

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2016

or

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

For the transition period from to

Commission file number 000-36149

STG GROUP, INC.

(Exact Name of Registrant as Specified on Its Charter)

Delaware

(State or Other Jurisdiction of Incorporation or
Organization)

46-3134302

(I.R.S. Employer Identification No.)

11091 Sunset Hills Road, Suite 200

Reston, Virginia

(Address of Principal Executive Offices)

20190

(Zip Code)

Registrant's telephone number including area code **(703) 691-2480**

Securities registered under Section 12(b) of the Exchange Act:

Title of Class

Common Stock, \$0.0001 par value

Securities registered under Section 12(g) of the Exchange Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

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 (§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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Yes No

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

Large accelerated filer

Non-accelerated filer

Accelerated filer

Smaller reporting company

(Do not check if smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The aggregate market value of the common stock held by non-affiliates of the registrant, computed by reference to the closing sales price for the registrant's common stock on June 30, 2016 (the last business day of the registrant's most recently completed second fiscal quarter), as reported on the OTCQB, was approximately \$2,762,373.25.

The number of shares outstanding of the registrant's common stock as of March 31, 2017, was 16,625,849.

STG GROUP, INC.
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PART I

INTRODUCTORY STATEMENT

The information contained in this report pertains to the registrant, STG Group, Inc. References in this annual report to “STGG,” the “Company,” “we,” “our” and “us” refer to STG Group, Inc. and its subsidiaries.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

We make forward-looking statements in this Annual Report on Form 10-K. These forward-looking statements relate to outlooks or expectations for earnings, revenues, expenses or other future financial or business performance, strategies or expectations, or the impact of legal or regulatory matters on business, results of operations or financial condition. Specifically, forward-looking statements may include statements relating to:

- the future financial performance of the Company;
- expansion plans and opportunities;
- maintaining/increasing our growth rates through marketing and an effective sales force;
- maintaining our technology platforms and continuing to develop enhancements;
- maintaining cost-effectiveness of technology and operations;
- maintaining and successfully bidding for government contracts;
- changes in economic, business, competitive, technological and/or regulatory factors;
- identify and consummating acquisitions on an accretive basis; and
- other statements preceded by, followed by or that include the words “estimate,” “plan,” “project,” “forecast,” “intend,” “expect,” “anticipate,” “believe,” “seek,” “target” or similar expressions.

Should one or more of these risks or uncertainties materialize, or should any of the underlying assumptions prove incorrect, actual results may vary in material respects from those expressed or implied by these forward-looking statements. You should not place undue reliance on these forward-looking statements. These forward-looking statements are based on information available to us as of the date of this Annual Report on Form 10-K and current expectations, forecasts and assumptions and involve a number of risks and uncertainties. Accordingly, forward-looking statements should not be relied upon as representing our views as of any subsequent date and we do not undertake any obligation to update forward-looking statements to reflect events or circumstances after the date they were made. These forward-looking statements involve a number of known and unknown risks and uncertainties or other assumptions that may cause actual results or performance to be materially different from those expressed or implied by these forward-looking statements. Some factors that could cause actual results to differ include:

- success in retaining or recruiting, or changes required in, officers, key employees or directors;
- economic weakness, either nationally, or in the local markets in which we operate;
- the pending acquisition of PSS, including our ability to close and subsequently realize the expected benefits from the transaction;
- our failure in our two most recent fiscal quarters to comply with covenants in our Credit Agreement related to consolidated EBITDA and our senior secured coverage ratio, and the expiration of the related forbearance;
- the size of our addressable markets and the amount of U.S. government spending on private contractors;
- adverse litigation or arbitration results;

- the potential liquidity and trading of our securities;
- risks and costs associated with regulation of corporate governance and disclosure standards (including pursuant to Section 404 of the Sarbanes-Oxley Act);
- the risk factors listed in this Annual Report on Form 10-K under “*Risk Factors*” beginning on page 17.
- changes in economic, business, competitive, technological and/or regulatory factors; and,
- competitors in our various markets.

ITEM 1 BUSINESS

OUR BUSINESS

The Company (formerly known as Global Defense & National Security Systems, Inc.), a former special purpose acquisition company focused on the U.S. defense and national security sector, successfully completed after the close of business November 23, 2015 (the “Closing Date”) the business combination (the “Business Combination”) with STG Group, Inc. (“STG Group” or the “Predecessor”), a provider of cyber, software and intelligence solutions to the U.S. government. At the closing of the Business Combination, the Company changed its name to “STG Group, Inc.” The Business Combination was consummated pursuant to the stock purchase agreement (the “Business Combination Agreement”), dated as of June 8, 2015, by and among the Company, the Predecessor, the stockholders of the Predecessor, Global Defense & National Security Holdings LLC (the “Sponsor”) and Simon S. Lee, as Stockholders’ Representative.

In connection with the closing of the Business Combination, the Predecessor changed its name to “STG Group Holdings, Inc.” (“STG Group Holdings”). Unless the context otherwise requires, the “Company”, “we,” “us,” and “our” refers to STG Group, Inc.

We provide specialist cyber, software and intelligence solutions to U.S. government organizations with a national security mandate. Our solutions are integral to national security-related programs run by more than 50 U.S. government agencies, including the Department of Defense, the Intelligence Community, the Department of Homeland Security, the Department of State and other government departments with national security responsibilities. Our programs are predominantly funded from base budgets and are essential to the effective day-to-day operations of our customers.

Our operational strength and track record has been established in securing highly sensitive, mission-critical national security networks, solving complex technology problems in mission-critical contexts and providing decision makers with actionable intelligence from multiple data sources.

Our primary areas of expertise include:

- Security information and event management
- Network intrusion detection and prevention
- Application vulnerability assessment
- Agile software development
- Command and control system development
- Complex application development
- Advanced collection and analysis
- Multi-intelligence exploitation and dissemination
- Multi-lingual intelligence analysis

We are SEI CMMI Maturity Level 3 Rated and hold certifications in ISO 9001:2008 and ISO/IEC 20000-1:2011. We fully integrate ISO 20000-1:2011 quality aspects into our corporate engineering methodology to ensure we deliver high-quality products and services on time and within budget.

We employ over 780 cybersecurity, software development and intelligence analysis professionals who deliver these solutions in both the continental United States and in approximately 6 overseas locations.

Our revenue for 2016 was \$164 million and our revenue for 2015 was \$194 million. As of December 31, 2016, our total backlog was \$290 million, of which \$75 million was funded and \$215 million was unfunded. For a discussion of how we calculate backlog, see “— *Backlog*”.

The Predecessor was founded in 1986 as the Software Technology Group. Over that time, we have built strong, trusted and enduring relationships with a wide range of Federal Government customers, supporting their mission-critical operations across a very broad contract base. We have achieved an average period of continuous performance of more than a decade, and sustain a relatively low degree of contract concentration — in 2016, our largest single contract award represented just 20% of total revenues; the top 5 contracts represented 58% of total revenues.

We are currently contracted with over 50 U.S. Federal Government organizations, and we derive the majority of our revenue from contracts with U.S. Government agencies with a national security mission. For 2016, we derived approximately 43% of our revenue from the Department of Defense; approximately 35% from the Department of State; approximately 20% from other Federal Civilian agencies, with most of that revenue coming from the Department of Homeland Security; and approximately 2% coming from the Intelligence Community.

Our Capabilities

The Company specializes in three core areas of capability:

- **Cyber Security and Secure Information Systems** — securing highly sensitive, mission-critical national security networks
- **Software Development, Systems and Services** — solving complex problems in mission-critical contexts
- **Intelligence and Analytics** — gathering and analyzing data from multiple sources to provide high quality, actionable intelligence across multiple contexts

Cybersecurity and Secure Information Systems

Our mission is to establish, develop and sustain secure, resilient, mission-critical information systems. We deliver across the cybersecurity spectrum with secure network engineering, information assurance platform deployment and incident response capabilities. In addition, we architect network configuration for optimal performance.

Our technical experts develop and integrate technologies to perform a range of essential tasks, from situational awareness and vulnerability assessments to encryption and authentication, each with the aim of supporting the protection of enterprise networks critical to the national interest.

We provide contextual technical analysis to enhance client understanding of the threats they face, and remain technology-neutral to provide the right tools to meet mission objectives.

The solutions we offer our customers in this area include:

- *Security Information & Event Management.* We provide customers with an integrated, holistic view of their organization's network activity, identifying and prioritizing the handling of anomalous events across the entire spectrum of users and devices.
- *Network Intrusion Detection & Protection.* We design and implement systems that gather and analyze network data in order to identify internal and external cybersecurity breaches.
- *Identity & Access Management.* We create systems that facilitate the oversight and management of digital identities — controlling access rights to resources and information across complex networks.

- *Network Vulnerability Assessment.* We implement and oversee systems that continuously scan and test networks to identify potential vulnerabilities, assess the risk associated those vulnerabilities and address risk mitigation.

Software Development, Systems and Services

Our mission is to create technology solutions tailored to our customers' needs. Our agile software development practices, ranging from iterative system builds to highly integrated enterprise platforms, scale dynamically to system demands.

Our systems and software engineering approach is highly adaptable to complex mission demands, ranging from multi-stakeholder identity and big data reconciliation to integrated mobile applications processing geospatially-based information.

We work to align and incorporate legacy enterprise systems, which are leveraged with our software methods and advanced technologies to deliver greatly enhanced functional value.

The solutions we offer our customers in this area include:

- *Agile Software Development.* We deliver software development services with an emphasis on providing functionality and flexibility on complex IT programs, incorporating legacy system sustainment and migration and new application development.
- *Command & Control Systems Development.* We develop software and systems that deliver a common operating picture for decision makers to help them evaluate, plan, direct and coordinate resources and operations.
- *Complex Application Development.* We design customized software solutions that help integrate information drawn from disparate sources and automate highly complex business processes.
- *Decision Support Systems (DSS) Integration.* We develop software applications and systems that combine raw data, structured models and analytic techniques to better enable our customers to make decisions in highly complex and changing circumstances.
- *Database Design & Development.* We design and integrate structured data models across various legacy and new applications and databases to improve the value and utility of customer data and the quality of operational decision-making.

Intelligence and Analytics

Our mission is to provide our customers with high quality intelligence as the basis for critical decision-making. We work to a proven, rigorous methodology that combines specialized analysts with leading technologies.

Our experts gather data from multiple sources, analyze and fuse the data to provide clarity and situational context, and disseminate the resulting intelligence to a diverse range of stakeholders. The Company employs a combination of large-scale processing and qualitative analysis to produce high quality intelligence products.

Our approach supports strategic and tactical decisions in the fields of defense and intelligence, homeland security, and diplomatic affairs.

The solutions we offer our customers in this area include:

- *Advanced Collection & Analysis Tools.* We design and employ leading-edge technology solutions that enhance the collection and analysis of high volumes of all-source data to deliver high quality, actionable intelligence to decision makers.
- *Multi-Intelligence Exploitation.* We create integrated solutions combining technology with our strong analytic expertise to gather, filter, fuse and visualize data from a wide variety of signals and sources.
- *Intelligence Analysis Training.* We provide comprehensive tradecraft training covering the full intelligence cycle, including advanced data harvesting and analysis tools, social media analysis, analytic visualization techniques and sustaining a network of highly specialized professionals, such as intelligence analysts, linguists and cultural advisors.
- *Multi-Lingual Intelligence Analysis.* We provide intelligence collection and analysis across more than 40 different languages through highly specialized, cleared professionals, including intelligence analysts, linguist and cultural advisors with a deep understanding of the political, social, cultural and economic contexts at source.

Our Market Opportunity

U.S. government defense and national security spending, incorporating multiple federal agencies and departments, is driven by a complex range of persistent and evolving threats to the U.S. homeland and to its interests overseas. Over the last decade, the U.S. government has realigned the strategic priorities of the U.S. national security community, its capabilities and posture to achieve a sustainable balance between the ability to face down conventional threats from opposing states, the ability to combat non-state actors or asymmetric threats, and the ability to defeat threats from new technologies. These efforts have been concentrated on counter-terrorism, stabilizing fragile regions of strategic importance to the U.S., and counterinsurgency. Most recently and as emphasized in the 2016 Cyber National Action Plan, these efforts also addressed cybersecurity, one of the most important challenges we face as a nation.

In each case, emphasis has been given to developing new technologically-driven capabilities to strengthen operational decision making through improved information and intelligence, deliver precision in offensive operations in complex environments, and strengthen both defensive and offensive capabilities in the cyber domain.

In the March 2013 Worldwide Threat Assessment report to the Senate Select Committee on Intelligence, the Director of National Intelligence, James R. Clapper, listed the cyber threat as the number one strategic threat to the United States, placing it ahead of terrorism for the first time since the attacks of September 11, 2001. Since then, the cyber threat has remained the number one strategic threat to the United States, as reported in the February 2015 Worldwide Threat Assessment. Over the past few years the number of cyber-attacks perpetrated by criminals, hackers and foreign nations against the U.S. Government's networks has risen sharply. Potential state and non-state adversaries conduct malicious cyber activities against U.S. interests globally and in a manner intended to test the limits of what the U.S. and the international community will tolerate. Actors may penetrate U.S. networks and systems for a variety of reasons, such as to steal intellectual property, disrupt an organization's operations for activist purposes, or to conduct disruptive and destructive attacks to achieve military objectives.

Since developing its first cyber strategy in 2011, the Department of Defense (DoD) has made significant investment and progress in building its cyber capabilities, developing its organizations and plans, and fostering the partnerships necessary to defend the country and its interests. However, as potential adversaries have also invested significantly in advancing their cyber capabilities, additional investment by the DoD will be needed to counter potential cyberattacks against the United States. As a reflection of our nation's investment in cyber defense, U.S. Cyber Command is building a Cyber Mission Force of 133 teams assembled from 6,200 military, civilian, and contractor support personnel from across the military departments and defense components. The Cyber Mission Force, which will be fully operational in 2018, is already employing capabilities in support of U.S. Government objectives across the spectrum of cyber operations.

U.S. national security is entrusted to a wide range of government organizations, including the Department of Defense, Department of State (DoS), Department of Homeland Security (DHS), and the Intelligence Community (IC).

The FY 2017 President's DoD budget request accounts for approximately 15% of the total budget authority requested by the current Administration. The FY 2017 DoD budget request is \$582.7 billion, including a base budget of \$523.9 billion and \$58.8 billion for overseas contingency operations, representing an increase in the DoD base budget of \$2.2 billion from the 2016 enacted DoD base budget of \$521.7 billion. The DoD projects the base budget will increase to \$570.0 billion by 2020.

The President's 2017 Budget requests \$35.2 billion in base funding for the Department of State and the United States Agency for International Development, an \$8 billion reduction from the 2016 annualized CR level. The Budget also requests \$14.9 billion as Overseas Contingency Operations funding for extraordinary costs, primarily in war areas like Syria, Iraq, and Afghanistan, for an agency total of \$50.1 billion.

The President's 2017 Budget requests \$40.6 billion in net discretionary budget authority for DHS, a \$.6 billion decrease from the 2016 annualized CR level. The Budget would allocate an additional \$.7 billion for the Disaster Relief Fund (DRF) requested separately from discretionary amounts. DHS has stated that safeguarding and securing cyberspace is a key focus area for the department, the FY 2017 budget request supports the DHS's two primary cyber acquisition programs: \$274.8 million for the Continuous Diagnostics and Mitigation program which provides hardware, software, and services designed to support activities that strengthen the operational security of federal ".gov" networks. It would also allocate \$471.1 million for the National Cybersecurity Protection System (NCPS), commonly referred to as EINSTEIN, to continue to combat intrusions, enhance information sharing, and deploy analytical capabilities to secure the Federal civilian information technology enterprise.

U.S. national security activities are also conducted by the U.S. Intelligence Community, a group composed of 17 agencies, departments, organizations, and branches of the U.S. military, which are organized to gather, analyze, and distribute intelligence. For FY 2017, the collective base budget request of the IC included \$16.8 billion for the Military Intelligence Program (MIP) and \$53.5 billion for the National Intelligence Program (NIP). The FY 2017 budget allocations represent a decrease over the FY 2016 budget estimates for the MIP of \$1.1 billion and NIP of \$.4 billion respectively. Key NIP initiatives include improving integration of programs spread across the 17 IC elements, expanding the use of shared IT capabilities, continuing to support the protection and security of the critical networks that facilitate IC information-sharing, and ensuring that mission-critical intelligence information flows anywhere and anytime it is required.

Below is an outline of the key areas of capability that we believe the U.S. government will continue to prioritize as critical to its defense and national security strategies and that we believe will drive continued growth in our target markets.

IT Systems and Support Spending

The operations of U.S. defense and federal agencies and the national security community demand a wide variety of technology-based systems and information that are increasingly integrated with support services and solutions in order to successfully offer a range of capabilities that support specific essential missions. These areas include, but are not limited to, C4ISR (command, control, communications, computers, intelligence, surveillance, and reconnaissance), information technology and related services, and other key support services.

Military operations and the modern warfighter rely on integrated technology platforms comprised of C4ISR systems and related information technology architectures (Mission IT). These platforms link networks of signals and sensors to people and platforms, providing greater interoperability within and between allied defense forces, enabling intelligent decision making, and delivering more operationally and cost-effective solutions to the defense and national security communities. In addition, the continuous reliance on C4ISR systems and Mission IT demands the frequent maintenance and upgrade of the platforms. The federal government procures systems and software engineering, integration, and technology development services to ensure that the technology is able to perform effectively, address evolving and complex challenges, and be customized for specific missions.

Information technology in the federal government spans a variety of initiatives in addition to areas focused on mission-oriented defense and national security, such as the growth and management of the significant administrative IT backbone of the defense and intelligence communities, which enables more routine but necessary communication. In addition, there is a complex systems architecture for managing the health and welfare of personnel. Furthermore, technology advancements have enabled new capabilities in information sharing which DoD and federal agencies are seeking. These agencies are focused on expanding, upgrading, and integrating their IT architecture to enhance information security, facilitate information sharing, increase efficiency, and mitigate costs.

Critical to supporting a wide range of government organizations, including the DoD, DHS, DoS and the Intelligence Community, in their national security initiatives, are the products and services related to information technology. According to the Federal Chief Information Officer, the total federal IT budget request for FY 2017 is approximately \$81.6 billion, including the DoD addressable IT budget request of \$44.9 billion, representing an overall decrease of 5.9% from the FY 2016 DoD IT budget request of \$47.7 billion.

For a discussion of the budget's cybersecurity-related information technology priorities, see "*Cybersecurity and Secure Information Systems*" below.

Due to an emphasis on cost effective federal IT spending, agencies have increased their use of agile development practices and evidence in the IT portfolio illustrates that agile projects have been nearly twice as likely to deliver on time as those using traditional development techniques, and have been 40% more likely to deliver planned capabilities on budget.

Cybersecurity and Secure Information Systems

Cyber attacks target networks and attempt to disrupt or sabotage information and control systems. Cyber attacks targeting networks to access sensitive data, disrupt systems and operations, and sabotage critical infrastructure are increasing in both frequency and sophistication, with perpetrators able to operate individually or in organized cells from anywhere in the world as part of terrorist, criminal or state networks. In recognition of these dynamics and the threats they pose to U.S. national security, the U.S. government is channeling greater resources into the drive to identify the sources of such attacks and develop and implement effective counter-measures. Although this drive is not simply a matter of technology, we believe that the development of advanced technological responses will remain the key element of defending networks, systems and critical infrastructure. In April 2015, the DoD outlined a new comprehensive cyber strategy with the purpose of guiding the development of DoD's cyber forces and strengthening its cyber defense and cyber deterrence posture. The DoD's cyber strategy focuses on building cyber capabilities and organizations for three principal cyber missions: (1) defend DoD networks, systems and information; (2) defend the U.S. and its interests against cyber attacks of significant consequence; and (3) provide integrated cyber capabilities to support military operations and contingency plans.

In FY 2017, the President's budget proposes approximately \$19 billion in cybersecurity funding to enhance America's cyber capabilities. This represents a more than 35 percent increase from FY 2016 in overall Federal resources for cybersecurity, a necessary investment to secure our Nation in the future. The 2017 budget calls for \$3.1 billion for a fund to replace IT legacy systems, and \$62 million for bolstering the federal cyber workforce through training and scholarships and other educational initiatives. Of the \$19 billion in cybersecurity requested in fiscal 2017, more than a third or \$7 billion will go to the Pentagon. In addition, the \$3.1 billion IT Modernization Fund request would provide funding for projects that target agencies with the biggest cyber security and IT concerns, and look to capitalize on shared services such as cloud infrastructure.

Competitive Strengths

Agile Technology Development Tailored to Customer Needs

Our innovative approach to technology development gives us the ability to adapt quickly to customer needs in a rapidly evolving technology environment. Many larger prime contractors can have difficulty incorporating newer, disruptive technologies because their business models rely on larger programs of record and multi-year technology development cycles to support larger overhead. Our approach enables us to create and deploy the most effective and cost-effective solution. In a changing procurement climate, this type of creativity and agility is critical. In addition to being more innovative and adaptive than many larger players, we believe we are also more stable and established than many small businesses in the Defense Technology market. Customers require financial and operational stability, especially in mission-critical contexts, and we have an established, trusted record of high-level performance that spans four decades. Additionally, many smaller businesses do not have the talent or the infrastructure to support programs that require world-class capabilities to protect national security interests.

Established, Long-Standing Customer Relationships

The Company has developed trusted, enduring relationships across an exceptionally broad customer base in the defense, national security and federal/civilian landscape, which is a testament to our customers' sustained confidence in our capabilities and our commitment to exceptional delivery. Our average period of continuous performance across our customer base is over a decade. We have worked with the U.S. Army for 18 years, the Department of State continuously for more than 21 years, the Department of Defense for over 18 years, the Department of the Treasury for over 16 years, and key elements of the Intelligence Community for over 13 years.

Diverse Contract Base

In addition to a diverse customer base, the Company is positioned on a wide range of contract vehicles, atypically broad for a company our size. We have positions on NETCENTS II, ITES-2, EAGLE II, CIO-SP3, SPAWAR ICO, GSA Alliant, and another large classified ID/IQ, as well as numerous single awards. Our breadth and diversity of contract vehicles provides our customers with various options to procure the solutions they require.

Strong Backlog and New Business Pipeline

We had backlog of \$290 million on active contracts as of December 31, 2016, of which \$75 million was funded and \$215 million was unfunded, spanning more than 69 discrete contracts or task orders. Because we perform tasks that are essential to the day-to-day operations and core missions of our customers, the budgets for our business are well protected and growing. Additionally, we have a current pipeline of more than \$3.5 billion of potential new business opportunities that we are currently pursuing or prospecting.

Experienced and Proven Leadership Team and Highly Skilled Workforce

The Company's directors and officers have combined experience spanning many years of acquiring, leading and growing operating companies addressing US national security priorities, and working at senior levels in the US government's defense and national security communities. Our workforce is staffed by highly skilled, qualified professionals, 84% of which have security clearances, with over 44% holding clearances to Top Secret and above. Over many years, the workforce has consistently earned the trust and confidence of key elements of the U.S. government's national security community responsible for handling much of the nation's most sensitive and mission-critical information.

Our Growth Strategy

Having established a strong platform in the mid-tier market, our objective is to consolidate, grow, and re-position the business as a technology innovator and provider of advanced solutions in the area of cybersecurity, agile software development, and integrated intelligence and data analytics in order to realize a premium valuation as the leading agile and sustainable mid-tier market player. Achieving this objective requires a detailed strategy to drive stronger organic growth in higher margin, high-growth market areas, and accelerate growth through strategic acquisitions using our proprietary mergers and acquisitions pipeline.

Organic Growth

We believe that the Company is well positioned to achieve strong platform growth, combining our significant, differentiated capabilities with our extensive network of government and industry relationships and experience of managing continuous operating improvements to enhance profitability and customer performance. The Company expects to achieve stronger organic growth through deeper and broader client relationships, a sustained emphasis on business efficiencies and the accelerated development of new solutions and capabilities.

Key areas of organic improvement to realize this growth include:

Business Development

The following areas of customer requirement have been prioritized for opportunity capture, each with significant alignment to current programs and capabilities; Software Development, Modernization and Enhancement (DME), Cyber Protection and Computer Network Defense (CND), and medium to large IT support services.

In addition, the Company has achieved greater alignment between its business development processes and human capital to allow for a more focused and effective application of resources against these identified opportunities. On September 12, 2016, Phillip E. Lacombe began employment as the Company's President and Chief Operating Officer replacing the retiring Paul Fernandes. Mr. Lacombe is a seasoned industry executive with over 20 years of leadership experience in the defense and national security technology sector. In addition, Business Development personnel have been centralized under a single reporting line with direct oversight by the new Senior Vice President of Business Development. Our growing pipeline of opportunities has highlighted the need for additional resources to ensure effective capture management. Several suitably qualified senior business development specialists were recruited during 2016 and early 2017. Finally, the capture management process itself has been re-invigorated with focused opportunity reviews conducted by senior management to ensure full alignment of effort and seamless functional support across the business.

Optimize Operational Efficiency

Immediately following the Business Combination, the Company completed a reorganization of its operations into the three competency-based Sectors – Cyber Security and Secure Information Systems (CSIS); Software Development Systems and Services (SDDS), and Intelligence and Analytics (IA). This organizational realignment has allowed us to deliver our solutions more efficiently across all the markets we serve and reduce cost in overhead and G&A. We expect to leverage these changes to improve margins and increase the opportunities for our senior management team to be more connected with our customers to deepen relationships and drive cross selling opportunities.

Significant Cross-Selling Opportunities

Significant opportunities exist for the Company's differentiated capabilities to be marketed and sold across adjacent clients in the defense, federal civilian, and intelligence communities. The creation of the Cyber Security and Secure Information Systems (CSIS), Software Development Systems and Services (SDSS) and Intelligence and Analytics (IA) Sectors has allowed for a much more effective segmentation of the pipeline. A renewed focus on identifying where in Government our capabilities are in significant and growing demand has encouraged greater creativity and market shaping to exploit cross-selling opportunities across multiple agencies.

Continue to Shift Services to Higher-End Solutions

The Company has charted a clear path that leverages current capabilities and contract vehicles to allow greater access to customers requiring higher-end, higher value solutions. Specifically, our strategic emphasis on Software DME, particularly where we can apply our proprietary agile software development methodology, Cadence, and urgent US Army and US Air Force requirements for Cyber Protection and Computer Network Defense solutions contracted through our NETCENTS 2 and ITES-2S contracts will allow us to enhance the value of the solutions we provide. This approach will also allow us to increase the amount and scale of higher margin work by broadening and deepening our penetration of currently under-developed customer sets through smart cross-selling.

Inorganic Growth

The Company intends to accelerate growth through acquisitions, and plans to build differentiated capabilities and new customers and contracts, with a focus on complementary, high-end technologies. We have established detailed plans to maximize leverage as a public company to accelerate growth through the acquisition of differentiated capabilities to achieve new customer penetration and enhance the sophistication of our offerings to existing customer sets. These plans include:

Pending PSS Acquisition

On February 18, 2017, the Company entered into an Agreement and Plan of Merger (the “Merger Agreement”) to acquire PSS Holdings, Inc. (“PSS”) for approximately \$119.5 million in cash, subject to certain adjustments based upon closing working capital, plus a portion of the value of certain tax benefits as they are realized after the closing. The purchase price will also be increased by an additional \$20,000 per day if the merger is consummated after March 31, 2017 and certain conditions to the obligations of the Company to close are otherwise satisfied, such increase applicable for each day after March 31, 2017 that such conditions are so satisfied.

PSS is a privately-held government services business that provides products and services in information technology, engineering, and program management, and is a leading provider of advanced computing, analytics, program and acquisition management, cyber and software solutions to key defense, intelligence and federal civilian customers, working with over 25 government agency partners. Upon consummation of the merger contemplated by the Merger Agreement (the “merger”), PSS will become a wholly-owned subsidiary of the Company.

The consummation of the merger is subject to the satisfaction of certain conditions, including receipt of certain required third party consents. If any condition to the merger is not satisfied or waived, the merger will not be completed. In addition, the Company intends to fund the merger consideration through a combination of equity and debt financing. We do not presently have commitments for such financing. To the extent the merger is not completed due to our inability to obtain financing for the merger, we may be required to pay a termination fee of \$625,000 to PSS.

On April 13, 2017, the Company received a letter from PSS purporting to terminate the Merger Agreement, unless we notify PSS that we are prepared to close and schedule the closing of the merger for no later than April 23, 2017. The Company does not believe the purported termination of the Merger Agreement is valid, and the Company is evaluating its alternatives and rights under the Merger Agreement.

Pursuing additional strategic, capability-enhancing acquisitions

We will continue to pursue selective strategic acquisitions that expand our platform of capabilities and solutions. This will include companies that are leaders in supporting the US intelligence and defense community, as well as technologies and solutions in high performance computing, cloud computing, data analytics and cybersecurity. We are also interested in identifying firms possessing demonstrated capability and innovation that are critical to (1) the transformation of the Defense and Intelligence Community’s cyber and intelligence operations and (2) improving the overall cybersecurity posture of the Federal, Defense and Intelligence Community and commercial critical infrastructure enterprises.

Add IP and Complementary, Differentiated Capabilities

In addition to the proposed acquisition of PSS, the Company plans to target mergers and acquisitions opportunities with strong intellectual property and differentiated capabilities complementary to our platform, with a focus on high-end technologies that will scale and command premium valuations, including mobile application development, mobile technology systems, agile software development and advanced data analytics.

Expand Customer and Contract Vehicle Base

The Company intends to place emphasis on acquiring businesses that will give it access to key new customers and large contract vehicles.

Competition

Our competitors span large, publicly traded organizations with a broad range of services and capabilities, to smaller, niche players that are privately held. Our larger competitors include Booz Allen Hamilton, CACI International, General Dynamics Information Technology, Leidos Holdings, ManTech International, Science Applications International Corporation, and CSRA International, among others.

As an agile and highly capable business, the Company has been particularly adept at acquiring prime positions on large ID/IQ vehicles. As such, we often compete at a task order level, where knowledge of the customer and their contractual and technical requirements is crucial to winning business. We have a particularly broad variety of contract vehicles for a business of our size. This provides a highly valuable opportunity to market our services to any U.S. government agency. We have deep insight into customer needs, their goals and their challenges; our customers typically consider technical capabilities and approach, personnel quality and management capabilities and past performance and price.

Customers

We are currently contracted with over 50 U.S. Federal Government organizations, and we derive the majority of our revenue from contracts with U.S. Government agencies with a national security mission. For 2016, we derived approximately 43% of our revenue from the Department of Defense; approximately 35% from the Department of State; approximately 20% from other Federal Civilian agencies, with most of that revenue coming from the Department of Homeland Security; and approximately 2% coming from the Intelligence Community.

Our customers include various defense, intelligence, federal, and other national security agencies such as:

Department of Defense

- U.S. Army Network Enterprise Technology Command (NETCOM)
- U.S. Army Test and Evaluation Center (ATEC)
- U.S. Army Forces Command (FORSCOM)
- U.S. Marine Corps
- Space and Naval Warfare Systems Command (SPAWAR)
- Department of Housing and Urban Development

National Agencies/Other

- Department of State
- Department of Homeland Security
- Intelligence Community
- U.S. Customs and Border Protection
- U.S. Internal Revenue Service
- Securities and Exchange Commission
- National Oceanic and Atmospheric Administration

Contracts

We derive our revenue primarily from contracts with U.S. government agencies, where we provide our services and solutions under three types of federal government contracts: time-and-materials, cost-plus, and firm fixed-price.

For the year ended December 31, 2016, we derived approximately 34%, 37%, and 29% of our revenue from time-and-materials, cost-plus fixed fee, and firm fixed-price contracts, respectively, and approximately 87% of our revenue was derived from contracts in which we were the prime contractor with the remaining 13% being derived from contracts in which we were a subcontractor. In 2016, our largest single-contract award accounted for approximately 20% of our total revenue, and our top five largest contracts accounted for 58% of total revenue.

In 2016, approximately 53% of our revenue was derived from stand-alone contracts, 26% from Blanket Purchase Agreements (BPAs) and General Services Administration (GSA) schedules, and 21% from agency-sponsored Indefinite Delivery, Indefinite Quantity (ID/IQ) contracts. The aggregate contract ceiling value across active ID/IQs, GSA schedules and stand-alone contracts is more than \$168 billion (excluding unlimited ceiling vehicles).

Backlog

We define total backlog as the amount of revenue we expect to realize (i) over the remaining base contract performance period and (ii) from the exercise of option periods that we reasonably believe will be exercised, in each case from signed contracts in existence as of the measurement date. We also include in backlog our estimates of revenue from future delivery orders on requirements and ID/IQ contracts for which we have an established pattern of revenues. At times, our estimates of future revenue on such contracts are less than the contract ceiling. Our estimates are based on our experience using such vehicles and similar contracts.

We define funded backlog as the portion of our total backlog for which funding is currently appropriated and obligated to us under a signed contract or task order by the purchasing agency, or otherwise authorized for payment to us by a customer upon completion of a specified portion of work. Our funded backlog does not include the full potential value of our contracts, because Congress often appropriates funds to be used by an agency for a particular program or contract only on a yearly or quarterly basis, even though the contract may call for performance over a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriations and the procuring agency allocates funding to the contract. Unfunded backlog is total backlog minus funded backlog.

As of December 31, 2016, our total backlog was \$290 million, of which \$75 million was funded and \$215 million was unfunded. As of December 31, 2016, we expect to recognize approximately 45% or \$131 million of our backlog as revenue in 2017.

Regulatory Matters

We must comply with laws and regulations relating to the formation, administration, and performance of U.S. Government contracts. The Federal Acquisition Regulation, or FAR, which mandates uniform policies and procedures for U.S. Government acquisitions and purchased services, governs the majority of our contracts. Individual agencies also have acquisition regulations that provide implementing language for the FAR or that supplement the FAR.

Other federal regulations require certification and disclosure of cost or pricing data in connection with contract negotiations for certain types of contracts, define allowable and unallowable costs, govern reimbursement rights under cost-based contracts, and restrict the use, dissemination and exportation of products and information classified for national security purposes.

Additionally, federal government contracts, by their terms, generally can be terminated at any time by the federal government, without cause, for the convenience of the federal government. If a federal government contract is so terminated, we would be entitled to receive compensation for the services provided and costs incurred through the time of termination, plus settlement expenses and a negotiated amount of profit. Federal government contractors who fail to comply with applicable U.S. Government procurement-related statutes and regulations may be subject to potential contract termination, suspension and debarment from contracting with the U.S. Government, or other remedies. See "*Risk Factors*" for a description of the various risks we may face regarding laws and regulations relating to U.S. Government Contracts.

Employees

As of December 31, 2016, we had 940 full-time and part-time employees. Security clearances are held by approximately 84% of our employees with over 44% of those clearances at the level of Top Secret or above. None of our employees are subject to collective bargaining agreements.

Properties

Our executive offices and certain of our operations are located at 11091 Sunset Hills Road, Suite 200, Reston, VA (35,491 square feet). The Company also has other facilities in Sierra Vista, AZ (6,450 square feet); Charleston, SC (2,518 square feet); and Arlington, VA (12,530 square feet). Most of our employees are located in Reston, Sierra Vista, and Charleston, SC.

Intellectual Property

We do not fund or invest into any material research and development initiatives. Our technology development, integration and implementation services within the cybersecurity, software development and intelligence and analytics business areas are not generally dependent upon any codified intellectual property of our own. We claim a proprietary interest in certain service offerings, approaches, methodologies and know-how. We do not consider our business to be materially dependent on the protection of such proprietary methodologies. Additionally, we have a number of trade secrets that contribute to our success and competitive positioning, and we endeavor to protect this information. While protecting trade secrets and proprietary information is important, we are not materially dependent on any specific trade secret or group of trade secrets. Other than licenses to commercially available third-party software, we have no licenses to intellectual property that are significant to our business.

Legal Proceedings

The Company is from time to time subject to various claims and lawsuits incidental to our business. In the opinion of management, these claims and suits, individually or in the aggregate, will not have a material adverse effect on our consolidated financial statements, results of operations or liquidity.

COMPANY WEBSITE AND INFORMATION

Our Internet address is www.stg.com. Information contained on our website is not part of this report. We make available free of charge on our Internet site our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13 or 15(d) of the Exchange Act, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Alternatively, you may access these reports at the SEC's Internet website: www.sec.gov.

You may request a copy of the materials identified in the preceding paragraph, at no cost, by writing or telephoning us at our corporate headquarters:

STG Group, Inc.
11091 Sunset Hills Road, Suite 200
Reston, VA 20190
Telephone: 703-691-2480

ITEM 1A. RISK FACTORS

In your evaluation of our company and business, you should carefully consider the risks and uncertainties described below, together with information included elsewhere in this Annual Report on Form 10-K and other documents we file with the SEC, in your evaluation of our business. The risks and uncertainties described below are those that we have identified as material, but are not the only risks and uncertainties facing us. If any of these risks or uncertainties actually occurs, our business, financial condition, or operating results could be materially harmed and the price of our stock could decline. Our business is also subject to general risks and uncertainties that affect many other companies, such as overall U.S. and non-U.S. economic and industry conditions, including a global economic slowdown, geopolitical events, changes in laws or accounting rules, fluctuations in interest and exchange rates, terrorism, international conflicts, major health concerns, natural disasters, or other disruptions of expected economic and business conditions. Additional risks and uncertainties not currently known to us or that we currently believe are immaterial also may materially harm our business, financial condition or operating results and result in a decline in the price of our stock.

Risks Related to Our Business, Operations and Industry

The following is a description of the principal risks inherent in our business.

Federal government spending levels for programs the Company supports may change or be delayed in a manner that adversely affects its future results and limits its growth prospects.

Our business depends upon continued federal government expenditures on intelligence, defense and other programs that we support. These expenditures have not remained constant over time. Spending levels for federal government programs generally, and in particular the U.S. defense budget, have come under pressure. Should spending level pressure continue, this may have an impact on operating margins in our industry, and shift authorizations to programs in areas where we do not currently provide services, thereby adversely impacting our future results of operations. The possibility that automatic spending reductions mandated by the American Taxpayer Relief Act of 2012 may still be triggered and uncertainty about how these automatic reductions may be applied results in a risk that spending levels for programs we support will change in a manner that is adverse to us. A significant decline in government expenditures, a shift of expenditures away from programs that we support or a change in federal government contracting policies could cause federal government agencies to reduce their purchases under contracts, to exercise their right to terminate contracts at any time without penalty, not to exercise options to renew contracts, or to delay or not to enter into new contracts. A reduction in the amount of services that we are contracted to provide, or incorporation of less favorable terms in existing or future contracts, could cause an adverse impact on the Company's business and future results of operations.

We face aggressive competition that can impact our ability to obtain contracts and therefore affect the future revenues and growth prospects of the Company.

