

Optex Systems Holdings Inc  
Form 10-K  
December 23, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-K**

**x ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended October 2, 2016**

**“ TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_ until \_\_\_**

**Commission File Number 000-54114**

**OPTEX SYSTEMS HOLDINGS, INC.**

(Exact name of registrant as specified in its charter)

|   |   |
|---|---|
| <b>Delaware</b><br>(State or other jurisdiction of<br>incorporation organization) | <b>33-143215</b><br>(I.R.S. Employer<br>Identification No.) |
|---|---|

|   |                                 |
|---|---------------------------------|
| <b>1420 Presidential Drive</b><br><b>Richardson, TX</b><br>(Address of principal executive offices) | <b>75081-2439</b><br>(Zip Code) |
|---|---------------------------------|

Registrant's telephone number, including area code **(972) 764-5700**

Securities Registered under Section 12(b) of the Act

**None**

Securities Registered under Section 12(g) of the Act

**Common Stock, par value \$.001 per share**

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 issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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 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.

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 the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  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 227,610 shares of voting stock held by non-affiliates of the registrant based on the closing price on the OTC Markets on March 31, 2016 was \$500,742.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

|                       | <b>Shares Outstanding</b> |
|-----------------------|---------------------------|
| <b>Title of Class</b> | <b>December 22, 2016</b>  |
| Common Stock          | 8,144,302                 |

**DOCUMENTS INCORPORATED BY REFERENCE**

None.

**TABLE OF CONTENTS**

**PART I**

|          |                                 |    |
|----------|---------------------------------|----|
| Item 1.  | <u>Description of Business.</u> | 4  |
| Item 1A. | <u>Risk Factors.</u>            | 20 |
| Item 2.  | <u>Properties.</u>              | 29 |
| Item 3.  | <u>Legal Proceedings.</u>       | 29 |
| Item 4.  | <u>Mine Safety Disclosures.</u> | 29 |

**PART II**

|          |   |    |
|----------|---|----|
| Item 5.  | <u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Securities.</u> | 30 |
| Item 7.  | <u>Management’s Discussion and Analysis of Financial Conditions and Results of Operations.</u>                | 31 |
| Item 8.  | <u>Financial Statements and Supplementary Data.</u>   | 46 |
| Item 9.  | <u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.</u>                  | 78 |
| Item 9A. | <u>Controls and Procedures.</u>   | 78 |

**PART III**

|          |  |    |
|----------|--|----|
| Item 10. | <u>Directors, Executive Officers and Corporate Governance.</u>   | 78 |
| Item 11. | <u>Executive Compensation.</u>   | 83 |
| Item 12. | <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.</u> | 89 |
| Item 13. | <u>Certain Relationships and Related Transactions, and Director Independence.</u>                      | 90 |
| Item 14. | <u>Principal Accounting Fees and Services.</u>   | 93 |

**PART IV**

|          |                 |    |
|----------|-----------------|----|
| Item 15. | <u>Exhibits</u> | 94 |
|----------|-----------------|----|

### **Cautionary Note Regarding Forward-Looking Information**

This Report on Form 10-K, in particular Part II Item 7 “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” contains certain “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). These forward-looking statements represent our expectations, beliefs, intentions or strategies concerning future events, including, but not limited to, any statements regarding our assumptions about financial performance; the continuation of historical trends; the sufficiency of our cash balances for future liquidity and capital resource needs; the expected impact of changes in accounting policies on our results of operations, financial condition or cash flows; anticipated problems and our plans for future operations; and the economy in general or the future of the defense industry, all of which were subject to various risks and uncertainties.

When used in this Report on Form 10- K and other reports, statements, and information we have filed with the Securities and Exchange Commission (“Commission” or “SEC”), in our press releases, presentations to securities analysts or investors, in oral statements made by or with the approval of an executive officer, the words or phrases “believes,” “may,” “will,” “expects,” “should,” “continue,” “anticipates,” “intends,” “will likely result,” “estimates,” “projects” or similar and variations thereof are intended to identify such forward-looking statements. However, any statements contained in this Report on Form 10-K that are not statements of historical fact may be deemed to be forward-looking statements. We caution that these statements by their nature involve risks and uncertainties, certain of which are beyond our control, and actual results may differ materially depending on a variety of important factors.

We do not assume the obligation to update any forward-looking statement. You should carefully evaluate such statements in light of factors described in this annual report. In this Form 10-K, Optex Systems Holdings, Inc. (“Optex Systems Holdings”) has identified important factors that could cause actual results to differ from expected or historic results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider any such list to be a complete list of all potential risks or uncertainties.

## **PART I**

### **Item 1 Description of Business**

#### **Background**

##### *Prior History — Sustut Exploration, Inc.*

Sustut Exploration, Inc. was a Delaware corporation formed on April 11, 2006 to search for available mining properties in North Central British Columbia. It entered into an option agreement in 2006 to purchase a mineral claim, and the option expired in May 2008 without any payment being made. Thus, as of May 2008, Sustut had no operating business.

As a result of the reorganization on March 30, 2009, which is described below, Optex Systems Holdings changed its name from Sustut Exploration Inc. to Optex Systems Holdings, Inc.

##### *Reorganization*

On March 30, 2009, a reorganization occurred whereby the then existing shareholders of Optex Systems, Inc., a private Delaware corporation (“Optex Systems, Inc. (Delaware)”), exchanged their shares of Optex Systems, Inc. (Delaware) common stock with the shares of common stock of us as follows (all on a pre-split basis due to the historical context): (i) the outstanding 85,000,000 shares of Optex Systems, Inc. (Delaware) common stock were exchanged for 113,333,282 shares of our common stock, (ii) the outstanding 1,027 shares of Optex Systems, Inc. (Delaware) Series A preferred stock were exchanged for 1,027 shares of Series A preferred stock and (iii) the 8,131,667 shares of Optex Systems, Inc. (Delaware) common stock purchased in the private placement were exchanged for 8,131,667 (presplit) shares of us common stock. Optex Systems, Inc. (Delaware) has remained our wholly-owned subsidiary. As a result of the reorganization, Sileas Corporation currently beneficially owns approximately 52.8% of our issued and outstanding common stock and Alpha Capital Anstalt owns approximately 0.1% of our issued and outstanding common stock.

##### *Current Line of Business*

We manufacture optical sighting systems and assemblies, primarily for Department of Defense applications. Our products are installed on various types of U.S. military land vehicles, such as the Abrams and Bradley fighting vehicles, light armored and armored security vehicles and have been selected for installation on the Stryker family of vehicles. We also manufacture and deliver numerous periscope configurations, rifle and surveillance sights and night vision optical assemblies. Our products consist primarily of build-to-customer print products that are delivered both directly to the armed services and to other defense prime contractors. Less than 1% of today's revenue is related to the resale of products substantially manufactured by others. In this case, the product would likely be a simple replacement part of a larger system previously produced by us.

We continue to field new product opportunities from both domestic and international customers. Given continuing unrest in multiple global hot spots, the need for precision optics continues to increase. Most of these requirements are for observation and situational awareness applications; however, we continue to see requests for higher magnification and custom reticles in various product modifications. The basic need to protect the soldier while providing information about the mission environment continues to be the primary driver for these requirements.

We do not believe that the change in government administration will cause a major change in the direction of funding or product need for the U.S. military. Maintenance will still be required, and the opportunities for us to upgrade existing systems with higher performing systems will continue to present themselves. Spending levels may change, but given the mix between foreign spending, domestic/prime demand, and the more recent commercial opportunities, we do not expect any negative trends arising from political domestic changes into fiscal 2017.

## **Recent Events**

### ***Reverse Stock Split***

On October 6, 2015, 20 calendar days had passed since the mailing to our shareholders of the Definitive Schedule 14C filed on September 11, 2015 regarding the approval by our Board of Directors and shareholders of a reverse stock split of our common stock, in a ratio to be determined by our board of directors, of not less than 1-for-400 nor more than 1-for-1000 and on October 7, 2015, we effected a 1-for-1000 reverse split of our common stock.

### ***Resignations of Directors***

Effective November 4, 2015, Stanley Hirschman retired as one of our directors. In recognition of his service, all of his unvested stock options were deemed to vest immediately, and the termination date of all of his stock options was extended to December 31, 2019. On May 26, 2016, Kerry Craven resigned as one of our directors.

### ***Compensation Changes***

On January 21, 2016, our Board of Directors Compensation Committee held a meeting and approved the following compensation changes:

▲ base salary increase of 10% for Danny Schoening, CEO, and Karen Hawkins, CFO.

▲ bonus payment of \$7.5 thousand awarded to Karen Hawkins for 2015 performance.

▲ \$10 thousand monthly director fee for Peter Benz, Chairman, effective for calendar 2016.

### ***Credit Facility — Avidbank***



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On April 20, 2016, we amended our revolving credit facility with Avidbank. The new renewable revolving maturity date is January 22, 2018. The facility provides up to \$2 million in financing against eligible receivables and is subject to meeting certain covenants including an asset coverage ratio test for up to twenty months. The material terms of the amended revolving credit facility are as follows:

The interest rate for all advances shall be the then in effect prime rate plus 2.5% and is subject to a minimum interest payment requirement per six month period of \$10,000.

Interest shall be paid monthly in arrears.

A facility fee of (0.5%) of the revolving line (\$10,000) was due (and paid) on May 22, 2016 and each anniversary thereof for so long as the revolving credit facility is in effect.

The loan period is from April 20 through January 22, 2018 at which time any outstanding advances, and accrued and unpaid interest thereon, will be due and payable.

Our obligations to Avidbank are secured by a first lien on all of its assets (including intellectual property assets should it have any in the future) in favor of Avidbank.

The facility contains customary events of default. Upon the occurrence of an event of default that remains uncured after any applicable cure period, Avidbank's commitment to make further advances may terminate, and Avidbank would also be entitled to pursue other remedies against us and the pledged collateral.

Pursuant to a guaranty executed by Optex Systems Holdings in favor of Avidbank, Optex Systems Holdings has guaranteed all obligations of Optex Systems, Inc. to Avidbank.

On October 17, 2016, we further amended our revolving credit facility with Avidbank to increase the facility to \$2.2 million and to allow for a \$250 thousand letter of credit sublimit with an annual fee of 1.5% of the face amount of the letter of credit. On October 17, 2016, we secured a \$250 thousand irrevocable letter of credit from Avidbank with Cabot Industrial Value Fund II Operating Partnership, L.P. as the beneficiary. The letter of credit was issued as a condition of our facility lease, executed on October 21, 2016<sup>t</sup> for the Applied Optics Center facility in Dallas, Texas.

### ***2016 Restricted Stock Unit Plan***

On June 14, 2016, our Compensation Committee approved our 2016 Restricted Stock Unit Plan. This plan provides for issuance of stock units (“RSUs”) for up to 1,000,000 shares of our common stock. Each RSU constitutes a right to receive one share of our common stock, subject to vesting, which unless otherwise stated in an RSU agreement, shall vest in equal amounts on the first, second and third anniversary of the grant date. Shares of our common stock underlying the number of vested RSUs will be delivered as soon as practicable after vesting. During the period between grant and vesting, the RSUs may not be transferred, and the grantee has no rights as a shareholder until vesting has occurred. If the grantee’s employment is terminated for any reason (other than following a change in control of us or a termination of an officer other than for cause), then any unvested RSUs under the award will automatically terminate and be forfeited. If an officer grantee’s employment is terminated by us without cause or by the grantee for good reason, then, provided that the RSUs have not been previously forfeited, the remaining unvested portion of the RSUs will immediately vest as of the officer grantee’s termination date. In the event of a change in control, our obligations regarding outstanding RSUs shall, on such terms as may be approved by the Committee prior to such event, immediately vest, be assumed by the surviving or continuing company or cancelled in exchange for property (including cash).

