate on our aggregate outstanding debt was 3.77%.

Our loan agreement contains collateral requirements to secure our loan obligations, restrictive covenants, a limit on annual dividends, and other affirmative and negative covenants, conditions and limitations. Restrictive covenants include a maximum Total Funded Debt/EBITDA Ratio and a minimum Fixed Charge Coverage Ratio. We were in compliance with the financial covenants and other terms and conditions at June 30, 2018.

| | | |
|--------------------------------|-----------------------------------|----------------------------------|
| Total Funded Debt/EBITDA Ratio | <u>Maximum Ratio</u> 3.00 to 1 | <u>Actual Ratio</u> 2.36 to 1 |
| Fixed Charge Coverage Ratio | <u>Minimum Ratio</u> 1.20 to 1 | <u>Actual Ratio</u> 2.54 to 1 |

We currently do not use public debt security financing.

Inflation and Pricing

Most of our contracts under which services are performed for the government provide for estimates of future labor costs to be escalated for any option periods, while the non-labor costs in our contracts are normally considered reimbursable at cost. Our property and equipment consists principally of land, buildings and improvements, shop and warehouse equipment, computer systems equipment, and furniture and fixtures. We do not expect the overall impact of inflation on replacement costs of our property and equipment to be material to our future results of operations or financial condition.

Disclosures About Market Risk

Interest Rates

Our bank loan agreement provides available borrowing to us at variable interest rates. Accordingly, future interest rate changes could potentially put us at risk for a material adverse impact on future earnings and cash flows. To mitigate the risks associated with future interest rate movements we have employed interest rate hedges to fix the rate on a portion of our outstanding borrowings for various periods. The resulting fixed rates on this portion of our debt have given us protection against interest rate increases.

In February 2015, we entered into a LIBOR based interest rate swap on our term loan for a term of four years with a notional amount of \$100 million. This swap amount decreases in increments on an annual basis. As of June 30, 2018, the amount of this swap was \$40 million and we pay an effective interest rate of 1.25% plus our base margin on the debt matched to it. In February 2018, we entered into a LIBOR based interest rate swap on our term loan for a term of three years with a notional amount of \$10 million for the first year and \$50 million for the second and third years. We pay an effective interest rate of 2.54% plus our base margin on the debt matched to this swap.

VSE CORPORATIONS AND SUBSIDIARIES

Item 3. Quantitative and Qualitative Disclosures About Market Risks

See "Disclosures About Market Risk" in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 4. Controls and Procedures

As of the end of the period covered by this report, based on management's evaluation, with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")), our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

There was no change in our internal control over financial reporting during our second quarter of fiscal 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. Other Information

Item 1. Legal Proceedings

On or about April 19, 2018 Joseph Waggoner and Clifford Tefteller, on behalf of themselves and all similarly situated individuals, filed a lawsuit against VSE Corporation, XOTECH Solutions, LLC (Tefteller's employer) and White's Paint and Blast (Waggoner's employer) in the United State District Court, Eastern District of Texas, Texarkana Division, alleging overtime compensation entitlement at a rate of one and on-half times their regular rate of pay for all hours worked over 40 hours in a workweek. The plaintiffs are seeking to certify the case as a collective action for similarly situated individuals. The plaintiffs work under a contract between defendants and the United States Army at the Red River Army Depot in Texas. The plaintiffs assert that employees' fifteen minute unpaid work breaks should have been included as "working hours" for the purposes of calculating overtime. While the results of legal proceedings cannot be predicted with certainty and the amount of loss, if any, cannot be reasonably estimated at this time, we believe the likelihood that this lawsuit will have a material adverse effect on our results of operation, financial condition, or cash flows is remote.