We operate in highly competitive markets and generally encounter intense competition to win contracts from a number of sources, both domestic and international. We compete with larger companies that have greater name recognition, financial resources and larger technical staffs. We also compete with smaller, more specialized companies that are able to concentrate their resources on particular areas. Some of our competitors have substantially greater financial and other resources than we have and others may price their products and services below our selling prices. To remain competitive, we must provide superior service and performance on a cost-effective basis to our customers. Our competitors may be able to provide our customers with different or greater capabilities or better contract terms than we can provide, including technical qualifications, past contract experience, geographic presence, price and the availability of qualified professional personnel. In particular, increased efforts by our competitors to meet federal government requirements for efficiency and cost reduction may necessitate that we become more competitive with respect to price, and thereby potentially reduce our profit margins, in order to win or maintain contracts. In addition, our competitors may consolidate or establish teaming or other relationships among themselves or with third parties to increase their ability to address customers' needs.

Failure to maintain strong relationships with other contractors could result in a decline in our revenues.

For the years ended December 31, 2016, we derived 13% of our revenues from contracts in which we acted as a subcontractor to other contractors. Additionally, where we are named as a prime contractor, we may sometimes enlist other companies to perform some services under the contract as subcontractors. We expect that such relationships with other contractors will continue to be important for a portion of our revenues for the foreseeable future. Our business, prospects, financial condition or operating results could be harmed if other contractors eliminate or reduce their contracts or joint venture relationships with us because they choose to establish relationships with our competitors; they choose to directly offer services that compete with our business; we choose to directly compete with them for services; the government terminates or reduces these other contractors' programs; or the government does not award them new contracts.

We depend on contracts with the U.S. federal government for substantially all of our revenues. The loss or impairment of our relationship with the U.S. government and its agencies could adversely affect our business, future revenues and growth prospects.

We derive the vast majority of our revenues from our federal government customers. We expect that federal government contracts will continue to be the primary source of our revenues for the foreseeable future. Our business, prospects, financial condition or operating results could be materially harmed if:

- We are suspended or debarred from contracting with the federal government or a significant government agency;
- Our reputation or relationship with government agencies is impaired; or
- The government ceases to do business with us, or significantly decreases the amount of business it does with us.

The failure by Congress to approve budgets on a timely basis for the federal agencies we support could delay procurement of our services and solutions and cause us to lose future revenues.

On an annual basis, Congress must approve budgets that govern spending by the federal agencies that we support. In years when Congress is not able to complete its budget process before the end of the federal government's fiscal year on September 30, Congress typically funds government operations pursuant to a continuing resolution. A continuing resolution allows federal government agencies to operate at spending levels approved in the previous budget cycle. When the U.S. government operates under a continuing resolution, it may delay funding we expect to receive from customers on work we are already performing and will likely result in new initiatives being delayed or in some cases canceled. We experienced order delays related to these factors in 2013. The federal government's failure to complete its budget process, or to fund government operations pursuant to a continuing resolution, may result in a federal government shutdown, during which time we may be required to perform "at-risk" or experience further delays.

The competitive bidding process can impose constraints and costs upon us and we may lose revenues, or our earnings and profitability may be adversely impacted, if we fail to compete effectively, if we are required to minimize our price in order to compete effectively, or if there are delays caused by protests or challenges of contract awards.

We derive significant revenues from federal government contracts that are awarded through a competitive bidding process. We expect that a significant portion of our future business will also be awarded through competitive bidding. Competitive bidding presents a number of risks, including:

- Incurring expense and delays due to competitor's protest or challenge of contract awards made to us, including the risk that any such protest or challenge could result in the resubmission of bids on modified specifications, or in the termination, reduction or modification of the awarded contract, which may result in reduced profitability;
- Bidding on programs in advance of the completion of their design may result in difficulties in execution, cost overruns, or, in the case of unsuccessful competition, the loss of committed costs;
- Spending cost and managerial time and effort to prepare bids and proposals for contracts that may not be awarded to us, which may result in reduced profitability; and
- Failing to accurately estimate the resources and cost structure that will be required to service any contract we are awarded.

If we cannot collect our receivables or if payment is delayed, our business may be adversely affected.

We depend on the timely collection of our receivables to generate cash flow, provide working capital and continue our business operations. If the U.S. government or any prime contractor for whom we are a subcontractor fails to pay or delays the payment of invoices for any reason, our business and financial condition may be materially and adversely affected. The U.S. government may delay or fail to pay invoices for a number of reasons, including lack of appropriated funds, lack of an approved budget, or as a result of audit findings by government regulatory agencies. Some prime contractors for whom we are a subcontractor have significantly fewer financial resources than we do, which may increase the risk that we may not be paid in full or that payment may be delayed.

Some of our contracts with the U.S. government are classified or subject to other security restrictions, which may limit investor insight into portions of our business.

For fiscal year 2016, we derived a portion of our revenue from contracts with the U.S. government that are classified or subject to security restrictions that preclude the dissemination of certain information. In addition, a significant number of our employees have security clearances which preclude them from providing information regarding certain of the Company's clients and services provided to such clients to persons without security clearances and investors. Because we are limited in its ability to provide information about these contracts and services, the various risks associated with these contracts or services or any dispute or claims relating to such contracts or services, you may not have information concerning our business, which will limit your insight into a portion of our business and therefore may be less able to fully evaluate the risks related to that portion of our business.

The U.S. government may reform its procurement or other practices in a manner adverse to us.

Because we derive nearly all of our revenue from contracts with the federal government or its agencies, the success and development of our business will depend on our continued successful participation in federal contracting programs. The U.S. government may reform its procurement practices or adopt new contracting rules and regulations, including cost accounting standards, that could be costly to satisfy or that could impair our ability to obtain new contracts. It also could adopt new contracting methods to General Services Administration, or GSA, or other government-wide contracts, or adopt new standards for contract awards intended to achieve certain socio-economic or other policy objectives, such as establishing new set-aside programs for small or minority-owned businesses. In addition, the U.S. government may face restrictions from new legislation or regulations, as well as pressure from government employees and their unions, on the nature and amount of services the U.S. government may obtain from private contractors. These changes could impair our ability to obtain new contracts. Any new contracting methods could be costly or difficult for us to implement and, as a result, could harm our operating results.

We may not receive the full amount authorized under our contracts and we may not accurately estimate our backlog, which could adversely affect our future revenues and growth prospects.

As of December 31, 2016, our estimated contract backlog totaled approximately \$290 million, of which approximately \$75 million was funded and \$215 million was unfunded. Backlog is our estimate of the remaining future revenues from existing signed contracts, assuming the exercise of all options relating to such contracts and including executed task orders issued under ID/IQ contracts. Backlog also includes estimates of revenue from future delivery orders on requirements and ID/IQ contracts for which we have an established pattern of revenues. At times, our estimates of future revenue on such contracts are less than the contract ceiling. Our estimates are based on our experience using such vehicles and similar contracts; however, we cannot assure that all, or any, of such estimated contract revenues will be recognized as revenues.

We historically have not realized all of the revenue included in our total backlog, and we may not realize all of the revenue included in our total backlog in the future. There is a somewhat higher degree of risk in this regard with respect to unfunded backlog, since it contains management's estimate of amounts expected to be realized on unfunded contract work that may never be realized as revenues. In addition, there can be no assurance that our backlog will result in actual revenue in any particular period, or at all, because the actual receipt, timing, and amount of revenue under contracts included in backlog are subject to uncertainties, including congressional appropriations, many of which are beyond our control. In particular, delays in the completion of the U.S. government's budgeting process and the use of continuing resolutions could adversely affect our ability to timely recognize revenue under our contracts included in backlog. Furthermore, the actual receipt of revenue from contracts included in backlog may never occur or may be delayed because: a program schedule could change or the program could be canceled; a contract's funding or scope could be reduced, modified, delayed, or terminated early, including as a result of a lack of appropriated funds or as a result of cost cutting initiatives and other efforts to reduce federal government spending. If we fail to realize as revenues those amounts included in our backlog, our future revenues and prospects may be adversely affected.

Five large contracts account for 58% of STG, Inc.'s ("STG") revenue. The loss of any one or more of these contracts could cause a decline in its operating results.

For the year ended December 31, 2016, STG had five contracts that comprised 58% of its total revenue. Although STG has been successful in continuing work on most of our large contracts in the past, there is no assurance that STG will be able to do so in the future. The revenue stream from one or more of these contracts could end for a number of reasons, including the completion of the customer's requirements, the completion or early termination of our current contract, the consolidation of STG's work into another contract where it is not the holder of that contract, or the loss of a competitive bid for the follow-on work related to STG's current contract. If any of these events were to occur, STG could experience an unexpected, significant reduction in revenue and net income. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" for further discussion with respect to these contracts.

Security breaches in sensitive U.S. government systems could result in the loss of clients and negative publicity.

Many of the systems the Company develops, installs and maintains involve managing and protecting information involved in intelligence, national security and other sensitive or classified U.S. government functions. A security breach in one of these systems could cause harm to the Company's business, damage its reputation, result in the termination of its contracts, and prevent us from being eligible for further work on sensitive or classified systems for U.S. government clients. We could incur losses from such a security breach that could exceed the policy limits under our errors and omissions and product liability insurance. Damage to the Company's reputation or limitations on its eligibility for additional work resulting from a security breach in one of the systems it develops, installs or maintains could cause it to incur remediation costs and could materially reduce its revenue. Costs it incurs to address security breaches could materially reduce the Company's operating margin.

Our business could be negatively affected by cyber or other security threats or other disruptions.

We face cyber threats, threats to the physical security of our facilities and employees, and terrorist acts, as well as the potential for business disruptions associated with information technology failures, natural disasters, or public health crises. These threats arise in some cases as a result of our role as a defense contractor.

Cyber security threats are evolving and include, but are not limited to, malicious software, attempts to gain unauthorized access to our sensitive information, including our customers, suppliers, subcontractors, and joint venture partners, and other electronic security breaches that could lead to disruptions in mission critical systems, unauthorized release of confidential or otherwise protected information, and corruption of data.

Although we utilize various procedures and controls to monitor and mitigate these threats, there can be no assurance that these procedures and controls will be sufficient to prevent security threats from materializing. If any of these events were to materialize, the costs related to cyber or other security threats or disruptions may not be fully insured or indemnified and could have a material adverse effect on the reputation, operating results, and financial condition of the Company.

The U.S. government may prefer minority-owned, small and small disadvantaged businesses, therefore, we may not win contracts we bid for.

As a result of the Small Business Administration, or SBA, set-aside program, the U.S. government may decide to restrict certain procurements only to bidders that qualify as minority-owned, small or small disadvantaged businesses. As a result, the Company would not be eligible to perform as a prime contractor on those programs and would be restricted to a maximum of 49% of the work as a subcontractor on those programs. An increase in the amount of procurements under the SBA set-aside program may impact our ability to bid on new procurements as a prime contractor or restrict our ability to re-compete on incumbent work that is placed in the set-aside program.

An accident or incident involving our employees or third parties could harm our reputation, affect our ability to compete for business, and if not adequately insured or indemnified, could adversely affect our results of operations and financial condition.

Our business involves providing services that require some of our employees to operate in countries that may be experiencing political unrest, war or terrorism. As a result, during the course of such deployments we are exposed to liabilities arising from accidents or incidents involving our employees or third parties. Any of these types of accidents or incidents could involve potential injury or other claims by employees and/or third parties. It is also possible that we will encounter unexpected costs in connection with additional risks inherent in sending our employees to dangerous locations, such as increased insurance costs, as well as the repatriation of our employees or executives for reasons beyond our control.

The Company maintains insurance policies that mitigate risk and potential liabilities related to its operations. Our insurance coverage may not be adequate to cover those claims or liabilities, and we may be forced to bear costs from an accident or incident. Claims in excess of our related insurance coverage could adversely affect our operating performance and may result in additional expenses and possible loss of revenues.

Furthermore, any accident or incident for which we are liable, even if fully insured, may result in negative publicity that could adversely affect our reputation among our customers and the public, which could result in the Company losing existing and future contracts or make it more difficult to compete effectively for future contracts. This could adversely affect our operating performance and may result in additional expenses and possible loss of revenues.

Our earnings and profitability may vary based on the mix of type of contracts we perform and may be adversely affected if we do not accurately estimate the expenses, time and resources necessary to satisfy some of our contractual obligations.

We enter into three types of federal government contracts for our services: cost-plus-fee, time-and-materials and fixed-price. Recently, our customers have increasingly procured our services under cost-plus-fee contracts, which tend to offer lower margin opportunities than other contract types. For the Company's last three fiscal years, it derived revenues from such contracts as follows:

Revenue by Contract Type	Year ended December 31,			
	2016		2015	
	(in thousands, except percentages)			
T&M	\$ 56,323	34%	\$ 64,523	33%
Fixed price	47,615	29%	58,858	30%
Cost Plus	60,117	37%	70,264	37%
	<u>\$ 164,055</u>		<u>\$ 193,645</u>	

Each of these types of contracts, to varying degrees, involves some risk that we could underestimate our cost of fulfilling the contract, which may reduce the profit we earn or lead to a financial loss on the contract.

- Under cost-plus contracts, we are reimbursed for allowable costs and paid a fee, which may be fixed ("Fixed Fee") or performance-based ("Award Fee"). To the extent that the actual costs incurred in performing a cost-plus-fee contract are within the contract ceiling and allowable under the terms of the contract and applicable regulations, we are entitled to reimbursement of our costs, plus a profit. However, if our costs exceed the ceiling or are not allowable under the terms of the contract or applicable regulations, we may not be able to recover those costs. In particular, there is increasing focus by the federal government on the extent to which contractors are able to receive reimbursement for employee compensation.
- Under time-and-material contracts, we are reimbursed for labor at negotiated hourly billing rates and for certain expenses. We assume financial risk on time-and-material contracts because we assume the risk of performing those contracts at negotiated hourly rates.
- Under fixed-price contracts, we perform specific tasks for a pre-negotiated fixed price. Compared to cost-plus-fee contracts, fixed-price contracts generally offer higher margin opportunities, but involve greater financial risk because we bear the impact of cost overruns, which could result in increased costs and expenses. Because we assume such risk, an increase in the percentage of fixed-price contracts in our contract mix, whether caused by a shift by the federal government toward a preference for fixed-price contracts or otherwise, could increase the risk that we suffer losses if we underestimate the level of effort required to perform the contractual obligations.

Our profits could be adversely affected if our costs under any of these contracts exceed the assumptions we used in bidding for the contract.

We face risks of cost overruns and losses on fixed-price contracts.

The Company sells certain of its products and services to its government, defense commercial customers under fixed-price contracts providing for fixed unit prices, regardless of costs incurred by it. The cost of producing products or providing services may be adversely affected by increases in the cost of labor, materials, fuel, overhead, and other unknown variants, including manufacturing and other operational inefficiencies and differences between assumptions used by the Company to price a contract and actual results. Increased costs may result in cost overruns and losses on such contracts, which could adversely affect the Company's results of operations and financial condition.

We sometimes incur costs before a contract is executed or appropriately modified. To the extent a suitable contract or modification is not later signed and these costs are not reimbursed, our revenue and profits will be reduced.

We sometimes incur expenses and perform work without a signed contract or appropriate modification to an existing contract to cover such expenses or work. When we do so, we are working “at-risk,” and there is a chance that the subsequent contract or modification will not ensue, or if it does, that it will not allow us to be paid for the expenses already incurred or work already performed or both. In such cases, we generally have been successful in obtaining the required contract or modification, but any failure to do so in the future could adversely affect operating results.

Many of our federal government customers execute their procurement budgets through multiple award contracts under which we are required to compete for post-award orders, or for which we may not be eligible to compete, potentially limiting our ability to win new contracts and increase revenues.

Budgetary pressures and reforms in the procurement process have caused many U.S. federal government customers to purchase goods and services through multiple award ID/IQ contracts and other multiple award and/or government wide acquisition contract vehicles. These contract vehicles require that we make sustained post-award efforts to obtain task orders under the relevant contract. There can be no assurance that we will obtain revenues under these contract vehicles. Our failure to compete effectively in this procurement environment could harm our operating results.

Federal government contracts contain provisions giving government customers a variety of rights that are unfavorable to the Company, including the ability to terminate a contract at any time for convenience.

Federal government contracts contain provisions and are subject to laws and regulations that give the government rights and remedies not typically found in commercial contracts. These provisions may allow the government to:

- Terminate existing contracts for convenience, as well as for default;
- Reduce orders under, or otherwise modify, contracts or subcontracts;
- Cancel multi-year contracts and related orders if funds for contract performance for any subsequent year become unavailable;
- Decline to exercise an option to renew multi-year contracts or issue task orders in connection with multiple award contracts;
- Suspend or debar the Company from doing business with the federal government or with a government agency;
- Prohibit future procurement awards with a particular agency as a result of a finding of an organizational conflict of interest based upon prior related work performed for the agency that would give a contractor an unfair advantage over competing contractors;
- Subject the award of contracts to protest by competitors, which may require the contracting federal agency or department to suspend its performance pending the outcome of the protest and may also result in a requirement to resubmit offers for the contract or in the termination, reduction or modification of the awarded contract;
- Terminate the Company’s facility security clearances and thereby prevent the Company from receiving classified contracts;

- Claim rights (including intellectual property rights) in products and systems produced by the Company; and
- Control or prohibit the export of the Company's products and services.

If the government terminates a contract for convenience, the Company may recover only its incurred or committed costs, settlement expenses and profit on work completed prior to the termination. If the government terminates a contract for default, the Company may not even recover those amounts and instead may be liable for excess costs incurred by the government in procuring undelivered items and services from another source. If one of the Company's government customers were to unexpectedly terminate, cancel or decline to exercise an option to renew one or more of the Company's significant contracts or programs, the Company's revenues and operating results would be materially harmed.

Our contracts with the U.S. government are subject to audits and cost adjustments.

U.S. government agencies, including the Defense Contract Audit Agency, or the DCAA, routinely audit and investigate government contracts and government contractors' incurred costs, administrative processes and systems. These agencies review our performance on contracts, pricing practices, cost structure and compliance with applicable laws, regulations and standards. They also review our compliance with government regulations and policies and the adequacy of our internal control systems and policies, including our purchase, property, estimation, compensation and management information systems. Any costs found to be improperly allocated to a specific contract will not be reimbursed, and any such costs already reimbursed must be refunded. Moreover, if any of the administrative processes and systems are found not to comply with requirements, we may be subjected to increased government scrutiny and approval that could delay or otherwise adversely affect our ability to compete for or perform contracts. Therefore, an unfavorable outcome by an audit by the DCAA or another government agency could cause actual results to be adversely affected and differ materially from those anticipated. If a government investigation uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeitures of profits, suspension of payments, fines and suspension or debarment from doing business with the U.S. government. In addition, we could suffer reputational harm if allegations of impropriety were made against it. Each of these results could cause our actual results to be adversely affected.

If the Company fails to comply with complex procurement laws and regulations, the Company could lose business and be liable for various penalties or sanctions.

The Company must comply with laws and regulations relating to the formation, administration and performance of federal government contracts. These laws and regulations affect how it conducts business with its federal government customers. In complying with these laws and regulations, the Company may incur additional costs. Non-compliance could result in the imposition of fines and penalties, including contractual damages. Among the more significant laws and regulations affecting the Company's business are the following:

- The Federal Acquisition Regulation and Defense Federal Acquisition Regulations, which comprehensively regulates the formation, administration and performance of federal government contracts;
- The Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with contract negotiations;
- The Cost Accounting Standards and Cost Principles, which impose accounting requirements that govern the Company's right to reimbursement under certain cost-based federal government contracts;
- Laws, regulations and executive orders restricting the use and dissemination of information classified for national security purposes and the export of certain products, services and technical data;

- U.S. export controls, which apply when the Company engages in international work; and
- The Foreign Corrupt Practices Act.

If the Company fails to comply with these laws and regulations or if a government audit, review, or investigation uncovers improper or illegal activities, it may be subject to penalties, both civil and criminal, or administrative sanctions, including debarment from contracting with the U.S. government. The Company may suffer harm if allegations of impropriety were made against it, which could adversely affect its operating performance and may result in additional expenses.

The Company's contracting agency customers periodically review its compliance with procurement laws and regulations, as well as its performance under the terms of its federal government contracts. If a government review or investigation uncovers improper or illegal activities, it may be subject to civil or criminal penalties or administrative sanctions, including:

- Termination of contracts;
- Forfeiture of profits;
- Cost associated with triggering of price reduction clauses; and
- Suspension of payments.

U.S. government contractors are subject to a greater risk of investigation, criminal prosecution, civil fraud, whistleblower lawsuits and other legal actions and liabilities than companies with solely commercial customers. Increased scrutiny and investigation into business practices and into major programs supported by the Company may lead to increased legal costs and may harm the Company's reputation and profitability if it is among the targeted companies, regardless of the underlying merit of the allegations being investigated.

If the Company fails to recruit and retain skilled employees or employees with the necessary skill sets, it might not be able to perform under its contracts or win new business and its growth may be limited.

To be competitive, the Company must have employees who have advanced information technology and technical services skills and who work well with its customers in a government or defense-related environment. These employees are in demand and are likely to remain a limited resource in the foreseeable future. Recruiting, training and retention costs may place significant demands on the Company's resources. If the Company is unable to recruit and retain a sufficient number of these employees, the Company's ability to maintain and grow its business could be negatively impacted. If the Company is required to engage larger numbers of contracted personnel, its profit margins could be adversely affected. In addition, some of the Company's contracts contain provisions requiring it to commit to staff a program with certain personnel the customer considers key to its successful performance under the contract. In the event the Company is unable to provide these key personnel or acceptable substitutions, the customer may terminate the contract and the Company may not be able to recover certain incurred costs.

A portion of our business depends upon obtaining and maintaining required security clearances, and our failure to do so could result in termination of certain of our contracts or cause us to be unable to bid or rebid on certain contracts.

Some U.S. government contracts require Company employees to maintain various levels of security clearances, and we may be required to maintain certain facility security clearances complying with U.S. government requirements.

Obtaining and maintaining security clearances for employees involves a lengthy process, and it is difficult to identify, recruit and retain employees who already hold security clearances. In addition, the U.S. Government has struggled with maintaining sufficient investigators to complete background and other security clearance investigations in a timely manner. If Company employees are unable to obtain or retain security clearances or if such employees who hold security clearances terminate their employment with the Company, the customer whose work requires cleared employees could terminate the contract or decide not to renew it upon expiration. To the extent we are not able to engage employees with the required security clearances for a particular contract, we may not be able to bid on or win new contracts, or effectively re-bid on expiring contracts, which could adversely affect our business.

In addition, we expect that some of the contracts on which we bid will require us to demonstrate our ability to obtain facility security clearances and perform work with employees who hold specified types of security clearances. A facility security clearance is an administrative determination that a particular facility is eligible for access to classified information or an award of a classified contract. A contractor or prospective contractor must meet certain eligibility requirements before it can be processed for facility security clearance. Contracts may be awarded prior to the issuance of a facility security clearance, and in such cases the contractor is processed for facility security clearance at the appropriate level and must meet the eligibility requirements for access to classified information. Our ability to obtain and maintain facility security clearances impacts our ability to compete for and perform U.S. government contracts, the performance of which requires access to classified information.

Our overall profit margins on our contracts may decrease and our results of operations could be adversely affected if materials and subcontract revenues grow at a faster rate than labor-related revenues.

Our revenues are generated both from the efforts of our employees (labor-related revenues) and from the receipt of payments for the cost of materials and subcontracts we use in connection with performing our services (materials and subcontract revenues). Generally, our materials and subcontract revenues have lower profit margins than our labor-related revenues. If our materials and subcontract revenues grow at a faster rate than labor-related revenues, our overall profit margins may decrease and our profitability could be adversely affected.

Our employees or subcontractors could engage in misconduct or other improper activities, which could cause us to lose customers or affect our ability to contract with the federal government.

Because we are a government contractor, should an employee or subcontractor commit fraud or should other misconduct occur, such occurrences could have an adverse impact on our business and reputation. Misconduct by employees, subcontractors or joint venture partners could involve intentional failures to comply with federal laws including: federal government procurement regulations; requirements for handling of sensitive or classified information; the terms of our contracts; or proper time-keeping practices. These actions could lead to civil, criminal and/or administrative penalties (including fines, imprisonment, suspension and/or debarment from performing federal government contracts) and harm our reputation.

If we are unable to complete our proposed acquisition of PSS Holdings, Inc., our expected financial results and the market value of our common stock could be adversely affected, and we may be required to pay a termination fee of \$625,000.

On February 18, 2017, we entered into the Merger Agreement to acquire PSS for approximately \$119.5 million in cash. Consummation of the merger is subject to customary conditions to closing.

If any condition to the merger is not satisfied or waived, the merger may not be completed. In addition, although not a condition to the merger, the Company intends to fund the merger consideration through a combination of equity and debt financing. We do not presently have commitments for such financing. To the extent the merger is not completed due to our inability to obtain financing for the merger, we may be required to pay a termination fee of \$625,000 to PSS.

On April 13, 2017, the Company received a letter from PSS purporting to terminate the Merger Agreement, unless we notify PSS that we are prepared to close and schedule the closing of the merger for no later than April 23, 2017. The Company does not believe the purported termination of the Merger Agreement is valid, and the Company is evaluating its alternatives and rights under the Merger Agreement.

Additional risks and uncertainties associated with the merger include:

- various conditions to the closing of the merger may not be satisfied or waived;
- the failure to consummate the merger may result in negative publicity and a negative impression of us in the investment community and among our customers, lenders and other creditors; and
- the attention of our employees and management may be diverted due to activities related to the merger, which may harm our relationships with our employees, customers, distributors, suppliers, and other business partners.

Any or all of the preceding could jeopardize our ability to consummate the merger on the negotiated terms. To the extent the merger is not completed for any reason, we would have devoted substantial resources and management attention to the transaction without realizing the accompanying benefits expected by our management and will have incurred substantial costs for which we will be solely responsible. Under certain circumstances, including with respect to our ability to obtain financing for the merger, we may also be required to pay the termination fee of \$625,000 to PSS. As a result of the foregoing, our financial condition and results of operations and the market value of our stock may be adversely affected.

Completing our pending acquisition of PSS or other acquisitions could result in operating difficulties or other adverse consequences to our business.

One of our proposed key operating strategies is to selectively pursue acquisitions, including the pending acquisition of PSS. Our acquisition strategy, including the pending PSS acquisition, poses many risks, including:

- we may not be able to identify suitable acquisition candidates at prices we consider attractive;
- we may not be able to compete successfully for identified acquisition candidates, complete acquisitions or accurately estimate the financial effect of acquisitions on our business;
- we may pay an above-market price for acquisitions and incur higher than expected acquisition costs;
- Our pending acquisition of PSS requires, and other potential future acquisitions may require, us to issue common stock, resulting in dilution of ownership, and obtain additional debt funding, and with respect to the pending acquisition of PSS, we can make no assurances that we will be able to obtain such financing on favorable terms or at all;

- we may have difficulty retaining an acquired company’s key employees or customers;
- we may have difficulty integrating and managing acquired businesses in a manner that permits the combined company to achieve the full revenue and cost synergies and other benefits anticipated to result from the acquisition, due to difficulties such as incompatible accounting, information management, or other control systems;
- we may have difficulty in maintaining customer, supplier, employee or other favorable business relationships of acquisition operations and restructuring or terminating unfavorable relationships;
- ensuring sufficient due diligence prior to an acquisition and addressing unforeseen liabilities of acquired businesses;
- failing to achieve anticipated business volumes;
- acquisitions may disrupt our business or distract our management from other responsibilities;
- as a result of an acquisition, we may need to record write-downs from future impairments of intangible assets, which could reduce our future reported earnings; and
- we may be subject to potential unknown liabilities and unforeseen increased expenses or delays associated with the pending acquisition of PSS.

Any of these factors could cause our acquisitions to perform poorly, and could adversely affect our business and financial results as well as our ability to achieve the anticipated benefits of our acquisitions.

We expect to incur debt in the future for acquisitions, including the pending acquisition of PSS, which could substantially reduce our profitability, limit our ability to pursue certain business opportunities, and reduce the value of your investment.

We incurred approximately \$82 million in debt to fund a portion of the purchase price of the Business Combination (as defined above). We may incur additional indebtedness in connection with the execution of our strategy to expand the Company through acquisitions, including the pending acquisition of PSS. The amount of our debt could have important consequences for holders of our stock, including, but not limited to:

- our ability to obtain additional financing for working capital, capital expenditures, product and service development, acquisitions, general corporate purposes, and other purposes may be impaired;
- a substantial portion of our cash flow from operations could be dedicated to the payment of the principal and interest on our debt;
- we may be more vulnerable to economic downturns and rises in interest rates;
- our flexibility in planning for and reacting to changes in our business and the marketplace may be limited; and
- we may be placed at a competitive disadvantage relative to other firms in our industry who do not have similar levels of debt.

Our debt agreements require us to comply with various restrictive covenants, and we have not been in compliance with certain of these covenants for the fiscal quarters ended September 30, 2016 and December 31, 2016. See the risk factor entitled “*The agreements governing our indebtedness require us to comply with financial maintenance covenants. We have not been in compliance with certain of these covenants in our two most recent fiscal quarters, and if we are unable to comply with these covenants, our business, results of operations and liquidity could be materially and adversely affected.*” These covenants, may restrict our ability to incur additional debt, change the nature of our business, sell or otherwise dispose of assets, make acquisitions, and merge and consolidate with other entities. As a result of these covenants and restrictions, we will be limited in how we conduct our business and we may be unable to raise additional debt or other financing to compete effectively or to take advantage of new business opportunities. Failure to comply with such restrictive covenants may lead to default and acceleration under our credit facility and may impair our ability to conduct business. We may not be able to maintain compliance with these covenants in the future and if we are unable to obtain waivers from the lenders and/or amend the covenants, it may adversely affect our financial condition.

Our ability to grow may be limited if we cannot obtain additional capital.

Our growth strategy includes pursuing strategic acquisitions, such as the pending acquisition of PSS. We believe that it may be difficult to fund acquisitions with cash from operating activities. As a result, we expect that the availability of debt or equity capital, which may or may not be available on favorable terms or at all, will be important. Our access to debt or equity capital depends on a number of factors, including the market's perception of our growth potential and our current and potential future earnings. Depending on the outcome of these factors, we could experience delay or difficulty in implementing our growth strategy, including the consummation of the pending acquisition of PSS, on satisfactory terms.

The agreements governing our indebtedness require us to comply with financial maintenance covenants. We have not been in compliance with certain of these covenants in our two most recent fiscal quarters, and if we are unable to comply with these covenants, our business, results of operations and liquidity could be materially and adversely affected.

Under our Credit Agreement, the Company is required to meet certain minimums for its fixed charge coverage ratio and consolidated EBITDA and certain maximums for its senior secured leverage ratio, as defined in the Credit Agreement. As of September 30, 2016 and December 31, 2016, the Company did not meet the required consolidated senior secured leverage ratio and minimum consolidated EBITDA. The Company remained in compliance with the Credit Agreement as of September 30, 2016 by using a provision of the Credit Agreement that allowed us to cure (the "Cure Right") certain covenant non-compliance by issuance of Common Stock for cash and use of proceeds to reduce the principal balance of the term loan. As a result, pursuant to the Credit Agreement, the financial covenants were recalculated giving effect to the pay down of the debt, and we remained in compliance under the Credit Agreement.

As of December 31, 2016, we again did not satisfy the covenants relating to our required consolidated senior secured leverage ratio and minimum consolidated EBITDA. On February 24, 2017, we entered into a Limited Forbearance to Credit Agreement (the "Forbearance Agreement") with MC Admin Co LLC and the other lenders under the Credit Agreement.

In the Forbearance Agreement, the lenders agreed to forbear from exercising rights and remedies (including enforcement and collection actions), for which we agreed to pay a fee of up to \$750,000, related to our failure to comply with covenants related to the fixed charge coverage ratio, consolidated EBITDA and the senior secured leverage ratio, for the fiscal quarter ended December 31, 2016 (the "Specified Financial Covenants"). The Forbearance Agreement requires us to obtain lender consent prior to use of our revolving credit facility during the period of forbearance. The forbearance period expired on March 31, 2017.

The Company entered into a Limited Waiver ("the Waiver") from MC Admin Co LLC and other lenders under the Credit Agreement as of March 31, 2017, pursuant to which the lenders waived the Company's noncompliance with the Specified Financial Covenants as of December 31, 2016. Pursuant to the Waiver:

- Loans under the Credit Agreement are subject to additional interest at a rate of 2% per annum until the earliest of (x) the date on which all loans are repaid and all commitments under the Credit Agreement are terminated, (y) the date we deliver the financial statements and certificates for the quarter ending March 31, 2017 showing that we are not in default under the Credit Agreement or (z) the date on which default interest is otherwise due under the Credit Agreement;
- We must obtain lender consent prior to using our revolving credit facility; and
- We cannot effect a Cure Right in respect of the quarter ending March 31, 2017.

The Credit Agreement also provides that the minimum consolidated EBITDA requirement will be increased on June 30, 2017. If our business continues to perform at the current level through that period, we do not expect to satisfy that covenant or the senior secured leverage ratio at that time, and it is likely that we will be in non-compliance at March 31, 2017. An inability to meet the required covenant levels could have a material adverse impact on us, including the need for us to effect an additional Cure Right or obtain additional forbearance or an amendment, waiver, or other changes in the Credit Agreement. The Credit Agreement does not allow the Company to exercise the Cure Right in consecutive fiscal quarters, more than three fiscal quarters in the aggregate, in more than two of any four fiscal quarters or for the quarter ending March 31, 2017. The amount allowed under the Cure Right may not exceed the lesser of \$2.5 million and 20% of consolidated EBITDA. The aggregate of Cure Rights may not exceed \$5 million. The Waiver does not apply to covenant non-compliance after December 31, 2016 or to covenants other than the Specified Financial Covenants. Any additional forbearance, amendment or waiver under the Credit Agreement may result in increased interest rates or premiums and more restrictive covenants and other terms less advantageous to us, and may require the payment of a fee for such forbearance, amendment or waiver. There can be no assurance that we would be able to obtain forbearance, a waiver or amendment, or effect a cure, on terms acceptable to us.

If we are not able to effect a Cure Right or otherwise obtain forbearance or an amendment to or waiver under the Credit Agreement, any future covenant non-compliance will give rise to an event of default thereunder, in which case the indebtedness under the Credit Agreement could be declared immediately due and payable, which could have a material adverse effect on the Company.

We may need to make significant capital expenditures to keep pace with technological developments in our industry.

The industries in which we participate are constantly undergoing development and change, and it is likely that new products and equipment will be introduced in the future. We may need to make significant expenditures to purchase new equipment and to train our employees to keep pace with any new technological developments. These expenditures could adversely affect our results of operations and financial condition.

The Defense Security Service (“DSS”) of the Department of Defense has determined that the Company is under foreign ownership, control or influence (“FOCI”), and has required the Company to operate under a mitigation arrangement in order to perform on U.S. classified contracts.

As long as our foreign ownership represents five percent or more of our voting power and the Company holds a facility security clearance, we will have to continue to disclose our ownership information to DSS. Based upon such disclosure, DSS determines whether the Company is under FOCI. According to the National Industrial Security Program Operating Manual (“NISPOM”), a company is under FOCI if a foreign person “has the power, direct or indirect, whether or not exercised, and whether or not exercisable through the ownership of the U.S. company’s securities, by contractual arrangements or other means, to direct or decide matters affecting the management or operations of that company in a manner which may result in unauthorized access to classified information or may adversely affect the performance of classified contracts.” Because a material percentage of our voting equity is owned by a non-U.S. entity, DSS currently considers us to be under FOCI. Because the Company has a facility security clearance and is a party to U.S. classified contracts, the Company is required to operate pursuant to a FOCI mitigation arrangement in order to be able to maintain the requisite facility security clearance, access classified information, and perform on U.S. classified contracts. Based on the minority foreign ownership of the Company, DSS has required a Security Control Agreement (SCA) in accordance with the NISPOM as the form of FOCI mitigation. Failure to comply with the obligations under our FOCI mitigation arrangement could result in our inability to maintain the requisite facility security clearance, access classified information, and perform on U.S. classified contracts.

Organized labor action or occupational health and safety laws and regulations could have a material adverse effect on our operations.

The security industry has been the subject of campaigns to increase the number of unionized employees. Although relationships between management and employees of acquired businesses may be good, assurances cannot be given on the likelihood that organized labor action may occur. Such organized labor actions and occupational health and safety laws could have a material adverse effect on our operations.

We are exposed to operational risks associated with operating internationally.

We conduct a portion our business in certain foreign countries, some of which are politically unstable or subject to military or civil conflicts. Consequently, we are subject to a variety of risks that are specific to international operations, including the following:

- military conflicts, civil strife, and political risks;
- the burden and cost of compliance with foreign laws, treaties, and technical standards and changes in those regulations;
- contract award and funding delays;
- potential restrictions on transfers of funds;
- import and export duties and value added taxes;
- foreign exchange risk;
- transportation delays and interruptions; and
- uncertainties arising from foreign local business practices and cultural considerations.

While we have and will continue to adopt measures to reduce the potential impact of losses resulting from the risks of doing business internationally, we cannot ensure that such measures will be adequate.

Our international operations are subject to special U.S. government laws and regulations, such as the Foreign Corrupt Practices Act, and regulations and procurement policies and practices, including regulations to import-export control, which may expose us to liability or impair our ability to compete in international markets.

Our international operations are subject to the U.S. Foreign Corrupt Practices Act, or the FCPA, and other laws that prohibit improper payments or offers of payments to foreign governments and their officials and political parties by U.S. and other business entities for the purpose of obtaining or retaining business. We have operations in and deals with governmental customers in countries known to experience corruption, including certain emerging countries in the Middle East. Our activities in these countries create the risk of unauthorized payments or offers of payments by one of our employees, consultants or contractors that could be in violation of various laws including the FCPA, even though these parties are not always subject to our control. We are also subject to import-export control regulations restricting the use and dissemination of information classified for national security purposes and the export of certain products, services, and technical data, including requirements regarding any applicable licensing of our employees involved in such work.

If we were to fail to comply with the FCPA or the applicable import-export control regulations, we could be subject to substantial civil and criminal penalties, and the possible loss of export or import privileges, which could have a material adverse effect on our business and results of operations.

The Company may be harmed by intellectual property infringement claims.

If our vendors or other third parties assert claims that we or our clients are infringing on their intellectual property, we could incur costs to defend those claims, even if we prevail. In addition, if any of these infringement claims are ultimately successful, we could be required to:

- pay damages;
- cease selling and using products and services that incorporate the challenged intellectual property;

- obtain a license or additional licenses from our vendors or third parties, which may not be available on commercially reasonable terms or at all; and
- Re design our products and services that rely on the challenged intellectual property, which may be expensive or commercially impractical.

Any of these outcomes could adversely affect our operating results.

Goodwill and other intangible assets represent approximately 72% of our total assets and any impairment of these assets could negatively impact our results of operations.

As of December 31, 2016, goodwill accounted for approximately \$72.3 million, or approximately 50%, of our recorded total assets. Under U.S. generally accepted accounting principles (GAAP), we review our goodwill for impairment quarterly and annually, or when events or changes in circumstances (“triggering events”) indicate the carrying value may not be recoverable. In the fourth quarter of 2016, the Company recorded a charge of \$41 million for the impairment of goodwill. If goodwill becomes impaired again, we will record a further charge to earnings in our financial statements during the period in which any impairment of our goodwill is determined, which may significantly reduce or eliminate our profits.