On June 15, 2016, we issued 150,000 RSUs to our Chief Executive Officer, Danny Schoening, and 50,000 RSUs to our Chief Financial Officer, Karen Hawkins. The RSUs issued to Mr. Schoening and Ms. Hawkins vest as follows: 34% on January 1, 2017, 33% on January 1, 2018 and 33% on January 1, 2019.

### ***Public Offering***

On August 26, 2016, we consummated a public offering of 2,291,000 Class A units consisting of common stock and warrants and 400 Class B units consisting of shares of Series C convertible stock and warrants for a total gross purchase price of \$4,750,280.

### **New Product Development**

During the first six months of 2015, we released a new digital spotting scope called Red Tail (patent pending). This device is targeted towards long range observation and image recording used by military, border patrol, and select consumer/commercial applications. The device is designed to deliver high definition images with military grade resolution, but at commercial “off the shelf” pricing. Using high grade optics to deliver a 45X magnified image onto a 5 megapixel CMOS sensor, the Red Tail device then transmits this image via Wi-Fi to the user’s smartphone or tablet. Digital still images or videos can then be captured and/or emailed using a custom Red Tail app available for either iOS or Android devices. We demonstrated this device in April 2015 at the Border Security Expo in Phoenix, Arizona and received positive feedback from U.S. border agents, police officers, and other Expo attendees.

On November 10, 2015, we entered into a retail sales relationship with Cabela’s Inc., to distribute our Red Tail Digital Spotting Scope as well as our new Stabilized Monocular. We are presently in negotiations to make these devices available via General Services Administration schedules for government personnel.

### **Products**

Our products are installed on various types of U.S. military land vehicles, such as the Abrams and Bradley, and Stryker families of fighting vehicles, as well as light armored and armored security vehicles. We also manufacture and deliver numerous periscope configurations, rifle and surveillance sights and night vision optical assemblies. We deliver our products both directly to the federal government and to prime contractors.

We deliver high volume products, under multi-year contracts, to large defense contractors and government customers. Increased emphasis in the past two years has been on new opportunities to promote and deliver our products in foreign military sales, where U.S.-manufactured, combat and wheeled vehicles, are supplied (and upgraded) in cooperation with the U.S. Department of Defense. We have a reputation for quality and credibility with our customers as a strategic supplier. We also anticipate the opportunity to integrate some of our night vision and optical sights products into commercial applications.

Specific product categories include:

Electronic sighting systems

Mechanical sighting systems

Laser protected plastic and glass periscopes

Non-laser protected plastic and glass periscopes

Howitzer sighting systems

M36 Thermal Day/Night Periscopes

M17 Day/Thermal Periscopes

Ship binoculars

Replacement optics (e.g. filters, mirrors)

Optical assemblies and laser filters

| <b>Product Line</b> | <b>Product Category</b>  |
|---------------------|--|
| Periscopes          | Laser & Non Laser Protected Plastic & Glass Periscopes, Electronic M17 Day/Thermal Periscopes, Vision Blocks |
| Sighting Systems    |  |

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Back Up Sights, Digital Day and Night Sighting Systems (DDAN), M36 Thermal Periscope, Unity Mirrors

Howitzers M137 Telescope, M187 Mount, M119 Aiming Device

Other Muzzle Reference Systems (MRS), Binoculars, Collimators, Optical Lenses & Elements, Windows

Applied Optics Center ACOG Laser filter, Laser Filter Interface, Optical Assemblies

### **Location and Facility**

We are headquartered in Richardson, TX and lease approximately 93,967 combined square feet of facilities including Richardson, Texas and Dallas, Texas. As of December 7, 2016, we had 90 full time equivalent employees. We operate with a single shift, and capacity could be expanded by adding a second shift. Our proprietary processes and methodologies provide barriers to entry for other competing suppliers. In many cases, we are the sole source provider or one of only two providers of a product. We have capabilities which include machining, bonding, painting, tracking, engraving and assembly and can perform both optical and environmental testing in-house. We renewed the lease on our 49,100 square foot, Richardson, Texas facility, effective as of December 10, 2013, with a lease expiration of March 31, 2021. As of December 7, 2016, the Richardson facility operates with 52 full time equivalent employees in a single shift operation.

In November 2014, we also acquired a business unit from L-3 Communications, Inc., which is described herein below under “Recent Events — Acquisition”. The acquisition, Applied Optics Center, is located in Dallas, Texas with leased premises consisting of approximately 44,867 square feet of space. As of December 7, 2016, the Applied Optics Center operates with 38 full time equivalent employees in a single shift operation.

### *Contracts*

Many of our contracts allow for government contract financing in the form of contract progress payments pursuant to Federal Acquisition Regulation 52.232-16, “Progress Payments”. As a small business, and subject to certain limitations, this clause provides for government payment of up to 90% of incurred program costs prior to product delivery. To the extent our contracts allow for progress payments, we intend to utilize this benefit, thereby minimizing the working capital impact on us for materials and labor required to complete the contracts.

Our contracts allow for Federal Acquisition Regulation 52.243-1 which entitles the contractor to an “equitable adjustment” to the contract if the contract changes result in a change in contract costs or time of performance. In essence, an equitable price adjustment request is a request for a contract price modification (generally an increase) that allows for the contractor to be “made whole” for additional costs incurred which were necessitated by some modification of the contract effort. This modification may come from an overt change in U.S. Government requirements or scope, or it may come from a change in the conditions surrounding the contract (e.g., differing site conditions or late delivery of U.S. Government-furnished property) which result in statement of work additions, deletions, part substitutions, schedule or other changes to the contract which impact the contractor’s overall cost to complete.

Each contract with our customers has specific quantities of material that need to be purchased, assembled, and then shipped. Prior to bidding a contract, we contact potential sources of material and receive qualified quotations for each material. In some cases, the entire volume is given to a single supplier and in other cases, the volume might be split between several suppliers. If a contract has a single source supplier and that supplier fails to meet their obligations (e.g., quality, delivery), then we would attempt to find an acceptable alternate supplier, and if successful, we would then renegotiate contractual deliverables (e.g., specifications, delivery, price). As of December 7, 2016, approximately 17% of our material requirements are single-sourced across 10 suppliers representing approximately 13% of our active supplier orders. Single-sourced component requirements span across all of our major product lines. Of these single sourced components, we have material contracts (purchase orders) with firm pricing and delivery schedules in place with each of the suppliers to supply the parts necessary to satisfy our current contractual needs.

We are subject to, and must comply with, various governmental regulations that impact, among other things, our revenue, operating costs, profit margins and the internal organization and operation of our business. The material regulations affecting our U.S. government business are summarized in the table below.

**Regulation**

**Summary**

Federal  
Acquisition  
Regulation

The principal set of rules in the Federal Acquisition Regulation System. This system consists of sets of regulations issued by agencies of the federal government of the United States to govern what is called the “acquisition process,” which is the process through which the government acquires goods and services. That process consists of three phases: (1) need recognition and acquisition planning, (2) contract formation, and (3) contract administration. This system regulates the activities of government personnel in carrying out that process. It does not regulate the purchasing activities of private sector firms, except to the extent that those activities involve government solicitations and contracts by reference.

International  
Traffic in Arms  
Regulations

United States government regulations that control the export and import of defense-related articles and services on the United States Munitions List. These regulations implement the provisions of the Arms Export Control Act.

Truth in  
Negotiations Act

A public law enacted for the purpose of providing for full and fair disclosure by contractors in the conduct of negotiations with the government. The most significant provision included is the requirement that contractors submit certified cost and pricing data for negotiated procurements above a defined threshold of \$750,000. It requires contractors to provide the government with an extremely broad range of cost or pricing information relevant to the expected costs of contract performance, and it requires contractors and subcontractors to submit cost or pricing data to the government and to certify that, to the best of their knowledge and belief, the data are current, accurate, and complete.

We are responsible for full compliance with the Federal Acquisition Regulation. Upon award, the contract may identify certain regulations that we need to meet. For example, a contract may allow progress billing pursuant to specific Federal Acquisition Regulation clauses incorporated into the contract. Other contracts may call for specific first article acceptance and testing requirements. The Federal Acquisition Regulation will identify the specific regulations that we must follow based on the type of contract awarded. The Federal Acquisition Regulation also contains guidelines and regulations for managing a contract after award, including conditions under which contracts may be terminated, in whole or in part, at the government's convenience or for default. These regulations also subject us to financial audits and other reviews by the government of our costs, performance, accounting and general business practices relating to our government contracts, which may result in adjustment of our contract-related costs and fees and, among other things and impose accounting rules that define allowable and unallowable costs governing our right to reimbursement under certain contracts.

First Article Testing and Acceptance requirements consist of specific steps. For example, the first article testing associated with Howitzer-type product is comprehensive and time consuming. The dimensions and material specifications of each piece of the assembly must be verified, and each product has in excess of 100 piece parts. Once the individual piece parts are verified to be compliant to the specification, the assembly processes are documented and verified. A sample of the production (typically three units) is verified to meet final performance specifications. Once the units meet the final performance specification, they are then subjected to accelerated life testing, a series of tests which simulate the lifetime use of the product in the field. This consists of exposing the units to thermal extremes, humidity, mechanical shock, vibration, and other physical exposure tests. Once completed, the units undergo a final verification process to ensure that no damage has occurred as a result of the testing and that they continue to meet the performance specification. All of the information and data is recorded into a final first article inspection and test report and submitted to the customer along with the test units for final approval. First Article Acceptance and Testing is generally required on new contracts/product awards but may also be required on existing products or contracts where there has been a significant gap in production, or where the product has undergone significant manufacturing process, material, tooling, equipment or product configuration changes.

We are also subject to laws, regulations and executive orders restricting the use and dissemination of information deemed classified for national security purposes and the exportation of certain products and technical data as covered by the International Traffic in Arms Regulation. In order to import or export items listed on the U.S. Munitions List, we are required to be registered with the Directorate of Defense Trade Controls office. The registration is valid for one year, and the registration fees are established based on the number of license applications submitted the previous year. We currently have an approved and current registration on file with the Directorate of Defense Trade Controls office. Once the registration is approved, each import/export license must be filed separately. License approval requires the company to provide proof of need, such as a valid contract or purchase order requirement for the specific product or technical data requested on the license and requires a detailed listing of the items requested for export/import, the end-user, the end-user statement, the value of the items, consignees/freight forwarders and a copy of a valid contract or purchase order from the end-user. The approval process for the license can vary from several weeks to six months or more. The licenses we currently use are the DSP-5 (permanent export), DSP-6 (license revisions) and DSP-73 (temporary export).