In a letter dated May 21, 2018, Dyncorp International ("Dyncorp") notified VSE's subsidiary Prime Turbines LLC that the U.S. Air Force ("USAF") had filed a claim against Dyncorp for approximately \$27 million in respect of work performed by Dyncorp and Prime Turbines in support of the USAF program for servicing fuel nozzle tips on aircraft engines. Dyncorp's notification also asserts that Dyncorp believes any liability arising from the USAF claim will be borne by Prime Turbines under its agreement dated August 21, 2013, with Dyncorp. As the events leading to the USAF claim against Dyncorp, including the work performed by Prime Turbines as a subcontractor, occurred prior to VSE's acquisition of Prime Turbines in January 2015, VSE notified the sellers of Prime Turbines of the Dyncorp and USAF claims and VSE's intention to seek restitution from the sellers for any damages arising from such claims. While the sellers have not acknowledged any liability in respect of Dyncorp's claim against Prime Turbines, they have assumed the defense of such claim under the acquisition agreement between the sellers and VSE. VSE believes that Dyncorp and Prime Turbines together with its insurance carrier, will appeal the USAF claim against Dyncorp and will otherwise aggressively defend against such claim. While the results of any resulting legal proceedings cannot be predicted with certainty and the amount of loss, if any, cannot be reasonably estimated at this time, we believe the likelihood that this claim will have a material adverse effect on our results of operation, financial condition, or cash flows is remote.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

We did not purchase any of our equity securities during the period covered by this report.

VSE's loan agreement prohibits VSE from paying cash dividends, except that if there is no event of default, no act, event or condition that would constitute an event of default with the giving of notice or the passage of time, or both, and no covenant breach would

occur giving effect to the payment of the dividend, VSE may pay cash dividends that do not exceed \$6 million in the aggregate in any fiscal year.

Item 6. Exhibits

(a) Exhibits

| | |
|------------------------------|---|
| Exhibit 31.1 | Section 302 CEO Certification |
| Exhibit 31.2 | Section 302 CFO and PAO Certification |
| Exhibit 32.1 | Section 906 CEO Certification |
| Exhibit 32.2 | Section 906 CFO and PAO Certification |
| Exhibit 101.INS | XBRL Instance Document |
| Exhibit 101.SCH | XBRL Taxonomy Extension Schema Document |
| Exhibit 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| Exhibit 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| Exhibit 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| Exhibit 101.PRE | XBRL Taxonomy Extension Presentation Document |

Pursuant to the requirements of the Exchange Act, VSE has omitted all other items contained in "Part II. Other Information" because such other items are not applicable or are not required if the answer is negative or because the information required to be reported therein has been previously reported.

VSE CORPORATION AND SUBSIDIARIES

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

VSE CORPORATION

Date: July 27, 2018

By: /s/ M. A. Gauthier
M. A. Gauthier
Chief Executive Officer,
President and Chief Operating Officer
(Principal Executive Officer)

Date: July 27, 2018

By: /s/ T. R. Loftus
T. R. Loftus
Executive Vice President and
Chief Financial Officer
(Principal Accounting Officer)

CERTIFICATION PURSUANT TO
RULE 13A-14 OF THE SECURITIES EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, M. A. Gauthier, certify that:

1. I have reviewed this report on Form 10-Q of VSE Corporation (the "Registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's Board of Directors (or persons performing the equivalent function):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: July 27, 2018

/s/ M. A. Gauthier

M. A. Gauthier
Chief Executive Officer,
President and Chief Operating Officer
(Principal Executive Officer)

CERTIFICATION PURSUANT TO
RULE 13A-14 OF THE SECURITIES EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, T. R. Loftus, certify that:

1. I have reviewed this report on Form 10-Q of VSE Corporation (the "Registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Registrant and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's Board of Directors (or persons performing the equivalent function):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: July 27, 2018

/s/ T. R. Loftus

T. R. Loftus
Executive Vice President and
Chief Financial Officer
(Principal Accounting Officer)

CERTIFICATION PURSUANT TO
SECTION 1350, CHAPTER 63 OF TITLE 18, UNITED STATES CODE,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned, as President, Chief Executive Officer and Chief Operating Officer of VSE Corporation (the "Company"), does hereby certify that to the best of the undersigned's knowledge:

- 1) the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018 (the "Report"), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) the information contained in the Company's Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: July 27, 2018

/s/ M. A. Gauthier

M. A. Gauthier

Chief Executive Officer,

President and Chief Operating Officer

(Principal Executive Officer)

CERTIFICATION PURSUANT TO
SECTION 1350, CHAPTER 63 OF TITLE 18, UNITED STATES CODE,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned, as Executive Vice President and Chief Financial Officer of VSE Corporation (the "Company"), does hereby certify that to the best of the undersigned's knowledge:

- 1) the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018 (the "Report"), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) the information contained in the Company's Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: July 27, 2018

/s/ T. R. Loftus

T. R. Loftus
Executive Vice President and
Chief Financial Officer
(Principal Accounting Officer)