We expect that upon closing the pending acquisition of PSS, goodwill and other intangible assets will increase, which may increase the likelihood of additional or greater goodwill impairment charges in future periods. Given the continued significant portion of the Company’s assets consisting of goodwill and intangible assets, if we are not able to improve our business, any additional significant goodwill or intangible asset impairment could reduce earnings in such period and have a material adverse effect on our financial condition and results of operations.

Our future taxable income may not be sufficient to realize our future tax benefits which could cause our deferred tax asset to become impaired, requiring substantial write-downs that could reduce our operating income

As of December 31, 2016, we had approximately \$4.5 million in net deferred tax assets. Deferred tax assets represent temporary differences in the tax basis of an asset or liability and its reported amount in the financial statements that will result in future tax deductions. Deferred tax assets are evaluated to determine if the future tax deductions will be realizable. Future realization of tax benefits ultimately depends on the existence of sufficient taxable income within the appropriate period that is available under the tax law. All available evidence is considered to determine if a valuation allowance for deferred tax assets is needed. If our future taxable income is insufficient to realize the future tax benefits and our deferred tax asset were to become impaired, we would record a charge to earnings in our financial statements during the period in which any impairment of our deferred tax asset is determined, which may significantly reduce or eliminate our profits.

Other Risks Related to Our Stock

NASDAQ has delisted our shares from trading on its exchange which could limit investors' ability to make transactions in our shares and subject us to additional trading restrictions.

Although at the time of our IPO in 2013 we met the applicable minimum initial listing standards set forth in the NASDAQ Listing Rules, our shares were delisted from NASDAQ in the first quarter of 2016 (for non-compliance with the minimum round lot shareholder requirement), and we cannot assure you that our shares will be relisted on NASDAQ in the future.

Since our delisting from NASDAQ, our shares are quoted in the over-the-counter market on the OTCQB. We could face material adverse consequences due to our shares being quoted on the OTCQB, including:

- a limited availability of market quotations for our shares;
- reduced liquidity for our shares;
- a determination that our common stock is a "penny stock" which will require brokers trading in our common stock to adhere to more stringent rules and possibly result in a reduced level of trading activity in the secondary trading market for our shares;
- a limited amount of news and analyst coverage; and
- a decreased ability to issue additional securities or obtain additional financing in the future.

Sales of outstanding shares of our Common Stock into the market in the future could cause the market price of our Common Stock to drop significantly.

Global Defense & National Security Systems Holdings, LLC, our sponsor ("Sponsor") owns 4,246,462 shares of our Common Stock and the stockholders of the Predecessor, own 10,773,110 shares of our Common Stock. If our Sponsor or the Predecessor's stockholders sell, or the market perceives that our Sponsor or the Predecessor's stockholders intends to sell, a substantial portion of their beneficial ownership interest in us in the public market, the market price of our Common Stock could decline significantly. Although the shares held by our Sponsor and the Predecessor's stockholders are subject to lock-up periods, such lock-up periods will expire over the next year. Such sales also could make it more difficult for us to sell equity or equity-related securities at a time and price that we deem appropriate.

We entered into a registration rights agreement with our Sponsor concurrently with the closing of our IPO, and we entered into a registration rights agreement with the Predecessor's stockholders in connection with the closing of the Business Combination. The registration and availability of such a number of securities for trading in the public market may have an adverse effect on the market price of our stock.

Concentration of ownership may have the effect of delaying or preventing a change in control.

Our Sponsor and the STG Stockholders own approximately 25.5% and 64.9% of our Common Stock, respectively. As a result, our Sponsor and the Predecessor's stockholders may have the ability to determine the outcome of corporate actions of the Company requiring stockholder approval. In addition, on the Closing Date (as defined below) and as a condition precedent for the closing of the Business Combination Agreement (as defined below), our Sponsor and the Predecessor's stockholders (collectively, the "Stockholder Group") (each of our Sponsor and the Stockholder Group, an "Investor Party") entered into a voting agreement (the "Voting Agreement"), pursuant to which, as long as each Investor Party beneficially owns at least 5% of our Common Stock, such Investor Party may designate one member to our board of directors. In addition, each Investor Party will support the other Investor Party's designee for director. This concentration of ownership and voting power may have the effect of delaying or preventing a change in control and might adversely affect the market price of our Common Stock.

Anti-takeover provisions in our charter documents and under Delaware law could make an acquisition of the Company, which may be beneficial to our stockholders, more difficult and may prevent attempts by our stockholders to replace or remove our current management.

Our certificate of incorporation and our bylaws contain provisions that may delay or prevent an acquisition of our company or a change in our management. These provisions include:

- no cumulative voting in the election of directors, which limits the ability of minority stockholders to elect director candidates;
- a classified board of directors;
- the ability of our board of directors to determine whether to issue shares of our preferred stock and to determine the price and other terms of those shares, including preferences and voting rights, without stockholder approval, which could be used to significantly dilute the ownership of a hostile acquirer;
- the exclusive right of our board of directors to elect a director to fill a vacancy created by the expansion of the board of directors or the resignation, death, or removal of a director, which prevents stockholders from being able to fill vacancies on our board of directors;
- a prohibition on stockholder action by written consent, which forces stockholder action to be taken at an annual or special meeting of our stockholders;
- the requirement that a special meeting of stockholders may be called only be called at the board of director's direction, which may delay the ability of our stockholders to force consideration of a proposal or to take action, including the removal of directors;
- limiting the liability of, and providing indemnification to, our directors and officers; and
- advance notice procedures that stockholders must comply with in order to nominate candidates to our board of directors or to propose matters to be acted upon at a stockholders' meeting, which may discourage or deter a potential acquirer from conducting a solicitation of proxies to elect the acquirer's own slate of directors or otherwise attempting to obtain control of the company.

Although we believe these provisions of our certificate of incorporation, bylaws, and Delaware corporate law collectively provide for an opportunity to receive higher bids by requiring potential acquirers to negotiate with us, they would apply even if stockholders consider the offer to be beneficial. In addition, these provisions may frustrate or prevent attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors, which is responsible for appointing the members of our management.

We have identified a material weakness in our internal control over financial reporting which could, if not remediated, result in additional material misstatements in our consolidated financial statements.

Section 404 of the Sarbanes-Oxley Act of 2002 requires the Company to document and test the effectiveness of its internal controls over financial reporting in accordance with an established control framework and to report on its management's conclusion as to the effectiveness of these internal controls over financial reporting with respect to the business of the Company. In connection with the prior year audit of our financial statements for the year ended December 31, 2015, our management and independent registered public accounting firm identified a material weakness in our internal control over financial reporting. The material weakness related to review and monitoring controls over the preparation of the Company's income tax provision. As a result, several significant audit adjustments to our tax provision were identified during the course of the audit. Our independent registered public accounting firm has not been engaged to express, nor have they expressed, an opinion on the effectiveness of our internal control over financial reporting. Had our independent registered public accounting firm performed an evaluation of our internal control over financial reporting in accordance with the provisions of the Sarbanes-Oxley Act, additional control deficiencies may have been identified by our independent registered public accounting firm, and those control deficiencies could have also represented one or more material weaknesses.

To assist with remediation of the material weakness in internal controls over Financial Reporting the Company identified at December 31, 2015, management has engaged a third party vendor to provide a comprehensive assessment of the Company's internal controls over financial reporting.

The comprehensive assessment of the Company's internal controls over financial reporting is currently in process. Although the activity completed to date has not yet identified any material weaknesses, including the review and monitoring controls over the consolidated income tax provision which resulted in the material weakness at December 31, 2015, we cannot conclude that no material weakness exists until the comprehensive assessment is complete and any identified findings have been remediated and tested.

Management believes that upon completion of the comprehensive assessment, such measures should be sufficient to remediate the identified material weaknesses and strengthen our internal control over financial reporting.

We can provide no assurance that our remediation efforts will be successful and that we will not have material weaknesses in the future. Any material weaknesses we identify could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements.

Pursuant to the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"), our independent registered public accounting firm will not be required to attest to the effectiveness of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act for so long as we are an "emerging growth company."

Section 404 of the Sarbanes-Oxley Act requires annual management assessments of the effectiveness of our internal control over financial reporting, and generally requires in the same report a report by our independent registered public accounting firm on the effectiveness of our internal control over financial reporting. The Company is required to provide management's attestation on internal controls. However, under the JOBS Act, our independent registered public accounting firm is not required to attest to the effectiveness of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act until we are no longer an "emerging growth company." We could be an "emerging growth company" until the earlier of (1) the last day of the fiscal year (a) following October 29, 2018, the fifth anniversary of our IPO, (b) in which we have total annual gross revenue of at least \$1.0 billion or (c) in which we are deemed to be a large accelerated filer, which means the market value of our common stock that is held by non-affiliates exceeds \$700 million as of the last business day of our prior second fiscal quarter, and (2) the date on which we have issued more than \$1.0 billion in non-convertible debt during the prior three-year period.

In addition, Section 107 of the JOBS Act also provides that an "emerging growth company" can take advantage of the extended transition period provided in Section 7(a)(2)(B) of the Securities Act for complying with new or revised accounting standards. An "emerging growth company" can therefore delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. However, we have chosen to "opt out" of such extended transition period and, as a result, we must comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for non-emerging growth companies. Section 107 of the JOBS Act provides that our decision to opt out of the extended transition period for complying with new or revised accounting standards is irrevocable.

Changes in laws or regulations, or failure to comply with any laws and regulations, may adversely affect our business, investments and results of operations.

We are subject to laws and regulations enacted by national, regional and local governments. In particular, we are and will continue to be required to comply with certain SEC and other legal requirements. Compliance with, and monitoring of, applicable laws and regulations may be difficult, time consuming and costly. Those laws and regulations and their interpretation and application may also change from time to time and those changes could have a material adverse effect on our business, investments and results of operations. In addition, a failure to comply with applicable laws or regulations, as interpreted and applied, by any of the persons referred to above could have a material adverse effect on our business and results of operations.

Our stock price is subject to volatility and could decline.

The price of our Common Stock may be volatile, and may fluctuate due to factors such as:

- investor sentiment toward government contractors in general;
- announcements concerning us or our competitors;
- shortfalls in operating results from levels forecasted by securities analysts;
- actual or anticipated fluctuations in our quarterly and annual results and those of our publicly-held competitors;
- success of our competitors;
- changes in the market's expectations about our operating results;
- our operating results failing to meet the expectation of securities analysts or investors in a particular period;
- changes in laws and regulations affecting our business;
- commencement of, or involvement in, litigation involving the Company;
- changes in the Company's capital structure, such as future issuances of securities or the incurrence of additional debt;
- the volume of shares of our common stock available for public sale;
- sales of substantial amounts of common stock by our directors, executive officers or significant stockholders or the perception that such sales could occur;
- investor sentiment toward companies with material indebtedness on their balance sheet; and
- the general state of the economy and securities markets.

As a result, investors in our common stock may experience a decrease in the value of their stock, including decreases unrelated to our operating performance or prospects. The price of our common stock could be subject to wide fluctuations in response to a number of factors, including those listed in this "Risk Factors" section.

In the past, securities class action litigation has, at times, been instituted against companies following periods of volatility in their stock price. This type of litigation against us could result in substantial costs and divert our management's attention and resources.

Our quarterly operating results may fluctuate significantly as a result of factors outside of our control, which could cause the market price of our common stock to decline.

We expect our revenue and operating results to vary from quarter to quarter. As a result, our operating results may fall below the expectations of securities analysts and investors, which could cause the price of our common stock to decline. Factors that may affect our operating results include those listed in this "Risk Factors" section and others such as:

- changes in contract type and profitability;
- fluctuations in revenue recognized on contracts;

- variability in demand for our services and solutions;
- commencement, completion, or termination of contracts during any particular quarter;
- timing of award or performance incentive-fee notices;
- timing of significant bid and proposal costs;
- timing of acquisition activities and the expensing of acquisition-related costs;
- variable purchasing patterns under the GSA Schedule 70 task orders, GWACs, blanket purchase agreements, and other agency-specific IDIQ contracts;
- strategic decisions by us or our competitors, such as acquisitions, divestitures, spin-offs, and joint ventures;
- strategic investments or changes in business strategy;
- changes in the extent to which we use subcontractors;
- fluctuations in staff utilization rates or penalties associated with not meeting staffing requirements; and
- U.S. Federal Government shutdowns or temporary facility closings.

Reductions in revenue in a particular quarter could lead to lower profitability during that quarter because a relatively large amount of our expenses are fixed in the short-term. We may incur significant operating expenses during the startup and early stages of large contracts and may not be able to recognize corresponding revenue during that same quarter. We also may incur additional expenses when contracts expire, are terminated, or are not renewed.

In addition, payments due to us from U.S. Federal Government Agencies may be delayed due to billing cycles or as a result of failures of Government budgets to gain Congressional and administration approval in a timely manner. The U.S. Federal Government's fiscal year ends September 30. If Federal appropriations for the next Federal fiscal year have not been approved by that date in each year, our customers may have to suspend engagements that we are working on until appropriations have been approved. Any such suspensions may reduce our revenue during the fourth quarter of that calendar year or the first quarter of the subsequent year. The U.S. Federal Government's fiscal year-end can also trigger increased purchase requests from customers for equipment and materials. Any increased purchase requests we receive as a result of the U.S. Federal Government's fiscal year-end would serve to increase our third- or fourth-quarter revenue but will generally decrease profit margins for that quarter, as these activities generally are not as profitable as our typical offerings.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We lease office facilities used in our business. Our executive offices and principal operations are located at 11091 Sunset Hills Road, Suite 200, Reston, Virginia, where we occupy space under a lease that expires in 2020. We also lease space located in Arizona, South Carolina, and Virginia. We do not currently own any real estate used in the performance of ongoing contracts and maintain flexibility in facility occupancy through termination and subleasing options concurrent with contract terms in many of our leases. We believe our facilities meet our current needs and that additional facilities will be available as needed.

ITEM 3. LEGAL PROCEEDINGS

We are not currently subject to any material legal proceedings, nor, to our knowledge, is any material legal proceeding threatened against us or any of our officers and directors in their corporate capacity

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**Price Range of Common Stock**

From October 24, 2013 through November 25, 2015, our common stock, par value \$0.0001 per share, traded on the NASDAQ under the symbol "GDEF". Commencing on November 25, 2015, our common stock traded on the OTC Pink Current Information tier of the over-the-counter market. The Company's common stock now trades over the counter on the OTCQB under the symbol "STGG". The following table sets forth, for the calendar quarter indicated, the high and low sale prices for the Company's common stock as reported on the NASDAQ, or the OTC Pink Current Information tier, as applicable, all as adjusted for the stock dividend paid on November 30, 2015. Prior to the consummation of the Business Combination, the Company's common stock was eligible for redemption in cash at a price of up to \$10.63 per share without adjustments for stock dividends.

Quarter ended	High	Low
Year ended December 31, 2015		
March 31, 2015	\$ 8.90	\$ 8.72
June 30, 2015	\$ 9.11	\$ 8.86
September 30, 2015	\$ 9.11	\$ 8.91
December 31, 2015	\$ 10.90	\$ 4.25
Year ended December 31, 2016		
March 31, 2016	\$ 5.50	\$ 2.20
June 30, 2016	\$ 5.30	\$ 1.50
September 30, 2016	\$ 3.00	\$ 1.20
December 31, 2016	\$ 3.19	\$ 0.90

Holders

On March 28, 2017, there were 196 holders of record of our common stock.

Dividends

We have not paid any cash dividends on our common stock to date. The payment of cash dividends in the future will be dependent upon our revenues and earnings, if any, capital requirements and general financial condition. The payment of any dividends will be within the discretion of our board of directors at such time. It is the present intention of our board of directors to retain all earnings, if any, for use in our business operations and, accordingly, our board of directors does not anticipate declaring any dividends in the foreseeable future. Further, our ability to declare dividends may be limited by restrictive covenants contained in the Credit Agreement.

Use of Proceeds from Registered Offering

The Company consummated the IPO on October 29, 2013 and received net proceeds of approximately \$73,545,000 which included \$7,215,000 received from the private placement of 721,500 shares to our Sponsor and \$9,495,000 as a result of the underwriters' exercise of the overallotment option.

At the July 2015 Extension Meeting and in accordance with our Charter, our stockholders redeemed 876,072 shares of Company Common Stock at a price of \$10.55 per share, for a total redemption of approximately \$9,242,560 that was effected on July 24, 2015 and paid from the IPO proceeds. In connection with the October Extension Meeting, on October 23, 2015, there were 3,209,123 shares redeemed at \$10.61 per share (\$34.0 million). Shares redeemed at Closing of the Business Combination amounted to 2,031,383 at \$10.63 per share (\$21.6 million). Pursuant to the Business Combination Agreement, upon the effectiveness of the Business Combination, a portion of the Cash Consideration was paid using proceeds held in our Trust Account.

PART II

ITEM 6 SELECTED FINANCIAL DATA

The selected financial data for the period January 1, 2016 to December 31, 2016, the period November 24, 2015 to December 31, 2015, and the period January 1, 2015 to November 23, 2015 and for the years ended December 31, 2015 and 2014 have been derived from STG Group's audited consolidated financial statements, including the notes thereto, appearing elsewhere in this Annual Report on Form 10-K.

Upon completion of the Business Combination on November 23, 2015 (the "Closing Date"), the Company was identified as the acquirer for accounting purposes, and STG Group Holdings is the acquiree and accounting predecessor. The Company's financial statement presentation distinguishes STG Group Holdings as "Predecessor" for periods prior to the Closing Date. The Company was subsequently renamed STG Group, Inc. and is the "Successor" for periods after the Closing Date, which includes consolidation of STG Group Holdings subsequent to the Business Combination on November 23, 2015. The acquisition was accounted for as a business combination using the acquisition method of accounting, and the Successor financial statements reflect a new basis of accounting that is based on the fair value of net assets acquired. See Note 2 of the audited consolidated financial statements included elsewhere in this Annual Report on Form 10-K for further discussion of the Business Combination. As a result of the application of the acquisition method of accounting as of the effective time of the acquisition, the financial statements for the Predecessor period and for the Successor period are presented on a different basis and, therefore, are not comparable.

The consolidated statements of operations data, consolidated statements of comprehensive income data and consolidated balance sheet data for the period January 1, 2015 to November 23, 2015 and for the years ended December 31, 2014 and 2013 are not comparable to the same information presented for the period November 24, 2015 to December 31, 2015 and January 1, 2016 to December 31, 2016. STG Group's financial results are not comparable across periods primarily due to the change in depreciation and amortization expense that results from the new accounting basis of its property plant and equipment and intangible assets. The changes in these expenses affect the comparability of cost of sales, gross profit and selling and administrative expense between Predecessor and Successor periods.

The historical results presented below are not necessarily indicative of the results to be expected for any future period. This information should be read in conjunction with "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations," and the Company's consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K.

Successor Successor Predecessor Predecessor
(In thousands, except for share and per share data)

	Year Ended December 31, 2016	November 24, 2015 Through December 31, 2015	January 1, 2015 Through November 23, 2015	Year Ended December 31, 2014
Contract Revenue	\$ 164,055	\$ 17,300	\$ 176,345	\$ 209,727
Cost of Revenue	111,263	11,702	120,989	141,925
Gross Profit	52,792	5,598	55,356	67,802
Operating Expenses Indirect and Selling Expenses	54,538	6,407	47,837	61,286
Impairment of Goodwill	41,276	0	2,064	5,117
Impairment of other Intangible Assets	0	0	906	1,811
Operating income (loss)	(43,022)	(809)	4,549	(412)
Other income (expense)				
Other (expense) income	(354)	(132)	37	313
Interest expense	(8,725)	(898)	(57)	(70)
Income (loss) before income taxes	(52,101)	(1,839)	4,529	(169)
Tax Provision (benefit)	(3,902)	(1,585)	644	0
Net (loss) income	(48,199)	(254)	3,885	(169)
Net (loss) income per share available to common shareholder- Basic and Diluted	\$ (2.98)	\$ (0.02)	\$ 3.497	(152)
Weighted-average shares outstanding:				
Basic and diluted	16,172,040	16,107,071	1,111	1,111
Consolidated Balance Sheet Data:				
Cash and cash equivalents	\$ 7,841	\$ 8,503	\$ 2,184	\$ 340
Total assets	145,128	204,323	48,556	68,635
Long-term debt	0	72,447	0	0
Total liabilities	98,609	111,978	33,362	45,678
Total Stockholders' equity	46,519	92,345	15,194	22,957

ITEM 7 MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of financial condition and results of operations of the Company should be read in conjunction with the consolidated financial statements for the year ended December 31, 2016, the periods November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015, and the years ended December 31, 2014, including the notes thereto, included elsewhere in this Annual Report on Form 10-K. The Company’s actual results may not be indicative of future performance. This discussion and analysis contains forward-looking statements and involves numerous risk and uncertainties, including, but not limited to, those discussed in “Cautionary Note Regarding Forward-Looking Statements” and “Risk Factors” included in Part I, Item 1A, or in other parts of this Annual Report on Form 10-K. Actual results may differ materially from those contained in any forward-looking statements.

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") contains certain financial measures, in particular EBITDA and Adjusted EBITDA, which are not presented in accordance with GAAP. These non-GAAP financial measures are being presented because management believes that they provide readers with additional insight into the Company's operational performance relative to earlier period and relative to its competitors. EBITDA and Adjusted EBITDA are key measures used by the Company to evaluate its performance. The Company does not intend for these non-GAAP financial measures to be a substitute for any GAAP financial information. Readers of this MD&A should use these non-GAAP financial measures only in conjunction with the comparable GAAP financial measures. Reconciliations of EBITDA and Adjusted EBITDA to net income, the most comparable GAAP measure, are provided in this MD&A.

On November 23, 2015, the Company (formerly known as Global Defense and National Security Systems, Inc.) and STG Group Holdings, Inc. ("STG Group Holdings") completed a transaction in which the Company acquired 100 percent of the capital stock of STG Group Holdings, Inc. from its then owners (the "Business Combination"). In connection with the closing of the Business Combination, the Company changed its name to STG Group, Inc., and commenced trading of its common stock under the symbol "STGG" on the OTC Pink Current Information tier of the over-the-counter market. The Company's common stock trades over the counter on the OTCQB. This transaction is further described in Note 2 to the Company's consolidated financial statements included herein.

Fiscal Year

The Company's fiscal year ends on December 31. Throughout the year, the Company reports its results using a fiscal calendar whereby each three month calendar end represents the end of a quarter. As a result, the number of work days may fluctuate between the various quarterly periods. For comparison purposes we have combined our contract revenue and Adjusted EBITDA in the period November 24, 2015 to December 31, 2015 (Successor) with STG Group's contract revenue and Adjusted EBITDA in the period January 1, 2015 through November 23, 2015 (Predecessor). Net sales and Adjusted EBITDA were not affected by acquisition accounting. Refer to Note 2 to the consolidated financial statements for additional information on acquisition accounting for the Business Combination.

Overview

The Company provides specialist cyber, software and intelligence solutions to U.S. government organizations with a national security mandate. Our solutions are integral to national security-related programs run by more than 50 U.S. government agencies, including the Department of Defense, the Intelligence Community, the Department of Homeland Security, the Department of State and other government departments with national security responsibilities. Our programs are predominantly funded from base budgets and essential to the effective day-to-day operations of our customers.

Our operational strength and track record has been established in securing highly sensitive, mission-critical national security networks, solving complex technology problems in mission-critical contexts and providing decision makers with actionable intelligence from multiple data sources.

The Company specializes in three core areas of capability:

- **Cyber Security and Secure Information Systems** — securing highly sensitive, mission-critical national security networks
- **Software Development, Systems and Services** — solving complex problems in mission-critical contexts
- **Intelligence and Analytics** — gathering and analyzing data from multiple sources to provide high quality, actionable intelligence across multiple contexts

Key Events

Business Combination. On November 23, 2015, the Company and STG Group Holdings completed the Business Combination in which the Company acquired 100% of the capital stock of STG Group Holdings from its then-current owners. In connection with the closing of the Business Combination, the Company changed its name to STG Group, Inc., and commenced trading of its common stock on the OTC Pink Current Information tier of the over-the-counter market. The Company's common stock now trades over the counter on the OTCQB. This transaction is further described in Note 2 to the Company's consolidated financial statements included herein.

The Company's 2015 results for the period January 1, 2015 through November 23, 2015 and the period November 24, 2015 through December 31, 2015, were impacted by approximately \$1 million and \$2 million in transaction expenses directly related to the Business Combination. The Company also incurred \$1.0 million and \$0.8 million in increased amortization and interest expense, respectively, during the period November 24, 2015 to December 31, 2015 resulting from the identification of intangibles at fair value in acquisition accounting for the Business Combination and the Term Note issued to finance the combination. See Notes 2 and 7 to the Company's consolidated financial statements included herein for further discussion of the Business Combination.

During the period ended December 31, 2016, the Company recognized an annual goodwill impairment charge of \$41 million. For a discussion of the methodology used for our goodwill impairment testing, see "*—Goodwill, Other Intangible Assets and Other Long-Lived Assets.*"

On February 18, 2017, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") to acquire PSS Holdings, Inc. ("PSS") for approximately \$119.5 million in cash, subject to certain adjustments based upon closing working capital, plus a portion of the value of certain tax benefits as they are realized after the closing. The purchase price will also be increased by an additional \$20,000 per day if the merger is consummated after March 31, 2017 and certain conditions to the obligations of the Company to close are otherwise satisfied, such increase applicable for each day after March 31, 2017 that such conditions are so satisfied.

PSS is a privately-held government services business that provides products and services in information technology, engineering, and program management, and is a leading provider of advanced computing, analytics, program and acquisition management, cyber and software solutions to key defense, intelligence and federal civilian customers, working with over 25 government agency partners. Upon consummation of the merger contemplated by the Merger Agreement (the "merger"), PSS will become a wholly-owned subsidiary of the Company.

The consummation of the merger is subject to the satisfaction of certain conditions, including receipt of certain required third party consents. If any condition to the merger is not satisfied or waived, the merger will not be completed. In addition, the Company intends to fund the merger consideration through a combination of equity and debt financing. We do not presently have commitments for such financing. To the extent the merger is not completed for any reason with respect to our ability to obtain financing for the merger, we may be required to pay a termination fee of \$625,000 to PSS.

On April 13, 2017, the Company received a letter from PSS purporting to terminate the Merger Agreement, unless we notify PSS that we are prepared to close and schedule the closing of the merger for no later than April 23, 2017. The Company does not believe the purported termination of the Merger Agreement is valid, and the Company is evaluating its alternatives and rights under the Merger Agreement.

Key Financial Definitions

Contract Revenue. Contract Revenue reflects the Company's sales of its services, software or material purchases. Several factors affect revenue in any period, including the contractual funding and timing of acquisitions and the purchasing habits of its customers.

Cost of Revenue. Cost of revenue includes all direct costs of providing services and products to the government. Such costs include direct labor, subcontract labor, software, hardware, materials, and travel. The largest component of cost of goods sold is labor.

Indirect and Selling Expenses. Indirect and selling expenses include all fringe related expenses, all management cost, sales and marketing, finance and administration, and quality expenses.

Impairment of Goodwill and Intangible Assets. As required by GAAP, when certain conditions or events occur, the Company recognizes impairment losses to reduce the carrying value of goodwill, other intangible assets, and property, plant and equipment. During the period ended December 31, 2016, the Company recognized an impairment charge of \$41 million related to goodwill in the Company's only reporting unit. For a discussion of the methodology used for our goodwill impairment testing, see "*—Goodwill, Other Intangible Assets and Other Long-Lived Assets.*"

Transaction-related expenses. Transaction-related expenses primarily consist of professional service fees related to the Business Combination.

Interest expense. Interest expense consists of interest paid to the Company's lenders under its line of credit revolving facilities and its term debt and amortization of deferred financing costs.

Other (expense) income. Other (expense) income is principally comprised of investment activity generated from the Rabbi Trust for the Company's deferred compensation plan. As a result of the transaction, the deferred compensation plan had a triggering event under which participant balances on deposit were liquidated in January 2016.

Tax (benefit) provision. The Company's tax provision is impacted by a number of factors, including the amount of taxable earnings derived in foreign jurisdictions with tax rates that are different than U.S. federal statutory rate, state tax rates in the jurisdictions where the Company does business, tax minimization planning and its ability to utilize various tax credits and net operating loss carry-forwards. Income tax expense also includes the impact of provision to return adjustments, changes in valuation allowances and changes in reserve requirements for unrecognized tax benefits.

Consolidated Results of Operations

	Successor	Successor	Predecessor	Predecessor
	(In thousands)			
	Year Ended December 31, 2016	November 24, 2015 Through December 31, 2015	January 1, 2015 Through November 23, 2015	Year Ended December 31, 2014
Contract Revenue	\$ 164,055	\$ 17,300	\$ 176,345	\$ 209,727
Cost of Revenue	111,263	11,702	120,989	141,925
Gross Profit	52,792	5,598	55,356	67,802
Indirect and Selling Expenses	54,538	6,407	47,837	61,286
Impairment of goodwill and intangible assets	41,276	0	2,970	6,928
Operating (loss) income	(43,022)	(809)	4,549	(412)
Interest Expense	(8,725)	(898)	(57)	(70)
Other income (expense), net	(354)	(132)	37	313
(Loss) income before income taxes	(52,101)	(1,839)	4,529	(169)
Tax (benefit) provision	(3,902)	(1,585)	644	0
Net (loss) income	(48,199)	(254)	3,885	(169)

Year ended December 31, 2016 and the periods November 24, 2015 through December 31, 2015 (Successor) and January 1, 2015 through November 23, 2015 (Predecessor). For the discussion below, the Successor and Predecessor periods have been combined to discuss results for the year ended December 31, 2015 as a whole.

Contract Revenue

Contract revenue was \$164.1 million for the year ended December 31, 2016, a decrease of \$29.5 million, or 15.3% compared to \$193.6 million for the year ended December 31, 2015. The decrease in revenue is primarily due to seven contracts. Three Department of Defense (DOD) contracts, two of which ended in 2015 and one early in 2016, an Intelligence Community contract which was completed and ended in September 2015, a Department of Homeland Security contract which ended in 2016 and contracts with Department of State and DEA which both ended in 2015.

The table below summarizes our revenue by customer for the year ended December 31, 2016 and 2015 (Combined Successor and Predecessor Periods).

Revenue by customer	Year ended December 31,			
	2016		2015	
	(in thousands, except percentages)			
Department of Defense	\$ 70,639	43%	\$ 83,855	43%
Department of State	57,334	35%	62,038	32%
Department of Homeland Security	10,532	7%	18,195	9%
Intelligence Community	3,810	2%	9,007	5%
Drug Enforcement Administration	-	0%	3,974	2%
Other Federal Civilian	21,740	13%	16,576	9%
	<u>\$ 164,055</u>		<u>\$ 193,645</u>	

The Department of Defense continues to be our largest customer with 43% of total revenue generated from this customer in the year ended December 31, 2016 compared to 43% of total revenue in the year ended December 31, 2015. Revenue generally decreased across the customer base for the year ended December 31, 2016 compared to the same period in 2015, although there was an increase in revenue from the Federal Civilian agencies.

The table below summarizes our revenue by contract billing type for the years ended December 31, 2016 and 2015 (Combined Successor and Predecessor Periods).

Revenue by Contract Type	Year ended December 31,			
	2016		2015	
	(in thousands, except percentages)			
T&M	\$ 56,323	34%	\$ 64,523	33%
Fixed price	47,615	29%	58,858	30%
Cost Plus	60,117	37%	70,264	37%
	<u>\$ 164,055</u>		<u>\$ 193,645</u>	

Time-and-materials contract revenue decreased by \$8.2 million in the year ended December 31, 2016 compared to the year ended December 31, 2015. The decrease in time-and-materials contract revenue was driven by the end of the DEA contract in the second quarter, the end of the Army/DOD contract in the third quarter of 2015 and the expiration of a Department of State contract in 2015. Fixed price contract revenue decreased by \$11.3 million. Reductions in Department of Defense and Department of Homeland Security customers' activities are responsible for these decreases. Cost Plus revenue was down \$10.1 million due primarily to a reduction of Intelligence Community and Department of Defense tasking.

Our prime contract revenue decreased by \$26.7 million in the year ended December, 2016 compared to the year ended December 31, 2015. The decrease was attributable to the expiration of the Department of Defense Intelligence Community, Department of Homeland Security, Department of State and DEA contracts.

The table below summarizes our revenue by prime and subcontract type for the years ended December 31, 2016 and 2015 (Combined Successor and Predecessor Periods).

Revenue – Prime and Subcontract	Year ended December 31,			
	2016		2015	
	(in thousands, except percentages)			
Prime	\$ 143,305	87%	\$ 170,070	88%
Subcontract	20,750	13%	23,575	12%
	<u>\$ 164,055</u>		<u>\$ 193,645</u>	

STG continues to concentrate on to increasing its presence as a prime contractor on larger, more complex programs where it delivers services to customers by deploying its own staff and expertise.

Direct Expenses and Gross Profit

Direct expenses consist of direct labor, subcontractors and consultants, and other direct costs. For the year ended December 31, 2016, direct expenses were \$111.3 million and \$132.7 million for the year ended December 31, 2015. The decrease of \$21.4 million, or 16.1%, was primarily a result of the Department of Defense, Intelligence Community, Department of Homeland Security, Department of State and DEA contracts that expired in 2015 and 2016.

Gross profit was \$52.8 million for the year ended December 31, 2016, compared to \$61 million for the year ended December 31, 2015. The decrease of in gross profit during the year ended December 31, 2016 of \$8.2 million or 13.4% is primarily a result of the Department of Defense, Department of Homeland Security, Department of State and DEA contracts that ended during 2015 and 2016.

Indirect and Selling Expenses

Indirect and selling expenses were \$54.5 million for the year ended December 31, 2016 compared to \$6.4 million for the period November 24, 2015 to December 31, 2015 and \$47.8 million for the period January 1, 2015 through November 23, 2015 or \$54.2 million for the full year ended December 31, 2015. This represents a small increase of \$0.3 million in overall indirect and selling expenses in 2016 compared to 2015.

During the year ended December 31, 2016, the Company incurred \$0.7 million in expense for share-based compensation related to the new equity awards granted upon consummation of the Business Combination and subsequent awards compared to \$0.03 million recognized in the period November 24, 2015 to December 31, 2015. No share based compensation expense was incurred in prior periods. Selling and administrative expenses for the year ended December 31, 2016 include \$0.5 million and \$7.0 million of depreciation and amortization expense, respectively, compared to \$0.9 million and \$1.6 million of depreciation and amortization expense, respectively in the combined periods November 24, 2015 to December 31, 2015 and January 1, 2015 to November 23, 2015.

The increase in intangible amortization of \$5.4 million is due to an increase in intangible assets from the Business Combination. Selling and administrative expenses in 2016 also include a decrease in personnel and benefits costs of (\$5.6) million due to savings realized in 2016 from the Company restructuring efforts implemented during 2015 and 2016. These savings were partially offset by increases in board of director compensation and expenses, third party professional fees and public filing related expenses, which approximated \$1.4 million for the year ended December 31, 2016 and \$0.3 million for the period November 24 to December 31, 2015. Selling and administrative expenses during the period January 1, 2015 to November 23, 2015, included an expense of \$0.7 million recognizing a loss on the sublease of space once the Company renegotiated its lease agreement and moved its Corporate Headquarters.

Additionally, for the period January 1, 2015 to November 23, 2015, the selling and administrative expenses included a charge of \$1.1 million related to the disposal of fixed assets. This was primarily associated with moving its Corporate Headquarters and writing off undepreciated leasehold improvements. For the period November 24, 2015 to December 31, 2015, and for the year ended December 31, 2014, no losses on disposal of fixed assets were material.

Impairment of Goodwill and Other Intangible Assets

In 2002, STG Group acquired DSTI and Seamast Incorporated (“Seamast”) as wholly-owned subsidiaries, which resulted in STG Group recording goodwill. Effective December 31, 2012, STG Group acquired Access Systems, which also resulted in STG Group recording additional amounts of goodwill. The Company’s goodwill balance consists of the following (in thousands):

	<u>DSTI</u>	<u>Seamast</u>	<u>Access</u>	<u>STG successor</u>	<u>Total</u>
Balance, December 31, 2014, Predecessor	\$ 440	\$ 1,898	\$ 2,361		\$ 4,699
Impairment loss	-	-	(2,064)		(2,064)
Balance, November 23, 2015, Predecessor	440	1,898	297		2,635
Elimination of predecessor goodwill	(440)	(1,898)	(297)		(2,635)
Acquisition of business, Successor	-	-	-	113,589	113,589
Balance, December 31, 2015, Successor				113,589	113,589
Impairment loss				(41,276)	(41,276)
Balance, December 31, 2016, Successor	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 72,313</u>	<u>\$ 72,313</u>

For the period from January 1, 2015 to November 23, 2015 and for the year ended December 31, 2014, the Company recorded impairment losses on Access Systems goodwill of \$2.1 million and \$3.5 million and impairment losses on Access Systems customer relationships of \$0.9 million and \$1.8 million, respectively. Additionally, for the year ended December 31, 2014, the Company recorded an impairment loss related to its previous acquisition of Decision Systems Technologies, Inc. (DSTI) of \$1.7 million. The primary methods used to measure the impairment losses for DSTI and Access Systems were the income method and the market approach. The impairment loss is primarily due to declining revenues and future cash flows generated for the DSTI and Access Systems reporting units.

For the year ended December 31, 2016, the Company recorded an impairment loss of \$41.3 million. For the year ended December 31, 2016, the Company's third party valuation firm performed the first step of the annual goodwill impairment test in the fourth quarter of 2016 and determined that the estimated fair value of the Company's sole reporting unit was lower than the carrying value, requiring further analysis under the second step of the impairment test. The decline in the estimated fair value of the Company was primarily due to significantly lower revenue in 2016 than planned. Growth rates in future years remain comparable to the prior planned growth; however future revenue and related profits are less than the previous plan due to significantly lower 2016 revenue.

Operating Income (Loss)

There was an operating loss of (\$43.0) million for the year ended December 31, 2016 compared to operating income of \$3.7 million for the year ended December 31, 2015.

The decrease in operating income of (\$46.7) million is primarily due to the impairment charge related to goodwill of (\$41.2) million and additional depreciation and amortization expense of (\$6.4) million recognized during the year ended December 31, 2016 versus the year ended December 31, 2015. These losses were partially offset by cost savings realized in the Company's indirect and selling expenses during 2016.

For a discussion of the methodology used for our goodwill impairment testing, see "*Goodwill, Other Intangible Assets and Other Long-Lived Assets.*"

Other Income (Expense)

Other (expense) income was (\$0.3) million for the year ended December 31, 2016 and (\$0.1) for the combined periods November 24, 2015 to December 31, 2015 and January 1, 2015 to November 23, 2015. Other income (expense) is primarily generated by market performance of the investments of the assets held in trust securing the Company's deferred compensation plan.

Interest Expense

Interest expense was \$8.7 million for the year ended December 31, 2016 compared to \$1.0 million for the combined periods November 24, 2015 to December 31, 2015 and January 1, 2015 to November 23, 2015. Interest expense for the year ended December 31, 2016 reflects the Company's new level of debt following the consummation of the Business Combination. See "Secured Credit Facilities" in the Liquidity and Capital Resources section of this MD&A for further discussion.