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The aforementioned licenses are valid for 48 months from date that each such license is issued as set forth on the table below (updated as of November 28, 2016).

| DSP - 5 licenses | Issue Date | Expiration Date<br>(48 months of issue) | Total Contract<br>Value (\$) |
|------------------|------------|---|------------------------------|
| 050430589        | 1/25/2013  | 1/24/2017                               | \$ 2,568                     |
| 050426798        | 2/8/2013   | 2/7/2017                                | 1,000                        |
| 050435218        | 3/7/2013   | 3/6/2017                                | 88,760                       |

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| DSP - 5 licenses | Issue Date | Expiration Date<br>(48 months of issue) | Total Contract<br>Value (\$) |
|------------------|------------|---|------------------------------|
| 050439431        | 3/7/2013   | 3/6/2017                                | 9,741                        |
| 050455029        | 6/10/2013  | 6/9/2017                                | 4,203                        |
| 050457320        | 6/24/2013  | 6/23/2017                               | 187,721                      |
| 050459204        | 6/28/2013  | 6/27/2017                               | 185,879                      |
| 050468553        | 7/29/2013  | 7/28/2017                               | 88,182                       |
| 050468550        | 8/30/2013  | 8/29/2017                               | 81,142                       |
| 050470855        | 9/9/2013   | 9/8/2017                                | 1,969                        |
| 050486760        | 12/5/2013  | 12/4/2017                               | 2,542                        |
| 050486727        | 12/6/2013  | 12/5/2017                               | 21,040                       |
| 050490628        | 1/3/2014   | 1/2/2018                                | 45,928                       |
| 050490371        | 1/14/2014  | 1/13/2018                               | 14,290                       |
| 050497324        | 2/1/2014   | 1/31/2018                               | 15,384                       |
| 050497307        | 2/12/2014  | 2/11/2018                               | 11,881                       |
| 050497162        | 2/20/2014  | 2/19/2018                               | 2,122                        |
| 050501481        | 2/26/2014  | 2/25/2018                               | 255,700                      |
| 050504795        | 3/27/2014  | 3/26/2018                               | 26,794                       |
| 050511388        | 4/21/2014  | 4/20/2018                               | 30,086                       |
| 050510061        | 5/19/2014  | 5/18/2018                               | 10,564                       |
| 050521562        | 6/27/2014  | 6/26/2018                               | 3,108                        |
| 050521680        | 7/7/2014   | 7/6/2018                                | 10,572                       |
| 050521706        | 7/15/2014  | 7/14/2018                               | 7,441                        |
| 050521673        | 7/15/2014  | 7/14/2018                               | 1,236                        |
| 050521555        | 7/17/2014  | 7/16/2018                               | 18,970                       |
| 050530555        | 9/22/2014  | 9/21/2018                               | 4,930                        |
| 050537697        | 11/4/2014  | 11/3/2018                               | 6,028                        |
| 050539610        | 11/14/2014 | 11/13/2018                              | 7,746                        |
| 050486913        | 11/20/2014 | 11/19/2018                              | 79,882                       |
| 050490381        | 12/11/2014 | 12/10/2018                              | 36,250                       |
| 050546222        | 1/9/2015   | 1/8/2019                                | 2,950                        |
| 050549789        | 2/18/2015  | 2/17/2019                               | 53,720                       |
| 050549846        | 2/23/2015  | 2/22/2019                               | 165,372                      |
| 050549534        | 2/25/2015  | 2/24/2019                               | 88,555                       |
| 050549933        | 2/27/2015  | 2/26/2019                               | 34,888                       |
| 050549843        | 3/23/2015  | 3/22/2019                               | 1,213                        |
| 050553879        | 3/23/2015  | 3/22/2019                               | 4,066                        |
| 050553874        | 3/27/2015  | 3/26/2019                               | 3,472                        |
| 050553876        | 3/27/2015  | 3/26/2019                               | 1,021                        |
| 050560846        | 5/21/2015  | 5/20/2019                               | 6,418                        |
| 050560953        | 5/29/2015  | 5/28/2019                               | 1,792                        |
| 050561878        | 6/5/2015   | 6/4/2019                                | 75,047                       |
| 050562319        | 6/12/2015  | 6/11/2019                               | 2,815                        |
| 050560740        | 6/30/2015  | 6/29/2019                               | 3,308                        |
| 050565738        | 7/9/2015   | 7/8/2019                                | 1,543                        |
| 050566061        | 7/22/2015  | 7/21/2019                               | 27,401                       |
| 050561747        | 7/27/2015  | 7/26/2019                               | 250                          |

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|           |           |           |         |
|-----------|-----------|-----------|---------|
| 050565746 | 7/30/2015 | 7/29/2019 | 1,543   |
| 050568890 | 8/7/2015  | 8/6/2019  | 4,204   |
| 050570373 | 8/21/2015 | 8/20/2019 | 4,297   |
| 050571083 | 9/8/2015  | 9/7/2019  | 92,042  |
| 050574185 | 9/25/2015 | 9/24/2019 | 413,263 |

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| DSP - 5 licenses | Issue Date | Expiration Date<br>(48 months of issue) | Total Contract<br>Value (\$) |
|------------------|------------|---|------------------------------|
| 050581564        | 12/11/2015 | 12/10/2019                              | 2                            |
| 050581341        | 12/17/2015 | 12/16/2019                              | 30,541                       |
| 050582302        | 12/17/2015 | 12/16/2019                              | 402                          |
| 050581218        | 12/18/2015 | 12/17/2019                              | 4,298                        |
| 050573342        | 10/7/2015  | 10/6/2019                               | 203,832                      |
| 050581341        | 12/17/2015 | 12/16/2019                              | 30,541                       |
| 050573343        | 10/7/2015  | 10/6/2019                               | 8,446                        |
| 050582108        | 1/20/2016  | 1/19/2020                               | 1,075                        |
| 050586060        | 2/24/2016  | 2/23/2020                               | 931                          |
| 050598474        | 6/10/2016  | 6/9/2020                                | 35,713                       |
| 050596660        | 6/23/2016  | 6/22/2020                               | 631                          |
| 050598467        | 6/23/2016  | 6/22/2020                               | 4,519                        |
| 050601710        | 7/12/2016  | 7/11/2020                               | 6,757                        |
| 050596660        | 6/20/2016  | 6/19/2020                               | 631                          |
| 050607056        | 10/5/2016  | 10/4/2020                               | 10,001                       |
| 050587550        | 3/1/2016   | 2/29/2020                               | 1                            |
| 050602855        | 7/27/2016  | 7/26/2020                               | 75,552                       |
| 050603610        | 8/9/2016   | 8/8/2020                                | 6,094                        |
| 050596718        | 6/28/2016  | 6/27/2020                               | 917                          |
| 050612378        | 11/28/2016 | 11/27/2020                              | 292,670                      |
| 050612416        | 11/28/2016 | 11/27/2020                              | 151,761                      |
| 050612399        | 11/28/2016 | 11/27/2020                              | 46,301                       |
| 050612547        | 11/28/2016 | 11/27/2020                              | 6,976                        |
| 050612382        | 11/28/2016 | 11/27/2020                              | 83,902                       |
| 050612402        | 11/28/2016 | 11/27/2020                              | 45,801                       |

| DSP - 6 Licenses | Issue Date | Expiration Date<br>(48 months of issue) | Total Contract<br>Value (\$) |
|------------------|------------|---|------------------------------|
| 060046631        | 10/22/2015 | 10/6/2019                               | \$ -                         |
| 060046632        | 10/21/2015 | 10/6/2019                               | -                            |

| DSP - 73<br>Licenses | Date<br>Issued | Expiration Date<br>(48 months of issue) | Total Contract<br>Value (\$) |
|----------------------|----------------|---|------------------------------|
| 730053549            | 7/29/2015      | 7/28/2019                               | \$ 30,000.00                 |

Licenses are subject to termination if a licensee is found to be in violation of the Arms Export Control Act or the International Traffic in Arms Regulations requirements. If a licensee is found to be in violation, in addition to a termination of its licenses, it can be subject to fines and penalties by the government.

Our contracts may also be governed by the Truth in Negotiation Act requirements where certain of our contracts or proposals exceed the \$750,000 threshold and/or are deemed as sole source, or non-competitive awards, covered under this act. For these contracts, we must provide a vast array of cost and pricing data in addition to certification that our pricing data and disclosure materials are current, accurate and complete upon conclusion of the negotiation. Due to the additional disclosure and certification requirements, if a post contract award audit were to uncover that the pricing data provided was in any way not current, accurate or complete as of the certification date, we could be subjected to a defective pricing claim adjustment with accrued interest. Currently, we do not have any pending defective pricing claim adjustments. Additionally, as a result of this requirement, contract price negotiations may span from two to six months and can result in undefinitized or not to exceed ceiling priced contracts subject to future downward negotiations and price adjustments. Currently, we do not have any undefinitized contracts subject to further price negotiation.

Our failure to comply with applicable regulations, rules and approvals or misconduct by any of our employees could result in the imposition of fines and penalties, the loss of security clearances, the loss of our U.S. government contracts or our suspension or debarment from contracting with the U.S. government generally, any of which could have a material adverse effect our business, financial condition, results of operations and cash flows. We are currently in compliance with all applicable regulations and do not have any pending claims as a result of noncompliance.

The terms of our material contracts are as follows (updated as of October 2, 2016):

| Customer  | Customer PO/Contract               | Contract Type <sup>(1)</sup> | Total Award Value <sup>(2)</sup> (millions) | Order Period Expiration | Remaining Value <sup>(3)</sup> (millions) | Delivery Period      |
|---|------------------------------------|------------------------------|---|-------------------------|---|----------------------|
| GDLS – Canada <sup>(4)</sup><br>DDAN Sighting Systems | Subcontract<br>PO 35334144         | FFPQ                         | \$ 8.7                                      | N/A                     | \$ 1.0                                    | Mid 2012 – Sept 2017 |
| GDLS – Canada <sup>(5)</sup><br>DDAN Sighting Systems | Subcontract<br>PO 35419634         | FFPQ                         | \$ 1.0                                      | N/A                     | \$ 1.0                                    | Sept 2017            |
| USACC – Warren <sup>(6)</sup><br>Plastic Periscopes   | Prime Contract<br>W56HZV-16-C-0091 | FFPQ<br>PP                   | \$ 1.1                                      | April 13, 2017          | \$ 0.7                                    | Oct 2016 – Dec 2016  |
| General Dynamics <sup>(7)</sup>                       | Subcontract<br>PO 40242047         | FFPQ                         | \$ 1.3                                      | N/A                     | \$ 1.1                                    | Aug 2016 – Jan 2018  |
| DLA<br>Aviation <sup>(8)</sup>                        | Prime Contract<br>SPE4A616C0228    | FFPQ                         | 0.6   | N/A                     | \$ 0.6                                    | May 2017             |
| DLA<br>Warren <sup>(9)</sup>                          | Prime Contract<br>SPRDL116C0280    | FFPQ                         | 0.5   | N/A                     | \$ 0.5                                    | May 2017             |

(1) FFPQ – Firm fixed price and quantity. Payment terms on shipments are net 30-45 days. PP – Progress Billable. “Total Award Value” as included in the table represents the total value of all delivery orders against the prime contract that have already been awarded to us. The total award value represents already awarded delivery order

(2) contracts. Based on our historical experience with these contracts and other similar contracts, the amount awarded has directly correlated to the amount received.

(3) The “Remaining Value” depicts the open undelivered values remaining to be delivered against the contract awards as of June 26, 2016. Only these undelivered values of the contracts may be subject to the contract

*termination clause. It has been our experience that these clauses are rarely invoked.*

(4) *Contract was awarded on October 24, 2011 but effective November 4, 2011 as the date on which approved for disclosure by contractor. Total award value includes all statement of work change orders through June 26, 2016.*

(5) *New contract award quantity added on December 3, 2013 as a follow on quantity to the original PO 35334144.*

*New prime U.S. government contract award on April 13, 2016 for \$0.84 million. The awarded contract includes a*

(6) *100%, one year option quantity, up to an additional \$0.84 million from the base award. As of July 12, 2016 \$0.22 million in option quantity values had been awarded.*

(7) *New contract award quantity awarded on January 24, 2016.*

(8) *New contract award quantity awarded on July 16, 2016.*

(9) *New contract award quantity awarded on August 16, 2016.*

**Market Opportunity — U.S. Military**

During the twelve months ending October 2, 2016, approximately 64% of our business was in support of U.S. military products. The chart below was derived from public government spending sources and depicts total U.S. military spending from 2007 through 2015 and forecasted spending through 2021. The purpose of including this chart is to provide the reader with historical trend data and projected U.S. military defense and procurement spending over time. Military spending peaked at \$678.1 billion in 2011. As of fiscal year 2016 the total projected military spending is projected to decline by 15.0% from the peak 2011 level. However, the military procurement in the below chart depicts a more significant decline through 2016 of 22.4% to \$103.6 billion from its peak level of \$133.6 billion in 2010. It is difficult to directly tie this spending to any specific military vehicles; however, we serve the U.S. armed forces, active duty and reserves, plus various state national guards.

The U.S. government spending reductions have had a significant impact on our product lines during these years as our products directly support various types of U.S. military land vehicle procurements. The projected total military spending will approximate or decline slightly from the current spending levels through fiscal year 2021. As a result of lower U.S. government spending, the Company has continued to explore other opportunities for manufacturing outside of our traditional product lines for products which could be manufactured using our existing lines in order to fully utilize our existing capacity. We do not believe that the recent presidential election will cause a major change in the direction of funding or product need for the U.S. military. Maintenance will still be required, and the opportunities for us to upgrade existing systems with higher performing systems will continue to present themselves. Further, we continue to look for additional strategic businesses to acquire that will strengthen our existing product line, expand our operations, and enter new markets.

The following factors are important to the U.S. military:

• Product reliability — failure can cost lives

• Speed to delivery and adherence to delivery schedule



System life cycle extension

Low cost/best value

Visual aids for successful execution of mission objectives

Mission critical products specifically related to soldier safety.

We focus on delivering products that satisfy these factors and believes it is well positioned to continue to service U.S. and foreign military needs.

### **Market Opportunity — Foreign Military**

Despite the downturn in U.S. military spending, foreign military funding for products built in the United States for selected foreign militaries has held to peak funding levels. Thus, we have increased efforts to promote our proven military products, as well as newly improved product solutions directly to foreign military representatives. In 2014, we completed the first shipments of M17 Day/Thermal Periscope (NSN 6650-01-619-6545) to a country in South America. During fiscal year 2016, Optex Systems completed its first order of its patented M17 Day / Thermal Periscope for \$0.6 million to Brazil. These direct sales transactions allow us to directly serve South American customers and affect influence into their future procurements. Additionally, shipment of the new M17 Day/Thermal Periscope validates our efforts to upgrade existing platforms with new technology. The M17 Day/Thermal Periscope is a cost effective upgrade to existing systems in that it provides both day and thermal views specifically designed for driving armored vehicles. It can be installed in vehicles which were originally designed without this technology and may be used as a backup to existing systems. We anticipate our efforts in South America will culminate in new orders for this technology in the near term. We are now bidding on several substantial government contracts to expand sales and production beyond the current production and backlog. For example, we are supporting General Dynamics Land Systems in their efforts related to the production of the Israeli Namer Armored Personnel Carrier (aka Merkava APC). We will continue to pursue international opportunities through direct sales (e.g., General Dynamics Land Systems — Canada), International Parts Supply and through other existing customers (e.g., General Dynamics Land Systems — Israeli Namer Project).

We are also exploring possibilities to adapt some of our products for commercial use in those markets that demonstrate potential for solid revenue growth, both domestically and internationally.

### **Market Opportunity — Commercial**

Our products are currently sold to military and related government markets. We believe there may be opportunities to commercialize various products we presently manufacture to address other markets. Our initial focus will be directed in four product areas.

**Big Eye Binoculars** — While the military application we produce is based on mature military designs, we own all castings, tooling and glass technology. These large fixed mount binoculars could be sold to cruise ships, personal yachts and cities/municipalities. The binoculars are also applicable to fixed, land based outposts for private commercial security as well as border patrols and regional law enforcement.

**Night Vision Sight** — We have manufactured the optical system for the NL-61 Night Vision Sight for the Ministry of Defense of Israel. This technology could be implemented for commercial applications.

**Infrared Imaging Equipment** — We manufacture and assemble infrared imaging equipment and components for Raytheon's Thermal Imaging M36 Mount product and has recently added a low-cost, uncooled, thin film, thermal imager through its partnership with selective suppliers. This combined equipment and technology has potential applications with the border patrol, police and governmental or commercial security agencies.

Thin Film Coatings — The acquisition of the Applied Optics Center (AOC) also creates a new sector of opportunity for commercial products for us. Globally, commercial optical products use thin film coatings to create product differentiation. These coatings can be used for redirecting light (mirrors), blocking light (laser protection), absorbing select light (desired wavelengths), and many other combinations. They are used in telescopes, rifle scopes, binoculars, microscopes, range finders, protective eyewear, photography, etc. Given this broad potential, the commercial applications are a key opportunity going forward.

Optical Assemblies – Through the Applied Optics Center, we are utilizing our experience in military sighting systems to pursue commercial opportunities associated with products that incorporate multi-lens optical cell assemblies, bonded optical elements and mechanical assemblies. There are a wide variety of products in the medical, machine vision, automotive and outdoor recreation fields that can benefit from our capabilities. Support to domestic customers for these type products has driven significant increases in overall sales during the last two years.

### **Customer Base**

We serve customers in four primary categories: as prime defense contractor (TACOM Life Cycle Command, DLA (Defense Logistics Agency) Warren, U.S. Army, Navy and Marine Corps), as defense subcontractor (General Dynamics, L-3 Communications, BAE, and NorcaTec) and also as a military supplier to foreign governments (Israel, Australia, South America and NAMSA) and a commercial optical assembly supplier (Nightforce Optics, Cabela's). During the twelve months ended October 2, 2016, we derived approximately 84% of our gross business revenue from four major customers: U.S. government agencies (45%), General Dynamics (18%), Exelis (6%), Nightforce Optics, Inc. (15%). We have approximately 80 discrete contracts for items that are utilized in vehicles, product lines and spare parts. Due to the high percentage of prime and subcontracted U.S. defense revenues, large customer size and the fact that there are multiple contracts with each entity, which are not interdependent, we are of the opinion that this provides us with a fairly well diversified revenue pool.

### **Marketing Plan**

Potential Entrants — Low Risk to us. In order to enter this market, potential competitors must overcome several barriers to entry. The first hurdle is that an entrant would need to prove to the government agency in question the existence of a government approved accounting system for larger contracts. Second, the entrant would need to develop the processes required to produce the product. Third, the entrant would then need to produce the product and then submit successful test requirements (many of which require lengthy government consultation for completion). Finally, in many cases, the customer has an immediate need and therefore cannot wait for this qualification cycle and therefore must issue the contracts to existing suppliers.



Historically, we competed with two other companies in different spaces. First, we previously competed with Miller-Holzwarth in the plastic periscope business. In July 2012, Miller-Holzwarth, Inc. ceased operations apparently as a result of an inability to meet its financial obligations combined with a decline in defense market conditions. Second, we currently compete with Seiler Instruments for fire control products. These contracts are higher value products, but lower quantities. Given the expense of development and qualification testing, the barrier to entry is high for new competitors. During the last four years, overall plastic periscope demand quantities have declined, while competition on the lower level periscope products has significantly increased as new contractors aggressively compete for market share amongst the existing customer base and quantities.

Buyers — Medium Risk to us. In most cases the buyers (usually government agencies or defense contractors) have two fairly strong suppliers. It is in their best interest to keep at least two, and therefore, in some cases, the contracts are split between suppliers. In the case of larger contracts, the customer can request an open book policy on costs and expects a reasonable margin to have been applied.

Substitutes — Low Risk to us. We have both new vehicle contracts and replacement part contracts for the exact same product. The U.S. government has declared that the Abrams/Bradley base vehicles will be the ground vehicle of choice through 2040.

The Bradley vehicle has been in service for 28 years, the Abrams for 27 years. In February 2008, the U.S. Army signed a multiyear third party contract for the delivery of improved Abrams and Bradleys. The contract is for up to 435 tanks and 540 Bradley vehicles. These are the only production tanks currently in production by the government. This, in conjunction with the 30-year life span, supports their continued use through 2040. The Abrams is the principal battle tank of the United States Army and Marine Corps, and the armies of Egypt, Kuwait, Saudi Arabia, and since 2007, Australia. The new contract terms allow efficiencies within the supply chain and a very long return on investment on new vehicle proposals.

Suppliers — Low to Medium Risk to Optex Systems Holdings. The suppliers of standard processes (e.g., casting, machining and plating) need to be very competitive to gain and/or maintain contracts. Those suppliers of products that use top secret clearance processes are slightly better off; however, there continues to be multiple avenues of supply and therefore only moderate power.

Consistent with our marketing plan and business model, the AOC acquisition strengthened our overall position by decreasing the bargaining power of their suppliers through the backwards integration of a key supplier and created additional barriers of entry of potential competitors. Overall, the customer base and the competition have seen the acquisition as creating a stronger company.

The second model is a two by two matrix for products and customers.

|                          |   |   |
|--------------------------|---|---|
| <b>New Products</b>      | <u>USACC</u> Binoculars   | <u>Chile</u> M17 Day/Thermal  |
|                          | <u>GDLS</u> DDAN  | <u>Brazil</u> M17 Day/Thermal                                       |
|                          |   | <u>Israel</u> M17 Day/Thermal                                       |
|                          | <u>Commercial</u> Optical Lens  | <u>Commercial:</u> Optical Lens, Spotting Scopes, Monocular Lens    |
| <b>Existing Products</b> | <u>USACC</u> Periscopes, Back Up Sights,<br>Binoculars, Vision Blocks,<br>ACOG Filter Units | <u>Marines</u> Sighting Systems                                     |
|                          | <u>GDLS</u> Periscopes, Collimators   | <u>Commercial:</u> Optical Lens, Spotting<br>Scopes, Monocular Lens |
|                          | <u>BAE</u> Periscopes   |   |
|                          | <u>L3-</u> Laser Interface Filters  |   |
|                          | <u>DLA</u> Optical Elements   |   |
|                          | <b>Existing Customers</b>   | <b>New Customers</b>  |

This product/customer matrix sets forth our four basic approaches:

- 1) Sell existing products to existing customers.
- 2) Sell existing products to new customers.
- 3) Develop new products to meet the needs of our existing customers.
- 4) Develop new products to meet the needs of new customers.