(Loss) Income before Income Taxes

(Loss) income before income taxes was (\$52.1) million for the year ended December 31, 2016 and \$2.7 million for the combined periods November 24, 2015 to December 31, 2015 and January 1, 2015 to November 23, 2015. The decrease in income before income taxes is primarily due to recognition of the non-cash impairment of Goodwill and additional amortization of intangible assets resulting from the Business Combination.

Tax Provision (Benefit)

The tax provision (benefit) was (\$3.9) million for the year ended December 31, 2016 and (\$0.9) million for the combined periods November 24, 2015 to December 31, 2015 and period January 1, 2015 to November 23, 2015. The post-acquisition net deferred tax liability is primarily due to the future tax expense related to the intangible assets recognized as a result of the Business Combination. Amortization of intangible assets recognized in the Business Combination is not deductible for tax purposes. The predecessor company was an S Corporation for Federal and most State related tax filings and as a result the tax liabilities flowed directly to its stockholders. Due to a change from a cash basis to accrual basis in the S Corporation period the predecessor company incurred higher state taxes in jurisdictions that tax S Corporations. As a result, pre and post-acquisition income tax related expenses will not be comparable.

Deferred income taxes are accounted for under the asset and liability method and reported on the Company's Balance Sheet as a net asset or net liability. Deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carry forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their income tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more-likely-than-not that some portion or all of the deferred tax assets may not be realized. Deferred tax assets and liabilities are adjusted for effects of changes in tax laws and rates on the date of enactment.

In connection with the Business Combination, STG Group (Predecessor) converted from a Subchapter S-Corporation to a C-Corporation. Prior to this, for the period from January 1, 2015 through November 23, 2015 and the year ended December 31, 2014, STG Group generally did not incur corporate level income taxes, exclusive of certain state level jurisdictions. In lieu of corporate income taxes, the Predecessor's stockholders separately accounted for their pro-rata share of STG Group's income, deductions, losses and credits. Therefore, the Company recognized corporate level deferred tax assets and liabilities for solely the Successor period. In addition, the Company released a valuation allowance against its deferred tax assets in the amount of \$1.05 million following the Business Combination due to an assessment that it was more likely than not that these deferred tax assets would be realized.

The consolidated entity was able to recognize a deferred tax asset of \$1.7 million in 2015 due to the tax amortization treatment of the start-up costs and the payout of the deferred compensation balances on January 25, 2016. Further, upon change to a C-Corporation on November 23, 2015, our taxable income generated from our operational activities is subject to an effective tax rate in excess of 35% for both Federal and State taxes.

Net (Loss) Income

For the reasons described above, net (loss) income was (\$48.2) million for the year ended December 31, 2016 compared to \$3.6 million for the combined periods November 24, 2015 to December 31, 2015 and January 1, 2015 to November 23, 2015.

Periods November 24, 2015 through December 31, 2015 (Successor), January 1, 2015 through November 23, 2015 (Predecessor), and the year ended December 31, 2014. For the discussion below, the Successor and Predecessor periods have been combined to discuss results for the year ended December 31, 2015 as a whole.

Contract Revenue

Contract revenues was \$193.6 million for the combined year ended December 31, 2015, a decrease of \$16.1 million, or 7.6% compared to \$209.7 million for the year ended December 31, 2014. The decrease in revenue is primarily due to three contracts, a Drug Enforcement Administration (DEA) contract which ended in June 2015, an Army contract which ended in August 2015, and an Intelligence Community contract which was completed and ended in September 2015.

The table below summarizes our revenue by customer for the year ended December 31, 2015 (Combined Successor and Predecessor Periods) and 2014.

Revenue by customer	Year ended December 31,			
	2015		2014	
	(in thousands, except percentages)			
Department of Defense	\$ 83,855	43%	\$ 87,057	41%
Department of State	62,038	32%	65,591	31%
Department of Homeland Security	18,195	9%	15,902	8%
Intelligence Community	9,007	5%	13,132	6%
Drug Enforcement Administration	3,974	2%	9,971	5%
Other Federal Civilian	16,576	9%	18,074	9%
	<u>\$ 193,645</u>		<u>\$ 209,727</u>	

The Department of Defense continues to be our largest customer with 43% of total revenue generated from this customer in the year ended December 31, 2015 compared to 41% of total revenue in the year ended December 31, 2014. Revenue by customer remained relatively consistent in the year ended December 31, 2015 compared to the year ended December 31, 2014, except for the loss of the Drug Enforcement Administration contract, the Army contract, and the loss of an Intelligence Community contract.

The table below summarizes our revenue by contract billing type for the years ended December 31, 2015 (Combined Successor and Predecessor Periods) and 2014.

Revenue by Contract Type	Year ended December 31,			
	2015		2014	
	(in thousands, except percentages)			
T&M	\$ 64,523	33%	\$ 76,532	37%
Fixed price	58,858	30%	59,388	28%
CPFF	70,264	37%	73,807	35%
	<u>\$ 193,645</u>		<u>\$ 209,727</u>	

Time-and-materials contract revenue decreased by \$12 million in the year ended December 31, 2015 compared to the year ended December 31, 2014. The decrease in time-and-materials contract revenue was driven by loss of the DEA contract ending in the second quarter and the loss of the Army contract in the third quarter of 2015.

The table below summarizes our revenue by prime and subcontract type for the years ended December 31, 2015 (Combined Successor and Predecessor Periods) and 2014.

Revenue – Prime and Subcontract	Year ended December 31,			
	2015		2014	
	(in thousands, except percentages)			
Prime	\$ 170,070	88%	\$ 181,008	86%
Subcontract	23,575	12%	28,719	14%
	<u>\$ 193,645</u>		<u>\$ 209,727</u>	

Our prime contract revenue percentage increased by 2% in the year ended December, 2015 compared to the year ended December 31, 2014. STG continues to concentrate on increasing its presence as a prime contractor on larger, more complex programs where it delivers services to customers by deploying its own staff and expertise.

Direct Expenses and Gross Profit

Direct expenses consist of direct labor, subcontractors and consultants, and other direct costs. In the year ended December 31, 2015, direct expenses were \$11.7 million for the period November 24, 2015 through December 31, 2015 and was \$121 million for the period January 1, 2015 through November 23, 2015 compared to \$141.9 million for the year ended December 31, 2014. The decrease of \$9.2 million, or 6.4% was primarily a result of the Drug Enforcement Administration contract ending, the loss of an Army contract, and the ending of an Intelligence Community contract.

Gross profit was \$5.6 million for the period November 24, 2015 through December 31, 2015 and \$55.4 million for the period January 1, 2015 through November 23, 2015, compared to \$68 million for the year ended December 31, 2014. The decrease in gross profit during the year ended December 31, 2015 of \$7.0 million or 10.3% is primarily due to the loss of the DEA contract, the Army contract, and the Intelligence Community contract during 2015.

Indirect and Selling Expenses

Indirect and selling expenses were \$6.4 million for the period November 24, 2015 to December 31, 2015 and \$47.8 million for the period January 1, 2015 through November 23, 2015, compared to \$61.3 million during the year ended December 31, 2014. The decrease of \$7.1 million or 12% was due to management's cost reduction efforts which included the relocation of the Corporate headquarters as well as personnel reductions.

During the period November 24, 2015 to December 31, 2015, the Company incurred \$0.03 million in expense for share-based compensation related to new equity awards granted upon consummation of the Business Combination, for which no expense was incurred in prior periods. Selling and administrative expenses for the period November 24, 2015 to December 31, 2015, include \$0.1 million and \$0.9 million of incremental depreciation and amortization expense, respectively, and the period January 1, 2015 to November 23, 2015, which includes \$0.8 million and \$0.7 million respectively, compared to \$1.2 million and \$0.6 million of depreciation and amortization expense for the year ended December 31, 2014. The increase in intangible amortization is due to an increase in intangible assets from the business combination. Selling and administrative expenses also increased in the period November 24, 2015 to December 31, 2015, due to the incurrence of additional expense in personnel costs, board of director compensation and expenses, third party professional fees and public filing related expenses, which approximated \$0.3 million for the period. Selling and administrative expenses during the period January 1, 2015 to November 23, 2015, included an expense of \$0.7 million recognizing a loss on the sublease of space once the Company renegotiated its lease agreement and moved its Corporate Headquarters.

Additionally, for the period January 1, 2015 to November 23, 2015, the selling and administrative expenses included a charge of \$1.1 million related to the disposal of fixed assets. This was primarily associated with moving its Corporate Headquarters and writing off undepreciated leasehold improvements. For the period November 24, 2015 to December 31, 2015, and for the year ended December 31, 2014, no losses on disposal of fixed assets were material.

Impairment of Goodwill and Other Intangible Assets

In 2002, STG Group acquired DSTI and Seamast Incorporated ("Seamast") as wholly-owned subsidiaries, which resulted in STG Group recording goodwill. Effective December 31, 2012, STG Group acquired Access Systems, which also resulted in STG Group recording additional amounts of goodwill. The Company's goodwill balance consists of the following (in thousands):

	<u>Predecessor DSTI</u>	<u>Predecessor Seamast</u>	<u>Predecessor Access</u>	<u>Successor STG Group</u>	<u>Total</u>
Balance, December 31, 2014, Predecessor	\$ 440	\$ 1,898	\$ 2,361	-	\$ 4,699
Impairment loss	-	-	(2,064)	-	(2,064)
Balance, November 23, 2015, Predecessor	440	1,898	297	-	2,635
Elimination of predecessor goodwill	(440)	(1,898)	(297)	-	(2,635)
Acquisition of business	-	-	-	113,589	113,589
Balance, December 31, 2015, Successor	-	-	-	113,589	113,589
Impairment loss	-	-	-	(41,276)	(41,276)
Balance, December 31, 2016, Successor	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 72,313</u>	<u>\$ 72,313</u>

For the period from January 1, 2015 to November 23, 2015 and for the year ended December 31, 2014, the Company recorded impairment losses on Access Systems goodwill of \$2.1 million and \$3.5 million and impairment losses on Access Systems customer relationships of \$0.9 million and \$1.8 million, respectively. Additionally, for the year ended December 31, 2014, the Company recorded an impairment loss related to its previous acquisition of Decision Systems Technologies, Inc. (DSTI) of \$1.7 million. The primary methods used to measure the impairment losses for DSTI and Access Systems were the income method and the market approach. The impairment loss is primarily due to declining revenues and future cash flows generated for the DSTI and Access Systems reporting units.

Operating Income (Loss)

Operating income was \$3.7 million for the year ended December 31, 2015 compared to (\$0.4) million in the year ended December 31, 2014.

The decrease in indirect and selling expenses was partially offset by a decrease in revenue and gross profit in the year ended December 31, 2015 compared to the year ended December 31, 2014. The impairment loss of goodwill and other intangible assets decreased the operating income in the Predecessor's third quarter by \$3.0 million.

Other Income (Expense)

Other (expense) income was (\$0.1) million for the period November 24, 2015 to December 31, 2015 and \$.03 for the period January 1, 2015 to November 23, 2015, and was \$0.3 million for the year ended December 31, 2014. Other income (expense) is primarily generated by market performance of the investments of the assets held in trust securing the Company's deferred compensation plan.

Interest Expense

Interest expense was \$0.9 million for the period November 24, 2015 to December 31, 2015 and was \$0.1 million for the period January 1, 2015 to November 23, 2015. Interest expense was \$0.1 million in 2014. Interest expense for the period November 24, 2015 to December 31, 2015 reflects the Company's new level of debt following the consummation of the Business Combination. See "Secured Credit Facilities" in the Liquidity and Capital Resources section of this MD&A for further discussion.

(Loss) Income before Income Taxes

(Loss) income before income taxes was (\$1.8) million for the period November 24, 2015 to December 31, 2015 and \$4.5 million for the period January 1, 2015 to November 23, 2015, compared to a loss of (\$0.2) million in 2014. The decrease in income before income taxes is primarily due to transaction-related expenses as well as increases in selling and administrative expenses from being a public company as a result of the transaction. The loss in 2014 was primarily due to impairment related charges around the Company's goodwill and intangible asset balances from previous acquisitions.

Tax Provision (Benefit)

The tax provision (benefit) was (\$1.6) million for the period November 24, 2015 to December 31, 2015 and \$0.6 million for the period January 1, 2015 to November 23, 2015. The post-acquisition deferred tax benefit was primarily due to the future benefit related to the capitalization and amortization (for tax purposes) of start-up costs. The predecessor company was an S Corporation for Federal and most State related tax filings and as a result the tax liabilities flowed directly to its stockholders. Due to a change from a cash basis to accrual basis in the S Corporation period ending November 23, 2015 the predecessor company incurred higher state taxes in jurisdictions that tax S Corporations. As a result, pre and post-acquisition income tax related expenses will not be comparable.

STG Group, excluding operations in the Netherlands and Qatar conducted through STG Netherlands, B.V. (“STG Netherlands”) and STG Doha, LLC (“STG Doha”), respectively, elected previous to the Business Combination to be treated as an S corporation under Subchapter S of the Internal Revenue Code, which provides that, in lieu of corporate income taxes, the stockholders separately accounted for their pro-rata share of STG Group’s items of income, deductions, losses and credits.

STG Netherlands and STG Doha are in jurisdictions that do not recognize S corporations. Deferred income taxes are accounted for under the asset and liability method. Deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carry forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their income tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more-likely-than-not that some portion or all of the deferred tax assets may not be realized. Deferred tax assets and liabilities are adjusted for effects of changes in tax laws and rates on the date of enactment.

In connection with the Business Combination, STG Group (Predecessor) converted from a Subchapter S-Corporation to a C-Corporation. Prior to this, for the period from January 1, 2015 through November 23, 2015 and the years ended December 31, 2014. STG Group, generally did not incur corporate level income taxes, exclusive of certain state level jurisdictions. In lieu of corporate income taxes, the Predecessor's stockholders separately accounted for their pro-rata share of STG Group's income, deductions, losses and credits. Therefore, the Company recognized corporate level deferred tax assets and liabilities for solely the Successor period. In addition, the Company released a valuation allowance against its deferred tax assets in the amount of \$1.05 million following the Business Combination due to an assessment that it was more likely than not that these deferred tax assets would be realized.

The consolidated entity was able to recognize a deferred tax asset of \$1.7 million due to the tax amortization treatment of the start-up costs and the payout of the deferred compensation balances on January 25, 2016. Further, upon change to a C-Corporation, our taxable income generated from our operational activities is subject to an effective tax rate in excess of 35% for both Federal and State taxes.

Net (Loss) Income

For the reasons described above, net (loss) income was (\$0.3) million for the period November 24, 2015 to December 31, 2015 and \$3.9 million for the period January 1, 2015 to November 23, 2015, compared to (\$0.2) million for the year ended December 31, 2014.

Key Measures the Company Uses to Evaluate Its Performance

EBITDA and Adjusted EBITDA

The Company defines EBITDA as net income (loss) before interest expense, provision (benefit) for income taxes, depreciation and amortization and (gain)/loss on disposal of property, plant and equipment.

The Company defines Adjusted EBITDA as EBITDA, excluding the impact of operational restructuring charges and non-cash or non-operational losses or gains, including long-lived asset impairment charges, formal cost reduction plans, excess and unutilized accruals, transactional legal fees, other professional fees and retention employee bonuses.

Management believes that Adjusted EBITDA provides a clear picture of our operating results by eliminating expenses and income that are not reflective of the underlying business performance. We use this metric to facilitate a comparison of operating performance on a consistent basis from period to period and to analyze the factors and trends affecting its core business areas. Our internal plans, budgets and forecasts use Adjusted EBITDA as a key metric and the Company uses this measure to evaluate its operating performance and core business operating performance and to determine the level of incentive compensation paid to its employees. Adjusted EBITDA is not an item recognized by the generally accepted accounting principles in the United States of America, or U.S. GAAP, and should not be considered as an alternative to net income, operating income, or any other indicator of a company's operating performance required by U.S. GAAP. Our definition of Adjusted EBITDA used here may not be comparable to the definition of Adjusted EBITDA used by other companies. A reconciliation of income from net income to Adjusted EBITDA is as follows:

Set forth below is a reconciliation of Adjusted EBITDA to net income (loss) (unaudited)

	Successor Year Ended December 31, 2016	Predecessor November 24, 2015 Through December 31, 2015	January 1, 2015 Through November 23, 2015	Year Ended December 31, 2014
Net (loss) income	\$ (48,199)	\$ (254)	\$ 3,885	\$ (169)
Income tax (benefit) expense*	(3,902)	(1,585)	644	346
Interest Expense	7,316	898	57	70
Amortization of loan issuance cost	1,409	119	0	0
Depreciation and Amortization	549	57	842	1,179
Amortization of intangibles	7,004	852	710	625
Impairment of Goodwill	41,276	0	2,064	5,117
Impairment of other intangible assets	0	0	906	1,811
EBITDA	<u>\$ 5,453</u>	<u>\$ 87</u>	<u>\$ 9,108</u>	<u>\$ 8,979</u>
Adjustments to EBITDA				
Integration and other restructuring costs (1)	\$ 3,656	\$ 468	\$ 5,207	\$ 6,678
Nonrecurring expenses – advisory, legal, and professional fees (2)	3,069	13	1,805	2,765
Transaction related expenses (3)	243	1,194	1,394	0
Share-based compensation (4)	707	0	0	0
Adjusted EBITDA	<u>\$ 13,128</u>	<u>\$ 1,762</u>	<u>\$ 17,514</u>	<u>\$ 18,422</u>

- (1) Integration and other restructuring costs including development of incentive compensation plans, branding, communication plans, and severance related to reductions in force.
- (2) Expenses incurred by the Company as a result of transitioning from a privately owned entity to a public company. These expenses include increased legal and accounting costs, investor relations, and marketing expenses.
- (3) Transaction-related expenses primarily consist of professional service fees related to the Business Combination.
- (4) Represents non-cash share based compensation expense for awards made under the Company's 2015 Omnibus Incentive Plan.

*Income tax expense in 2014 relates to tax payments made in jurisdictions where the Company filed as if it were a C Corporation for tax purposes (i.e. the District of Columbia). These expenses were included in indirect and selling expenses in those years.

Backlog

Backlog, both funded and unfunded at, December 31, 2016, 2015 and 2014, is as follows:

Backlog	December 31,		
	2016	2015	2014
Funded	\$ 75	\$ 107	\$ 90
Unfunded	215	212	288
Funded and Unfunded	<u>\$ 290</u>	<u>\$ 319</u>	<u>\$ 378</u>

All of our existing contracts may have funded and unfunded backlog, each of which is described below. The contract values and management's estimated revenues do not include any task orders or ceiling value under ID/IQ contracts, except to the extent that task orders have been awarded to the Company under those contracts.

The amount of the Company's backlog as of December 31, 2015 increased from the amount previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2015 to include amounts inadvertently excluded. This increased backlog at December 31, 2015 by \$66.3 million.

The Company defines total backlog as the amount of revenue it expects to realize (i) over the remaining base contract performance period and (ii) from the exercise of option periods that management reasonably believes will be exercised, in each case from signed contracts in existence as of the measurement date. The Company also includes in backlog its estimates of revenue from future delivery orders on requirements and ID/IQ contracts for which we have an established pattern of revenues. At times, our estimates of future revenue on such contracts are less than the contract ceiling. Our estimates are based on our experience using such vehicles and similar contracts.

The Company defines funded backlog as the portion of its total backlog for which funding is currently appropriated and obligated to it under a signed contract or task order by the purchasing agency, or otherwise authorized for payment to the Company by a customer upon completion of a specified portion of work. Our funded backlog does not include the full potential value of our contracts, because Congress often appropriates funds to be used by an agency for a particular program or contract only on a yearly or quarterly basis, even though the contract may call for performance over a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriations and the procuring agency allocates funding to the contract. Unfunded backlog is primarily unfilled firm and expected follow-on orders that have not yet met our established funding criteria. Our established funding criteria require both authorizations by the customer as well as our management's determination that there is little or no risk of the authorized funding being rescinded. For example, option years on an existing contract are within the customer's budgetary and procurement plans and represent their plans to continue work on the contract. Those option years are not constituted as "funded backlog" until the customer provides written authorization for work within that period of performance, which is usually expressed in one year terms.

Our funded and unfunded backlog estimates are determined by analyzing a number of key factors and attributes for executed contracts, task orders or delivery orders. Based upon the result of our analysis we establish the expected revenue value for each of those contracts, task orders or delivery orders and report those results on a consolidated basis. We may not realize the full amount of our backlog, which could lower future revenue. See "Risk Factors — Risks Related to the Business, Operations and Industry."

The \$29 million or 9% decrease in backlog from December 31, 2015 to December 31, 2016 was primarily due to not replacing contracts that expired in 2015 and 2016. The decrease of \$59 million or 16% in backlog from December 31, 2014 to December 31, 2015 was primarily the result of contracts expiring in 2015 that were not replaced by new contracts.

There can be no assurance that our existing contracts will result in actual revenue in any particular period, or at all, or that any contract included in backlog will be profitable. There is a higher degree of risk in this regard with respect to unfunded backlog. The actual receipt and timing of any revenue is subject to various contingencies, many of which are beyond our control. The actual recognition of revenue on contracts included in our backlog may never occur or may change because a program schedule could change, the program could be cancelled, a contract could be reduced, modified, or terminated early, whether for the convenience of the government or otherwise; or an option that we had assumed would be exercised could not be exercised.

The primary risks that could affect timing and recognition of backlog-related contract revenue include: schedule changes, contract modifications, and our ability to assimilate and deploy new staff against funded backlog; U.S. government cost cutting initiatives and other efforts to reduce spending, which could reduce or delay funding for orders for services; and delayed funding of our contracts due to delays in the completion of the U.S. government's budgeting process and the use of continuing resolutions by the U.S. government to fund its operations, as described under "*Risk Factors — Risks Related to the Business, Operations and Industry.*" We depend on U.S. government contracts for substantially all of our revenue. Changes in the contracting or fiscal policies of the U.S. government could adversely affect our business, financial condition, results of operations and ability to satisfy our financial obligations and grow our business and we may not realize the full amount of our backlog, which could lower future revenue.

Liquidity and Capital Resources

Background

On November 23, 2015, the Company, together with STG Group Holdings, STG, Inc., and Access Systems entered into a Credit Agreement (the "Credit Agreement") with the lenders party thereto from time to time, MC Admin Co LLC (the "Lender"), as administrative agent, PNC Bank, National Association, as collateral agent (the "Collateral Agent"), and MC Admin Co LLC, as lead arranger. The Company served as the initial borrower of the term loans under the Credit Agreement, and STG, Inc. and Access Systems (collectively, the "Borrowers") each immediately assumed all obligations of the Company under the Credit Agreement as if they had originally incurred them as borrowers. The Company and STG Group Holdings have each guaranteed Borrowers' obligations under the Credit Agreement. Our debt agreement requires payment of administrative fees, interest, and for the Company to be in compliance with certain financial covenants, including Quarterly EBITDA, Fixed Charge Coverage Ratio, Senior Secured Leverage Ratio, as well as restrictions on the amount of outstanding liens, sale of assets, payment of dividends, other indebtedness, and investments.

Each of the Revolving Loan and the Term Loan matures on November 23, 2020.

As of December 31, 2016, the Company had \$7.8 million of available cash. Because the Company did not meet the required consolidated senior secured leverage ratio and minimum consolidated EBITDA required in the Credit Agreement as of December 31, 2016, the \$15 million of borrowings under the revolving credit facility are only available subject to lender consent, and the \$90 million uncommitted accordion facility is not available.

In addition, on February 18, 2017, we entered into the Merger Agreement to acquire PSS for approximately \$119.5 million in cash, subject to certain adjustments based upon closing working capital, plus a portion of the value of certain tax benefits as they are realized after the closing. The purchase price will also be increased by an additional \$20,000 per day if the merger is consummated after March 31, 2017 and certain conditions to the obligations of the Company to close are otherwise satisfied, such increase applicable for each day after March 31, 2017 that such conditions are so satisfied.

The Company intends to fund the merger consideration through a combination of equity and debt financing. We do not presently have commitments for such financing. To the extent the merger is not completed for any reason with respect to our ability to obtain financing for the merger, we may be required to pay a termination fee of \$625,000 to PSS.

Going Concern Consideration: The consolidated financial statements included in this Form 10-K have been prepared using the going concern basis of accounting, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business.

The Company was not in compliance with its financial covenants at September 30, 2016 or at December 31, 2016. At September 30, 2016, the non-compliance was cured by raising equity from stockholders' ("Equity Cure") as was allowed by the Lending Agreement. At December 31, 2016 the Company received a forbearance which expired on March 31, 2017. The Company entered into a Limited Waiver ("the Waiver") from MC Admin Co LLC and other lenders under the Credit Agreement as of March 31, 2017, pursuant to which the lenders waived the Company's noncompliance with the Specified Financial Covenants as of December 31, 2016. Based upon the preliminary results of operations through the first quarter of 2017, the Company anticipates that it will not be in compliance with the same financial covenants at March 31, 2017. One of the remedies the Lender has available to it, amongst others is the ability to accelerate repayment of the loan which the Company would not be able to immediately repay.

The potential inability to meet financial covenants under the Company's existing Credit Agreement and the potential acceleration of the debt by the Lender resulting in the reclassification of our debt from a long-term liability to a current liability due to the potential of future covenant defaults required us to evaluate whether there is substantial doubt regarding the Company's ability to continue as a going concern.

Management's Plan to alleviate this condition is as follows:

1. Identify, qualify, and win new business to increase revenue and profits;
2. Complete the PSS transaction, including the raising of equity and refinancing of our current Credit Agreement; or
3. Renegotiate the current Credit Agreement to obtain relief from the existing financial covenants and other terms.

We considered the likelihood of refinancing the current Credit Agreement in connection with the PSS acquisition financing which contemplates new financial covenants and the renegotiation of the financial covenants in the event the acquisition of PSS is not completed. Based upon the executed term sheet for financing of the planned acquisition of the PSS which contemplates new financial covenants and discussions with our Lender regarding the need to renegotiate the existing financial covenants in the Credit Agreement in the event the acquisition is not completed, management determined that it was probable that the condition giving rise to the going concern evaluation has been sufficiently alleviated.

Indebtedness

In connection with the consummation of the Business Combination, all indebtedness under STG Group's prior credit facility was repaid in full and the agreement was terminated. The Company replaced the prior credit facility and entered into a new facility (the Credit Agreement) with the Lender.

The Credit Agreement provides for:

- (a) a term loan in an aggregate principal amount of \$81.75 million
- (b) a \$15 million asset-based revolving line-of-credit
- (c) an uncommitted accordion facility to be used to fund acquisitions of up to \$90 million.

Concurrent with the consummation of the Business Combination, the full amount of the term loan was drawn and there were no amounts drawn on the other two facilities. Each facility matures on November 23, 2020. The Company recorded \$6.4 million of debt issuance costs in connection with the new facility as a reduction to the carrying amount of the new term loan. These costs are being amortized using the effective interest method over the life of the term loan.

The principal amount of the term loan amortizes in quarterly installments which increase after each annual period. The quarterly installments range from 0.625% to 2.500% of the original principal amount and are paid through the quarter ending September 30, 2019. The remaining unpaid principal is due on the maturity date of November 23, 2020.

At the Company's election, the interest rate per annum applicable to all the facilities is based on a fluctuating rate of interest. The interest rate in effect as of December 31, 2016 was 10.55%. The Borrowers may elect to use either a Base Rate or a Eurodollar Rate. The interest rate per annum for electing the Base Rate is equal to the sum of 6.80% plus the Base Rate, which is equal to the highest of: (a) the base commercial lending rate of the Collateral Agent as publicly announced to be in effect from time to time, as adjusted by the Collateral Agent; (b) the sum of 0.50% per annum and the Federal Funds Rate (as defined in the Credit Agreement); (c) the daily one month LIBOR rate as published each business day in the Wall Street Journal for a one month period divided by a number equal to 1.00 minus the Reserve Percentage (as defined in the Credit Agreement) plus 100 basis points, as of such day and; (d) 2.00%.

The interest rate per annum for electing the Eurodollar Rate will be equal to the sum of 7.80% plus the Eurodollar Rate, which is equal to the highest of: (a) the amount calculated by dividing (x) the rate which appears on the Bloomberg Page BBAM1, or the rate which is quoted by another authorized source, two business days prior to the commencement of any interest period as the LIBOR for such an amount by (y) a number equal to 1.00 minus the Reserve Percentage (as defined in the Credit Agreement) and; (b) 1.00%.

Advances under the revolving line-of-credit are limited by a borrowing base which may not exceed the lesser of (x) the difference between \$15,000,000 and amounts outstanding under letters of credit issued pursuant to the Credit Agreement; and (y) an amount equal to the sum of: (i) up to 85% of certain accounts receivable of the Company plus (ii) up to 100% of unrestricted cash on deposit in the Company's accounts with the Collateral Agent, minus (iii) amounts outstanding under letters of credit issued pursuant to the Credit Agreement, minus (iv) reserves established by the Collateral Agent from time to time in its reasonable credit judgment exercised in good faith.

The Company is also subject to certain provisions which will require mandatory prepayments of its term loan and has agreed to certain minimums for its fixed charge coverage ratio and consolidated EBITDA and certain maximums for its senior secured leverage ratio, as defined in the Credit Agreement.

Future annual maturities of long-term debt outstanding at December 31, 2016 are as follows (in millions):

<u>Year Ending December 31,</u>	
2017	4.50
2018	6.34
2019	6.13
2020	60.05
	<u>\$ 77.02</u>

Debt and Covenant Compliance

As of September 30, 2016, the Company did not meet the required consolidated senior secured leverage ratio and minimum consolidated EBITDA under the Credit Agreement. The Company remained in compliance with the Credit Agreement using a provision of the Credit Agreement that allowed us to cure (the "Cure Right") certain covenant non-compliance by issuances of Common Stock for cash and use of the proceeds to reduce the principal balance of the term loan.

On November 14, 2016, we entered into Common Stock Purchase Agreements with Simon S. Lee Management Trust, for which Simon Lee, our Chairman, is Trustee, and Phillip E. Lacombe, our President and Chief Operating Officer (collectively, the "Investors") that provided for the sale to the Investors of 462,778 shares of Common Stock at a purchase price of \$3.60 per share, an aggregate of approximately \$1.7 million. We used the proceeds to reduce the principal balance of the term loan as required to effect the Cure Right.

The Credit Agreement does not allow the Company to exercise the Cure Right in consecutive fiscal quarters, more than three fiscal quarters in the aggregate, or in no more than two of any four fiscal quarters. The amount allowed under the Cure Right may not exceed \$2.5 million and 20% of consolidated EBITDA. The aggregate Cure Rights may not exceed \$5 million.

As of December 31, 2016, the Company did not meet the required consolidated senior secured leverage ratio and minimum consolidated EBITDA required in the Credit Agreement. The Company was in compliance with all other financial covenants.

On February 24, 2017, we entered into a Limited Forbearance to Credit Agreement (the "Forbearance Agreement") with MC Admin Co LLC and other lenders relating to the Credit Agreement.

In the Forbearance Agreement, the lenders agreed to forbear from exercising rights and remedies (including enforcement and collection actions), for which we agreed to pay a fee of up to \$750,000, related to our failure to comply with the Specified Financial Covenants. The Forbearance Agreement requires us to obtain lender consent prior to use of our revolving credit facility during the period of forbearance. The forbearance expired on March 31, 2017. On or after the termination of forbearance, the lenders may proceed to enforce any or all of their rights and remedies. The Company also agreed to pay an additional two percent (2%) per annum in interest on the amount outstanding under the loans under the Credit Agreement from January 1, 2017, until the earlier of (1) the date on which all loans under the Credit Agreement are repaid and (2) the date on which the non-compliance with the Specified Financial Covenants is waived by the lenders.

The Company entered into a Limited Waiver (“the Waiver”) from MC Admin Co LLC and other lenders under the Credit Agreement as of March 31, 2017, pursuant to which the lenders waived the Company’s noncompliance with the specified Financial Covenants as of December 31, 2016. Pursuant to the Waiver:

- Loans under the Credit Agreement are subject to additional interest at a rate of 2% per annum until the earliest of (x) the date on which all loans are repaid and all commitments under the Credit Agreement are terminated, (y) the date we deliver the financial statements and certificates for the quarter ending March 31, 2017 showing that we are not in default under the Credit Agreement or (z) the date on which default interest is otherwise due under the Credit Agreement;
- We must obtain lender consent prior to use of our revolving credit facility; and
- We cannot effect a Cure Right in respect of the quarter ending March 31, 2017.

The Credit Agreement also provides that the minimum consolidated EBITDA requirement will be increased on June 30, 2017. If our business continues to perform at the current level through that period, we do not expect to satisfy that covenant or the senior secured leverage ratio at that time, and it is likely that we will be in non-compliance at March 31, 2017. An inability to meet the required covenant levels could have a material adverse impact on us, including the need for us to effect an additional Cure Right or obtain additional forbearance or an amendment, waiver, or other changes in the Credit Agreement. The Credit Agreement does not allow the Company to exercise the Cure Right in consecutive fiscal quarters, more than three fiscal quarters in the aggregate, in more than two of any four fiscal quarters or for the quarter ending March 31, 2017. The amount allowed under the Cure Right may not exceed the lesser of \$2.5 million and 20% of consolidated EBITDA. The aggregate of Cure Rights may not exceed \$5 million. The Waiver does not apply to covenant non-compliance after December 31, 2016 or to covenants other than the Specified Financial Covenants. Any additional forbearance, amendment or waiver under the Credit Agreement may result in increased interest rates or premiums and more restrictive covenants and other terms less advantageous to us, and may require the payment of a fee for such forbearance, amendment or waiver. Although we anticipate that we will be able to renegotiate the financial covenants either through a new credit agreement in connection with the anticipated financing of our planned acquisition of PSS or in the event the acquisition of PSS is not completed, through an amendment of the existing financial covenants under our current Credit Agreement, if we are unsuccessful in executing an amendment to the existing financial covenants, we may not be able to obtain a forbearance, waiver or effect a cure, on terms acceptable to us.

If we are not able to effect an amendment to the Credit Agreement, any future covenant non-compliance will give rise to an event of default thereunder if we are unable to effect a Cure Right or otherwise obtain forbearance or a waiver in which case the indebtedness under the Credit Agreement could be declared immediately due and payable, which could have a material adverse effect on the Company.

Consolidated Condensed Statements of Cash Flows for the Year Ended December 31, 2016, the Periods November 24, 2015 to December 31, 2015 (Successor), January 1, 2015 to November 23, 2015 (Predecessor), and Year Ended December 31, 2014 (Predecessor)

<i>(in millions)</i>	Successor Year Ended, December 31, 2016	Successor November 24, 2015 to December 31, 2015	Predecessor January 1, 2015 to November 23, 2015	Predecessor Year Ended, December 31, 2014
Cash (used in) provided by operating activities	\$ (1.91)	\$ (9.60)	\$ 34.42	\$ 13.99
Cash provided (used in) by investing activities	3.80	(69.23)	(1.38)	(1.28)
Cash used in financing activities	(2.56)	78.95	(31.20)	(12.53)
Net (decrease) increase in cash and cash equivalents	(0.66)	0.12	1.84	0.18
Cash and cash equivalents at beginning of period	8.50	8.38	0.34	0.16
Cash and cash equivalents at end of period	<u>\$ 7.84</u>	<u>\$ 8.50</u>	<u>\$ 2.18</u>	<u>\$ 0.34</u>
Depreciation and amortization	8.96	1.03	1.55	1.8
Capital expenditures	(0.01)	(0.1)	(1.38)	(1.28)

Year Ended December 31, 2016 compared to Periods November 24, 2015 through December 31, 2015 (Successor) and the period January 1, 2015 to November 23, 2015 (Predecessor)

Cash used in operating activities

Operating cash flows are primarily affected by the Company's ability to invoice and collect from its clients in a timely manner, its ability to manage its vendor payments, the overall profitability of its contracts and its cash interest expense. Customers are mostly billed monthly after services are rendered.

For the year ended December 31, 2016 (Successor), cash flows used in operating activities were (\$1.9) million. The cash flows used in operating activities were significantly impacted by a net loss of (\$48.2) million and a distribution of (\$3.8) million triggered by the Business Combination offset by adding back the non-cash impairment of goodwill in the amount of \$41.3 million, and a net increase in cash due to changes in accounts receivable of \$4.2 million.

In the period November 24, 2015 to December 31, 2015, cash flows used in operating activities were (\$9.6) million. The cash flows used in operating activities were significantly impacted by (a) a net loss of (\$0.3) million, (ii) payments for accrued payroll and payroll related liabilities of (\$4.3) million, and (iii) payments of accounts payable and accrued expenses of (\$6.4) million, which included \$2.8 million of accrued transaction costs and professional service fees, and (iv) partially offset by a net increase in cash due to changes in accounts receivable of \$1.5 million.

In the period January 1, 2015 to November 23, 2015, cash flows provided by operating activities were \$34.4 million. The cash flows provided by operating activities were significantly impacted by the (i) net income of \$3.9 million and (ii) improved accounts receivable collections for \$13.2 million, (iii) increases in accounts payable and accrued expenses of \$9.3 million which included accrued transaction costs and professional fees incurred by the Company related to the Business Combination and paid upon consummation of the Business Combination. (iii) operating income included \$3.0 million in non-cash impairment loss charges related to goodwill and intangible assets, (iv) a \$1.1 million one-time non-cash loss incurred on capitalized leasehold improvements written off due to the Company moving premises in the period ended November 23, 2015, and (v) a, \$0.7 million one-time lease termination cost associated with subletting two floors on a previous premises at a loss to maturity of the agreement There was an increase of \$20.4 million over the prior year. Interest per annum remained consistent with that for the same period in 2014.

The Company had cash collections of \$168.7 million or 103% of revenue for the year ended December 31, 2016, \$160.9 million, or 83.1% of revenue for the year ended December 31, 2015 and \$162.2 million. Collections have improved as a percent of revenue year over year as a result of efforts to maximize cash realization.

The Company computes accounts receivable days sales outstanding ("DSO") based on trailing three-month revenue. Days sales outstanding decreased by 1 day from 66 days as of December 31, 2015, to 65 days as of December 31, 2016. Total receivables for purposes of the DSO calculation includes both billed and unbilled receivables.

Cash used in investing activities

For the year ended December 31, 2016, cash flows provided by investing activities of \$3.8 million is primarily proceeds from the sale of the investments held in the Rabbi Trust for distribution to the plan participants.

In the period November 24, 2015 to December 31, 2015, cash flows used in investing activities were (\$69.2) million. The cash flows used in investing activities were primarily the result of the acquisition of the Company for \$69.2 million, net of \$2.2 million of cash acquired.

In the period January 1, 2015 to November 23, 2015, cash flows used in investing activities were (\$1.4) million. The cash flows used in investing activities were primarily the result of investing in equipment and software, and leasehold improvements of \$1.4 million primarily the result of the Company's headquarters relocation.

Cash used in financing activities

For the year ended December 31, 2016, cash flows used in financing activities was (\$2.6) million, the net of payments due on the Company's term debt of (\$4.2) million offset by the proceeds of the issuance of Company stock of \$1.7 million as a result of the exercise of the Cure Right on November 14, 2016.

In the period November 24, 2015 through December 31, 2015, cash flows provided by financing activities were \$78.9 million. The cash flows provided by financing activities were primarily the result of (i) net proceeds from the Term Loan on our Credit Facility of \$81.8 million, partially offset by debt issuance costs of (\$6.4) million, (ii) redemption of redeemable common stock of (\$21.6) million, (ii) net proceeds from the issuance of common stock of \$11.0 million, partially offset by payments of deferred underwriters fees of (\$1.9) million (iv) repayment of notes to the Sponsor of (\$5.0) million and (v) repayment of the first installment of principal under the Term Loan of (\$0.5) million.

In the period January 1, 2015 to November 23, 2015, cash flows used in financing activities were (\$31.2) million. The cash flows provided by financing activities were primarily the result of (i) repayment of the prior revolving credit facility at November 23, 2015 of (\$13.5) million, (ii) decrease of outstanding checks in excess of the bank balance of (\$6.1) million, (iii) distributions to the Predecessor's stockholders of (\$9.0) million, and the issuance of a note receivable of (\$2.5) million.

Depreciation and Amortization

Depreciation and amortization totaled \$9.0 million for the year ended December 31, 2016, compared to \$1.0 million and \$1.6 million for the period November 24, 2015 through December 31, 2015 and the period January 1, 2015 through November 23, 2015, respectively. The \$6.4 million increase was primarily due to the amortization of the intangible assets recorded as a result of the Business Combination.

Capital Expenditures

Capital expenditures for property, plant, and equipment totaled \$0.01 million for the year ended December 31, 2016 compared to \$0.01 million and \$1.4 million for the period November 24, 2015 to December 31, 2015 and January 1, 2015 to November 23, 2015, respectively. Capital expenditures were lower in 2016 due to expenditures in 2015 related to the build out for the Company's new headquarters.

Cash Paid for Income Taxes

Cash paid for income taxes, net of refunds totaled \$0.6 million, \$0 million, \$0.2 million and \$0.3 million for the year ended December 31, 2016, periods November 24, 2015 to December 31, 2015 and January 1, 2015 to November 23, 2015 and the year ended December 31, 2014, respectively.

The Combined Periods for the Year Ended December 31, 2015 Compared to Year Ended December 31, 2014

Cash used in operating activities

Operating cash flows are primarily affected by the Company's ability to invoice and collect from its clients in a timely manner, its ability to manage its vendor payments, the overall profitability of its contracts and its cash interest expense. Customers are mostly billed monthly after services are rendered.

In the year ended December 31, 2015, cash flows used in operating activities were \$24.8 million. The cash flows used in operating activities were significantly impacted by (a) the consolidated net income of \$3.6 million, (ii) payments for accrued payroll and payroll related liabilities of (\$2.7) million, and (iii) payments of accounts payable and accrued expenses of \$2.9 million, (iv) partially offset by a net increase in cash due to changes in accounts receivable of \$14.7 million, (v) operating income included \$3.0 million in non-cash impairment loss charges related to goodwill and intangible assets, (vi) a \$1.1 million one-time non-cash loss incurred on capitalized leasehold improvements written off due to the Company moving premises during 2015, and (vii) a \$0.7 million one-time lease termination cost associated with subletting two floors on a previous premises at a loss to maturity of the agreement. There was an increase of \$24.8 million over the prior year.

For the year ended December 31, 2015 (predecessor and successor periods), the Company had cash collections of \$160.9 million or 83% of revenue in 2015. For the year ended December 31, 2014, the Company collected cash of \$162.2 million which was 77% of revenue recognized in 2014. The Company improved its cash collections as a percent of revenue recognized in 2015 versus 2014. The Company continues to develop efficiencies in an effort to maximize cash realization.

The Company computes accounts receivable days sales outstanding ("DSO") based on trailing three-month revenue. Days sales outstanding decreased by 17 days from 83 days as of December 31, 2014, to 66 days as of December 31, 2015. Total receivables for purposes of the DSO calculation includes both billed and unbilled receivables.

Cash used in investing activities

In the combined year ended December 31, 2015, cash flows used in investing activities were (\$70.6) million. The cash flows used in investing activities were primarily the result of the acquisition of the Company for \$71.7 million, net of \$2.2 million of cash acquired. The cash flows used in investing activities were primarily the result of investing in equipment and software, and leasehold improvements for \$1.4 million primarily the result of the Company's headquarters relocation compared to cash flows used in investing activities in 2014 of (\$1.3) million which was mainly a result of leasehold build out cost of the Company's old headquarters during 2014.

Cash used in financing activities

For the combined period ending December 31, 2015, cash flows provided by financing activities were \$47.8 million. The cash flows provided by financing activities were primarily the result of (i) net proceeds from the Term Loan on our Credit Facility of \$81.8 million, partially offset by debt issuance costs of (\$6.4) million, (ii) redemption of redeemable common stock of (\$21.6) million, (iii) net proceeds from the issuance of common stock of \$11.0 million, partially offset by payments of deferred underwriters fees of (\$1.9) million (iv) repayment of notes to the sponsor of (\$5.0) million (v) repayment of the first installment of principal under the Term Loan of (\$0.5) million, (vi) repayment of the previous revolving credit facility of (\$13.5) million, (vii) decrease of outstanding checks in excess of the bank balance of (\$6.1) million, and (viii) distributions to the Predecessor's stockholders of (\$9.0) million.

Depreciation and Amortization

Depreciation and amortization totaled \$2.6 million for the year ended December 31, 2015 compared with \$1.8 million for the year ended 2014. The \$0.8 million increase in 2015 was primarily caused recording property, plant, and equipment and identifiable intangible assets at fair value in acquisition accounting for the Business Combination.

Capital Expenditures

Capital expenditures for property, plant, and equipment totaled \$1.4 million for the year ended December 31, 2015. Capital Expenditures totaled \$1.3 million for year ended December 31, 2014. Capital expenditures were higher in 2015 due to the build out for the Company's new headquarters. In 2014, the capital expenditures related to leasehold improvements to renovate the Company's old headquarters to be able to sublease the facility.

Cash Paid for Income Taxes

Cash paid for income taxes, net of refunds totaled \$0.2 million and \$0.3 million for the combined year ended December 31, 2015 and the year ended December 31, 2014, respectively.

Off-Balance Sheet Arrangements

Company accounts for operating leases entered into in the routine course of business in accordance with ASC 840 Leases. At December 31, 2016, the Company has no off-balance sheet financing arrangements other than operating leases. During the predecessor period of January 1, 2015 through November 23, 2015, the Company had a letter of credit related to an operating lease previously issued under STG Group's terminated credit facility. At December 31, 2015, the lease was secured by a cash security deposit of \$0.4 million. At December 31, 2014, a letter of credit had been issued and was outstanding for \$0.8 million. The Company has no relationship with any unconsolidated or special purpose entity and has not issued any guarantees.

Short-term borrowings

The following table summarizes the activity under STG Group's prior revolving credit facility for the years ended December 31, 2016, 2015 and 2014, not including issued and outstanding letters of credit:

Short term borrowings	2016	Year Ended December 31,	
		2015	2014
		(in millions)	
Balance – beginning of period	\$ 0	\$ 13.5	\$ 20.0
Net revolving credit facility repayments	-	(13.5)	(6.5)
Net change in revolving credit facility balance payable	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 13.5</u>

Because the Company did not meet the required consolidated senior secured leverage ratio and minimum consolidated EBITDA required in the Credit Agreement as of December 31, 2016, the \$15 million of borrowings under the revolving credit facility are only available subject to lender consent

Contingent obligations

From time to time we may be involved in litigation in the normal course of our business. Our management does not expect that the resolution of these matters would have a material adverse effect on our business, operations, financial condition or cash flows.

We have no other contingent obligations.

Related Party Transactions

On November 14, 2016, we entered into Common Stock Purchase Agreements with the Investors that provided for the sale to the Investors of 462,778 shares of Common Stock at a purchase price of \$3.60 per share, an aggregate of approximately \$1.7 million. We used the proceeds to reduce the principal balance of the term loan under the Credit Agreement as required to effect the Cure Right.

A company owned by a party related to the majority stockholder of the Company is both a subcontractor to and customer of the Company on various contracts. As of December 31, 2016 and 2015, amounts due from this entity totaled \$0.01 million and \$0.02 million respectively. The Company recorded revenue of \$0.01 million for the year ended December 31, 2016, \$0.01 million and \$0.11 million, respectively, for the periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015.

There was no work performed under subcontracts with this entity during the year ended December 31, 2016, however the Company recorded direct costs of \$0.02 million for the period from January 1, 2015 through November 23, 2015 and \$0.14 million for the year ended December 31, 2014 relating to such work performed.

On September 15, 2015, the Company issued a note receivable to the Predecessor's stockholder for \$2.5 million. The note bore interest at 2.35%. The principal and accrued interest was payable in full on the earlier of December 31, 2015 or the closing of the Business Combination which is described previously in Note 2. This note was satisfied with the closing of the Business Combination that took effect on November 23, 2015

On November 23, 2015, Global Strategies Group (North America) Inc., an affiliate of Holdings, and the Company entered into a services agreement, pursuant to which the Company may retain Global Strategies Group (North America) Inc. from time to time to perform certain services: corporate development services such as assisting the Company in post-integration matters, regulatory compliance support services, financial services and financial reporting, business development and strategic services, marketing and public relations services, and human resources services. Global Strategies Group (North America) Inc. is an affiliate of both the Company and a Board member. Amounts paid and expensed under this agreement during the year ended December 31, 2016 totaled \$0.6 million.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company evaluates its estimates on an ongoing basis, based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. The following policies and procedures are considered by management to be the most critical in understanding the judgments that are involved in the preparation of our consolidated financial statements and the uncertainties that could impact our results of operations, financial position, and cash flows. Application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. Although the Company has listed a number of accounting policies below which it believes to be the most critical, the Company also believes that all of its accounting policies are important to the reader. Therefore, please see Note 1 "Summary of Significant Accounting Policies", of the accompanying consolidated financial statements of the Company appearing elsewhere in this Annual report.

Goodwill, Other Intangible Assets and Other Long-Lived Assets:

The Company's goodwill, other intangible assets and tangible fixed assets are held at historical cost, net of depreciation and amortization, less any provision for impairment. Tangible assets with determinable lives are amortized or depreciated on a straight line basis over their estimated useful lives. Other intangible assets are comprised of customer relationships and trade name acquired as a result of the Business Combination. The Company has determined that the customer relationships and trade name represent finite-lived intangible assets with useful lives ranging from 8 to 15 years, respectively. The assets are being amortized proportionately over the term of their useful lives based on the estimated economic benefit derived over the course of the asset life.

Intangible Assets	
Goodwill	No Amortization
Customer Relationships	Amortized over 8 years
Trade Name	Amortized over 15 years
Tangible Asset	
Leasehold Improvements	Life of lease
Furniture and Fixtures	1-7 years
Computer Equipment and Software	1-3 years

On an annual basis, or more frequently if triggering events occur, the Company compares the estimated fair value of its reporting unit to the carrying value to determine if a potential goodwill impairment exists. If the fair value of the reporting unit is less than the carrying value, an impairment loss, if any, is recorded for the difference between the implied fair value and the carrying value of the unit's goodwill. The estimated fair value represents the amount at which a reporting unit could be bought or sold in a current transaction between willing parties on an arms-length basis. In estimating the fair value, the Company uses several models, which are dependent on a number of assumptions including estimated future revenues and expenses, weighted average cost of capital, capital expenditures and other variables. The Company also reviews other intangible assets and tangible fixed assets for impairment when events or changes in business circumstances indicate that the carrying amount of assets may not be fully recoverable. If such indicators are present, the Company performs undiscounted cash flow analyses to determine if an impairment exists. If an impairment is determined to exist, any impairment loss is calculated based on fair value.

As a result of the Business Combination, the carrying value of the Company's reporting unit was equal to its fair value on the acquisition date. The stock consideration was valued at the estimated fair value per share using the three day average closing prices of Company, shares traded preceding the Business Combination or \$10.63 per share and then was discounted by approximately 20% for a lack of marketability or a share price of \$8.50 a share.

In performing the annual goodwill impairment assessment in the fourth quarter of 2015, the fair value exceeded the carrying value in the reporting unit. As the carrying values of tangible assets and other intangible assets with the reporting unit decrease due to depreciation and amortization and the fair value of the reporting unit increases through value creation, we expect the estimated fair value to increase in the future. The Company is subject to financial risk in the event that business or economic conditions unexpectedly decline and goodwill becomes impaired.

For impairment testing for the year ended December 31, 2016, the Company engaged a third party valuation firm to assist management with determining fair value estimates for the Company's only reporting unit in the first step of the goodwill impairment test, and in estimating fair values of tangible and intangible assets used in the second step of the goodwill impairment test. In connection with obtaining an independent third party valuation, management provided certain information and assumptions that were utilized in the fair value calculation. Significant assumptions used in determining reporting unit fair value include forecasted cash flows, revenue growth rates, adjusted EBITDA margins, weighted average cost of capital (discount rate), assumed tax treatment of a future sale of the reporting unit, terminal growth rates, capital expenditures, sales and EBITDA multiples used in the market approach, and the weighting of the income and market approaches. The fair value of the Company's only reporting unit is determined using the discounted cash flow valuation methodology primarily based on the Company's five year plan. Two market based approaches were performed as well to gain additional comfort that the guideline public company analysis resulted in a similar range of value.

For the year ended December 31, 2016, the Company's third party valuation firm performed the first step of the annual goodwill impairment test in the fourth quarter of 2016 and determined that the estimated fair value of the Company's sole reporting unit was lower than the carrying value, requiring further analysis under the second step of the impairment test. The decline in the estimated fair value of the Company was primarily due to significantly lower revenue in 2016 than planned. Growth rates in future years remain comparable to the prior planned growth however future revenue and related profits are less than the previous plan due to significantly lower 2016 revenue.

In performing the second step of the impairment testing, the Company's third party valuation firm performed a theoretical purchase price allocation for the Company to determine the implied fair values of goodwill which were compared to the recorded amounts of goodwill for the Company's sole reporting unit.

Upon completion of the second step of the goodwill impairment test, the Company recorded a noncash goodwill impairment charge of \$41 million, or 36% of the total goodwill asset. Additional sensitivity testing was completed using assumptions of only achieving 90% and 85% of the 2017 forecasted plan with other major assumptions including growth rates, profit margins, and discount factors remaining the same. The result of this analysis was an estimated additional goodwill impairment of between \$5 million and \$8 million and \$11 million and \$14 million respectively. The Company also has some flexibility in its ability to control indirect costs during 2017 that could mitigate any shortfalls in our 2017 revenue and profit estimates.

The goodwill impairment charges are recorded as impairment charges in the consolidated statements of operations. The assumptions that have the most significant impact on determination of the reporting unit fair value are the growth rate of estimated free cash flows, including 3 percent in the terminal year, maintaining adjusted EBITDA margins of 10% throughout the forecast period, and the weighted average cost of capital (discount rate), of 15.08%. A change in any of these assumptions, individually or in the aggregate, or future financial performance that is below management expectations may result in the carrying value of this reporting unit exceeding its fair value and could result in additional impairment to goodwill and amortizable intangible assets in future periods.

In connection with the evaluation of the goodwill impairment, the Company assessed intangible assets for impairment prior to performing the first step of the goodwill impairment test. As a result of this analysis, the undiscounted future cash flows of each asset group within the Company's sole reporting unit exceeded the recorded carrying values of the net assets within each asset group, and as such, no noncash impairment charges resulted from such assessment.

A considerable amount of management judgments and assumptions is required in performing the impairment tests, principally in determining the fair value of the reporting unit and specifically identifiable intangible and tangible assets. While the Company believes its judgments and assumptions are reasonable, different assumptions could change the estimated fair values and, therefore, additional impairment charges could be required in future periods.

Income Taxes

The Company is subject to income taxes in the United States. Significant judgment is required in determining our provision for income taxes and recording the related deferred tax assets and liabilities. The Company assesses its income tax positions and records tax liabilities for all years subject to examination based upon management's evaluation of the facts and circumstances and information available at the reporting dates. For those income tax positions where it is more-likely-than-not that a tax benefit will be sustained upon the conclusion of an examination, the Company has recorded the largest amount of tax benefit having a cumulatively greater than 50% likelihood of being realized upon ultimate settlement with the application taxing authority assuming that it has full knowledge of all relevant information. For those income tax positions that do not meet the more-likely-than-not threshold regarding the ultimate realization of the related tax benefit, no tax benefit has been recorded in the financial statements.

The Company recognizes deferred tax assets and liabilities for the future tax consequences attributable to differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases, net operating losses, tax credit and other carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered, or settled. The Company regularly reviews its deferred tax assets for recoverability and establishes a valuation allowance based on historical losses, projected future taxable income and the expected timing of the reversals of existing temporary differences. As a result of this review, the Company has not established any reserves at this time. Future tax authority rulings and changes in tax laws, changes in projected levels of taxable income and future tax planning strategies could affect the actual effective tax rate and tax balances recorded. See Note 13 "Income Taxes", of the accompanying consolidated financial statements for further discussion.

Use of Estimates

The Company records reserves or allowances for doubtful accounts, incurred by not reported claims, litigation, and incentive compensation. These reserves require the use of estimates and judgment. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. The Company believes that such estimates are made on a consistent basis and with appropriate assumptions and methods. However, actual results may differ from these estimates.

Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, services have been rendered or goods delivered, the contract price is fixed or determinable and collectability is reasonably assured. Revenue associated with work performed prior to the completion and signing of contract documents is recognized only when it can be reliably estimated and realization is probable. The Company bases its estimates on previous experiences with the customer, communications with the customer regarding funding status and its knowledge of available funding for the contract.

Revenue on cost-plus-fee contracts is recognized to the extent of costs incurred plus a proportionate amount of the fee earned. The Company considers fixed fees under cost-plus-fee contracts to be earned in proportion to the allowable costs incurred in performance of the contract. The Company considers performance-based fees, including award fees, under any contract type to be earned when it can demonstrate satisfaction of performance goals, based upon historical experience, or when the Company receives contractual notification from the customer that the fee has been earned. Revenue on time-and-materials contracts is recognized based on the hours incurred at the negotiated contract billing rates, plus the cost of any allowable material costs and out-of-pocket expenses. Revenue on fixed-price contracts is primarily recognized using proportional performance method of contract accounting. Unless it is determined as part of the Company's regular contract performance review that overall progress on a contract is not consistent with costs expended to date, the Company determines the percentage completed based on the percentage of costs incurred to date in relation to total estimated costs expected upon completion of the contract. Revenue on fixed-price services contracts is primarily recognized on a straight-line basis over the contractual service period, unless the revenue is earned, or obligations fulfilled, in a different manner.

Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined and are recorded as forward loss liabilities in the consolidated financial statements. Changes in job performance, job conditions and estimated profitability may result in revisions to costs and revenue and are recognized in the period in which the revisions are determined.

Contract Receivables

Contract receivables are generated primarily from prime and subcontracting arrangements with federal government agencies. Billed contract receivables represent invoices that have been prepared based on contract terms and sent to the customer. Billed accounts receivable are considered past due if the invoice has been outstanding more than 30 days. The Company does not charge interest on accounts receivable; however, federal governmental agencies are required under certain circumstances to pay interest on invoices outstanding more than 30 days. The Company records interest income from federal governmental agencies when received. All contract receivables are on an unsecured basis.

Unbilled amounts represent costs and anticipated profits awaiting milestones to bill, contract retainages, award fees and fee withholdings, as well as amounts currently waiting to be invoiced.

In accordance with industry practice, contract receivables relating to long-term contracts are classified as current, even though portions of these amounts may not be realized within one year.

Management determines the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history, and current economic conditions. Management has recorded an allowance for contract receivables that are considered to be uncollectible. Both billed and unbilled receivables are written off when deemed uncollectible. Recoveries of receivables previously written off are recorded when received.

New Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which establishes a comprehensive revenue recognition standard for virtually all industries under GAAP, including those that previously followed industry-specific guidance. Under the guidance, all entities should recognize revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additionally, various updates have been issued during 2015 and 2016 to clarify the guidance in Topic 606. The guidance is effective for the Company in the first quarter of 2018. Early adoption is permitted. Management has not yet assessed the potential impact of this guidance on the consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. ASU 2014-15 explicitly requires management to evaluate, at each annual or interim reporting period, whether there are conditions or events that exist which raise substantial doubt about an entity's ability to continue as a going concern and to provide related disclosures. The guidance is effective for annual periods ending after 15 December 2016 and for annual periods and interim periods thereafter. See Note 1 of the Financial Statements.

In September 2015, the FASB issued ASU 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments*. This ASU eliminates the requirement to retrospectively account for changes to provisional amounts initially recorded in a business combination. ASU 2015-16 requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustments are determined, including the effect of the change in provisional amount as if the accounting had been completed at the acquisition date. The provisions of this ASU are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years and should be applied prospectively to adjustments to provisional amounts that occur after the effective date. The adoption of this standard has not had a significant impact on the consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*. This ASU simplifies the presentation of deferred income taxes by eliminating the requirement for entities to separate deferred tax liabilities and assets into current and noncurrent amounts in classified balance sheets. Instead it requires deferred tax assets and liabilities be classified as noncurrent in the balance sheet. This ASU is effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted, and this ASU may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company has adopted this standard prospectively during the quarter ended June 30, 2016. The adoption of ASU 2015-17 resulted in the aggregation of a \$4.5 million deferred tax asset and a \$10.9 million deferred tax liability to a single line reported on the balance sheet as a non-current deferred tax liability in the amount of \$6.4 million.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The standard impacts both lessors and lessees. The most significant change for lessees is that the requirement to recognize right-to-use assets and lease liabilities for all leases not considered short term. The guidance is effective for fiscal years beginning after December 15, 2018, and will be applied on a modified retrospective basis. The Company is currently evaluating the expected impact of the adoption of this standard on the consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Compensation – Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting (ASU 2016-09)*. ASU 2016-09 is intended to simplify several aspects of accounting for share-based payment awards. The effective date will be the first quarter of fiscal year 2017, with early adoption permitted. The Company is evaluating the expected impact that adoption of this new standard will have on the consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. The amendments in this update clarify the guidance regarding the classification of operating, investing, and financing activities for certain types of cash receipts and payments. The amendments in this update are effective for the annual periods, and the interim periods within those years, beginning after December 15, 2017, and should be applied using a retrospective transition method to each period presented. Early adoption is permitted. The Company is evaluating the expected impact of adoption, if any, to the consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)*, which provides guidance on the presentation of restricted cash or restricted cash equivalents in the statement of cash flows. These amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The Company is currently evaluating the expected impact of the adoption of this guidance on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, "*Business Combinations (Topic 805) Clarifying the Definition of a Business*", which amends the guidance of FASB Accounting Standards Codification (ASC) Topic 805, "*Business Combinations*", adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions or disposals of assets or businesses. The definition of a business affects many areas of accounting including acquisitions, disposals, goodwill, and consolidation. This guidance is effective for annual and interim periods beginning after December 15, 2017, and early adoption is permitted under certain circumstances. We intend to evaluate the impact of this guidance on our consolidated financial statements and related disclosures in connection with the potential business combination as disclosed in note 15 to the consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04 "Intangibles-Goodwill and Other (Topic 350) Simplifying the Test for Goodwill Impairment" ("ASU 2017-04"). ASU 2017-04 provides guidance to simplify the subsequent measurement of goodwill by eliminating the Step 2 procedure from the goodwill impairment test. Under the updates in ASU 2017-04, an entity should perform its annual or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The amendments of this ASU are effective for annual or any interim goodwill impairment tests beginning after December 15, 2019. The Company has not yet evaluated the impact, if any, that the adoption of ASU 2017-04 will have on our Consolidated Financial Statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

STG Group, Inc.

Financial Report
December 31, 2016

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Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
STG Group, Inc.
Reston, VA

We have audited the accompanying consolidated balance sheet of STG Group, Inc. (“Successor” or the “Company”) as of December 31, 2016 and 2015 and the related consolidated statements of operations, stockholders’ equity, and cash flows for the period from November 24, 2015 through December 31, 2015 and the year ended December 31, 2016. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of STG Group, Inc. at December 31, 2016 and 2015, and the results of its operations and its cash flows for the period from November 24, 2015 through December 31, 2015 and year ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO USA, LLP

McLean, Virginia
April 17, 2017

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
STG Group, Inc.
Reston, VA

We have audited the accompanying consolidated balance sheet of STG Group Holdings, Inc. (“Predecessor”) as of December 31, 2014 and the related consolidated statements of operations, stockholders’ equity, and cash flows for the period from January 1, 2015 through November 23, 2015 and the year ended December 31, 2014. These consolidated financial statements are the responsibility of the Predecessor management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of STG Group Holdings, Inc. at December 31, 2014, and the results of its operations and its cash flows for the period from January 1, 2015 through November 23, 2015 and the year ended December 31, 2014 in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO USA, LLP

McLean, Virginia
April 17, 2017

STG Group, Inc.

Consolidated Balance Sheets

(In Thousands, Except Share and Per Share Amounts)

	December 31, 2016	December 31, 2015
Assets		
Current Assets		
Cash and cash equivalents	\$ 7,841	\$ 8,503
Contract receivables, net	28,784	32,824
Investments held in Rabbi Trust	332	4,517
Prepaid expenses and other current assets	2,294	1,357
Deferred income taxes	-	2,415
Total current assets	<u>39,251</u>	<u>49,616</u>
Property and equipment, net	1,157	1,698
Goodwill	72,313	113,589
Intangible assets, net	31,984	38,988
Other assets	423	432
Total assets	<u>\$ 145,128</u>	<u>\$ 204,323</u>
Liabilities and Stockholders' Equity		
Current Liabilities		
Long-term debt, current portion	\$ 4,496	\$ 2,555
Accounts payable and accrued expenses	11,683	9,605
Accrued payroll and related liabilities	6,391	8,441
Income taxes payable	-	561
Billings in excess of revenue recognized	688	304
Deferred compensation plan	332	4,517
Deferred rent	228	81
Total current liabilities	<u>23,818</u>	<u>26,064</u>
Long-term debt, net of current portion and discount	72,522	72,447
Deferred income taxes	6,354	12,630
Deferred rent	743	837
Total liabilities	<u>98,609</u>	<u>111,978</u>
Commitments and Contingencies		
Stockholders' Equity		
Preferred stock; \$0.0001 par value; 10,000,000 shares authorized; none issued and outstanding at December 31, 2016 and 2015	-	-
STG Group, Inc. (Successor) common stock; \$0.0001 par value; 100,000,000 shares authorized; 16,603,449 shares issued and outstanding at December 31, 2016 and 16,107,071 shares issued and outstanding at December 31, 2015	2	2
Additional paid-in capital	102,920	100,547
Accumulated deficit	(56,403)	(8,204)
Total stockholders' equity	<u>46,519</u>	<u>92,345</u>
Total liabilities and stockholders' equity	<u>\$ 145,128</u>	<u>\$ 204,323</u>

See accompanying notes to the consolidated financial statements.

STG Group, Inc.

Consolidated Statements of Operations

(In Thousands, Except Share and Per Share Amounts)

	Successor Year Ended <u>December 31, 2016</u>	Successor November 24, 2015 Through <u>December 31, 2015</u>	Predecessor January 1, 2015 Through <u>November 23, 2015</u>	Predecessor Year Ended <u>December 31, 2014</u>
Contract revenue	\$ 164,055	\$ 17,300	\$ 176,345	\$ 209,727
Direct expenses	<u>111,263</u>	<u>11,702</u>	<u>120,989</u>	<u>141,925</u>
Gross profit	52,792	5,598	55,356	67,802
Indirect and selling expenses	54,538	6,407	47,837	61,286
Impairment of goodwill	41,276	-	2,064	5,117
Impairment of other intangible assets	-	-	906	1,811
	<u>95,814</u>	<u>6,407</u>	<u>50,807</u>	<u>68,214</u>
Operating (loss) income	<u>(43,022)</u>	<u>(809)</u>	<u>4,549</u>	<u>(412)</u>
Other income (expense)				
Other income (expense), net	(354)	(132)	37	313
Interest expense	(8,725)	(898)	(57)	(70)
	<u>(9,079)</u>	<u>(1,030)</u>	<u>(20)</u>	<u>243</u>
(Loss) income before income taxes	(52,101)	(1,839)	4,529	(169)
Income tax (benefit) expense	(3,902)	(1,585)	644	-
Net (loss) income	<u>\$ (48,199)</u>	<u>\$ (254)</u>	<u>\$ 3,885</u>	<u>\$ (169)</u>
Net (Loss) income per share available to common stockholders				
Basic and diluted	<u>\$ (2.98)</u>	<u>\$ (0.02)</u>	<u>\$ 3,497</u>	<u>\$ (152)</u>
Weighted average number of common shares outstanding				
Basic and diluted	<u>16,172,040</u>	<u>16,107,071</u>	<u>1,111</u>	<u>1,111</u>

See accompanying notes to the consolidated financial statements.

STG Group, Inc.

Consolidated Statements of Stockholders' Equity

(In Thousands, Except Share Amounts)

	Common Stock		Additional	Stockholder	(Accumulated	Total
	Shares	Amount	Paid-In Capital	Note Receivable	Deficit) Retained Earnings	Stockholders' Equity
Balance, January 1, 2014, Predecessor	1,111	-	12,891	-	18,416	31,307
Distributions to stockholders	-	-	-	-	(8,181)	(8,181)
Net loss	-	-	-	-	(169)	(169)
Balance, December 31, 2014, Predecessor	1,111	-	12,891	-	10,066	22,957
Stockholder note receivable	-	-	-	(2,500)	-	(2,500)
Distributions to stockholders	-	-	-	-	(9,148)	(9,148)
Net income	-	-	-	-	3,885	3,885
Balance, November 23, 2015, Predecessor	1,111	-	12,891	(2,500)	4,803	15,194
Elimination of Predecessor common stock, additional paid-in capital, and retained earnings	(1,111)	-	(12,891)	2,500	(4,803)	(15,194)
Adjustment to reflect STG Group, Inc. common stock, additional paid-in capital, and accumulated deficit (Note 1)	3,027,986	-	6,939	-	(7,950)	(1,011)
Issuance of common stock to Predecessor stockholders in conjunction with the Business Combination (Note 2)	9,716,873	1	82,631	-	-	82,632
Issuance of common stock to Sponsor (Note 11)	1,030,103	-	10,950	-	-	10,950
Balance, November 24, 2015, Successor	13,774,962	1	100,520	-	(7,950)	92,571
Common stock dividends declared (2)	2,332,109	1	(1)	-	-	-
Stock-based compensation	-	-	28	-	-	28
Net loss	-	-	-	-	(254)	(254)
Balance, December 31, 2015, Successor	16,107,071	2	100,547	-	(8,204)	92,345
Issuance of common stock	462,778	-	1,666	-	-	1,666
Restricted stock awards	33,600	-	-	-	-	-
Stock-based compensation	-	-	707	-	-	707
Net loss	-	-	-	-	(48,199)	(48,199)
Balance, December 31, 2016, Successor	16,603,449	-	102,920	\$ -	(56,403)	46,519

(1) Adjustment to reflect STG Group, Inc. common stock, additional paid-in capital, and accumulated deficit is net of 2,031,383 shares of common stock redeemed, which reduced common stock and additional paid-in capital by \$21,594 (Note 11).

(2) The Company declared a dividend of one share of common stock for every 1.06 shares of common stock payable to stockholders of record immediately following the consummation of the Business Combination. Certain stockholders forfeited this right to receive the dividends as described further in Note 11.

See accompanying notes to the consolidated financial statements.

STG Group, Inc.

Consolidated Statements of Cash Flows

(In Thousands, Except Share Amounts)

	Successor	Successor	Predecessor	Predecessor
	Year Ended December 31, 2016	November 24 , 2015 Through December 31, 2015	January 1, 2015 Through November 23, 2015	Year Ended December 31, 2014
Cash Flows From Operating Activities				
Net (loss) income	\$ (48,199)	\$ (254)	\$ 3,885	\$ (169)
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:				
Bad debt expense (recoveries)	(210)	-	-	200
Lease termination costs	-	-	703	-
Deferred rent	53	66	(40)	(1,009)
Deferred taxes	(3,861)	(1,598)	(90)	-
Amortization of deferred financing costs	1,409	119	-	-
Depreciation and amortization of property and equipment	549	57	842	1,179
Amortization of intangible assets	7,004	852	710	625
Impairment of goodwill	41,276	-	2,064	5,117
Impairment of other intangible assets	-	-	906	1,811
Net loss on disposal of property and equipment	-	-	1,113	40
Stock-based compensation	707	28	-	-
Changes in assets and liabilities:				
(Increase) decrease in:				
Contract receivables	4,250	1,530	13,163	7,049
Prepaid expenses and other current assets	(937)	527	425	1,695
Other assets	9	(356)	24	80
Increase (decrease) in:				
Accounts payable and accrued expenses	2,078	(6,395)	9,254	(2,306)
Accrued payroll and related liabilities	(2,050)	(4,321)	1,589	(413)
Income taxes payable	(561)	-	-	-
Deferred compensation plan	(3,808)	-	-	-
Billings in excess of revenue recognized	384	142	(125)	92
Net cash (used in) provided by operating activities	(1,907)	(9,603)	34,423	13,991
Cash Flows From Investing Activities				
Acquisition of Predecessor business, net of cash acquired of \$2,184	-	(69,216)	-	-
Proceeds from the sale of property and equipment	-	-	16	-
Proceeds from sales of investments held in Rabbi Trust	3,808	-	-	-
Purchases of property and equipment	(8)	(10)	(1,397)	(1,280)
Net cash provided by (used in) investing activities	3,800	(69,226)	(1,381)	(1,280)
Cash Flows From Financing Activities				
Net repayments of line-of-credit	-	-	(13,520)	(6,517)
Increase (decrease) in outstanding checks in excess of bank balance	-	-	(6,141)	2,172
Proceeds from long-term debt	-	81,750	-	-
Payments on long-term debt	(4,221)	(512)	-	-
Payments on note to Sponsor	-	(4,986)	-	-
Deferred financing costs	-	(6,357)	-	-
Deferred underwriters' fees	-	(1,898)	-	-
Proceeds from issuance of common stock to Shareholders	1,666	10,950	-	-
Note receivable issued to Predecessor stockholder	-	-	(2,500)	-
Distributions to stockholders	-	-	(9,037)	(8,181)
Net cash (used in) provided by financing activities	(2,555)	78,947	(31,198)	(12,526)
Net (decrease) increase in cash and cash equivalents	(662)	118	1,844	185
Cash and Cash Equivalents				
Beginning	8,503	8,385	340	155
Ending	<u>\$ 7,841</u>	<u>\$ 8,503</u>	<u>\$ 2,184</u>	<u>\$ 340</u>
Supplemental Disclosure of Cash Flow Information				
Cash paid for interest	<u>\$ 7,316</u>	<u>\$ 779</u>	<u>\$ 16</u>	<u>\$ 70</u>

Cash paid for income taxes	\$ <u>615</u>	\$ <u>-</u>	\$ <u>184</u>	\$ <u>-</u>
Supplemental Disclosures of Non-Cash Investing Activities				
Change in investments held in Rabbi Trust	\$ <u>377</u>	\$ <u>113</u>	\$ <u>320</u>	\$ <u>615</u>
Change in deferred compensation plan	\$ <u>(377)</u>	\$ <u>(113)</u>	\$ <u>(320)</u>	\$ <u>(615)</u>
Property and equipment distributed to Predecessor stockholder	\$ <u>-</u>	\$ <u>-</u>	\$ <u>111</u>	\$ <u>-</u>
Issuance of 9,681,873 shares of common stock to Predecessor stockholder	\$ <u>-</u>	\$ <u>82,632</u>	\$ <u>-</u>	\$ <u>-</u>

See accompanying notes to the consolidated financial statements.

STG Group, Inc.

Notes to Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies

Nature of business: STG Group, Inc. (formerly, Global Defense & National Security Systems, Inc. or GDEF) and its subsidiaries (collectively, the Company) was originally incorporated in Delaware on July 3, 2013 as a blank check company, with Global Defense & National Security Holdings LLC (“Global Defense LLC” or the “Sponsor”) as Sponsor, formed for the purpose of effecting a merger, capital stock exchange, asset acquisition, stock purchase, reorganization, exchangeable share transaction or other similar business combination. On November 23, 2015, the Company consummated its business combination with STG Group Holdings, Inc. (formerly, STG Group, Inc. or “STG Group”) pursuant to the stock purchase agreement, dated as of June 8, 2015, which provided for the purchase of all the capital stock of STG Group by the Company (the “Business Combination”). In connection with the closing of the Business Combination, the Company ceased to be a shell company in accordance with its Amended and Restated Certificate of Incorporation. The Company also changed its name from Global Defense & National Security Systems, Inc. to STG Group, Inc., and the Company’s securities were delisted from The NASDAQ Capital Market. The Company recommenced trading of its common stock under the symbol “STGG” on the OTC Pink Current Information tier of the over-the-counter market. The Company’s common stock now trades over-the-counter on the OTCQB. See Note 2 for a further discussion of the Business Combination.

The Company provides enterprise engineering, telecommunications, information management and security products and services to the federal government and commercial businesses. Segment information is not presented since all of the Company’s revenue is attributed to a single reportable segment.

STG Group was incorporated in the State of Delaware on July 12, 2012, for the purpose of holding shares of STG, Inc. (STG) and the ownership interests of other entities in the future. Concurrent with the incorporation of STG Group, STG became a wholly-owned subsidiary of STG Group. Effective July 27, 2012, STG Ventures, LLC (STG Ventures) was created and its sole member was STG Group. On October 24, 2012, STG Netherlands, B.V. (STG Netherlands) was created as a cooperative in Amsterdam, and is 99% owned by STG Group and 1% owned by STG Ventures. Effective November 28, 2012, STG Doha, LLC (STG Doha) was incorporated in Doha, Qatar, and is 49% owned by STG Netherlands and 51% owned by Pro-Partnership, a local Qatar Company. STG Group holds full control over STG Doha due to an arrangement with the other partner, whereby the partner gives up ownership rights in lieu of a management fee paid to them by STG Group.

STG Ventures, STG Netherlands and STG Doha did not have significant activity from the dates of inception through the year ended December 31, 2016, periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015, and year ended December 31, 2014, since any activity would be eliminated entirely upon consolidation with STG Group or with the Company.

At the close of business on December 31, 2012, STG Group entered into a Reorganization and Acquisition Agreement with the stockholders of Access Systems, Incorporated (Access), a company incorporated under the laws of the Commonwealth of Virginia on June 15, 1992, to acquire all of the outstanding common stock of Access. Access provides software development and facilities management under contractual relationships, primarily with various agencies of the federal government. On January 2, 2013, STG Group contributed all of the outstanding common stock of Access to STG, Inc. As a result of the transfer, Access became STG, Inc.’s wholly owned subsidiary.

STG Group, Inc.

Notes to the Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

During the year ended December 31, 2013, STG Group formed STG Sentinel, LLC (Sentinel). During the year ended December 31, 2014, Sentinel formed STG Sentinel AFG, LLC (Sentinel AFG). STG Group is the sole member of Sentinel, which is the sole member of Sentinel AFG. There was no significant activity related to any of these subsidiaries formed during the year ended December 31, 2016, periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015, and year ended December 31, 2014.