The product categories described in the above matrix are associated with the product lines set forth below:

| <b>Product Line</b>   | <b>Product Category</b>  |
|-----------------------|--|
| Periscopes            | Laser & Non Laser Protected Plastic & Glass Periscopes, Electronic M17 Day/Thermal Periscopes, Vision Blocks |
| Sighting Systems      | Back Up Sights, Digital Day and Night Sighting Systems (DDAN), M36 Thermal Periscope, Unity Mirrors          |
| Howitzers             | M137 Telescope, M187 Mount, M119 Aiming Device   |
| Other                 | Muzzle Reference Systems (MRS), Binoculars, Collimators, Optical Lenses & Elements, Windows                  |
| Applied Optics Center | ACOG Laser filter, Laser Filter Interface, Optical Assemblies  |

### **Operations Plan**

Our operations plan can be broken down into three distinct areas: material management, manufacturing space planning and efficiencies associated with economies of scale.

### ***Materials Management***

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The largest portion of our costs is materials. We have completed the following activities in order to demonstrate continuous improvement:

- Successful completion of annual surveillance audit for ISO 9001:2008 certificate, with no major nonconformance issues
- Weekly cycle counts on inventory items
- Weekly material review board meeting on non-moving piece parts
- Kanban kitting on products with consistent ship weekly ship quantities
- Daily cross functional floor meetings focused on delivery, yields and labor savings
- Redesigned floor layout using tenant improvement funds
- Daily review of yields and product velocity
- Bill of material reviews prior to work order release



Future continuous improvement opportunities include installation and training of shop floor control module within the ERP system and organizational efficiencies of common procurement techniques among buyers.

### *Manufacturing Space Planning*

We currently lease 93,967 square feet of manufacturing space (see “Location and Facility”), including the additional leased space in conjunction with our recent acquisition as described under “Recent Events”. Our current facilities are sufficient to meet our immediate production needs without excess capacity. As our processes are primarily labor driven, we are able to easily adapt to changes in customer demand by adjusting headcounts, overtime schedules and shifts in line with production needs. In the event additional floor space is required to accommodate new contracts, Optex has the option to lease adjacent floor space at the current negotiated lease cost per square foot. Consistent with the space planning, we will drive economies of scale to reduce support costs on a percentage of sales basis. These cost reductions can then be either passed through directly to the bottom line or used for business investment.

Our manufacturing process is driven by the use of six sigma techniques and process standardization. Initial activities in this area have been the successful six sigma projects in several production areas which have led to improved output and customer approval on the aesthetics of the work environment. In addition, we use many tools including 5S programs, six sigma processes, and define, measure, analyze, improve, control (DMAIC) problem solving techniques to identify bottlenecks within the process flow, reduce cost and improve product yields. Successful results can then be replicated across the production floor and drive operational improvements.

### *Economies of Scale*

Plant efficiencies fluctuate as a function of program longevity, complexity and overall production volume. Our internal processes are primarily direct labor intensive and can be more easily adapted to meet fluctuations in customer demand; however, our material purchases, subcontracted operations and manufacturing support costs are extremely sensitive to changes in volume. As our volume increases, our support labor, material and scrap costs decline as a percentage of revenue as we are able to obtain better material pricing, and scrap, start up and support labor (fixed) costs and they are spread across a higher volume base. On the contrary, as production volumes decline, our labor and material costs per unit of production generally increase. Additional factors that contribute to economies of scale relate to the longevity of the program. Long running, less complex programs (e.g., periscopes) do not experience as significant of an impact on labor costs as production volumes change, as the associated workforce is generally less skilled and can be ramped quickly as headcounts shift. Our more complex thin laser filter coatings, Howitzer and thermal day/night programs are more significantly impacted by volume changes as they require a more highly-skilled workforce and ramp time is longer as the training is more complex. We continually monitor customer demand over a rolling twelve-month window and in order to anticipate any changes in necessary manpower and material which allows us to capitalize on any benefits associated with increased volume and minimize any negative impact associated

with potential declines in product quantities.

### *Intellectual Property*

We utilize several highly specialized and unique processes in the manufacture of our products. While we believe that these trade secrets have value, it is probable that our future success will depend primarily on the innovation, technical expertise, manufacturing and marketing abilities of our personnel. We cannot assure you that we will be able to maintain the confidentiality of our trade secrets or that our non-disclosure agreements will provide meaningful protection of our trade secrets, know-how or other proprietary information in the event of any unauthorized use, misappropriation or other disclosure. The confidentiality agreements that are designed to protect our trade secrets could be breached, and we might not have adequate remedies for the breach. Additionally, our trade secrets and proprietary know-how might otherwise become known or be independently discovered by others. We possess two patents and have applied for another in the US and in foreign countries. While we are optimistic that our application will be approved, we cannot guarantee that this patent application will ever transpire into an awarded patent. The claims were based on technology which is believed to be unique; however, there are many companies and many patents already awarded in this space. Further, the time frame for the US Patent and Trademark Office to review the patent application and engage in negotiations cannot be guaranteed.

Our competitors, many of which have substantially greater resources, may have applied for or obtained, or may in the future apply for and obtain, patents that will prevent, limit or interfere with our ability to make and sell some of our products. Although we believe that our products do not infringe on the patents or other proprietary rights of third parties, we cannot assure you that third parties will not assert infringement claims against us or that such claims will not be successful.

In May 2015, we announced the issuance to us of U.S. Patent No. 13,792,297 titled “ICWS Periscope”. This invention improves previously accepted levels of periscope performance that, in turn, improve soldier’s safety.

In December 2013, Optex Systems, Inc. was issued U.S. Patent No. 23,357,802 titled “Multiple Spectral Single Image Sighting System Using Single Objective Lens Set.” The technology platform, designed for our DDAN program, is applicable to all ground combat vehicles used by the US and foreign militaries. This invention presents a single image to both day and night sensors using precision optics, which in turn allows the user to individually observe day, night, or day and night simultaneously. In addition, it has proven to be especially useful in light transition points experienced at dusk and dawn. We are in production and currently delivering sighting systems with this advanced technology, a significant upgrade in the goal of supporting our customers as they modernize the worldwide inventory of aging armored vehicles. This technology is applicable to many sighting systems, and it has already been designed for implementation on the Light Armored Vehicles, the Armored Security Vehicle, the Amphibious Assault Vehicle, and the M60 Main Battle Tank. Digital Day and Night technology has advanced the capabilities of these installed weapon systems and is the first in a series of patents we have applied for to protect our Intellectual Property portfolio in support of the warfighters who use these systems.

In May 2012, we purchased a perpetual, non-exclusive license, with a single up front license fee of \$200,000 to use Patent 7,880,792 “Optical and Infrared Periscope with Display Monitor” owned by Synergy International Optronics, LLC. We believe the purchase of the license agreement may allow us to extend and expand our market potential for the M113APC vehicle type which has the highest number of commonly used armored vehicles in the world. The current estimated active M113 APC worldwide inventory is over 80,000 units. This licensing of this patent allows us to develop additional products for this vehicle type, including the M17 Day/Thermal and M17 Day/Night periscopes. We are actively marketing the new periscopes internationally and completed our first international shipment utilizing this technology in March 2014. We continue to prototype these products and demonstrate them to potential customers.

### *Competition*

The markets for our products are competitive. We compete primarily on the basis of our ability to design and engineer products to meet performance specifications set by our customers. Our customers include military and government end users as well as prime contractors that purchase component parts or subassemblies, which they incorporate into their end products. Product pricing, quality, customer support, experience, reputation and financial stability are also

important competitive factors.

There are a limited number of competitors in each of the markets for the various types of products that we design, manufacture and sell. At this time, we consider our primary competitors for the Optex, Richardson site to be Seiler Instruments, Kent Periscopes and Synergy International Optronics, LLC. The Applied Optics Center thin film and laser coatings products compete primarily with Materion-Barr, Artemis and Alluxa.

Our competitors are often well entrenched, particularly in the defense markets. Some of these competitors have substantially greater resources than we do. While we believe that the quality of our technologies and product offerings provides us with a competitive advantage over certain manufacturers, some of our competitors have significantly more financial and other resources than we do to spend on the research and development of their technologies and for funding the construction and operation of commercial scale plants.

We expect our competitors to continue to improve the design and performance of their products. We cannot assure investors that our competitors will not develop enhancements to, or future generations of, competitive products that will offer superior price or performance features, or that new technology or processes will not emerge that render our products less competitive or obsolete. Increased competitive pressure could lead to lower prices for our products, thereby adversely affecting our business, financial condition and results of operations. Also, competitive pressures may force us to implement new technologies at a substantial cost, and we may not be able to successfully develop or expend the financial resources necessary to acquire new technology. We cannot assure you that we will be able to compete successfully in the future.

### *Employees*

We had 91 full time equivalent employees as of October 2, 2016. We also utilize small temporary work forces to handle peak loads as needed. To the best of our knowledge, we are compliant with local prevailing wage, contractor licensing and insurance regulations, and has good relations with its employees, who are not currently unionized.

### *Leases*

We are headquartered in Richardson, TX and lease 93,967 combined square feet of facilities including Richardson, Texas and Dallas, Texas. We operate with a single shift, and capacity could be expanded by adding a second shift. Our proprietary processes and methodologies provide barriers to entry for other competing suppliers. In many cases, we are the sole source provider or one of only two providers of a product. We have capabilities which include machining, bonding, painting, tracking, engraving and assembly and can perform both optical and environmental testing in-house.

We renewed the lease on our 49,100 square foot, Richardson, Texas facility, effective as of December 10, 2013, with a lease expiration of March 31, 2021. As of October 2, 2016, the Richardson facility operates with approximately 53 full time equivalent employees in a single shift operation.

In November 2014, we also acquired a new business unit from L-3 Communications, Inc., which is described herein below under “Recent Events — Acquisition”. The acquisition, the Applied Optics Center, is located in Dallas, Texas with leased premises consisting of approximately 44,867 square feet of space. We executed a new lease for the Applied Optics Center location, effective as of October 1, 2016, which was countersigned by the landlord on October 21, 2016. The term of the lease expires October 31, 2021. There are two renewal options available to the tenant, and each renewal term is five years in duration. As of October 2, 2016, Applied Optics Center operates with approximately 38 full time equivalent employees in a single shift operation.

## **Item 1A Risk Factors**

Investing in our common stock involves a high degree of risk. Prospective investors should carefully consider the risks described below, together with all of the other information included or referred to in this annual report, before purchasing shares of our common stock. There are numerous and varied risks, known and unknown, that may prevent us from achieving our goals. The risks described below are not the only risks we will face. If any of these risks actually occurs, our business, financial condition or results of operations may be materially adversely affected. In such

case, the trading price of our common stock could decline and investors in our common stock could lose all or part of their investment. The risks and uncertainties described below are not exclusive and are intended to reflect the material risks that are specific to us, material risks related to our industry and material risks related to companies that undertake a public offering or seek to maintain a class of securities that is registered or traded on any exchange or over-the-counter market.

Investing in our common stock involves a high degree of risk. Prospective investors should carefully consider the risks described below, together with all of the other information included or referred to in this annual report, before purchasing shares of our common stock. There are numerous and varied risks, known and unknown, that may prevent us from achieving our goals. The risks described below are not the only risks we will face. If any of these risks actually occurs, our business, financial condition or results of operations may be materially adversely affected. In such case, the trading price of our common stock could decline and investors in our common stock could lose all or part of their investment. The risks and uncertainties described below are not exclusive and are intended to reflect the material risks that are specific to us, material risks related to our industry and material risks related to companies that undertake a public offering or seek to maintain a class of securities that is registered or traded on any exchange or over-the-counter market.