A summary of the Company's significant accounting policies follows:

Basis of presentation and principles of consolidation: As a result of the Business Combination, the Company was identified as the acquirer for accounting purposes, and STG Group is the acquiree and accounting predecessor. This determination was based upon an evaluation of facts which included, but was not limited to, consideration of the following: 1) the relative voting rights of the stockholders in the combined entity after the Business Combination; 2) the composition of the board of directors of the combined entity; 3) the composition of the senior management team of the combined entity; 4) and the cash consideration that was transferred by the Company to the acquiree's shareholders. Based upon this evaluation, the preponderance of facts supported the conclusion that the Company was the accounting acquirer. The Company's consolidated financial statement presentation distinguishes a "Predecessor" for STG Group for the periods up to and prior to the Closing Date. The Company was subsequently re-named as STG Group, Inc. and is the "Successor" for periods after the Closing Date, which includes the consolidation of STG Group subsequent to the Business Combination. The acquisition was accounted for as a business combination using the acquisition method of accounting, and Successor financial statements reflect a new basis of accounting that is based on the fair value of the net assets acquired. See Note 2 for further discussion of the Business Combination. As a result of the application of the acquisition method of accounting as of the effective date of the acquisition, the financial statements for the Predecessor period and for the Successor period are presented on a different basis and, therefore, are not comparable.

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The consolidated financial statements include the accounts of STG Group, Inc. (Successor) and STG Group (Predecessor) and their wholly owned subsidiaries, including STG Doha, which is consolidated under the variable interest entity model. Activity under STG Doha is immaterial to these consolidated financial statements. These entities are collectively referred to as the Company. All intercompany accounts and transactions have been eliminated in the accompanying consolidated financial statements.

Figures are expressed in thousands of dollars unless otherwise indicated.

Going Concern Consideration: The accompanying consolidated financial statements have been prepared using the going concern basis of accounting, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business.

The Company was not in compliance with its financial covenants at September 30, 2016 or at December 31, 2016. At September 30, 2016, the non-compliance was cured by raising equity from stockholders' ("Equity Cure") as was allowed by the Lending Agreement. At December 31, 2016 the Company received a forbearance which expired on March 31, 2017. The Company entered into a Limited Waiver ("the Waiver") from MC Admin Co LLC and other lenders under the Credit Agreement as of March 31, 2017, pursuant to which the lenders waived the Company's non-compliance with the Specified Financial Covenants as of December 31, 2016. Based upon the preliminary results of operations through the first quarter of 2017, the Company anticipates that it will not be in compliance with the same financial covenants at March 31, 2017. One of the remedies the Lender has available to it, amongst others is the ability to accelerate repayment of the loan which the Company would not be able to immediately repay. The potential inability to meet financial covenants under the Company's existing Credit Agreement and the potential acceleration of the debt by the Lender resulting in the reclassification of our debt from a long-term liability to a current liability due to the potential of future covenant defaults required us to evaluate whether there is substantial doubt regarding the Company's ability to continue as a going concern.

Management's Plan to alleviate this condition is as follows:

1. Identify, qualify, and win new business to increase revenue and profits.
2. Complete the PSS transaction including the raising of equity and refinancing of our current Credit Agreement; or
3. Renegotiate the current Credit Agreement to obtain relief from the existing financial covenants and other terms.

We considered the likelihood of refinancing the current Credit Agreement in connection with the PSS acquisition financing which contemplates new financial covenants and the renegotiation of the financial covenants in the event the acquisition of PSS is not completed. Based upon the executed term sheet for financing of the planned acquisition of the PSS which contemplates new financial covenants and discussions with our Lender regarding the need to renegotiate the existing financial covenants in the Credit Agreement in the event the acquisition is not completed, management determined that it was probable that the condition giving rise to the going concern evaluation has been sufficiently alleviated.

These consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets and liabilities that may result in the Company not being able to continue as a going concern.

Use of estimates: The preparation of financial statements requires management 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 consolidated financial statements. Actual results could differ from those estimates.

Significant estimates embedded in the consolidated financial statements for the periods presented include revenue recognition on fixed-price contracts, the allowance for doubtful accounts, the valuation and useful lives of intangible assets, the length of certain customer relationships, useful lives of property, plant and equipment, valuation of a Rabbi Trust and related deferred compensation liability. Estimates and assumptions are also used when determining the

allocation of the purchase price in a business combination to the fair value of assets and liabilities and determining related useful lives.

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Revenue recognition: Revenue is recognized when persuasive evidence of an arrangement exists, services have been rendered or goods delivered, the contract price is fixed or determinable and collectability is reasonably assured. Revenue associated with work performed prior to the completion and signing of contract documents is recognized only when it can be reliably estimated and realization is probable. The Company bases its estimates on previous experiences with the customer, communications with the customer regarding funding status and its knowledge of available funding for the contract.

Revenue on cost-plus-fee contracts is recognized to the extent of costs incurred plus a proportionate amount of the fee earned. The Company considers fixed fees under cost-plus-fee contracts to be earned in proportion to the allowable costs incurred in performance of the contract. The Company considers performance-based fees, including award fees, under any contract type to be earned when it can demonstrate satisfaction of performance goals, based upon historical experience, or when the Company receives contractual notification from the customer that the fee has been earned. Revenue on time-and-materials contracts is recognized based on the hours incurred at the negotiated contract billing rates, plus the cost of any allowable material costs and out-of-pocket expenses. Revenue on fixed-price contracts is primarily recognized using the proportional performance method of contract accounting. Unless it is determined as part of the Company's regular contract performance review that overall progress on a contract is not consistent with costs expended to date, the Company determines the percentage completed based on the percentage of costs incurred to date in relation to total estimated costs expected upon completion of the contract. Revenue on other fixed-price service contracts is generally recognized on a straight-line basis over the contractual service period, unless the revenue is earned, or obligations fulfilled, in a different manner.

Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined and are recorded as forward loss liabilities in the consolidated financial statements. Changes in job performance, job conditions and estimated profitability may result in revisions to costs and revenue and are recognized in the period in which the revisions are determined.

Multiple agencies of the federal government directly or indirectly provided the majority of the Company's contract revenue during the year ended December 31, 2016 and periods from November 24, 2015 through December 31, 2015 and from January 1, 2015 through November 23, 2015, and the year ended December 31, 2014. For the year ended December 31, 2016 and periods from November 24, 2015 through December 31, 2015 and from January 1, 2015 through November 23, 2015, and the year ended December 31, 2014, there were two, three, two, and three customers, respectively, that each provided revenue in excess of 10% of total revenue. These customers accounted for approximately 78%, 89%, 75%, and 84%, respectively, of the Company's total revenue for the year ended December 31, 2016, periods from November 24, 2015 through December 31, 2015 and from January 1, 2015 through November 23, 2015, and the year ended December 31, 2014.

Federal government contract costs, including indirect costs, are subject to audit and adjustment by the Defense Contract Audit Agency. Contract revenue has been recorded in amounts that are expected to be realized upon final settlement.

Costs of revenue: Costs of revenue include all direct contract costs, as well as indirect overhead costs and selling, general and administrative expenses that are allowable and allocable to contracts under federal procurement standards. Costs of revenue also include costs and expenses that are unallowable under applicable procurement standards and are not allocable to contracts for billing purposes. Such costs and expenses do not directly generate revenue, but are necessary for business operations.

Notes to the Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

For the year ended December 31, 2016, periods from November 24, 2015 through December 31, 2015 and from January 1, 2015 through November 23, 2015, and the year ended December 31, 2014, there was one vendor that comprised approximately 16%, 10%, 11%, and 10%, of total direct expenses, respectively.

Cash and cash equivalents: The Company considers all highly liquid investments purchased with an original maturity of three months or less at the date of purchase to be cash equivalents.

Investments held in Rabbi Trust: The Company has investments in mutual funds held in a Rabbi Trust that are classified as trading securities. Management determines the appropriate classification of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. The securities are classified as trading securities because they are held for resale in anticipation of short-term (generally 90 days or less) fluctuations in market prices. The trading securities are stated at fair value. Realized and unrealized gains and losses and other investment income are included in other income (expense) in the accompanying consolidated statements of operations.

Contract receivables: Contract receivables are generated primarily from prime and subcontracting arrangements with federal governmental agencies. Billed contract receivables represent invoices that have been prepared based on contract terms and sent to the customer. Billed accounts receivable are considered past due if the invoice has been outstanding more than 30 days. The Company does not charge interest on accounts receivable; however, federal governmental agencies may pay interest on invoices outstanding more than 30 days. The Company records interest income from federal governmental agencies when received. All contract receivables are on an unsecured basis.

Unbilled amounts represent costs and anticipated profits awaiting milestones to bill, contract retainages, award fees and fee withholdings, as well as amounts currently billable.

In accordance with industry practice, contract receivables relating to long-term contracts are classified as current, even though portions of these amounts may not be realized within one year.

Management determines the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history and current economic conditions. Management has recorded an allowance for contract receivables that are considered to be uncollectible. Both billed and unbilled receivables are written off when deemed uncollectible. Recoveries of receivables previously written off are recorded when received.

Valuation of long-lived assets: The Company accounts for the valuation of long-lived assets, including amortizable intangible assets, under authoritative guidance issued by the Financial Accounting Standards Board (FASB), which requires that long-lived assets and certain intangible assets be reviewed for impairment whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the long-lived assets is measured by a comparison of the carrying amount of the asset to future undiscounted net cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. During the period from January 1, 2015 through November 23, 2015 and for the year ended December 31, 2014, the Company recorded an impairment loss on its customer relationships of \$0.9 million and \$1.8 million, respectively. No indicators of impairment were identified for the year ended December 31, 2016 and for the period from November 24, 2015 through December 31, 2015.

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Identifiable intangible assets: Intangible assets of the Company are comprised of customer relationships and a trade name acquired as a result of the Business Combination described further in Note 2. The Company determined that the customer relationships and trade name represent finite-lived intangible assets with useful lives of eight and fifteen years, respectively. The assets are being amortized proportionately over the term of their useful lives based on the estimated economic benefit derived over the course of the asset life.

Goodwill: The Company records the excess of the purchase price of an acquired company over the fair value of the identifiable net assets acquired as goodwill. In accordance with authoritative guidance issued by the FASB, entities can elect to use a qualitative approach to test goodwill for impairment. Under this approach, the Company performs a qualitative assessment (Step Zero) to determine whether it is more-likely-than-not that the fair value of the reporting unit is less than the carrying value. If the fair value of the reporting unit is less than the carrying value of the reporting unit, the Company is required to perform a goodwill impairment test using a two-step approach, which is performed at the reporting unit level. In the second step, the implied value of the goodwill is estimated at the fair value of the reporting unit, less the fair value of all other tangible and identifiable intangible assets of the reporting unit. If the carrying amount of the goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized in the amount equal to that excess, not to exceed the carrying amount of the goodwill. If the fair value of the reporting unit is not less than the carrying value of the reporting unit, the two-step goodwill test is not required.

Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for the business, estimation of the useful life over which cash flows will occur and determination of the weighted-average cost of capital. This discounted cash flow analysis is corroborated by top-down analysis, including a market assessment of enterprise value.

The Company has elected to perform its annual analysis on December 31 each year at the reporting unit level and, during the Predecessor periods, had identified three reporting units with goodwill: DSTI, Seamast, and Access Systems. During the period from January 1, 2015 through November 23, 2015 and the year ended December 31, 2014, the Company recorded an impairment loss for goodwill of \$2.1 million and \$5.1 million, respectively. As of the Closing Date of the Business Combination, the Company determined that there was one reporting unit and as a result of acquisition accounting for the Business Combination, the carrying value of the reporting unit was equal to its fair value on the Closing Date. After performing a step zero analysis, no indicators of impairment were identified for the period from November 24, 2015 through December 31, 2015. For the year ended December 31, 2016, the Company has been unable to achieve its targeted revenue and profit forecasts; therefore, the Company recorded an impairment loss for goodwill of \$41.3 million.

Income taxes: In connection with the Business Combination, STG Group (Predecessor) converted from a Subchapter S Corporation to a C Corporation. Prior to this, STG Group, excluding STG Netherlands and STG Doha, was treated as an S corporation under Subchapter S of the Internal Revenue Code. Therefore, in lieu of corporate income taxes, the Predecessor stockholder separately accounted for his pro-rata share of STG Group's income, deductions, losses and credits.

Notes to the Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

The Company accounts for income taxes under FASB Accounting Standards Codification (ASC) Topic 740, Income Taxes (ASC 740). At the end of each interim period, the Company estimates an annualized effective tax rate expected for the full year based on the most recent forecast of pre-tax income, permanent book and tax differences, and global tax planning strategies. The Company uses this effective rate to provide for income taxes on a year-to-date basis, excluding the effect of significant, unusual, discrete or extraordinary items, and items that are reported net of their related tax effects. The Company records the tax effect of significant, unusual, discrete or extraordinary items, and items that are reported net of their tax effects in the period in which they occur.

In accordance with authoritative guidance on accounting for uncertainty in income taxes issued by the FASB, management has evaluated the Company's tax positions and has concluded that the Company has taken no uncertain tax positions that require adjustment to the quarterly condensed consolidated financial statements to comply with the provisions of this guidance.

Interest and penalties related to tax matters are recognized in expense. There was no accrued interest or penalties recorded during the year ended December 31, 2016, for the periods from November 24, 2015 through December 31, 2015 and from January 1, 2015 through November 23, 2015, and the year ended December 31, 2014. STG Group (Predecessor) is generally no longer subject to income tax examinations by the U.S. federal, state or local tax authorities for the years ended December 31, 2013, and prior.

Fair value of financial instruments The carrying value of the Company's cash and cash equivalents, contract receivables, line-of-credit, accounts payable and other short-term liabilities are believed to approximate fair value as of December 31, 2016 and 2015, respectively, because of the relatively short duration of these instruments. The Company also assessed long-term debt and determined that such amounts approximated fair value primarily since its terms and interest approximate current market terms and was negotiated with an unrelated third party lender. The Company considers the inputs related to these estimates to be Level 2 fair value measurements.

Certain assets and liabilities are recorded at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability between market participants in an orderly transaction on the measurement date. The market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability is known as the principal market. When no principal market exists, the most advantageous market is used. This is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received or minimizes the amount that would be paid. Fair value is based on assumptions market participants would make in pricing the asset or liability. Generally, fair value is based on observable quoted market prices or derived from observable market data when such market prices or data are available. When such prices or inputs are not available, the reporting entity should use valuation models.

The Company's assets recorded at fair value on a recurring basis are categorized based on the priority of the inputs used to measure fair value. Fair value measurement standards require an entity to maximize the use of observable inputs (such as quoted prices in active markets) and minimize the use of unobservable inputs (such as appraisals or other valuation techniques) to determine fair value. The inputs used in measuring fair value are categorized into three levels, as follows:

Notes to the Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

- Level 1: Inputs that are based upon quoted prices for identical instruments traded in active markets.
- Level 2: Inputs that are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar investments in markets that are not active, or models based on valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the investment.
- Level 3: Inputs that are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques that include option pricing models, discounted cash flow models and similar techniques. As of December 31, 2016 and 2015, the Company has no financial assets or liabilities that are categorized as Level 3.

The Company has investments carried at fair value in mutual funds held in a Rabbi Trust, which is included in investments held in Rabbi Trust on the accompanying consolidated balance sheets. The Company does not measure non-financial assets and liabilities at fair value unless there is an event which requires this measurement.

Financial credit risk: The Company's assets that are exposed to credit risk consist primarily of cash and cash equivalents, investments held in Rabbi Trust and contract receivables. Cash and cash equivalents are deposited with high-credit, quality financial institutions whose balances may, at times, exceed federally insured limits. The Company has not experienced any losses in such amounts and believes that it is not exposed to any significant credit risk on cash and cash equivalents. Investments held in Rabbi Trust are stated at fair value at each reporting period and are subject to market fluctuations. Contract receivables consist primarily of amounts due from various agencies of the federal government or prime contractors doing business with the federal government. Historically, the Company has not experienced significant losses related to contract receivables and, therefore, believes that the credit risk related to contract receivables is minimal.

Debt issuance costs: In April 2015, the FASB issued Accounting Standards Update (ASU) 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. ASU 2015-03 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted, and retrospective application is required. The Company decided to early adopt this ASU as of December 31, 2015. Therefore, financing costs incurred for fees paid to lenders and other parties in connection with debt issuances are recorded as a deduction against the related debt agreement and amortized by the effective interest method over the terms of the related financing arrangements. In connection with the term loan described further in Note 7, the Company originally recorded \$6.4 million in debt issuance costs as a discount against the carrying amount of the loan. Amortization of \$1.4 million and \$0.1 million for the year ended December 31, 2016, and the period from November 24, 2015 through December 31, 2015, is included in interest expense.

Notes to the Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Transaction-related expenses: The Company incurs transaction-related expenses primarily consisting of professional service fees and costs related to business acquisition activities. The Company recognized transaction-related expenses of approximately \$2.6 million, \$0.6 million, and \$0.89 million, respectively, during the year ended December 31, 2016, the period from November 24, 2015 through December 31, 2015, and the period from January 1, 2015 through November 23, 2015, which primarily includes fees related to the Business Combination and related transactions, and the pending transaction disclosed further in Note 15. The transaction-related expenses were recognized as incurred within the respective Successor or Predecessor periods in accordance with the applicable accounting guidance on business combinations and classified with indirect and selling expenses on the consolidated statements of operations.

Stock based compensation: The Company measures compensation expense for stock based equity awards based on the fair value of the awards on the grant date. Compensation is recognized as expense in the accompanying consolidated statements of operations ratably over the required service period or, for performance based awards, when the achievement of the performance targets become probable.

Net (loss) income per share: Basic net (loss) income per share available to common shareholders of the Company is calculated by dividing the net (loss) income by the weighted average number of common shares outstanding during the year. Common shares issuable upon exercise of the stock options and future vesting of the restricted stock awards (see Note 12) have not been included in the computation because their inclusion would have had an antidilutive effect for all periods presented.

Recent accounting pronouncements: We consider the applicability and impact of all ASUs. ASUs not listed below were assessed and determined to be either not applicable or are expected to have minimal impact on our consolidated financial position or results of operations.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which establishes a comprehensive revenue recognition standard for virtually all industries under GAAP, including those that previously followed industry-specific guidance. Under the guidance, all entities should recognize revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additionally, various updates have been issued during 2015 and 2016 to clarify the guidance in Topic 606. The guidance is effective for the Company in the first quarter of 2018. Early adoption is permitted. Management has not yet assessed the potential impact of this guidance on the consolidated financial statements.

In August 2014, the FASB issued Accounting Standards Update (“ASU”) 2014-15, *Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. ASU 2014-15 explicitly requires management to evaluate, at each annual or interim reporting period, whether there are conditions or events that exist which raise substantial doubt about an entity's ability to continue as a going concern and to provide related disclosures. The guidance is effective for annual periods ending after 15 December 2016 and for annual periods and interim periods thereafter. The adoption of ASU 2014-15 did not have a material effect on the Company's consolidated financial statements, however the standard does require additional disclosure of management's evaluation of potential conditions or events that exist that raise substantial doubt about an entity's ability to continue as a going concern. Such disclosure has been made in note 1 of the Company's financial statements.

Notes to the Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

In September 2015, the FASB issued ASU 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments*. This ASU eliminates the requirement to retrospectively account for changes to provisional amounts initially recorded in a business combination. ASU 2015-16 requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustments are determined, including the effect of the change in provisional amount as if the accounting had been completed at the acquisition date. The provisions of this ASU are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years and should be applied prospectively to adjustments to provisional amounts that occur after the effective date. The adoption of this standard has not had a significant impact on the consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*. This ASU simplifies the presentation of deferred income taxes by eliminating the requirement for entities to separate deferred tax liabilities and assets into current and noncurrent amounts in classified balance sheets. Instead it requires deferred tax assets and liabilities be classified as noncurrent in the balance sheet. This ASU is effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted, and this ASU may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company has adopted this standard prospectively during the quarter ended June 30, 2016. The adoption of ASU 2015-17 resulted in the aggregation of a \$4.5 million deferred tax asset and a \$10.9 million deferred tax liability to a single line reported on the balance sheet as a non-current deferred tax liability in the amount of \$6.4 million.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The standard impacts both lessors and lessees. The most significant change for lessees is that the requirement to recognize right-to-use assets and lease liabilities for all leases not considered short term. The guidance is effective for fiscal years beginning after December 15, 2018, and will be applied on a modified retrospective basis. The Company is currently evaluating the expected impact of the adoption of this standard on the consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Compensation – Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting (ASU 2016-09)*. ASU 2016-09 is intended to simplify several aspects of accounting for share-based payment awards. The effective date will be the first quarter of fiscal year 2017, with early adoption permitted. The Company is evaluating the expected impact that adoption of this new standard will have on the consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments-Credit Losses* (“ASU 2016-13”). ASU 2016-13 will replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The amendments affect loans, debt securities, trade receivables, net investments in leases, off balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. ASU 2016-13 will be effective for the Company beginning in the first quarter of fiscal year 2020, and early adoption is permitted but not earlier than fiscal year 2019. The Company does not expect the adoption of ASU 2016-13 to have a material impact on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. The amendments in this update clarify the guidance regarding the classification of operating, investing, and financing activities for certain types of cash receipts and payments. The amendments in this update are effective for the annual periods, and the interim periods within those years, beginning after December 15, 2017, and should be applied using a retrospective transition method to each period presented. Early adoption is permitted. The Company is evaluating the expected impact of adoption, if any, to the consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)*, which provides guidance on the presentation of restricted cash or restricted cash equivalents in the statement of cash flows. These amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The Company is currently evaluating the expected impact of the adoption of this guidance on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, *Business Combinations (Topic 805) Clarifying the Definition of a Business*, which amends the guidance of FASB Accounting Standards Codification (ASC) Topic 805, *Business Combinations*, adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions or disposals of assets or businesses. The definition of a business affects many areas of accounting including acquisitions, disposals, goodwill, and consolidation. This guidance is effective for annual and interim periods beginning after December 15, 2017, and early adoption is permitted under certain circumstances. We intend to evaluate the impact of this guidance on our consolidated financial statements and related disclosures in connection with the potential business combination as disclosed in note 15 to the consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04 “Intangibles-Goodwill and Other (Topic 350) Simplifying the Test for Goodwill Impairment” (“ASU 2017-04”). ASU 2017-04 provides guidance to simplify the subsequent measurement of goodwill by eliminating the Step 2 procedure from the goodwill impairment test. Under the updates in ASU 2017-04, an entity should perform its annual or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The amendments of this ASU are effective for annual or any interim goodwill impairment tests beginning after December 15, 2019. The Company has not yet evaluated the impact, if any, that the adoption of ASU 2017-04 will have on our Consolidated Financial Statements.

Notes to the Consolidated Financial Statements

Note 2. Business Combination

After the close of business on November 23, 2015, the Company and STG Group completed the Business Combination in which the Company acquired STG Group from its current owner. The purchase price consisted of: (a) \$68 million paid in cash and \$3.4 million of an estimated net working capital adjustment and other purchase price adjustments paid in cash (“Cash Consideration”); (b) 8,578,199 new shares of Company common stock, 445,161 shares that were forfeited by the Sponsor and reissued to the STG Stockholders, and an additional 35,000 shares that were transferred by the Sponsor to the STG Stockholders, valued at a price of approximately \$8.50 per share (“Stock Consideration”); and (c) \$5.6 million worth of stock at approximately \$8.50 per share (658,513 “Conversion Shares”) in a private placement. The Company funded a majority of the purchase price through new debt financing as described further in Note 7. On the date of the Business Combination, the Company also collected \$2.5 million from the Predecessor’s stockholder pursuant to a note receivable agreement outstanding. This is netted against the purchase price adjustments that were settled in cash.

Upon consummation of the Business Combination, the Predecessor changed its name to STG Group Holdings, Inc. and the Company changed its name from Global Defense & National Security Systems, Inc. to STG Group, Inc.

STG Group, Inc.

Notes to the Consolidated Financial Statements

Note 2. Business Combination (Continued)

The Company has recorded an allocation of the purchase price to the Predecessor's tangible and identifiable intangible assets acquired and liabilities assumed based on their fair values as of the Business Combination date. The calculation of purchase price and purchase price allocation is as follows (in thousands):

Cash consideration:	
Cash consideration per Stock Purchase Agreement	\$ 68,000
Net working capital and other cash consideration adjustments	3,400
Total cash consideration	71,400
Stock consideration, including Conversion Shares	82,632
Total purchase price	\$ 154,032
Current assets	\$ 42,716
Property and equipment	1,745
Goodwill	113,589
Identifiable intangible assets	39,840
Other assets	166
Total assets acquired	198,056
Current liabilities	26,639
Deferred income taxes	11,903
Other long-term liabilities	5,482
Total liabilities assumed	44,024
Total purchase price	154,032
Less cash acquired	2,184
Total purchase price, net of cash acquired	\$ 151,848

Separately identifiable intangible assets are considered to be Level 3 fair value measurements and were valued by a third party valuation specialist. Intangible assets comprised of customer relationships for \$26.4 million and a trade name for \$13.5 million were valued using a discounted cash flow method and a relief from royalty method, respectively. The stock consideration was valued at the estimated fair value per share using other stock based transactions and the actively traded share price around the time prior to and immediately after the Closing Date for the Business Combination, as discounted by approximately 20% for a lack of marketability discount. Goodwill is not deductible for tax purposes.

Notes to the Consolidated Financial Statements

Note 2. Business Combination (Continued)

The following unaudited pro forma financial information for the years ended December 31, 2015 and 2014, assumes the Business Combination occurred on January 1, 2014, after giving effect to certain adjustments for amortization, interest, and transaction-related expenses and income tax effects. There was also an adjustment to reverse the impairment charges taken on goodwill and other intangibles during these periods. The pro forma information is presented for illustrative purposes only and is not indicative of what actual results would have been if the acquisition had taken place on January 1, 2014, or of future results. The table below summarizes pro forma results for the years ended December 31, 2015 and 2014, (in thousands, except for per share information):

	(unaudited)	
	2015	2014
Contract revenue	\$ 193,645	\$ 209,727
Operating income	3,134	(680)
Net loss	(3,134)	(5,414)
Net loss per share, basic and diluted	(0.19)	(0.34)

The pro forma adjustments increased amortization and interest expense by \$5.0 million and \$7.2 million, respectively, reversed transaction-related expenses of \$1.4 million, reversed goodwill and other intangible asset impairment charges of \$3.0 million, and decreased the income tax benefit by \$1.1 million for the year ended December 31, 2015.

The pro forma adjustments increased amortization and interest expense by \$6.7 million and \$8.4 million, respectively, increased transaction-related expenses of \$0.6 million for solely the buyer related costs, reversed goodwill and other intangible asset impairment charges of \$7.0 million, and increased the income tax benefit by \$3.5 million for the year ended December 31, 2014.

There were no adjustments made to purchase price allocation during the year ended December 31, 2016.

Note 3. Contract Receivables and Billings in Excess of Revenue Recognized

At December 31, 2016 and 2015, contract receivables consist of the following (in thousands):

	Successor	
	December 31, 2016	December 31, 2015
Billed accounts receivable	\$ 21,588	\$ 27,875
Unbilled accounts receivable	7,262	5,225
	28,850	33,100
Less allowance for doubtful accounts	(66)	(276)
	<u>\$ 28,784</u>	<u>\$ 32,824</u>

Billing in excess of revenue recognized as of December 31, 2016 and 2015, is comprised primarily of billings from firm fixed-price contracts, where revenue is recognized in accordance with the proportional performance method.

STG Group, Inc.

Notes to the Consolidated Financial Statements

Note 4. Property and Equipment

At December 31, 2016 and 2015, property and equipment consists of the following (in thousands):

	Estimated Life	Successor	
		December 31, 2016	December 31, 2015
Leasehold improvements	Life of lease	\$ 1,324	\$ 1,316
Computer hardware and software	1 - 3 years	329	329
Office furniture and equipment	1 - 7 years	110	110
		<u>1,763</u>	<u>1,755</u>
Less accumulated depreciation and amortization		(606)	(57)
		<u>\$ 1,157</u>	<u>\$ 1,698</u>

Depreciation and amortization expense on property and equipment totaled \$0.6 million, \$0.06 million, \$0.8 million, and \$1.2 million for the year ended December 31, 2016, the periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015, and the year ended December 31, 2014, respectively.

Notes to the Consolidated Financial Statements

Note 5. Intangible Assets and Goodwill

Identifiable intangible assets as of December 31, 2016, consist of the following (in thousands):

	Estimated Life	Successor December 31, 2016		
		Cost	Accumulated Amortization	Net
Customer relationships	8 years	\$ 26,380	\$ 6,136	\$ 20,244
Trade name	15 years	13,460	1,720	11,740
		<u>\$ 39,840</u>	<u>\$ 7,856</u>	<u>\$ 31,984</u>

Identifiable intangible assets as of December 31, 2015, consist of the following (in thousands):

	Estimated Life	Successor December 31, 2015		
		Cost	Accumulated Amortization	Net
Customer relationships	8 years	\$ 26,380	\$ 698	\$ 25,682
Trade name	15 years	13,460	154	13,306
		<u>\$ 39,840</u>	<u>\$ 852</u>	<u>\$ 38,988</u>

Amortization expense amounted to \$7.0 million, \$0.9 million, \$0.7 million, and \$0.6 million for the year ended December 31, 2016, the periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015, and the year ended December 31, 2014, respectively.

STG Group, Inc.

Notes to the Consolidated Financial Statements

Note 5. Intangible Assets and Goodwill (Continued)

Estimated amortization of the intangible assets for subsequent years is as follows (in thousands):

Year Ending December 31,	
2017	\$ 6,535
2018	5,600
2019	5,111
2020	4,537
2021	3,191
Thereafter	7,010
	<u>\$ 31,984</u>

The Company's goodwill balance by reporting unit, consists of the following as of December 31 (in thousands):

	Predecessor DSTI	Predecessor Seamast	Predecessor Access	Successor STG Group	Total
Balance, January 1, 2015, Predecessor	\$ 440	\$ 1,898	\$ 2,361	\$ -	\$ 4,699
Impairment loss	-	-	(2,064)	-	(2,064)
Balance, November 23, 2015, Predecessor	440	1,898	297	-	2,635
Elimination of Predecessor goodwill	(440)	(1,898)	(297)	-	(2,635)
Acquisition of business	-	-	-	113,589	113,589
Balance, December 31, 2015, Successor	-	-	-	113,589	113,589
Impairment loss	-	-	-	(41,276)	(41,276)
Balance, December 31, 2016, Successor	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 72,313</u>	<u>\$ 72,313</u>

During the Predecessor periods, the Company completed three acquisitions resulting in goodwill: DSTI, Seamast, and Access Systems. Subsequent to the Business Combination, the Company determined that there was one reporting unit and determined that the carrying value of the reporting unit was equal to its fair value on the Closing Date.

For the year ended December 31, 2016, the Company recorded an impairment loss of \$41.3 million. For the year ended December 31, 2016, the Company's third party valuation firm performed the first step of the annual goodwill impairment test in the fourth quarter of 2016 and determined that the estimated fair value of the Company's sole reporting unit was lower than the carrying value, requiring further analysis under the second step of the impairment test. The decline in the estimated fair value of the Company was primarily due to significantly lower revenue in 2016 than planned. Growth rates in future years remain comparable to the prior planned growth however future revenue and related profits are less than the previous plan due to significantly lower 2016 revenue.

In performing the second step of the impairment testing, the Company's third party valuation firm performed a theoretical purchase price allocation for the Company to determine the implied fair values of goodwill which were compared to the recorded amounts of goodwill for the Company's sole reporting unit.

Upon completion of the second step of the goodwill impairment test, the Company recorded a noncash goodwill impairment charge of \$41.3 million, or 36% of the total goodwill asset. Additional sensitivity testing was completed using assumptions of only achieving 90% and 85% of the 2017 forecasted plan with other major assumptions including growth rates, profit margins, and discount factors remaining the same. The result of this analysis was an estimated additional goodwill impairment of between \$5 million and \$8 million and \$11 million and \$14 million respectively. The Company also has some flexibility in its ability to control indirect costs during 2017 that could mitigate any shortfalls in our 2017 revenue and profit estimates.

The goodwill impairment charges are recorded as impairment charges in the consolidated statements of operations. The assumptions that have the most significant impact on determination of the reporting unit fair value are the revenue growth rate, including 3 percent in the terminal year, maintaining adjusted EBITDA margins of 10% throughout the forecast period, and the weighted average cost of capital (discount rate), of 15.08%. A change in any of these assumptions, individually or in the aggregate, or future financial performance that is below management expectations may result in the carrying value of this reporting unit exceeding its fair value, could result in additional impairment to goodwill and amortizable intangible assets in future periods.

For the period from January 1, 2015 through November 23, 2015, the Company recorded an impairment loss on Access Systems' goodwill of \$2.0 million. For the year ended December 31, 2014, the Company recorded an impairment loss on Access Systems' goodwill of \$3.5 million, and an impairment loss on DSTI's goodwill of \$1.7 million. The Company also recorded an impairment loss on the Access Systems customer relationships of \$0.91 million during the period from January 1, 2015 through November 23, 2015 and \$1.8 million for the year ended December 31, 2014, primarily due to declining profits on contracts.

The primary methods used to measure the impairment losses were the income method and the market approach. The significant unobservable inputs used were based on Company-specific information and included estimates of revenue, profit margins and discount rates. The Company used the two-step approach in measuring the impairment loss. In the second step, the implied value of the goodwill is estimated at the fair value of the reporting unit less the fair value of all other tangible and identifiable intangible assets of the reporting unit. If the carrying amount of the goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized in the amount equal to that excess, not to exceed the carrying amount of the goodwill. Following an assessment of revenue, profit, and cash flow projections and the relevant discount rates, the Company did not record any impairment charges for the Successor period during the period from November 24, 2015 through December 31, 2015.

Additionally, the Company performed an impairment test on its long-lived intangible assets. The first step of the impairment test is to compare the undiscounted cash flows of the asset group to the carrying amount. If the results of the test determine that the undiscounted cash flows of the asset group are less than the carrying amount, then an impairment exists and further testing is required. An impairment was not required as of December 31, 2016.

Notes to the Consolidated Financial Statements

Note 6. Fair Value Measurements

The Company has investments in mutual funds held in a Rabbi Trust which are classified as trading securities. The Rabbi Trust assets are used to fund amounts the Company owes to key managerial employees under the Company's non-qualified deferred compensation plan (See Note 9). Based on the nature of the assets held, the Company uses quoted market prices in active markets for identical assets to determine fair values, which apply to Level 1 investments. The following tables set forth the fair values of financial assets that are measured at fair value on a recurring basis as of December 31, 2016 and 2015, (in thousands):

Description	Successor			
	As of December 31, 2016			
	Assets	Fair Value Hierarchy Level		
Level 1		Level 2	Level 3	
Assets				
Mutual Funds				
US Equity – Large Cap Growth	\$ 67	\$ 67	\$ -	\$ -
US Equity – Large Cap Value	2	2	-	-
US Equity – Large Cap Blend	84	84	-	-
US Equity – Mid Cap Growth	2	2	-	-
US Equity – Mid Cap Value	94	94	-	-
US Equity – Small Cap Growth	73	73	-	-
International Equity	7	7	-	-
Fixed Income	1	1	-	-
Money Market Funds	2	2	-	-
Total	\$ 332	\$ 332	\$ -	\$ -

Description	Successor			
	As of December 31, 2015			
	Assets	Fair Value Hierarchy Level		
Level 1		Level 2	Level 3	
Assets				
Mutual Funds				
US Equity – Large Cap Growth	\$ 374	\$ 374	\$ -	\$ -
US Equity – Large Cap Value	48	48	-	-
US Equity – Large Cap Blend	1,038	1,038	-	-
US Equity – Mid Cap Growth	28	28	-	-
US Equity – Mid Cap Value	1,795	1,795	-	-
US Equity – Small Cap Growth	833	833	-	-
Growth Real Estate	25	25	-	-
International Equity	37	37	-	-
Fixed Income	158	158	-	-
Money Market Funds	181	181	-	-
Total	\$ 4,517	\$ 4,517	\$ -	\$ -

STG Group, Inc.

Notes to the Consolidated Financial Statements

Note 6. Fair Value Measurements (Continued)

The mark to market adjustments are recorded in other income (expense), net, in the accompanying consolidated statements of operations for the year ended December 31, 2016, the periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015, and the year ended December 31, 2014, for a net investment (loss) income of \$0.4 million, (\$0.14) million, \$0.03 million, \$0.4 million, respectively.

Note 7. Debt

The Company's debt as of December 31, 2016 and 2015, consists of the following:

	<u>Successor</u> <u>December 31, 2016</u>	<u>Successor</u> <u>December 31, 2015</u>
Term loan	77,018	81,239
Less: debt discount on term loan	(4,828)	(6,237)
Less: current portion	(4,496)	(2,555)
	<u>\$ 67,694</u>	<u>\$ 72,447</u>

Credit Agreement (Successor): In connection with the consummation of the Business Combination, all indebtedness under STG Group's prior credit facility was repaid in full and the agreement was terminated. The Company replaced the prior credit facility and entered into a new facility (the Credit Agreement) with a different lending Group. The Credit Agreement provides for (a) a term loan in an aggregate principal amount of \$81.8 million; (b) a \$15 million asset-based revolving line-of-credit; and (c) an uncommitted accordion facility to be used to fund acquisitions of up to \$90 million. Concurrent with the consummation of the Business Combination, the full amount of the term loan was drawn and there were no amounts drawn on the other two facilities. Each facility matures on November 23, 2020. The Company recorded \$6.4 million of debt issuance costs in connection with the new facility as a reduction to the carrying amount of the new term loan. These costs will be amortized using the effective interest method over the life of the term loan.

The principal amount of the term loan amortizes in quarterly installments which increase after each annual period. The quarterly installments range from 0.625% to 2.500% of the original principal amount and are paid through the quarter ending September 30, 2019. The remaining unpaid principal is due on the maturity date of November 23, 2020.

At the Company's election, the interest rate per annum applicable to all the facilities is based on a fluctuating rate of interest. The interest rate in effect as of December 31, 2016 and 2015 was 10.30% and 8.80%, respectively. The Borrowers may elect to use either a Base Rate or a Eurodollar Rate. The interest rate per annum for electing the Base Rate will be equal to the sum of 6.80% plus the Base Rate, which is equal to the highest of: (a) the base commercial lending rate of the Collateral Agent as publicly announced to be in effect from time to time, as adjusted by the Collateral Agent; (b) the sum of 0.50% per annum and the Federal Funds Rate (as defined in the Credit Agreement); (c) the daily one month LIBOR as published each business day in *The Wall Street Journal* for a one month period divided by a number equal to 1.00 minus the Reserve Percentage (as defined in the Credit Agreement) plus 100 basis points, as of such day and; (d) 2.00%.

Note 7. Debt (Continued)

The interest rate per annum for electing the Eurodollar Rate will be equal to the sum of 7.80% plus the Eurodollar Rate, which is equal to the highest of: (a) the amount calculated by dividing (x) the rate which appears on the Bloomberg Page BBAM1, or the rate which is quoted by another authorized source, two business days prior to the commencement of any interest period as the LIBOR for such an amount by (y) a number equal to 1.00 minus the Reserve Percentage (as defined in the Credit Agreement) and; (b) 1.00%.