**Risks Related to our Business**

*We expect that we may need to raise additional capital in the future beyond any cash flow from our existing business; additional funds may not be available on terms that are acceptable to us, or at all.*

We anticipate we may have to raise additional capital in the future to service our debt and to finance our future working capital needs. We cannot assure you that any additional capital will be available on a timely basis, on acceptable terms, or at all. Future equity or debt financings may be difficult to obtain. If we are not able to obtain additional capital as may be required, our business, financial condition and results of operations could be materially and adversely affected.

We anticipate that our capital requirements will depend on many factors, including:

• our ability to fulfill backlog;

• our ability to procure additional production contracts;

• our ability to control costs;

• the timing of payments and reimbursements from government and other contracts, including but not limited to changes in federal government military spending and the federal government procurement process;

- increased sales and marketing expenses;

• technological advancements and competitors' response to our products;

• capital improvements to new and existing facilities;

- our relationships with customers and suppliers; and

general economic conditions including the effects of future economic slowdowns, acts of war or terrorism and the current international conflicts.

Even if available, financings may involve significant costs and expenses, such as legal and accounting fees, diversion of management's time and efforts, and substantial transaction costs. If adequate funds are not available on acceptable terms, or at all, we may be unable to finance our operations, develop or enhance our products, expand our sales and marketing programs, take advantage of future opportunities or respond to competitive pressures.

***Current economic conditions may adversely affect our ability to continue operations.***

Current economic conditions may continue to cause a decline in business and consumer spending and capital market performance, which could adversely affect our business and financial performance. Our ability to raise funds, upon which we are fully dependent to continue to conduct and expand our operations, may be adversely affected by current and future economic conditions, such as a reduction in the availability of credit, financial market volatility and economic recession.

***Our ability to fulfill our backlog may have an effect on our long term ability to procure contracts and fulfill current contracts.***

Our ability to fulfill our backlog may be limited by our ability to devote sufficient financial and human capital resources and limited by available material supplies. If we do not fulfill our backlog in a timely manner, we may experience delays in product delivery which would postpone receipt of revenue from those delayed deliveries. Additionally, if we are consistently unable to fulfill our backlog, this may be a disincentive to customers to award large contracts to us in the future until they are comfortable that we can effectively manage our backlog.



***Our historical operations depend on government contracts and subcontracts. We face risks related to contracting with the federal government, including federal budget issues and fixed price contracts.***

Future general political and economic conditions, which cannot be accurately predicted, may directly and indirectly affect the quantity and allocation of expenditures by federal agencies. Even the timing of incremental funding commitments to existing, but partially funded, contracts can be affected by these factors. Therefore, cutbacks or re-allocations in the federal budget could have a material adverse impact on our results of operations. Given the continued adverse economic conditions, the federal government has slowed its pace with regard to the release of orders for the U.S. military. Since we depend on orders for equipment for the U.S. military for a significant portion of our revenues, this slower release of orders will continue to have a material adverse impact on our results of operations. Obtaining government contracts may also involve long purchase and payment cycles, competitive bidding, qualification requirements, delays or changes in funding, budgetary constraints, political agendas, extensive specification development, price negotiations and milestone requirements. In addition, our government contracts are primarily fixed price contracts, which may prevent us from recovering costs incurred in excess of budgeted costs. Fixed price contracts require us to estimate the total project cost based on preliminary projections of the project's requirements. The financial viability of any given project depends in large part on our ability to estimate such costs accurately and complete the project on a timely basis. Some of those contracts are for products that are new to our business and are thus subject to unanticipated impacts to manufacturing costs. Given the current economic conditions, it is also possible that even if our estimates are reasonable at the time made, that prices of materials are subject to unanticipated adverse fluctuation. In the event our actual costs exceed fixed contractual costs of our product contracts, we will not be able to recover the excess costs which could have a material adverse effect on our business and results of operations. We examine these contracts on a regular basis and accrue for anticipated losses on these contracts, if necessary. As of October 2, 2016, there was zero in accrued loss provisions for loss contracts or cost overruns.

Approximately 85% of our contracts contain termination clauses for convenience. In the event these clauses should be invoked by our customer, future revenues against these contracts could be affected, however these clauses allow for a full recovery of any incurred contract costs plus a reasonable fee up through and as a result of the contract termination. We are currently unaware of any pending terminations on our existing contracts.

In some cases, contract awards may be issued that are subject to renegotiation at a date (up to 180 days) subsequent to the initial award date. Generally, these subsequent negotiations have had an immaterial impact (zero to 5%) on the contract price of the affected contracts. Currently, none of our awarded contracts are subject to renegotiation.

We have sought to mitigate the adverse impact from the slower pace of U.S. military orders on our results of operations by seeking to obtain foreign military orders as well as new commercial business. We do not expect these markets to completely mitigate the negative impact of lower U.S. defense spending.

***There is further uncertainty which arises from the sequestration in early 2013 which may continue to affect business opportunities at the federal government level.***

Military spending has been negatively impacted by the Budget Control Act of 2011, which was passed in August 2011. The Budget Control Act mandated a \$917.0 billion reduction in discretionary spending over the next decade, and \$1.2 trillion in automatic spending cuts over a nine-year period to be split between defense and non-defense programs beginning in January 2013.

On November 2, 2015 Congress passed the Bipartisan Budget Act of 2015 which sets federal spending through the 2016 and 2017 fiscal years, and eases strict caps on spending set forth in the 2011 sequestration. The plan lifted caps on the appropriated spending each year by \$50 billion in 2016 and \$30 billion in 2017, evenly divided between defense and domestic programs with an additional \$16 billion added each year in the form of inflated war spending, evenly split between the Defense and State departments. The agreed budget framework for the fiscal 2016 and 2017 budget years combined with the increased spending limits provides the needed stability for the defense agencies to plan the required programs over the next two years. On November 10, 2015, Congress passed the National Defense Authorization Act 2016, which is the comprehensive legislation to authorize the budget authority of the Department of Defense and the national security programs of the Department of Energy. The bill authorizes \$607 billion in defense funding for fiscal year 2016, a 3.9% increase from the authorized funding of \$584 billion in fiscal year 2015. As of December 7, 2017 the National Defense Authorization funding for fiscal year 2017 has been approved by Congress, pending Presidential approval. The approved estimates on the fiscal year 2017 spending are up slightly, 2%, from 2016 levels to \$619 billion. It is further anticipated that the new administration will request a defense supplemental to increase defense spending above the current compromised amounts within its first 100 days of office. We are unable to tie the budget increase to any specific military vehicle and as such, the impact of the funding increase to our company is unknown as of December 7, 2016.

***If we fail to scale our operations appropriately in response to growth and changes in demand, we may be unable to meet competitive challenges or exploit potential market opportunities, and our business could be materially and adversely affected.***

Our past growth has placed, and any future growth in our historical business is expected to continue to place, a significant strain on our management personnel, infrastructure and resources. To implement our current business and product plans, we will need to continue to expand, train, manage and motivate our workforce, and expand our operational and financial systems and our manufacturing and service capabilities. All of these endeavors will require substantial management effort and additional capital. If we are unable to effectively manage our expanding operations, we may be unable to scale our business quickly enough to meet competitive challenges or exploit potential market opportunities, and our current or future business could be materially and adversely affected.

***We do not have employment agreements with our key personnel, other than our Chief Executive and Financial Officers, and our management has very minimal unencumbered equity ownership in us. If we are not able to retain our key personnel or attract additional key personnel as required, we may not be able to implement our business plan and our results of operations could be materially and adversely affected.***

We depend to a large extent on the abilities and continued participation of our executive officers and other key employees. The loss of any key employee could have a material adverse effect on our business. We currently have only two employment agreements, with our Chief Executive Officer which renews on an annual basis and currently expires on December 1, 2017, and our Chief Financial Officer which expires on January 31, 2018, with renewable terms each 18 months thereafter. We do not presently maintain “key man” insurance on any other key employees. Our management also has minimal unencumbered ownership interest in us, thus limiting their direct stake in our outcome. We believe that as our activities increase and change in character, additional, experienced personnel will be required to implement our business plan. Competition for such personnel is intense, and we cannot assure you that they will be available when required, or that we will have the ability to attract and retain them. In addition, due to our small size, we do not presently have depth of staffing in our executive, operational and financial management areas in order to have an effective succession plan should the need arise. Thus, in the event of the loss of one or more of our management employees, our results of operations could be vulnerable to challenges associated with recruiting additional key personnel, if such recruiting efforts are not successful in a timely manner.

***Certain of our products are dependent on specialized sources of supply that are potentially subject to disruption which could have a material, adverse impact on our business.***

We have selectively single-sourced some of our material components in order to mitigate excess procurement costs associated with significant tooling and startup costs. Furthermore, because of the nature of government contracts, we are often required to purchase selected items from U.S. government approved suppliers, which may further limit our

ability to utilize multiple supply sources for these key components.

To the extent any of these single sourced or government approved suppliers may have disruptions in deliveries due to production, quality, or other issues, we may also experience related production delays or unfavorable cost increases associated with retooling and qualifying alternate suppliers. The impact of delays resulting from disruptions in supply for these items could negatively impact our revenue, our reputation with our customers, and our results of operations. In addition, significant price increases from single-source suppliers could have a negative impact on our profitability to the extent that we are unable to recover these cost increases on our fixed price contracts.

Each contract has a specific quantity of material which needs to be purchased, assembled, and shipped. Prior to bidding a contract, we contact potential sources of material and receive qualified quotations for this material. In some cases, the entire volume is given to a single supplier and in other cases; the volume might be split between several suppliers. If a contract has a single source supplier and that supplier fails to meet their obligations (e.g., quality, delivery), then we would find an alternate supplier and bring this information back to the final customer. Contractual deliverables would then be re-negotiated (e.g., specifications, delivery, price. As of December 7, 2016, approximately 17% of our material requirements are single-sourced across 10 suppliers representing approximately 13% of our active supplier orders. Single-sourced component requirements span across all of our major product lines. The vast majority of these single-sourced components could be provided by another supplier with minimal interruption in schedule (supply delay of 3 months or less) or minimally increased costs. We do not believe these single sourced materials to pose any significant risk to us as other suppliers are capable of satisfying the purchase requirements in a reasonable time period with minimal increases in cost. Of these single sourced components, we have contracts (purchase orders) with firm pricing and delivery schedules in place with each of the suppliers to supply parts in satisfaction of our current contractual needs.

We consider only those specialized single source suppliers where a disruption in the supply chain would result in a period of three months or longer for us to identify and qualify a suitable replacement to present a material financial or schedule risk. In the table below, we identify only those specialized single source suppliers and the product lines supported by those materials utilized by us as of December 7, 2016.

| <b>Product Line</b>       | <b>Supplier</b>         | <b>Supply Item</b>     | <b>Risk</b>  | <b>Purchase Orders</b>  |
|---------------------------|-------------------------|------------------------|--|---|
| Sighting Systems M36 DDAN | L3 Communications Corp  | Image intensifier tube | Alternative source would take in excess of six months to qualify | Current firm fixed price & quantity purchase orders are in place with the supplier to meet all contractual requirements. Supplier is on schedule.         |
| Sighting Systems M36 DDAN | Libra Industries        | Digital camera system  | Alternative source would take in excess of six months to qualify | This supplier is the designated replacement for Raytheon for the video system boards. One P.O. is currently in place to drive the transfer from Raytheon. |
| Sighting Systems M36 DDAN | Raytheon EO Innovations | Digital camera system  | Alternative source would take in excess of six months to qualify | Current firm fixed price & quantity purchase orders are in place with the supplier to meet all contractual requirements. Supplier is on schedule.         |
| Periscopes                | Brown Die Casting       | Die-cast housings      | Consolidated all die cast tooling at this                        |   |

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|   |                                  |  |   |   |
|---|----------------------------------|--|---|---|
|   |                                  |  | supplier. Would take approximately six months to move tooling and re-qualify.         | Current firm fixed price & quantity purchase orders are in place with the supplier to meet all contractual requirements. Supplier is on schedule.   |
| Periscopes  | Harbor Castings                  | Steel castings                             | Alternative source would take six months to qualify                                   | Current firm fixed price & quantity purchase orders are in place with the supplier to meet all contractual requirements.                            |
| Periscopes  | Lanzen                           | MIL Spec welded housings for vision blocks | Would take approximately 4-6 months to re-qualify a new supplier                      | Current firm fixed price & quantity purchase orders are in place with the supplier to meet all contractual requirements. Supplier is on schedule.   |
| Other<br>Big Eye                                    | Corbett-Steeves<br>Pattern Works | Sand castings for big eye binocular parts  | Would take approximately 4-6 months to re-qualify a new supplier                      | Current firm fixed price & quantity purchase orders are in place with the supplier to meet all contractual requirements.                            |
| Applied<br>Optics<br>Center<br>M22/M24<br>Binocular | FujiFilm North<br>America        | Spare<br>Components                        | Only approved source due to proprietary rights. Alternate source cannot be developed. | Current firm fixed price and quantity purchase orders are in place with the supplier to meet all contractual requirements. Supplier is on schedule. |

| Product Line                            | Supplier             | Supply Item   | Risk   | Purchase Orders   |
|---|----------------------|---------------|--|---|
| Applied Optics Center<br>Coated Filters | Carter Glass Blowing | Quartz Blocks | Alternative source would take in excess of six months to develop and qualify | Current firm fixed price and quantity purchase orders are in place with the supplier to meet all contractual requirements. Supplier is on schedule. |

*The defense technology supply industry is subject to technological change and if we are not able to keep up with our competitors and/or they develop advanced technology as response to our products, we may be at a competitive disadvantage.*

The market for our products is generally characterized by technological developments, evolving industry standards, changes in customer requirements, frequent new product introductions and enhancements, short product life cycles and severe price competition. Our competitors could also develop new, more advanced technologies in reaction to our products. Currently accepted industry standards may change. Our success depends substantially on our ability, on a cost-effective and timely basis, to continue to enhance our existing products and to develop and introduce new products that take advantage of technological advances and adhere to evolving industry standards. An unexpected change in one or more of the technologies related to our products, in market demand for products based on a particular technology or of accepted industry standards could materially and adversely affect our business. We may or may not be able to develop new products in a timely and satisfactory manner to address new industry standards and technological changes, or to respond to new product announcements by others. In addition, new products may or may not achieve market acceptance.

*As a result of our November 2014 acquisition of the Applied Optics Center from L-3, we believe we have incurred the following additional risks, which may have a material adverse effect on our business results as we integrate the operations.*

As a result of the purchase and integration of the Applied Optics Center from L-3 with our traditional business lines, the combined businesses are subject to some additional risks which were not formerly present.

AOC has a substantial fixed cost base that is inflexible in the short term to changes in market conditions. This is due to the highly skilled and specialized workforce with established benefits for severance and vacation accruals that may exceed 6 months. In the short term, we may not be able to generate sufficient business revenue to cover these costs, so there will likely be increased cash flow requirements that exceed our availability and would entail our raising additional funds to cover cash flow.

The manufacturing process entails use of coating equipment chambers which require utilization of high amounts of electrical power and are thus highly sensitive to changes in energy costs. Current energy rates are locked in through May 28, 2018; however, if energy costs or usage increase significantly, it would have a material impact on future financials if AOC were unable to successfully incorporate the increases into priced contracts. Further, significant interruptions or surges in the electrical power supply could result in equipment damage, repair expenses and machine down time.

Above and beyond the normal risks to retain skilled personnel, there may be an inability to retain the specialized work force of AOC as a result of the changed corporate climate and the difference in corporate values of L-3 and us. A failure to retain such personnel could result in a material adverse ability to produce the traditional AOC products or cause delays and additional costs as we would need to train new personnel.

***Unexpected warranty and product liability claims could adversely affect our business and results of operations.***

The possibility of future product failures could cause us to incur substantial expense to repair or replace defective products. Some of our customers require that we warrant the quality of our products to meet customer requirements and be free of defects for twelve to fifteen months subsequent to delivery. As of October 2, 2016, approximately 85% of our current contract deliveries were covered by these warranty clauses. We establish reserves for warranty claims based on our historical rate of less than one percent of returned shipments against these contracts. There can be no assurance that this reserve will be sufficient if we were to experience an unexpectedly high incidence of problems with our products. Significant increases in the incidence of such claims may adversely affect our sales and our reputation with consumers. Costs associated with warranty and product liability claims could materially affect our financial condition and results of operations.



***We derive almost all of our revenue from four customers and the loss of any of these customers could have a material adverse effect on our revenues.***

For the year ended October 2, 2016, we derived approximately 84% of our gross operating revenue from four customers: 45% from the U.S. Government (primarily USACC — Warren and DLA Land and Maritime), 18% from General Dynamics Land Systems Divisions, 15% from Nightforce Optics Inc. , and 6% from Exelis, Inc. Procuring new customers and contracts may partially mitigate this risk. In particular, a decision by General Dynamics Land System Divisions, USACC-Warren, or DLA to cease issuing contracts to us could have a significant material impact on our business and results of operations given that they represent over 60% of our gross business revenue. There can be no assurance that we could replace these customers on a timely basis or at all.

We have approximately 70 discrete contracts with General Dynamics Land System Division and the U.S. Government (primarily USACC-Warren and DLA), and other prime contractors. If they choose to terminate these contracts, we are entitled to fully recover all contractual costs and reasonable profits incurred up to or as a result of the terminated contract.

***We only possess two patents and one patent license and rely primarily on trade secrets to protect our intellectual property.***

We utilize several highly specialized and unique processes in the manufacture of our products, for which we rely solely on trade secrets to protect our innovations. We cannot assure you that we will be able to maintain the confidentiality of our trade secrets or that our non-disclosure agreements will provide meaningful protection of our trade secrets, know-how or other proprietary information in the event of any unauthorized use, misappropriation or other disclosure. The non-disclosure agreements that are designed to protect our trade secrets could be breached, and we might not have adequate remedies for the breach.

It is also possible that our trade secrets will otherwise become known or independently developed by our competitors, many of which have substantially greater resources than us, and these competitors may have applied for or obtained, or may in the future apply for or obtain, patents that will prevent, limit or interfere with our ability to make and sell some of our products. Although based upon our general knowledge (and we have not conducted patent searches), we believe that our products do not infringe on the patents or other proprietary rights of third parties; however, we cannot assure you that third parties will not assert infringement claims against us or that such claims will not be successful.

We have one outstanding patent application. While we are optimistic that our application will be approved, we cannot guarantee that this patent application will ever result in an actual patent being awarded. The application was based on

technology which is believed to be unique; however, there are many companies and many patents already awarded in this space. Further, the time frame for the US Patent and Trademark Office to review the patent application and engage in negotiations cannot be guaranteed.

***In the future, we may look to acquire other businesses in our industry and the acquisitions will require us to use substantial resources.***

In the future, we may decide to pursue acquisitions of other businesses in our industry. In order to successfully acquire other businesses, we would be forced to spend significant resources for both acquisition and transactional costs, which could divert substantial resources in terms of both financial and personnel capital from our current operations. Additionally, we might assume liabilities of the acquired business, and the repayment of those liabilities could have a material adverse impact on our cash flow. Furthermore, when a new business is integrated into our ongoing business, it is possible that there would be a period of integration and adjustment required which could divert resources from ongoing business operations.

***The Financial Industry Regulatory Authority, or FINRA, has adopted sales practice requirements which may also limit a shareholder's ability to buy and sell our stock.***

FINRA has adopted rules that require that in recommending an investment to a customer, a broker-dealer must have reasonable grounds for believing that the investment is suitable for that customer. Prior to recommending speculative low priced securities to their non-institutional customers, broker-dealers must make reasonable efforts to obtain information about the customer's financial status, tax status, investment objectives and other information. Under interpretations of these rules, FINRA believes that there is a high probability that speculative low priced securities will not be suitable for at least some customers. FINRA requirements make it more difficult for broker-dealers to recommend that their customers buy our common stock, which may limit your ability to buy and sell our stock and have an adverse effect on the market for our shares.

***The elimination of monetary liability against our directors, officers and employees under Delaware law and the existence of indemnification rights to our directors, officers and employees may result in substantial expenditures by us and may discourage lawsuits against our directors, officers and employees.***

We provide indemnification to our directors and officers to the extent provided by Delaware law. The foregoing indemnification obligation could result in our incurring substantial expenditures to cover the cost of settlement or damage awards against directors and officers, which we may be unable to recoup. These provisions and resultant costs may also discourage us from bringing a lawsuit against directors and officers for breaches of their fiduciary duties and may similarly discourage the filing of derivative litigation by our stockholders against our directors and officers even though such actions, if successful, might otherwise benefit us and our stockholders.

## **Risks Related to Our Stock**

***We have issued a large number of shares of preferred stock, warrants and options, which if converted or exercised would substantially increase the number of common shares outstanding.***

On December 22, 2016, we had 8,144,302 shares of common stock outstanding, and (a) we have vested options outstanding to purchase common stock that, if fully exercised, would generate proceeds of \$562,900 and result in the issuance of an additional 56,290 shares of common stock, and (b) we have 342 shares of Series C preferred stock that, if fully converted at the 4,167 common shares per preferred share, would result in the issuance of an additional 1,425,000 shares of common stock and (c) we have 4,125,200 warrants outstanding at an exercise price of \$1.50 per share. Future sales of our common stock, warrants, options and Series C preferred stock may also adversely affect our stock price and our ability to raise funds in new offerings.

As a key component of our growth strategy we have provided and intend to continue offering compensation packages to our management and employees that emphasize equity-based compensation and would thus cause further dilution.

***Historically, we have not paid dividends on our common stock, and we do not anticipate paying any cash dividends in the foreseeable future.***

We have never paid cash dividends on our common stock. We intend to retain our future earnings, if any, to fund operational and capital expenditure needs of our business, and we do not anticipate paying any cash dividends in the foreseeable future. As a result, capital appreciation, if any, of our common stock will be the sole source of gain for our common stockholders in the foreseeable future.

***The warrants and our Series C preferred stock are unlisted securities and there is no public market for them.***

There is no established public trading market for the warrants or the Series C preferred stock, and we do not expect a market to develop. In addition, the warrants and Series C preferred stock are not listed, and we do not intend to apply for listing of the warrants or the Series C preferred stock on any securities exchange or trading system. Without an active market, the liquidity of the warrants and the Series C preferred stock is limited, and investors may be unable to liquidate their investments in the warrants and Series C preferred stock.