Advances under the revolving line-of-credit are limited by a borrowing base which may not exceed the lesser of (x) the difference between \$15 million and amounts outstanding under letters of credit issued pursuant to the Credit Agreement; and (y) an amount equal to the sum of: (i) up to 85% of certain accounts receivable of the Company plus (ii) up to 100% of unrestricted cash on deposit in the Company's accounts with the Collateral Agent, minus (iii) amounts outstanding under letters of credit issued pursuant to the Credit Agreement, minus (iv) reserves established by the Collateral Agent from time to time in its reasonable credit judgment exercised in good faith. The amount available under the line-of-credit was \$15 million at December 31, 2016 (subject to lender consent) and 2015.

The Company is also subject to certain provisions which will require mandatory prepayments of its term loan and has agreed to certain minimums for its fixed charge coverage ratio and consolidated EBITDA and certain maximums for its senior secured leverage ratio, as defined in the Credit Agreement. As of September 30, 2016, the Company did not meet the required consolidated senior secured leverage ratio and minimum consolidated EBITDA. The Company remained in compliance with the Credit Agreement as of September 30, 2016 by using a provision of the Credit Agreement that allowed the Company to cure (the "Cure Right") certain covenant non-compliance by issuances of common stock for cash and use of the proceeds to reduce the principal balance of the term loan.

On November 14, 2016, the Company entered into Common Stock Purchase Agreements with Simon S. Lee Management Trust, for which Simon Lee, Chairman, is Trustee, and Phillip E. Lacombe, President and Chief Operating Officer (collectively, the "Investors"), that provided for the sale to the Investors of 462,778 shares of Common Stock at a purchase price of \$3.60 per share, for an aggregate purchase price of approximately \$1.7 million. The Company used the proceeds to reduce the principal balance of the term loan as required to effect the Cure Right.

As of December 31, 2016, the Company did not satisfy the covenants related to its required consolidated senior secured leverage ratio and minimum consolidated EBITDA. The Credit Agreement does not allow the Company to exercise the Cure Right in consecutive fiscal quarters; therefore, on February 24, 2017, the Company entered into a limited forbearance to credit agreement (the "Forbearance Agreement") with MC Admin Co LLC and the other lenders under the Credit Agreement. In the Forbearance Agreement, the lenders agreed to forbear from exercising rights and remedies (including enforcement and collection actions), for which we agreed to pay a fee of up to \$750,000, related to our failure to comply with covenants related to the fixed charge coverage ratio, consolidated EBITDA and the senior secured leverage ratio, for the fiscal quarter ended December 31, 2016 (the "Specified Financial Covenants"). The Forbearance Agreement requires us to obtain lender consent prior to use of our revolving credit facility during the period of forbearance. The forbearance period expired on March 31, 2017. The Company has also agreed to pay an additional two percent (2%) per annum in interest on the amount outstanding under the loan under the Credit Agreement from January 1, 2017 until the earlier of (1) the date on which all loans under the Credit Agreement are repaid and (2) the date on which the non-compliance with the Specified Financial Covenants is waived by the lenders.

Notes to the Consolidated Financial Statements

Note 7. Debt (Continued)

The Company entered into a Limited Waiver (“the Waiver”) from MC Admin Co LLC and other lenders under the Credit Agreement as of March 31, 2017, pursuant to which the lenders waived the Company’s noncompliance with the Specified Financial Covenants as of December 31, 2016. Pursuant to the Waiver:

- Loans under the Credit Agreement are subject to additional interest at a rate of 2% per annum until the earliest of (x) the date on which all loans are repaid and all commitments under the Credit Agreement are terminated, (y) the date we deliver the financial statements and certificates for the quarter ending March 31, 2017 showing that we are not in default under the Credit Agreement or (z) the date on which default interest is otherwise due under the Credit Agreement;
- We must obtain lender consent prior to use of our revolving credit facility; and
- We cannot effect a Cure Right in respect of the quarter ending March 31, 2017.

The Credit Agreement also provides that the minimum consolidated EBITDA requirement will be increased on June 30, 2017. If our business continues to perform at the current level through that period, we do not expect to satisfy that covenant or the senior secured leverage ratio at that time, and it is likely that we will be in non-compliance at March 31, 2017. An inability to meet the required covenant levels could have a material adverse impact on us, including the need for us to effect an additional Cure Right or obtain additional forbearance or an amendment, waiver, or other changes in the Credit Agreement. The Credit Agreement does not allow the Company to exercise the Cure Right in consecutive fiscal quarters, more than three fiscal quarters in the aggregate, in more than two of any four fiscal quarters or for the quarter ending March 31, 2017. The amount allowed under the Cure Right may not exceed the lesser of \$2.5 million and 20% of consolidated EBITDA. The aggregate of Cure Rights may not exceed \$5 million. The Waiver does not apply to covenant non-compliance after December 31, 2016 or to covenants other than the Specified Financial Covenants. Any additional forbearance, amendment or waiver under the Credit Agreement may result in increased interest rates or premiums and more restrictive covenants and other terms less advantageous to us, and may require the payment of a fee for such forbearance, amendment or waiver. Although we anticipate that we will be able to renegotiate the financial covenants either through a new credit agreement in connection with the anticipated financing of our planned acquisition of PSS or in the event the acquisition of PSS is not completed, through an amendment of the existing financial covenants under our current Credit Agreement, if we are unsuccessful in executing an amendment to the existing financial covenants, we may not be able to obtain a forbearance, waiver or effect a cure, on terms acceptable to us.

If we are not able to effect an amendment to the Credit Agreement, any future covenant non-compliance will give rise to an event of default thereunder if we are unable to effect a Cure Right or otherwise obtain forbearance or a waiver in which case the indebtedness under the Credit Agreement could be declared immediately due and payable, which could have a material adverse effect on the Company.

In accordance with the terms of the Credit Agreement, and withstanding no acceleration of repayment of the debt, future annual maturities of long-term debt outstanding at December 31, 2016, are as follows (in thousands):

Year Ending December 31,

2017	\$ 4,496
2018	6,336
2019	6,131
2020	60,055
	<u>\$ 77,018</u>

Line-of-credit (Predecessor): Until consummation of the Business Combination, the Company maintained a bank line-of-credit agreement, whereby the Company could borrow up to the lesser of either (1) the sum of its billed accounts receivable and unbilled accounts receivable, less the balance in its doubtful accounts; or (2) \$15 million up through the date of the Business Combination. Borrowings under this facility were secured by all assets of the Company. This facility bore interest at London Interbank Offered Rate (LIBOR) plus 1.75%. This facility was closed on November 23, 2015 as a result of the Business Combination described further in Note 2.

Notes to the Consolidated Financial Statements

Note 8. Commitments and Contingencies

Operating leases: The Company leases office space and equipment under the terms of non-cancellable operating leases that expire at various dates through 2021.

On March 25, 2015, the Company terminated a portion of an office lease agreement. The Company agreed to vacate the space no later than August 31, 2015. The remaining space is still under a lease agreement that expires on December 31, 2021, and has been subleased under the terms of a sublease agreement. Because the Company vacated the space where its principal office was located, the Company disposed of the related leasehold improvements. There was a tenant improvement liability associated with the disposed assets. The Company recorded a loss on property and equipment of \$1.1 million from the disposal of the assets and related liability. The Company also expects to incur a loss of approximately \$0.7 million in lease termination costs related to the sublease agreements that are in effect on the remaining space. The related unfavorable lease liability was adjusted to its fair value as part of the Business Combination. This liability totaled approximately \$0.8 million and \$0.9 million as of December 31, 2016 and 2015, respectively.

On April 8, 2015, the Company entered into a new lease agreement to lease space under an agreement which expires on September 30, 2020. The new lease agreement includes rent abatement and an escalation clause which has increased the existing deferred rent liability related to the new lease. Similarly, the Company recognizes landlord incentive payments received as a reduction of rent expense over the lease term. The unrecognized portion of landlord incentive payments is reflected as deferred rent in the accompanying consolidated balance sheets. In connection with the Business Combination, any existing deferred rent liabilities were removed as a result.

The future minimum lease payments have not been reduced by minimum required rental income under sublease agreements totaling approximately \$7.6 million as of December 31, 2016. The following is a schedule of the approximate future minimum lease payments required under non-cancelable operating leases that have initial or remaining terms in excess of one year at December 31, 2016 (in thousands):

Year Ending December 31,

2017	\$	3,343
2018		2,591
2019		2,579
2020		2,350
2021		1,754
	\$	<u>12,617</u>

In conjunction with the principal office lease agreement, the Company was required to issue a letter-of-credit to the landlord as security for the new facility in the amount of \$0.8 million. The letter-of-credit can be reduced to \$0.4 million in conjunction with the termination agreement. This letter-of-credit was cancelled due to the termination of the prior credit facility described further in Note 7. As a result, the Company was required to increase its security deposit. The security deposit shall be the security for the performance of the Company's obligations, covenants and agreements under the deed of the lease.

Rent expense, net of sublease income, aggregated to \$1.9 million, \$0.2 million, \$2.3 million, and \$3.3 million for the year ended December 31, 2016, the period from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015, and the year ended December 31, 2014, respectively.

Underwriters' Agreement: In 2013, pursuant to their public offering, the Company entered into an agreement with their underwriters which entitled them to an underwriting discount of 3.0%. This fee was paid in cash at the closing of the public offering, including any amounts raised pursuant to the over-allotment option. In addition, the underwriters were entitled to a deferred fee of 2.75% of the public offering, including any amounts raised pursuant to the over-allotment option, payable in cash upon the closing of a business combination. This amount, totaling approximately \$1.9 million, was paid upon closing of the Business Combination with STG Group. The Company also paid \$0.6 million in additional fees and other expenses to the underwriters upon close of the Business Combination. These costs are included as part of the buyer related transaction costs which are recorded during the period from November 24, 2015 through December 31, 2015.

Legal matters: From time to time the Company may be involved in litigation in the normal course of its business. Management does not expect that the resolution of these matters would have a material adverse effect on the Company's business, operations, financial condition or cash flows.

Note 9. Benefit Plans

The Deferred Compensation Plan: The Company maintains a deferred compensation plan (the Deferred Compensation Plan) in the form of a Rabbi Trust, covering key managerial employees of the Company as determined by the Board of Directors. The Deferred Compensation Plan gives certain senior employees the ability to defer all, or a portion, of their salaries and bonuses on a pre-tax basis and invest the funds in marketable securities that can be bought and sold at the employee's discretion. The future compensation is payable upon either termination of employment or change of control. The liabilities are classified within current liabilities as of December 31, 2016 and 2015 on the consolidated balance sheets. The assets held in the Rabbi Trust are comprised of mutual funds and are carried at fair value based on the quoted market prices (see Note 6). As of December 31, 2016 and 2015, the amount payable under the Deferred Compensation Plan was equal to the value of the assets owned by the Company. These assets total \$0.3 million and \$4.5 million as of December 31, 2016 and 2015, respectively, and are included as part of current assets in the accompanying consolidated balance sheets. Additionally, the Company may make discretionary matching contributions to the Deferred Compensation Plan, which vest ratably over three years. The Company recorded no contributions to the Deferred Compensation Plan for the year ended December 31, 2016, and \$0.01 million, \$0.05 million, and \$0.1 million for the periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015, and the year ended December 31, 2014, respectively. The assets are available to satisfy the claims of the Company's creditors in the event of bankruptcy or insolvency of the Company. The participants in the Deferred Compensation Plan were paid a distribution of their earnings to date through the consummation of the Business Combination. This distribution totaled \$4.1 million and was paid on January 25, 2016.

401(k) profit sharing plan: The Company maintains a defined contribution 401(k) plan (the Plan) with respect to all full time employees. Participants may make voluntary contributions to the Plan up to the maximum amount allowable by law, but not to exceed 50% of their annual compensation. The Company makes matching contributions to the Plan for all participants, which vest ratably over three years, equal to 50% of employee contributions, up to a maximum of 3% for those employees contributing 6% or more of their annual compensation. The Company recorded contributions to the Plan of \$1.4 million, \$0.3 million, \$1.6 million, and \$2.1 million for the year ended December 31, 2016, the periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015, and the year ended December 31, 2014, respectively.

Self-funded insurance plan: The Company has a self-funded medical insurance plan available to all employees, which includes coinsurance to minimize the Company's annual financial risk. The maximum amount of claims that will be paid during the plan year is \$0.1 million per employee per annum, up to an aggregate amount of \$7.5 million for the year ended December 31, 2016, and the periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015 and \$10.6 million for the year ended December 31, 2014. As of December 31, 2016 and 2015, the Company has accrued \$0.9 million and \$0.9 million, respectively, for unpaid liabilities related to claims, premiums and administrative fees.

Note 9. Benefit Plans (Continued)

Predecessor Management Incentive Plan: The Predecessor had the STG, Inc. Management Incentive Plan (the MIP Plan) in place prior to the consummation of the Business Combination. The MIP Plan was created effective November 1, 2011. The purpose of the MIP Plan was to enable STG Group to retain and recruit employees by providing them with the incentive of participating in the appreciation of the value of the STG Group's common stock. The value of STG Group's common stock represented the equity value determined by the Plan Committee based on a valuation performed by an external appraisal, which was performed as of the effective date of the MIP Plan (baseline valuation). The appreciation in value of the common stock, if any, was determined based on the appreciation between the baseline valuation and an internal appraisal performed by STG Group or external appraisal annually. STG Group would record annual compensation expense based on the proportion of this appreciation allocated to designated individuals. Only designated individuals had been identified to participate in the MIP Plan, as determined by the MIP Plan Committee. Awards (units under the MIP Plan) could be granted by the MIP Plan Committee at any time. Participants vested daily in their awards over a three year measurement period. If a participant remained employed with STG Group through the fifth anniversary of the grant date of an award, the participant's plan account would be paid in three annual installments, commencing immediately following the fifth anniversary. If an employee separated from STG Group for other than cause, the participant's vested portion would be paid in three annual installments, the first of which being due on the anniversary date of the first year of separation. If a change of control event were to occur (change in over 50% ownership), then all vested amounts under the grant were to be payable within five business days of such change of control. Select individuals were designated to participate in the MIP Plan. Upon consummation of the Business Combination, the MIP Plan was terminated with no resulting payouts to the participants.

Note 10. Related Party Transactions

On November 14, 2016, the Company entered into Common Stock Purchase Agreements with Simon S. Lee Management Trust, for which Simon Lee, the Company's Chairman, is Trustee, and Phillip E. Lacombe, President and Chief Operating Officer (collectively, the "Investors") that provided for the sale to the Investors of 462,778 shares of Common Stock at a purchase price of \$3.60 per share, an aggregate of approximately \$1.7 million. We used the proceeds to reduce the principal balance of the term loan under the Credit Agreement as required to effect the Cure Right.

A company owned by a party related to the majority stockholder of the Company is both a subcontractor to and customer of the Company on various contracts. As of December 31, 2016 and 2015, amounts due from this entity totaled \$0.01 million and \$0.02 million, respectively. The Company recorded revenue of \$0.07 million, \$0.01 million, \$0.11 million, and \$0.08 million, respectively, for the year ended December 31, 2016, the periods from November 24, 2015 through December 31, 2015 and January 1, 2015 through November 23, 2015 and for the year ended December 31, 2014.

No amount was due to this entity as of December 31, 2016 and 2015 for amounts relating to work performed under subcontracts. The Company also recorded no direct costs for the year ended December 31, 2016 and \$0.02 million and \$0.14 million, for the period from January 1, 2015 through November 23, 2015, and for the year ended December 31, 2014, respectively, relating to such work performed.

On September 15, 2015, the Company issued a note receivable to the Predecessor stockholder for \$2.5 million. The note bore interest at 2.35%. The principal and accrued interest was payable in full on the earlier of December 31, 2015 or the closing of the Business Combination which is described previously in Note 2. This note was satisfied with the closing of the Business Combination that took effect on November 23, 2015.

Notes to the Consolidated Financial Statements

Note 10. Related Party Transactions (Continued)

On November 23, 2015, Global Strategies Group (North America) Inc. and the Company entered into a services agreement, pursuant to which the Company may retain Global Strategies Group (North America) Inc. from time to time to perform certain services: corporate development services such as assisting the Company in post-integration matters, regulatory compliance support services, financial services and financial reporting, business development and strategic services, marketing and public relations services, and human resources services. Global Strategies Group (North America) Inc. is an affiliate of both the Company and a Board member. Amounts paid and expensed under this agreement during the year ended December 31, 2016 and the period from November 24, 2015 through December 31, 2015 totaled \$0.6 million and \$0.04 million, respectively.

Note 11. Stockholders' Equity

On November 13, 2015, the Company held a special meeting in lieu of the 2015 Annual Meeting of the Stockholders where the Business Combination was approved by the Company's stockholders. At the special meeting, 4,598,665 shares of common stock were voted in favor of the proposal to approve the Business Combination and 676,350 shares of common stock were voted against that proposal. In connection with the closing, the Company redeemed a total of 2,031,383 shares of its common stock, pursuant to the terms of the Company's amended and restated certificate of incorporation, at \$10.63 per share, for a total payment to redeeming stockholders of \$21.6 million.

On November 23, 2015, the Company's amended and restated certificate of incorporation authorized 110,000,000 shares of capital stock, consisting of (i) 100,000,000 shares of common stock, par value \$0.0001 per share, and (ii) 10,000,000 shares of preferred stock, par value \$0.0001 per share.

At December 31, 2016 and 2015, the Company had authorized for issuance 100,000,000 shares of \$0.0001 par value common stock, of which 16,603,449 shares were issued and outstanding, including 33,600 shares subject to the vesting of restricted stock awards, and 16,107,071 shares issued and outstanding at December 31, 2015, and had authorized for issuance 10,000,000 shares of \$0.0001 par value preferred stock, of which no shares were issued and outstanding as of December 31, 2016 and 2015.

Preferred Stock

The Board of Directors of the Company is authorized to provide for the issuance of all or any shares of the Preferred Stock in one or more classes or series, and to fix for each such class or series such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights and such qualifications, limitations or restrictions thereof, as shall be stated and expressed in the resolution or resolutions adopted by the Board of Directors providing for the issuance of such class or series, including, without limitation, the authority to provide that any such class or series may be: (i) subject to redemption at such time or times and at such price or prices; (ii) entitled to receive dividends (which may be cumulative or noncumulative) at such rates, on such conditions, and at such times, and payable in preference to, or in such relation to, the dividends payable on any other class or classes or any other series; (iii) entitled to such rights upon the dissolution of, or upon any distribution of the assets of, the Company; or (iv) convertible into, or exchangeable for, shares of any other class or classes of stock, or of any other series of the same or any other class or classes of stock, of the Company at such price or prices or at such rates of exchange and with such adjustments; all as may be stated in such resolution or resolutions.

Notes to the Consolidated Financial Statements

Note 11. Stockholders' Equity (Continued)

Backstop Purchase Agreement

On November 23, 2015, the Company entered into a Second Amended and Restated Backstop Common Stock Purchase Agreement ("Backstop Purchase Agreement") with the Sponsor of GDEF. The Backstop Purchase Agreement granted the Sponsor the right to purchase shares of common stock, at a price of \$10.63 per share (the "Backstop Purchase"). The purchase right was exercisable only in the event, and to the extent, that the Company did not meet the Threshold Cash Amount (\$20,000,000 in cash available to the Company from (1) the trust account at the closing of the Business Combination following the payment in full to stockholders who had requested to be redeemed in connection with the closing of the Business Combination, and (2) the payment of any aggregate purchase price for the Backstop Purchase). In connection with the closing of the Business Combination, the Sponsor purchased 1,030,103 shares for approximately \$11 million.

Common Stock Dividends

The Company declared a dividend of one share of common stock for every 1.06 shares of common stock payable to stockholders of record immediately following the consummation of the Business Combination. The Sponsor and the Predecessor's stockholder, with respect to the shares of common stock currently held by the Sponsor, have agreed to forfeit this dividend. The Sponsor did not forfeit the right to receive dividends with respect to any shares it acquired pursuant to the Backstop Purchase and the Predecessor's stockholder did not forfeit the right to receive dividends with respect to the Conversion Shares described further in Note 2. Payment of the dividend was contingent upon the closing of the Business Combination and made in connection with the close of the Business Combination.

Common Stock Purchase Agreements

As further described in Note 7, on November 14, 2016, the Company entered into two Common Stock Purchase Agreements that provided for the sale of 462,778 shares of common stock at a purchase price of \$3.60 per share, for an aggregate purchase price of approximately \$1.7 million.

Note 12. Stock Based Compensation

In connection with the approval of the Business Combination, the 2015 Omnibus Incentive Plan (the Plan) was approved by shareholders to provide incentives to key employees, directors, and consultants of the Company and its subsidiaries. Awards under the Plan are generally not restricted for any specific form or structure and could include, without limitation, stock options, stock appreciation rights, dividend equivalent rights, restricted stock awards, cash-based awards, or other right or benefit under the Plan. The Plan allowed for the lesser of: (i) 1.60 million shares of common stock; or (ii) 8% of the outstanding common shares immediately following the consummation of the Business Combination as reserved and authorized for issuance under the Plan. At December 31, 2016 and 2015, there were 0.94 million and 1.57 million shares, respectively, of common stock authorized and available for issuance under the Plan.

Stock Options

Upon completion of the Business Combination, the Company approved initial grants of non-qualified stock option awards under the Plan to the current independent members of the Board of Directors. The stock option awards expire in ten years from the date of grant and vest over a period of one year – 20% of the options will vest 30 days following the grant date, 40% of the options will vest six months following the grant date subject to the Director's continued service and the remaining 40% of the options will vest 12 months following the grant date subject to the director's continued service. The exercise price is required to be set at not less than 100% of the fair market value of the Company's common stock on the date of grant.

In June 2016, the Company granted non-qualified stock option awards under the Plan to certain key employees of the Company. The stock option awards expire in ten years from the date of grant and vest in 20% increments over a period that ranges from the grant date to approximately 4.5 years.

In September 2016, the Company granted non-qualified stock option awards under the Plan to a key employee of the Company. The stock option awards expire in ten years from the date of grant and vest at 25% on the grant date and in 25% increments thereafter over approximately 1.5 years.

STG Group, Inc.

Notes to the Consolidated Financial Statements

Note 12. Stock Based Compensation (Continued)

During the year ended December 31, 2016, and the period from November 24, 2015 through December 31, 2015, the fair value of each option was estimated on the date of grant using the Black-Scholes model that uses the following weighted average assumptions:

	2016	2015
Expected dividend yield	0%	0%
Risk-free interest rate	1.5%	1.7%
Expected option term	6 years	5.5 years
Volatility	88.3%	75.4%
Weighted-average fair value	\$ 2.66	\$ 3.46

The Company calculated the expected term of the stock option awards using the “simplified method” in accordance with the *Securities and Exchange Commission Staff Accounting Bulletins No. 107 and 110* because the Company lacks historical data and is unable to make reasonable assumptions regarding the future. The Company also estimates forfeitures of share-based awards at the time of grant and revises such estimates in subsequent periods if actual forfeitures differ from original projections. The Company’s assumptions with respect to stock price volatility are based on the average historical volatility of peers with similar attributes. The Company determines the risk-free interest rate by selecting the U.S. Treasury constant maturity rate.

The total compensation expense related to stock option awards under the Plan was \$0.6 million and \$0.03 million for the year ended December 31, 2016, and the period from November 24, 2015 through December 31, 2015, respectively. The income tax benefit related to share-based compensation expense was approximately \$0.3 million and nominal for the year ended December 31, 2016, and the period from November 24, 2015 through December 31, 2015, respectively. As of December 31, 2016, \$1.0 million of total unrecognized compensation expense related to the share-based compensation Plan is expected to be recognized over a weighted-average period of 2.50 years. The total unrecognized share-based compensation expense to be recognized in future periods as of December 31, 2016 does not consider the effect of share-based awards that may be issued in future periods.

Stock option awards as of December 31, 2016, and changes during the year ended December 31, 2016 were as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding, beginning of period	33,336	\$ 5.40		
Granted	567,972	4.12		
Exercised	-	-		
Forfeited	-	-		
Outstanding, end of period	<u>601,308</u>	<u>\$ 4.19</u>	<u>9.51</u>	<u>\$ -</u>
Exercisable, end of period	<u>210,485</u>	<u>\$ 4.47</u>	<u>9.43</u>	<u>\$ -</u>

There was no aggregate intrinsic value for the options outstanding and exercisable at December 31, 2016 because the exercise price exceeds the underlying share price.

Restricted Stock Awards

In June 2016, the Company granted restricted stock awards under the Plan to members of the Board of Directors. The awards vest at 20% on the date of the award and in two 40% increments during the remaining annual period.

The total compensation expense related to restricted stock awards granted under the Plan was \$0.1 million for the year ended December 31, 2016. The income tax benefit related to the restricted stock awards was approximately \$0.03 million for the year ended December 31, 2016. As of December 31, 2016, \$0.05 million of total unrecognized compensation expense related to the restricted stock awards under the Plan is expected to be recognized over a weighted-average period of 0.5 years. The total unrecognized share-based compensation expense to be recognized in future periods as of December 31, 2016 does not consider the effect of share-based awards that may be issued in future periods.

Outstanding (non-vested) and vested restricted awards as of December 31, 2016 totaled 22,400 and 33,600, respectively, and 33,600 that vested during the year ended December 31, 2016. The fair value grant date fair value of vested and non-vested awards was \$1.99 per share.

Notes to the Consolidated Financial Statements

Note 13. Income Taxes

The consolidated provision for income taxes included within the consolidated statements of operations consisted of the following:

	Successor		Predecessor
	Year Ended December 31, 2016	November 24, 2015 Through December 31, 2015	January 1, 2015 Through November 23, 2015
Current			
Federal	\$ -	\$ -	\$ -
State	(42)	13	734
	(42)	13	734
Deferred			
Federal	(3,415)	(1,337)	-
State	(445)	(261)	(90)
	(3,860)	(1,598)	(90)
Total income tax (benefit) provision	\$ (3,902)	\$ (1,585)	\$ 644

Income tax (benefit) expense recognized in the accompanying consolidated statements of operations differs from the amounts computed by applying the Federal income tax rate to earnings before income tax (benefit) expense. A reconciliation of income taxes at the Federal statutory rate to the effective tax rate is summarized as follows:

	Successor	Successor	Predecessor
	Year Ended December 31, 2016	November 24, 2015 Through December 31, 2015	January 1, 2015 Through November 23, 2015
Tax at Federal statutory rate of 35%	35.0%	35.0%	35.0%
State taxes – net of Federal benefit	0.9	8.8	9.3
Benefit from S corporation election	-	-	(30.0)
Non-deductible transaction costs	(1.1)	(10.4)	-
Release of valuation allowance	-	51.4	-
Goodwill impairment	(27.7)	-	-
Permanent differences	-	(0.1)	-
Other	0.4	1.4	-
	<u>7.5%</u>	<u>86.1%</u>	<u>14.3%</u>

STG Group, Inc.

Notes to the Consolidated Financial Statements

Note 13. Income Taxes (Continued)

The Company's temporary differences which gave rise to deferred tax assets and liabilities as of December 31, 2016 and 2015 were as follows:

	Successor	
	December 31, 2016	December 31, 2015
Deferred tax assets		
Deferred Compensation	\$ 101	\$ 1,445
Accrued expenses and reserves	1,045	929
Deferred rent	381	521
Share-based compensation	262	-
Net operating losses	2,726	476
	<u>4,515</u>	<u>3,371</u>
Deferred tax liabilities		
Property and equipment	(270)	(11)
Intangible assets	(10,599)	(13,575)
	<u>(10,869)</u>	<u>(13,586)</u>
Net deferred tax liability	\$ (6,354)	\$ (10,215)

In connection with the Business Combination, STG Group (Predecessor) converted from a Subchapter S Corporation to a C Corporation. Prior to this, for the period from January 1, 2015 through November 23, 2015, and the year ended December 31, 2014, STG Group, generally did not incur corporate level income taxes, exclusive of certain state level jurisdictions. In lieu of corporate income taxes, the Predecessor stockholder separately accounted for his pro-rata share of STG Group's income, deductions, losses and credits. Therefore, the Company presented corporate level deferred tax assets and liabilities for solely the Successor period. In addition, the Company released a valuation allowance against GDEF's deferred tax assets in the amount of \$1.1 million. The Company's gross net operating losses totaling approximately \$6.8 million and \$8.2 million for federal and state income taxes, respectively, as of December 31, 2016 will expire in 2033 through 2036. The net deferred tax liability is presented on the consolidated balance sheets as a long-term liability totaling \$6.4 million as of December 31, 2016, and a current asset totaling \$2.4 million and as a long-term liability totaling \$12.6 million as of December 31, 2015. The Company adopted ASU 2015-17 prospectively during the quarter ended June 30, 2016. The adoption of ASU 2015-17 resulted in the aggregation of a current deferred tax asset and a long-term deferred tax liability to a single line reported on the consolidated balance sheets as a non-current deferred tax liability.

Note 14. Segment Information

Segment information is not presented since all of the Company's revenue and operations are attributed to a single reportable segment. In accordance with authoritative guidance on segment reporting under the FASB, the chief operating decision maker has been identified as the President. The President reviews operating results to make decisions about allocating resources and assessing performance for the entire company.

Note 15. Subsequent Events

Merger Agreement to Acquire PSS Holdings Inc. ("PSS").

On February 18, 2017, the Company entered into the Merger Agreement to acquire PSS. Under the terms of the Merger Agreement, the aggregate purchase price to be paid for PSS at closing is \$119.5 million in cash, subject to certain adjustments based upon closing working capital plus a portion of the value of certain tax benefits as they are realized after the closing. The purchase price will also be increased by an additional \$20,000 per day if the merger is consummated after March 31, 2017 and certain conditions to the obligations of the Company to close are otherwise satisfied, such increase applicable for each day after March 31, 2017 that such conditions are so satisfied.

The consummation of the merger is subject to the satisfaction of certain conditions, including receipt of certain required third party consents. If any condition to the merger is not satisfied or waived, the merger will not be completed. In addition, the Company intends to fund the merger consideration through a combination of equity and debt financing. The Company does not presently have commitments for such financing. To the extent the merger is not completed for any reason with respect to our ability to obtain financing for the merger, we may be required to pay a termination fee of \$625,000 to PSS.

On April 13, 2017, the Company received a letter from PSS purporting to terminate the Merger Agreement, unless we notify PSS that we are prepared to close and schedule the closing of the merger for no later than April 23, 2017. The Company does not believe the purported termination of the Merger Agreement is valid, and the Company is evaluating its alternatives and rights under the Merger Agreement.

Forbearance Agreement and Waiver

On February 24, 2017, we entered into a forbearance agreement with MC Admin Co LLC and the other lenders under our Credit Agreement. Under the forbearance agreement, the lenders agreed to forbear from exercising rights and remedies (including enforcement and collection actions) related to our failure to comply with the covenants related to the fixed charge coverage ratio, consolidated EBITDA and the senior secured leverage ratio, for the fiscal quarter ended December 31, 2016. The forbearance will expire no later than March 31, 2017.

The Company entered into a Limited Waiver ("the Waiver") from MC Admin Co LLC and other lenders under the Credit Agreement as of March 31, 2017, pursuant to which the lenders waived the Company's noncompliance with the Specified Financial Covenants as of December 31, 2016. Pursuant to the

Waiver:

- Loans under the Credit Agreement are subject to additional interest at a rate of 2% per annum until the earliest of (x) the date on which all loans are repaid and all commitments under the Credit Agreement are terminated, (y) the date we deliver the financial statements and certificates for the quarter ending March 31, 2017 showing that we are not in default under the Credit Agreement or (z) the date on which default interest is otherwise due under the Credit Agreement;
- We must obtain lender consent prior to use of our revolving credit facility; and
- We cannot effect a Cure Right in respect of the quarter ending March 31, 2017.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports the period covered by Company files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

As of the end of the period covered by this Annual Report on Form 10-K, we, including our principal executive officer and our principal financial officer, conducted an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934). Based upon this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are not effective in timely alerting management of any material information relating to us that is required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934 due to the material weakness in internal control over financial reporting described in "Management's Report on Internal Control Over Financial Reporting" below.

Management's Report on Internal Control Over Financial Reporting

As required by the SEC rules and regulations for the implementation of Section 404 of the Sarbanes-Oxley Act, our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of our consolidated financial statements for external reporting purposes in accordance with GAAP. Our internal control over financial reporting includes those policies and procedures that:

- (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of our company,
- (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors, and
- (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect errors or misstatements in our consolidated financial statements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree or compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting at December 31 2016. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control — Integrated Framework (2013).

Based on our assessment and those criteria, management determined that we did not maintain effective internal control over financial reporting at December 31, 2016 due to the ongoing remediation of the prior year material weakness discussed below. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Remediation of Material Weakness in Internal Control over Financial Reporting

Management is committed to improving our overall system of internal control over financial reporting, including taking necessary steps to fully remediate the identified material weakness identified as of December 31, 2015. Management determined that the Company's review and monitoring controls over the consolidated income tax provision failed to prevent or detect material errors in the calculation of the income tax provision for the year ended December 31, 2015, and that this was a material weakness in the Company's internal control over financial reporting. To assist with remediation of the material weakness in internal controls over Financial Reporting the Company identified at December 31, 2015, management has engaged a third party vendor to provide a comprehensive assessment of the Company's internal controls over financial reporting.

The comprehensive assessment of the Company's internal controls over financial reporting is currently in process. Although the activity completed to date has not yet identified any material weaknesses, including the review and monitoring controls over the consolidated income tax provision which resulted in the material weakness at December 31, 2015. We cannot conclude that no material weakness exists until the comprehensive assessment is complete and any identified findings have been remediated and tested.

Management believes that upon completion of the comprehensive assessment, such measures should be sufficient to remediate the identified material weaknesses and strengthen our internal control over financial reporting. We cannot assure you that these steps will remediate such weaknesses, nor can we be certain of whether additional actions will be required or the costs of any such actions.

Changes in Internal Control Over Financial Reporting

On November 23, 2015, we completed our Business Combination with STG Group, which was previously not a reporting company. We have begun to implement internal control over financial reporting related to the operation of STG Group as the subsidiary of a public company. Other than in connection with the foregoing and the remedial action outlined above, there have been no changes in our internal control over financial reporting that occurred during the year ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None

PART III

Certain information required by Part III is incorporated by reference from the Company's definitive Proxy Statement to be filed on or about April 28, 2017. Except for those portions specifically incorporated in this Form 10-K by reference to the Company's Proxy Statement, no other portions of the Proxy Statement are deemed to be filed as part of this Form 10-K.

PART IV**Item 15. Exhibits, Financial Statement Schedules**

Exhibit Number	Description	Incorporated by Reference			Filed or Furnished Herewith
		Form	Exhibit	Filing Date	
2.1	Stock Purchase Agreement, dated June 8, 2015, by and among Company, STG Group, Inc., the stockholders of STG Group, Inc., Sponsor and Simon S. Lee, as stockholder representative	8-K	2.1	6/9/2015	
3.1	Amended and Restated Certificate of Incorporation	8-K	3.1	11/30/2015	
3.2	Amended and Restated Bylaws	8-K	3.2	11/30/2015	
4.1	Specimen Common Stock Certificate	S-1/A	4.1	10/22/2015	
10.1	Amended and Restated Registration Rights Agreement, dated November 23, 2015, between the Company and the Sponsor	8-K	3.2	11/30/2015	
10.2	Second Amended and Restated Stock Escrow Agreement, dated October 23, 2015, among the Company, American Stock Transfer & Trust Company, and the Sponsor	8-K	10.9	10/23/2015	
10.3	Form of Indemnification Agreement	S-1/A	10.10	10/7/2013	
10.4	Promissory Note issued to the Sponsor, dated July 18, 2013	S-1/A	10.4	10/2/2013	
10.5	Convertible Promissory Note issued to the Sponsor, dated May 15, 2014	8-K	10.1	5/19/2014	
10.6	Amendment to Convertible Promissory Note (issued May 15, 2014), dated July 21, 2015 issued by the Company to the Sponsor	8-K	10.2	7/21/2015	
10.7	Second Amendment to Convertible Promissory Note (issued May 15, 2014), dated October 23, 2015 issued by the Company to the Sponsor	8-K	10.2	10/23/2015	

Item 16. Form 10-K Summary

None

10.8	Convertible Promissory Note, dated May 12, 2015, issued by the Company to the Sponsor	8-K	10.1	5/14/2015
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10.12	Amendment to Promissory Note issued to the Sponsor (issued July 21, 2015), dated October 23, 2015	8-K	10.4	10/23/2015
10.13	Convertible Promissory Note, dated October 8, 2015, issued by the Company to the Sponsor	8-K	10.1	10/13/2015
10.14	Amendment to Convertible Promissory Note (issued October 8, 2015), dated October 23, 2015, issued by the Company to the Sponsor	8-K	10.5	10/23/2015
10.15	Promissory Note issued to the Sponsor, dated October 23, 2015	8-K	10.11	10/23/2015
10.16	Convertible Promissory Note, dated November 13, 2015, issued by the Company to the Sponsor	8-K	10.1	11/13/2015
10.17	Form of Inside Director Letter	10-Q	10.1	5/13/2015
10.18	Form of Independent Director Letter	10-Q	10.2	5/13/2015
10.19	Share Contribution and Dividend Waiver Letter, dated as of November 23, 2015, from the Sponsor to the Company	10-K	10.19	3/30/2016
10.20	Credit Agreement, dated as of November 23, 2015, by and among the Company, STG, STG, Inc., Access Systems Incorporated, the lenders party thereto from time to time, MC Admin Co LLC, as administrative agent, PNC Bank, National Association, as collateral agent, and MC Admin Co LLC, as lead arranger	8-K	10.1	11/30/2015
10.21	Security Agreement, dated as of November 23, 2015, by and among the Company, STG, STG, Inc., Access Systems, Incorporated, and such other assignors party thereto and PNC Bank, National Association	8-K	10.2	11/30/2015
10.22	Pledge Agreement, dated as of November 23, 2015, by and among the Company, STG, STG, Inc., Access Systems, Incorporated, such other Pledgors party thereto and PNC Bank, National Association	8-K	10.3	11/30/2015
10.23	Registration Rights Agreement, dated as of November 23, 2015, by and among the Company and the Predecessor's Stockholders	8-K	10.4	11/30/2015
10.24	Voting Agreement, dated as of November 23, 2015, by and among the Company, the Predecessor's Stockholders and the Sponsor	8-K	10.6	11/30/2015
10.25	Escrow Agreement, dated as of November 23, 2015, by and among the Company, the Predecessor's Stockholders, Simon S. Lee, as Stockholders Representative, and Branch Banking and Trust Company	8-K	10.7	11/30/2015
10.26	Second Amended and Restated Backstop Common Stock Purchase Agreement, dated as of November 23, 2015, issued by the Company to the Sponsor	8-K	10.8	11/30/2015
10.27	Contribution and Exchange Agreement, dated as of November 23, 2015, by and between the Company and the Sponsor	8-K	10.9	11/30/2015
10.28	Employment Agreement, dated as of November 23, 2015, by and between the Company and Paul Fernandes	8-K	10.10	11/30/2015
10.29	Employment Agreement, dated as of November 23, 2015, by and between the Company and Charles Cosgrove	8-K	10.11	11/30/2015
10.30	Employment Agreement, dated as of November 23, 2015, by and between the Company and Glenn W. Davis, Jr.	8-K	10.12	11/30/2015
10.31	Employment Agreement, dated as of November 23, 2015, by and between the Company and Keith Lynch	8-K	10.13	11/30/2015
10.32	Employment Agreement, dated as of November 30, 2015, by and between the Company and Dale R. Davis	8-K	10.14	11/30/2015

10.33	Master Services Agreement, dated as of November 10, 2015, by and between the Company and Global Strategies Group (North America) Inc.	8-K	10.15	11/30/2015	
10.34	Letter Agreement, dated as of November 23, 2015, between the Company and the Predecessor's Stockholders	10-K	10.34	3/30/2016	
10.35	Global Defense & National Security Systems, Inc. 2015 Omnibus Incentive Plan	10-K	10.35	3/30/2016	
10.36	Form of Stock Option Award Agreement	10-K	10.36	3/30/2016	
10.37	Executive Employment Agreement, revised May 2, 2016, by and between Dale Davis and the Company	8-K	10.1	5/5/2016	
10.38	Executive Employment Agreement, dated August 31, 2016, by and between the Company and Phillip E. Lacombe	8-K	10.1	9/7/2016	
10.39	Separation and General Release Agreement, dated June 30, 2016, by and between the Company and Paul Fernandes	10-Q	10.1	11/14/2016	
10.40	Form of Common Stock Purchase Agreement, dated as of November 14, 2016				X
10.41	Limited Forbearance to Credit Agreement, dated as of February 24, 2017, by and among the Company, STG, Inc., Access Systems, Incorporated, STG Group Holdings, Inc., MC Admin Co LLC, and the requisite lenders party thereto.				X
14.1	Code of Ethics	S-1/A	14.1	10/2/2013	
21.1	Subsidiaries of the Registrant				X
23.1	Consent of BDO USA LLP, Independent Registered Public Accounting Firm				X
24.1	Power of Attorney				(1)
31.1	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
31.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
32.1	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				X
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				X
101.INS	XBRL Instance Document				(2)
101.SCH	XBRL Taxonomy Schema				(2)
101.CAL	XBRL Taxonomy Calculation Linkbase				(2)
101.DEF	XBRL Taxonomy Definition Linkbase				(2)
101.LAB	XBRL Taxonomy Label Linkbase				(2)
101.PRE	XBRL Taxonomy Presentation Linkbase				(2)

(1) included on signature page herein.

(2) filed herewith electronically.

* All schedules to this agreement have been omitted pursuant to Item 601(b)(2) of Regulation S-K. The Company hereby agrees to furnish supplementally a copy of any omitted schedule to the SEC upon request.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

STG GROUP, INC.

Date: April 17, 2017

By: /s/ Charles L. Cosgrove

Name: Charles L. Cosgrove

Title: Chief Financial Officer

POWER OF ATTORNEY

Know all persons by these presents, that each person whose signature appears below constitutes and appoints Charles L. Cosgrove as his attorney-in-fact, with the power of substitution, for him in any and all capacities, to sign any amendments to this Annual Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that said attorney-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Date: April 17, 2017

By: /s/ Phillip E. Lacombe

Name: Phillip E. Lacombe

Title: President and Chief Operating Officer
(Principal Executive Officer)

Date: April 17, 2017

/s/ Charles L. Cosgrove

Name: Charles L. Cosgrove

Title: Chief Financial Officer
(Principal Financial Officer)

Date: April 17, 2017

By: /s/ David Pearson

Name: David Pearson

Title: Vice President, Accounting and Corporate Controller

Date: April 17, 2017

By: /s/ Simon S. Lee

Name: Simon S. Lee

Title: Chairman of the Board

Date: April 17, 2017

By: /s/ Damian Perl

Name: Damian Perl

Title: Director

Date: April 17, 2017

By: /s/ Hon. David C. Gompert
Name: Hon. David C. Gompert
Title: Director

Date: April 17, 2017

By: /s/ Hon. Ronald R. Spoehel
Name: Hon. Ronald R. Spoehel
Title: Director

Date: April 17, 2017

By: /s/ Robert B. Murrett
Name: Robert B. Murrett
Title: Director

EXHIBIT INDEX

Exhibit Number	Description	Incorporated by Reference			Filed or Furnished Herewith
		Form	Exhibit	Filing Date	
2.1	Stock Purchase Agreement, dated June 8, 2015, by and among Company, STG Group, Inc., the stockholders of STG Group, Inc., Sponsor and Simon S. Lee, as stockholder representative	8-K	2.1	6/9/2015	
3.1	Amended and Restated Certificate of Incorporation	8-K	3.1	11/30/2015	
3.2	Amended and Restated Bylaws	8-K	3.2	11/30/2015	
4.1	Specimen Common Stock Certificate	S-1/A	4.1	10/22/2015	
10.1	Amended and Restated Registration Rights Agreement, dated November 23, 2015, between the Company and the Sponsor	8-K	3.2	11/30/2015	
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101.DEF	XBRL Taxonomy Definition Linkbase	(2)
101.LAB	XBRL Taxonomy Label Linkbase	(2)
101.PRE	XBRL Taxonomy Presentation Linkbase	(2)

(1) included on signature page herein.

(2) filed herewith electronically.

* All schedules to this agreement have been omitted pursuant to Item 601(b)(2) of Regulation S-K. The Company hereby agrees to furnish supplementally a copy of any omitted schedule to the SEC upon request.

COMMON STOCK PURCHASE AGREEMENT

This Common Stock Purchase Agreement (this "Agreement"), is entered into as of November 14, 2016, by and between STG Group, Inc., a Delaware corporation (the "Company"), and [] (the "Purchaser").

WHEREAS, the Company is a party to that certain Credit Agreement, dated as of November 21, 2015 (the "Credit Agreement"), by and among the Company, MC Admin Co LLC and the other parties named therein, and the Company wishes to exercise its equity right under the Credit Agreement, pursuant to which the Company may sell shares of the Company's capital stock to potential investors; and

WHEREAS, the Purchaser desires to purchase, and the Company desires to sell to the Purchaser, shares of the common stock of the Company, par value \$0.0001 per share ("Common Stock"), pursuant to the terms and conditions set forth herein.

NOW, THEREFORE, in consideration of the premises, representations, warranties and the mutual covenants contained in this Agreement, and for other good and valuable consideration, the receipt, sufficiency and adequacy of which are hereby acknowledged, the parties hereto agree as follows:

1. Stock Purchase. Subject to the terms and conditions contained in this Agreement and concurrently with the execution of this Agreement by the parties hereto, the Company hereby issues and sells to the Purchaser, and the Purchaser hereby purchases from the Company (the "Stock Purchase"), [] shares of Common Stock from the Company, at a purchase price of \$3.60 per share (the "Per Share Purchase Price"), for an aggregate purchase price of \$[].

2. Deliveries.

(a) Purchase Price. Concurrently with the execution of this Agreement by the parties hereto, the Purchaser has delivered to the Company an amount equal to (i) the Per Share Purchase Price, multiplied by (ii) the number of shares of Common Stock being purchased by the Purchaser.

(b) Certificates. Concurrently with the execution of this Agreement by the parties hereto, the Company has delivered to American Stock Transfer & Trust Company, LLC, the Company's transfer agent, irrevocable instructions to issue to the Purchaser a certificate evidencing the shares purchased hereby (the "Shares").

(c) Legend. Each certificate evidencing the Shares and each certificate issued in exchange for or upon the transfer of any Shares shall be stamped or otherwise imprinted with a legend in substantially the following form:

"THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"). THE SHARES REPRESENTED BY THIS CERTIFICATE ARE HELD BY AN AFFILIATE OF THE ISSUER AS DEFINED IN RULE 144 PROMULGATED UNDER THE SECURITIES ACT. THE SECURITIES MAY NOT BE SOLD, OFFERED FOR SALE, PLEDGED OR HYPOTHECATED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT AS TO THE SECURITIES UNDER SAID ACT OR UNLESS SUCH REGISTRATION IS NOT REQUIRED IN THE OPINION OF COUNSEL FOR THE COMPANY."

3. Representations and Warranties of the Purchaser. The Purchaser represents and warrants to the Company as follows:

(a) Organization and Good Standing. The Purchaser is a trust, duly organized, validly existing, and in good standing under the laws of the State of Delaware.

(b) Power and Authority; Enforceability. This Agreement constitutes the legal, valid, and binding obligation of the Purchaser, enforceable against the Purchaser in accordance with its terms. The Purchaser has full entity power and authority to execute and deliver this Agreement and to perform its obligations hereunder. The Purchaser has taken all actions necessary to authorize the execution and delivery of this Agreement, the performance of its obligations hereunder and the consummation of the transactions contemplated hereby. This Agreement has been duly authorized, executed and delivered by the Purchaser.

(c) Investment Representations.

(i) The Purchaser is an “accredited investor” as defined in Rule 501 of Regulation D under the Securities Act of 1933, as amended (the “Securities Act”).

(ii) The Purchaser has received, has thoroughly read, is familiar with and understands the contents of this Agreement.

(iii) The Purchaser hereby acknowledges that an investment in the Shares involves certain significant risks. The Purchaser acknowledges that there is a substantial risk that it will lose all or a portion of its investment and that it is financially capable of bearing the risk of such investment for an indefinite period of time. The Purchaser has no need for liquidity in its investment in the Shares for the foreseeable future and is able to bear the risk of that investment for an indefinite period. The Purchaser’s present financial condition is such that the Purchaser is under no present or contemplated future need to dispose of any portion of the Shares purchased hereby to satisfy any existing or contemplated undertaking, need or indebtedness. The Purchaser’s overall commitment to investments which are not readily marketable is not disproportionate to its net worth and the investment in the Company will not cause such overall commitment to become excessive.

(iv) The Purchaser acknowledges that the Shares have not been registered under the Securities Act, or any state securities act, and are being sold on the basis of exemptions from registration under the Securities Act and applicable state securities acts. Reliance on such exemptions, where applicable, is predicated in part on the accuracy of the Purchaser’s representations and warranties set forth herein. The Purchaser acknowledges and hereby agrees that the Shares will not be transferable under any circumstances unless the Shares are registered in accordance with federal and state securities laws or the Purchaser finds and complies with an available exemption under such laws. Accordingly, the Purchaser hereby acknowledges that there can be no assurance that it will be able to liquidate its investment in the Company.

(v) There are substantial risk factors pertaining to an investment in the Company. The Purchaser acknowledges that it has read the information set forth above regarding certain of such risks and is familiar with the nature and scope of all such risks, including, without limitation, risks arising from the fact that the Company is an entity with limited operating history and financial resources; and the Purchaser is fully able to bear the economic risks of such investment for an indefinite period, and can afford a complete loss thereof.

(vi) The Purchaser has been given the opportunity to (i) ask questions of and receive answers from the Company and its designated representatives concerning the terms and conditions of the purchase of the Shares, the Company and the business and financial condition of the Company and (ii) obtain any additional information that the Company possesses or can acquire without unreasonable effort or expense that is necessary to assist the Purchaser in evaluating the advisability of the purchase of the Shares and an investment in the Company. The Purchaser further represents and warrants that, prior to signing this Agreement, it has asked such questions, received such answers and obtained such information as it has deemed necessary or advisable to evaluate the merits and risks of the purchase of the Shares and an investment in the Company. The Purchaser is not relying on any oral representation made by any person as to the Company or its operations, financial condition or prospects.

(vii) The Purchaser understands that no federal, state or other governmental authority has made any recommendation, findings or determination relating to the merits of an investment in the Company.

(viii) The Purchaser acknowledges that neither the Company, nor any of its officers, directors, employees, agents or affiliates has made any representation or warranty, express or implied, regarding the Company, the Shares or otherwise, other than the representations and warranties set forth herein.

(ix) The Purchaser acknowledges its obligations under the Securities Act, and the rules and regulations promulgated thereunder, with respect to the treatment of non-public information relating to the Company.

4. Representations and Warranties of the Company. The Company represents and warrants to the Purchaser as follows:

(a) Organization. The Company is a corporation duly organized and validly existing under the laws of the State of Delaware.

(b) Power and Authority; Enforceability. This Agreement constitutes the legal, valid, and binding obligation of the Company, enforceable against the Company in accordance with its terms. The Company has full power and authority to execute and deliver this Agreement and to perform its obligations hereunder. The Company has taken all actions necessary to authorize the execution and delivery of this Agreement, the performance of its obligations hereunder, and the consummation of the transactions contemplated hereby. This Agreement has been duly authorized, executed, and delivered by the Company.

(c) No Violation; Necessary Approvals. Neither the execution and delivery of this Agreement by the Company, nor the consummation or performance by the Company of any of the transactions contemplated hereby, will: (i) with or without notice or lapse of time, constitute, create or result in a breach or violation of, default under, loss of benefit or right under, termination, cancellation, suspension or modification of, or acceleration of performance of any obligation required under any (A) law (statutory, common or otherwise), constitution, ordinance, rule, regulation, executive order or other similar authority enacted, adopted, promulgated or applied by any legislature, agency, bureau, branch, department, division, commission, court, tribunal or other similar recognized organization or body of any federal, state, county, municipal, local or foreign government or other similar recognized organization or body exercising similar powers or authority (collectively, "Law"), (B) order, ruling, decision, award, judgment, injunction or other similar determination or finding by, before or under the supervision of any governmental authority or arbitrator (collectively, "Order"), (C) contract or agreement, (D) permit, license, certificate, waiver, filing, notice or authorization (collectively, "Permit") to which the Company is a party or by which it is bound or any of its assets are subject, or (E) any provision of the Company's organizational documents as in effect on the date hereof, (ii) result in the imposition of any lien, claim or encumbrance upon any assets owned by the Company; (iii) require any consent, approval, notification, waiver, or other similar action under any contract or agreement or organizational document to which the Company is a party or by which it is bound (other than the consent of the Investor Parties under the Voting Agreement, dated as of November 23, 2015, by and among the Company and the Investor Parties named therein); or (iv) require any Permit under any Law or Order other than (A) required filings, if any, with the Securities and Exchange Commission and (B) notifications or other filings with state or federal regulatory agencies after the date hereof that are necessary or convenient and do not require approval of the agency as a condition to the validity of the transactions contemplated hereunder; or (v) trigger any rights of first refusal, preemptive or preferential purchase or similar rights with respect to any of the Shares.

(d) Authorization of the Shares. The Shares have been duly authorized, and when issued in accordance with this Agreement, will be duly and validly issued, fully paid and non-assessable and will be free and clear of all liens, claims or encumbrances, other than (A) transfer restrictions hereunder, (B) transfer restrictions under federal and state securities laws, and (C) liens, claims or encumbrances imposed due to the actions of the Purchaser.

5. General Provisions.

(a) Survival of Representations and Warranties. All of the representations and warranties contained herein shall survive the closing of the transactions contemplated hereby.

(b) Entire Agreement. This Agreement, together with any documents, instruments and writings that are delivered pursuant hereto or referenced herein, constitutes the entire agreement and understanding of the parties hereto in respect of its subject matter and supersedes all prior understandings, agreements, or representations by or among the parties hereto, written or oral, to the extent they relate in any way to the subject matter hereof or the transactions contemplated hereby.

(c) Successors. All of the terms, agreements, covenants, representations, warranties, and conditions of this Agreement are binding upon, and inure to the benefit of and are enforceable by, the parties hereto and their respective successors.

(d) Assignments. Neither party hereto may assign either this Agreement or any of its rights, interests, or obligations hereunder without the prior written approval of the other party.

(e) Counterparts. This Agreement may be executed in two or more counterparts, each of which will be deemed an original but all of which together will constitute one and the same instrument.

(f) Headings. The section headings contained in this Agreement are inserted for convenience only and will not affect in any way the meaning or interpretation of this Agreement.

(g) Governing Law. This Agreement, the entire relationship of the parties hereto, and any litigation between the parties (whether grounded in contract, tort, statute, law or equity) shall be governed by, construed in accordance with, and interpreted pursuant to the laws of the State of Delaware, without giving effect to its choice of laws principles.

(h) Waiver of Jury Trial. The parties hereto hereby waive any right to a jury trial in connection with any litigation pursuant to this Agreement and the transactions contemplated hereby.

(i) Amendments. This Agreement may not be amended, modified or waived as to any particular provision, except by a written instrument executed by all parties hereto.

(j) Severability. The provisions of this Agreement will be deemed severable and the invalidity or unenforceability of any provision will not affect the validity or enforceability of the other provisions hereof; provided that if any provision of this Agreement, as applied to either party hereto or to any circumstance, is adjudged by a governmental authority, arbitrator, or mediator not to be enforceable in accordance with its terms, the parties hereto agree that the governmental authority, arbitrator, or mediator making such determination will have the power to modify the provision in a manner consistent with its objectives such that it is enforceable, and/or to delete specific words or phrases, and in its reduced form, such provision will then be enforceable and will be enforced.

(k) Expenses. Except as otherwise expressly provided in this Agreement or in the definitive documents for the Transaction, each party hereto will bear its own costs and expenses incurred in connection with the preparation, execution and performance of this Agreement and the consummation of the transactions contemplated hereby.

(l) Waiver. No waiver by either party hereto of any default, misrepresentation, or breach of warranty or covenant hereunder, whether intentional or not, may be deemed to extend to any prior or subsequent default, misrepresentation, or breach of warranty or covenant hereunder or affect in any way any rights arising because of any prior or subsequent occurrence.

(m) Further Assurances. The parties hereto shall execute and deliver such additional documents and take such additional actions as either party reasonably may deem to be practical and necessary in order to consummate the purchase and sale of Common Stock as contemplated by this Agreement.

[Signature page(s) follow]

IN WITNESS WHEREOF, the undersigned have executed this Agreement to be effective as of the date first set forth above.

COMPANY:

STG GROUP, INC.

By:
Name:
Title:

PURCHASER:

By:
Name:
Title:

va-484219

[Signature Page to Common Stock Purchase Agreement]

LIMITED FORBEARANCE TO CREDIT AGREEMENT

THIS LIMITED FORBEARANCE TO CREDIT AGREEMENT (this “**Forbearance**”) is entered into as of February 24, 2017 by and among STG GROUP, INC., a Delaware corporation (“**Holdings**”), STG, INC., a Virginia corporation (the “**Administrative Borrower**”), ACCESS SYSTEMS, INCORPORATED, a Virginia corporation (“**Access**”), STG GROUP HOLDINGS, INC., a Delaware corporation (“**Parent**”, and together with Holdings, the Administrative Borrower, and Access, collectively, the “**STG Parties**”), the lenders party hereto (the “**Required Lenders**”), MC ADMIN CO LLC, a Delaware limited liability company, as administrative agent under the Credit Agreement (as defined below) (in such capacity, the “**Administrative Agent**”), and PNC BANK, NATIONAL ASSOCIATION, as collateral agent under the Credit Agreement (as defined below) (in such capacity, the “**Collateral Agent**”).

RECITALS

WHEREAS, Holdings, the Administrative Borrower, Access, Parent and the Lenders and the Administrative Agent entered into that certain Credit Agreement, dated as of November 23, 2015 (as it may amended, restated, supplemented or otherwise modified from time to time, the “**Credit Agreement**”);

WHEREAS, the Administrative Borrower has informed the Administrative Agent and the Lenders that Holdings and the Borrowers have failed to comply with the covenants set forth in Section 11.08 through 11.10 of the Credit Agreement as of the last day of the fiscal quarter ending on December 31, 2016 and such events constitute Events of Default under Section of the Credit Agreement (collectively, the “**Financial Covenant Defaults**”);

WHEREAS, the Administrative Borrower has requested that the Administrative Agent and the Lenders forbear from exercising remedies with respect to the Financial Covenant Defaults for a limited period of time, as provided herein,

WHEREAS, the Administrative Borrower has requested that the Revolving Lenders continue to make Revolving Loans during the forbearance period, subject to the discretion of the RL Lenders; and

WHEREAS, the Administrative Agent and the Required Lenders (which includes the Majority Lenders with Revolving Loans and/or Revolving Commitments) are willing to forbear from exercising their rights with respect to the Financial Covenant Defaults on the terms and conditions set forth herein;

NOW THEREFORE, in consideration of the premises and the mutual agreements set forth, the receipt and sufficiency of which are hereby acknowledged, the parties hereto hereby agree as follows:

1. Acknowledgment; Forbearance; No Waiver.

(a) Acknowledgment of Rights and Remedies. Each STG Party (i) acknowledges that the Financial Covenant Defaults have occurred and (ii) acknowledges and agrees that but for the terms of this Forbearance, the Administrative Agent and the Lenders may, if they so elect, proceed to enforce their rights and remedies under the Credit Documents to collect the Obligations owing under the Credit Agreement and the other Credit Documents.

(b) Forbearance. Subject to all of the terms and conditions set forth herein, the Administrative Agent and the Required Lenders agree to forbear from exercising their rights and remedies under the Credit Agreement and the other Credit Documents solely with respect to the Financial Covenant Defaults, until that date (the “**Forbearance Termination Date**”) which is the earliest to occur of: (i) the date on which any Event of Default (other than the Financial Covenant Defaults) occurs, including, without limitation, as a result of any failure to comply with any term set forth in this Forbearance, (ii) the date on which any STG Party makes any payment or prepayment of any claims that are junior or subordinated to the Obligations, other than as permitted by the Credit Agreement or with the prior written consent of the Administrative Agent, and (iii) March 31, 2017. As used herein, the term “**Forbearance Period**” shall mean the period beginning on the Forbearance Effective Date (as defined below) and ending on the Forbearance Termination Date.

Each STG Party acknowledges that on and after the Forbearance Termination Date, the Agent and the Lenders may proceed, in accordance with the terms of the Credit Agreement and any other Credit Documents, whether with respect to the Financial Covenant Defaults or otherwise, to enforce any or all of their rights and remedies under or in respect of this Forbearance, the Credit Agreement, any of the other Credit Documents or applicable law, including, without limitation, the right: (i) to accelerate the Obligations, (ii) to commence any legal or other action to collect any or all of the Obligations from any or all of the STG Parties and any other person liable therefor and/or any Collateral, (iii) to foreclose or otherwise realize on any or all of the Collateral and/or as appropriate, set-off or apply to the payment of any or all of the Obligations, any or all of the Collateral, (iv) to vote equity interests by proxy, (v) to exercise dominion over cash in deposit accounts, (vi) to take any other enforcement action or otherwise exercise any or all rights and remedies provided for by any or all of the Credit Agreement, the other Credit Documents or applicable law and (vii) to reject any subsequent forbearance, financial restructuring or other proposal made by or on behalf of STG Parties, or any of them, or any creditor or equity holder.

(c) Revolving Credit Facility. Subject to all of the terms and conditions set forth herein and in the Credit Agreement, the Majority Lenders with Revolving Loans and/or Revolving Commitments agree that, during the Forbearance Period, the Administrative Borrower may request Revolving Loans, and the RL Lenders may, but shall not be obligated to, in their sole discretion advance the requested Revolving Loans; provided that each of the conditions set forth in Section 8 of the Credit Agreement shall be satisfied, other than Section 8.01 solely as a result of the Financial Covenant Defaults.

(d) Additional Interest. In connection with the Financial Covenant Defaults, and in consideration of the agreements contained herein, the STG Parties shall pay to the Administrative Agent (or, at the option of the Administrative Agent, to a designated affiliate of the Administrative Agent) (for distribution pro rata among the Lenders) additional interest (the “**Additional Interest**”) for the period from and including January 1, 2017 (the first day following the occurrence of the Financial Covenant Defaults) to, but excluding, the earlier of (x) the date on which all Loans are repaid and all Commitments under the Credit Agreement are terminated or (y) the date on which the Financial Covenant Defaults are waived by the Lenders in their sole discretion, at a rate per annum equal to 2% on the outstanding amount of the Loans. Additional Interest shall be payable (x) on the Forbearance Effective Date for the period to, but excluding, the Forbearance Effective Date and (y) thereafter, monthly in arrears.

(e) No Waiver or Amendment. Nothing in this Forbearance, nor any of the Agent's and the Required Lenders' entry into this Forbearance or any of the documents referenced herein, their negotiations with any party with respect to any STG Party, their conduct of any analysis or investigation of any Collateral for the Obligations or any Credit Document, their acceptance of any payment from any STG Party or any other party, or any other action or failure to act on the part of the Agent or any Lender, shall (i) constitute or be construed as a waiver of or acquiescence to the Financial Covenant Defaults, which shall continue in existence subject only to the agreement of the Agent and the Required Lenders, as set forth herein, not to enforce their remedies for a limited period of time, (ii) constitute an extension, modification or waiver of, or give rise to any obligation on the part of the Agent or any Lender to extend, modify or waive, any term, condition or other aspect of the Credit Agreement or the other Credit Documents; (iii) extend the terms of the Credit Agreement or the due date of any of the Obligations; or (iv) give rise to any defenses or counterclaims to the right of the Agent and the Lenders to compel payment of the Obligations or to otherwise enforce their rights and remedies described in the Credit Agreement and the other Credit Documents. Except as expressly limited herein, the Agent and the Lenders hereby expressly reserves all of their rights and remedies described in the Credit Agreement and the other Credit Documents that may exist by virtue of the Financial Covenant Defaults, and from and after the Forbearance Termination Date, the Agent and the Lenders shall be entitled to enforce such rights and remedies according to the original terms of the Credit Documents. This Forbearance shall not constitute a course of dealing with the Agent or any Lender at variance with the Credit Agreement such as to require further notice by the Agent or the Lenders to require strict compliance with the terms of the Credit Agreement and the other Credit Documents in the future. The STG Parties acknowledge and expressly agree that the Agent and the Lenders reserve the right to, and does in fact, require strict compliance with all terms and provisions of the Credit Agreement and the other Credit Documents.

2 . Defined Terms. Capitalized terms used but not defined herein shall have the respective meanings ascribed to such terms in the Credit Agreement.

3 . Condition to Effectiveness. This Forbearance shall be effective upon Administrative Agent's receipt of or satisfaction of the following conditions (each in form and substance satisfactory to Administrative Agent in its reasonable discretion):

(a) this Forbearance shall have been duly executed by the STG Parties, the Administrative Agent and the Required Lenders;

(b) the Fee Letter dated as of the date hereof, by and among the STG Parties and the Administrative Agent, shall have been duly executed by each of the STG Parties and the Administrative Agent and all fees contemplated thereby shall have been paid; and

(c) the Administrative Borrower shall have paid in full all fees and expenses of DLA Piper LLP (US), counsel to the Administrative Agent, required to be paid pursuant to the Credit Agreement.

The date on which each of the foregoing conditions is satisfied is referred to herein as the “**Forbearance Effective Date**”.

4. Representations and Warranties. In order to induce the Lenders and the Administrative Agent to enter into this Forbearance, each of STG Parties represents and warrants to the Administrative Agent and the Lenders, that the following statements are true and correct on and as of the date hereof and as of the Forbearance Effective Date (it being understood and agreed that any representation or warranty which by its terms is made as of a specified date shall be required to be true and correct in all material respects only as of such specified date):

(a) Each STG Party has the corporate power and authority to execute, deliver and perform the terms and provisions of the Forbearance and has taken all necessary corporate action to authorize the execution, delivery and performance by it of the Forbearance. Each STG Party has duly executed and delivered the Forbearance, and the Forbearance constitutes its legal, valid and binding obligation enforceable in accordance with its terms, except to the extent that the enforceability thereof may be limited by applicable bankruptcy, insolvency, reorganization, moratorium or other similar laws generally affecting creditors’ rights and by equitable principles (regardless of whether enforcement is sought in equity or at law);

(b) neither the execution, delivery or performance by any STG Party of the Forbearance, nor compliance by it with the terms and provisions thereof, (i) will contravene in any material respects any provision of any law, statute, rule or regulation or any order, writ, injunction or decree of any court or Governmental Authority, (ii) will conflict in any material respect with or result in any breach of any of the terms, covenants, conditions or provisions of, or constitute a default under, or result in the creation or imposition of (or the obligation to create or impose) any Lien (except pursuant to the Security Documents) upon any of the property or assets of any STG Party or any of its Subsidiaries pursuant to the terms of any indenture, mortgage, deed of trust, credit agreement or loan agreement, or any other material agreement, contract or instrument, in each case to which any STG Party or any of its Subsidiaries is a party or by which it or any its property or assets is bound or to which it may be subject, or (iii) will violate any provision of the certificate or articles of incorporation, certificate of formation, limited liability company agreement or by-laws (or equivalent organizational documents), as applicable, of any STG Party or any of its Subsidiaries;

(c) after giving effect to this Forbearance and the transactions contemplated hereby, each of the representations and warranties contained in the Credit Agreement and the other Credit Documents is true and correct in all material respects (or in all respects if such representation or warranty contains any materiality qualifier, including references to “material,” “Material Adverse Effect” or dollar thresholds) on and as of the date hereof (except to the extent that such representation or warranty expressly relates to an earlier date, in which case such representation or warranty shall be true and correct in all material respects as of such earlier date); and

(d) no Default or Event of Default shall have occurred and be continuing or would result immediately from the effectiveness of this Forbearance or the consummation of the transactions contemplated hereby, other than, the Financial Covenant Defaults.

5. Acknowledgment of Rights: Release of Claims. Each of Holdings, the Administrative Borrower, Access and Parent unconditionally and irrevocably acquits and fully and forever releases, remises, relieves and discharges and shall be deemed to have forever acquitted, remised, released and discharged the Administrative Agent and its affiliates and its and their respective past and present partners, members, subsidiaries, affiliates, officers, employees, agents, attorneys, principals, directors and shareholders and each of their respective heirs, legal representatives, successors and assigns (collectively, the “**Releasees**”) on the date hereof from any and all manner of action and actions, cause and causes of action, (including, without limitation, a claim for contribution), charge, counterclaim, debt, demand, dues, suit, sum of money, account, reckoning, bond, bill, specialty, covenant, contract, controversy, damages, judgment, expense, execution, lien, claim of liens, claim of costs, penalties, attorneys’ fees, or any other compensation, recovery or relief on account of any liability, obligation, demand or cause of action of whatever nature, whether in law, equity or otherwise (including, without limitation, interest or other carrying costs, penalties, legal, accounting and other professional fees and expenses, and incidental, consequential and punitive damages payable to any third party), whether known or unknown, fixed or contingent, joint and/or several, secured or unsecured, due or not due, primary or secondary, liquidated or unliquidated, contractual or tortious, direct, indirect or derivative, asserted or unasserted, foreseen or unforeseen, suspected or unsuspected, now existing, heretofore existing or which may heretofore accrue against any or all of the Releasees, whether held in a personal or representative capacity, and which is based on any act, fact, event or omission or other matter, cause or thing occurring at or from the beginning of time to and including the date hereof directly or indirectly with respect to, based on, arising out of or in any way related to this Forbearance, the other Credit Documents or any other related documents, instruments, agreements or matters or the enforcement or attempted or threatened enforcement by any of the Releasees of any of their respective rights, remedies or recourse related thereto (collectively, the “**Released Claims**”). Each of Holdings, the Administrative Borrower, Access and Parent covenants and agrees never to commence, voluntarily aid in any way, prosecute or cause to be commenced or prosecuted against any of the Releasees any action or other proceeding based upon any of the Released Claims.

6. Reaffirmation. Each STG Party as borrower, debtor, grantor, pledgor, guarantor, assignor, or in other any other similar capacity in which the such Party grants liens or security interests in its property or otherwise acts as accommodation party or guarantor, as the case may be, hereby (i) ratifies and reaffirms all of its payment and performance obligations, contingent or otherwise, under each of the Credit Documents to which it is a party (after giving effect hereto) and (ii) to the extent such STG Party granted liens on or security interests in any of its property pursuant to any such Credit Document as security for or otherwise guaranteed Obligations under or with respect to the Credit Documents, ratifies and reaffirms such guarantee and grant of security interests and liens and confirms and agrees that such security interests and liens hereafter secure all of the Obligations as amended hereby. Each STG Party hereby consents to this Forbearance and acknowledges that each of the Credit Documents remains in full force and effect and is hereby ratified and reaffirmed. The execution of this Forbearance shall not operate as a waiver of any right, power or remedy of Administrative Agent or the Lenders, constitute a waiver of any provision of any of the Credit Documents or serve to effect a novation of the Obligations. This Forbearance shall constitute a Credit Document.

7. Execution in Counterparts. This Forbearance may be executed in any number of counterparts and by the different parties hereto on separate counterparts, each of which when so executed and delivered shall be an original, but all of which shall together constitute one and the same instrument. A set of counterparts executed by all the parties hereto shall be lodged with the Administrative Borrower and the Administrative Agent. Delivery of an executed counterpart hereof by facsimile or electronic transmission shall be as effective as delivery of any original executed counterpart hereof.

8. Entire Agreement. THIS FORBEARANCE AND THE OTHER CREDIT DOCUMENTS REPRESENT THE FINAL AGREEMENT AMONG THE PARTIES AND MAY NOT BE CONTRADICTED BY EVIDENCE OF PRIOR, CONTEMPORANEOUS, OR SUBSEQUENT ORAL AGREEMENTS OF THE PARTIES. THERE ARE NO UNWRITTEN ORAL AGREEMENTS AMONG THE PARTIES.

9. Miscellaneous. Sections 14.04, 14.07, 14.08 and 14.11 of the Credit Agreement are incorporated herein by reference and are made a part hereof and are applicable to this Forbearance as if fully set forth herein, *mutatis mutandis*.

[Signature Pages Follow]

IN WITNESS WHEREOF, the parties hereto have caused their duly authorized officers to execute and deliver this Forbearance as of the date first above written.

STG GROUP, INC., as Holdings

By: /s/ Phillip Lacombe

Name: Phillip Lacombe

Title: President

STG GROUP HOLDINGS, INC., as Parent

By: /s/ Phillip Lacombe

Name: Phillip Lacombe

Title: President

STG, INC.

By: /s/ Phillip Lacombe

Name: Phillip Lacombe

Title: President

ACCESS SYSTEMS, INCORPORATED

By: /s/ Phillip Lacombe

Name: Phillip Lacombe

Title: President

MC ADMIN CO LLC,

MC ADMIN CO LLC,
as Administrative Agent under the
Credit Agreement

By: /s/ Jonathan Tunis
Name: Jonathan Tunis
Title: Managing Director

SIGNATURE PAGE TO THE LIMITED
FORBEARANCE TO CREDIT
AGREEMENT DATED AS OF THE
DATE FIRST WRITTEN ABOVE,
AMONG STG GROUP, INC., STG
GROUP HOLDINGS, INC., STG, INC.,
ACCESS SYSTEMS, INCORPORATED,
THE LENDERS PARTY HERETO, MC
ADMIN CO LLC, AS
ADMINISTRATIVE AGENT AND PNC
BANK, NATIONAL ASSOCIATION, AS
COLLATERAL AGENT

NAME OF INSTITUTION:

MC CREDIT FUND I LP

By: /s/ A. Nayyar

Name:

Title:

SIGNATURE PAGE TO THE LIMITED
FORBEARANCE TO CREDIT AGREEMENT
DATED AS OF THE DATE FIRST
WRITTEN ABOVE, AMONG STG GROUP,
INC., STG GROUP HOLDINGS, INC., STG,
INC., ACCESS SYSTEMS,
INCORPORATED, THE LENDERS PARTY
HERETO, MC ADMIN CO LLC, AS
ADMINISTRATIVE AGENT AND PNC
BANK, NATIONAL ASSOCIATION

NAME OF INSTITUTION:

MC CREDIT FUND II LP

By: /s/ A. Nayyar

Name:

Title:

SIGNATURE PAGE TO THE LIMITED
FORBEARANCE TO CREDIT
AGREEMENT DATED AS OF THE DATE
FIRST WRITTEN ABOVE, AMONG
GLOBAL DEFENSE & NATIONAL
SECURITY SYSTEMS, INC., STG
GROUP, INC., STG, INC., ACCESS
SYSTEMS, INCORPORATED, THE
LENDERS PARTY HERETO, MC ADMIN
CO LLC, AS ADMINISTRATIVE AGENT
AND PNC BANK, NATIONAL
ASSOCIATION, AS COLLATERAL
AGENT

NAME OF INSTITUTION:

CERBERUS PNC FUNDING LLC

By: /s/ Dan Wolf

Name: Dan Wolf

Title: CEO

Subsidiaries of the Registrant

<u>Subsidiary</u>	<u>Jurisdiction of Organization</u>	<u>Percentage Ownership (A)</u>
<u>U.S. Subsidiaries</u>		
STG Group Holdings, Inc.	DE	100%
STG, Inc.	DE	100%
Access Systems, Incorporated	VA	100%
STG Sentinel, LLC	VA	100%
STG Ventures, LLC	VA	100%
Ripcord Acquisition Corp.	DE	100%
<u>Foreign Subsidiaries</u>		
STG Netherlands B.V.	Netherlands	100%
STG Sentinel AFG, LLC	Afghanistan	100%

(A) Includes direct and indirect ownership.

Consent of Independent Registered Public Accounting Firm

STG Group, Inc.
Reston, VA

We hereby consent to the incorporation by reference in the Registration Statement on Form S-8 (No. 333-211401), of STG Group, Inc. of our report dated April 17, 2017, relating to the consolidated financial statements which appears in this Form 10-K.

/s/ BDO USA, LLP

McLean, Virginia
April 17, 2017

**CERTIFICATION PURSUANT TO
RULE 13a—14(a) or RULE 15d—14(a)
OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Phillip E. Lacombe, certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2016 (the “Report”) of the Company;
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 officer 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 (the registrant’s fourth fiscal quarter in the case of an annual report) 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 officer 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 the registrant’s board of directors (or persons performing the equivalent functions):
 - (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.

/s/ Phillip E. Lacombe

Phillip E. Lacombe
President and Chief Operating Officer
STG Group, Inc.
April 17, 2017

**CERTIFICATION PURSUANT TO
RULE 13a—14(a) or RULE 15d—14(a)
OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Charles L. Cosgrove, certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2016 (the “Report”) of the Company;
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 officer 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 (the registrant’s fourth fiscal quarter in the case of an annual report) 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 officer 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 the registrant’s board of directors (or persons performing the equivalent functions):
 - (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.

/s/ Charles L. Cosgrove

Charles L. Cosgrove
Chief Financial Officer
STG Group, Inc.
April 17, 2017

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of STG Group, Inc. (the "Company") on Form 10-K for the year ended December 31, 2016 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Phillip E. Lacombe, President and Chief Operating Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) 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 Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Phillip E. Lacombe

Phillip E. Lacombe
President
STG Group, Inc.
April 17, 2017

A signed original of this written statement required by Section 906 has been provided to STG Group, Inc. and will be retained by STG Group, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of STG Group, Inc. (the "Company") on Form 10-K for the year ended December 31, 2016 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Charles L. Cosgrove, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) 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 Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Charles L. Cosgrove

Charles L. Cosgrove

Chief Financial Officer
STG Group, Inc.
April 17, 2017

A signed original of this written statement required by Section 906 has been provided to STG Group, Inc. and will be retained by STG Group, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.