*Our stock price is speculative and there is a risk of litigation.*

The trading price of our common stock has in the past and may in the future be subject to wide fluctuations in response to factors such as the following:

• revenue or results of operations in any quarter failing to meet the expectations, published or otherwise, of the investment community;

• speculation in the press or investment community;

• wide fluctuations in stock prices, particularly with respect to the stock prices for other defense industry companies;

• announcements of technological innovations by us or our competitors;

• new products or the acquisition of significant customers by us or our competitors;

• changes in investors' beliefs as to the appropriate price-earnings ratios for us and our competitors;

• changes in management;

• sales of common stock by directors and executive officers;

• rumors or dissemination of false or misleading information, particularly through Internet chat rooms, instant messaging, and other rapid-dissemination methods;

• conditions and trends in the defense industry generally;

• the announcement of acquisitions or other significant transactions by us or our competitors;

• adoption of new accounting standards affecting our industry;

general market conditions;

domestic or international terrorism and other factors; and

the other factors described in this section.

Fluctuations in the price of our common stock may expose us to the risk of securities class action lawsuits. Although no such lawsuits are currently pending against us and we are not aware that any such lawsuit is threatened to be filed in the future, there is no assurance that we will not be sued based on fluctuations in the price of our common stock. Defending against such suits could result in substantial cost and divert management's attention and resources. In addition, any settlement or adverse determination of such lawsuits could subject us to significant liability.

***Future sales of our common stock could depress our stock price.***

Sales of a large number of shares of our common stock, or the availability of a large number for sale, could materially adversely affect the per share market price of our common stock and could impair our ability to raise funds in addition offering of our debt or equity securities. In the event that we propose to register shares of common stock under the Securities Act for our own account, certain shareholders are entitled to include their shares in the registration, subject to limitations described in the agreements granting these rights.

*If you are not an institutional investor, you may purchase securities in this offering only if you reside within the states in which we will apply to have the securities registered or are exempt from registration, and, if required, meet any requisite suitability standards.*

### **Cautionary Note Regarding Forward-Looking Information**

This prospectus, in particular the “Management’s Discussion and Analysis of Financial Condition and Results of Operations” appearing herein, contains certain “forward-looking statements” within the meaning of Section 27A of the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended (“Exchange Act”). These forward-looking statements represent our expectations, beliefs, intentions or strategies concerning future events, including, but not limited to, any statements regarding our assumptions about financial performance; the continuation of historical trends; the sufficiency of our cash balances for future liquidity and capital resource needs; the expected impact of changes in accounting policies on our results of operations, financial condition or cash flows; anticipated problems and our plans for future operations; and the economy in general or the future of the electrical storage device industry, all of which are subject to various risks and uncertainties.

When used in this prospectus as well as in reports, statements, and information we have filed with the Securities and Exchange Commission, in our press releases, presentations to securities analysts or investors, in oral statements made by or with the approval of an executive officer, the words or phrases “believes,” “may,” “will,” “expects,” “should,” “continue,” “anticipates,” “intends,” “will likely result,” “estimates,” “projects” or similar expressions and variations thereof are intended to identify such forward-looking statements. However, any statements contained in this prospectus that are not statements of historical fact may be deemed to be forward-looking statements. We caution that these statements by their nature involve risks and uncertainties, certain of which are beyond our control, and actual results may differ materially depending on a variety of important factors.

### **Item 2 Properties**

We are headquartered in Richardson, TX and lease 93,967 combined square feet of facilities including Richardson, Texas and Dallas, Texas. As of December 7, 2016, we had 90 full time equivalent employees. We operate with a single shift, and capacity could be expanded by adding a second shift. Our proprietary processes and methodologies provide barriers to entry for other competing suppliers. In many cases, we are the sole source provider or one of only two providers of a product. We have capabilities which include machining, bonding, painting, tracking, engraving and assembly and can perform both optical and environmental testing in-house.

We renewed the lease on our 49,100 square foot, Richardson, Texas facility, effective as of December 10, 2013 with a lease expiration of March 31, 2021. As of December 7, 2016, the Richardson facility operates with 52 full time equivalent employees in a single shift operation.

In November 2014, we also acquired a new business unit from L-3 Communications, Inc., which is described herein below under “Recent Events — Acquisition”. The acquisition, the Applied Optics Center, is located in Dallas, Texas with leased premises consisting of approximately 44,867 square feet of space. We executed a new lease for the Applied Optics Center location, effective as of October 1, 2016, which was countersigned by the landlord on October 21, 2016. The term of the lease expires October 31, 2021. There are two renewal options available to the tenant, and each renewal term is five years in duration. As of December 7, 2016, Applied Optics Center operates with approximately 38 full time equivalent employees in a single shift operation.

### **Item 3 Legal Proceedings**

From time to time, we are involved in lawsuits, claims, investigations and proceedings, including pending opposition proceedings involving patents that arise in the ordinary course of business. There are no matters pending that we expect to have a material adverse impact on our business, results of operations, financial condition or cash flows.

### **Item 4 Mine Safety Disclosures**

None.



**PART II**

**Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

**Market information**

Our common stock is currently quoted on the OTCQB Marketplace under the symbol “OPXS”. Trading in our common stock has historically lacked consistent volume, and the market price has been volatile.

The following table shows the range of high and low bid prices for our common stock as reported by the OTCQB Marketplace. The quotations reflect inter-dealer prices, without retail markup, markdown or commission and may not represent actual transactions.

| Period              | High    | Low     |
|---------------------|---------|---------|
| Fourth Quarter 2013 | \$20.00 | \$8.00  |
| First Quarter 2014  | \$9.00  | \$8.00  |
| Second Quarter 2014 | \$30.00 | \$30.00 |
| Third Quarter 2014  | \$10.00 | \$10.00 |
| Fourth Quarter 2014 | \$20.00 | \$10.00 |
| First Quarter 2015  | \$10.00 | \$10.00 |
| Second Quarter 2015 | \$10.00 | \$8.00  |
| Third Quarter 2015  | \$7.00  | \$5.00  |
| Fourth Quarter 2015 | \$8.00  | \$8.00  |
| First Quarter 2016  | \$7.30  | \$2.60  |
| Second Quarter 2016 | \$3.50  | \$2.00  |
| Third Quarter 2016  | \$2.60  | \$1.75  |
| Fourth Quarter 2016 | \$2.75  | \$0.68  |

On December 21, 2016, the closing price for our common stock as reported on the OTCQB was \$0.73 per share.

**Securities outstanding and holders of record**

On December 22, 2016, there were approximately 81 shareholders of record for our common stock and 8,144,302 shares of our common stock issued and outstanding.

## **Dividends**

We have never paid dividends. We currently anticipate that we will retain all future earnings for the expansion and operation of our business and do not anticipate paying cash dividends in the foreseeable future.

## **Information respecting equity compensation plans**

### Summary Equity Compensation Plan Information

Optex Systems Holdings adopted its 2009 Stock Option Plan on March 26, 2009. On December 9, 2011, the Board of Directors of Optex Systems Holdings, Inc. authorized an amendment to its Stock Option Plan to increase the number of issuable shares from 6,000 to 50,000 and authorized the grant of 10,000 options to two board members and a total of 36,070 to Optex Systems Holdings employees including 20,000 options to executive officers. On December 19, 2013, the Board of Directors of Optex Systems Holdings, Inc. authorized an amendment to its Stock Option Plan to increase the number of issuable shares from 50,000 to 75,000 and authorized the grant of 20,000 options to three board members and a grant of 5,000 to an Optex Systems Holdings officer. The options granted in 2011 and 2013 were at exercise prices of \$10.00 per share with each grant to vest 25% per year over four years for each year with which the grantee is still employed by or serving as a director of Optex Systems Holdings, Inc. (with all unvested options automatically expiring on the date of termination of employment by or service as a director of Optex Systems Holdings, Inc.) and all unvested options immediately vesting upon a change of control due to a merger or acquisition of the Company. As of December 18, 2016, 73,752 options had been granted, 8,712 of these options had forfeited due to terminations or expiration, and 61,290 had vested of which 5,000 options were exercised. The outstanding vested and unvested options are 56,290 and 3,750, respectively.

### ***2016 Restricted Stock Unit Plan***

On June 14, 2016, our Compensation Committee approved our 2016 Restricted Stock Unit Plan. This plan provides for issuance of stock units (“RSUs”) for up to 1,000,000 shares of our common stock. Each RSU constitutes a right to receive one share of our common stock, subject to vesting, which unless otherwise stated in an RSU agreement, shall vest in equal amounts on the first, second and third anniversary of the grant date. Shares of our common stock underlying the number of vested RSUs will be delivered as soon as practicable after vesting. During the period between grant and vesting, the RSUs may not be transferred, and the grantee has no rights as a shareholder until vesting has occurred. If the grantee’s employment is terminated for any reason (other than following a change in control of us or a termination of an officer other than for cause), then any unvested RSUs under the award will automatically terminate and be forfeited. If an officer grantee’s employment is terminated by us without cause or by the grantee for good reason, then, provided that the RSUs have not been previously forfeited, the remaining unvested portion of the RSUs will immediately vest as of the officer grantee’s termination date. In the event of a change in control, our obligations regarding outstanding RSUs shall, on such terms as may be approved by the Committee prior to such event, immediately vest, be assumed by the surviving or continuing company or cancelled in exchange for property (including cash).

On June 15, 2016, we issued 150,000 RSUs to our Chief Executive Officer, Danny Schoening, and 50,000 RSUs to our Chief Financial Officer, Karen Hawkins. The RSUs issued to Mr. Schoening and Ms. Hawkins vest as follows: 34% on January 1, 2017, 33% on January 1, 2018 and 33% on January 1, 2019.

## **Item 7 Management’s Discussion and Analysis of Financial Condition and Results of Operations**

***The following discussion should be read in conjunction with the consolidated financial statements and the related notes that are set forth in our financial statements elsewhere in this annual report.***

This management’s discussion and analysis reflects information known to management as of our fiscal year end, October 2, 2016, and the date of filing. This MD&A is intended to supplement and complement our audited financial statements and notes thereto for the year ended October 2, 2016, prepared in accordance with U.S. generally accepted accounting principles (GAAP). You are encouraged to read our financial statements in conjunction with your reading of this MD&A. The financial information in this MD&A has been prepared in accordance with GAAP, unless otherwise indicated. In addition, we use non-GAAP financial measures as supplemental indicators of our operating performance and financial position. We use these non-GAAP financial measures internally for comparing actual results from one period to another, as well as for planning purposes. We will also report non-GAAP financial results as supplemental information, as we believe their use provides more insight into our performance. When a non-GAAP measure is used in this MD&A, it is clearly identified as a non-GAAP measure and reconciled to the most closely corresponding GAAP measure.

*The following discussion highlights the principal factors that have affected our financial condition and results of operations as well as our liquidity and capital resources for the periods described. This discussion contains forward-looking statements. Please see “Special cautionary statement concerning forward-looking statements” and “Risk factors” for a discussion of the uncertainties, risks and assumptions associated with these forward-looking statements. The operating results for the periods presented were not significantly affected by inflation.*

## Background

On March 30, 2009, a reorganization was consummated pursuant to which the then existing shareholders of Optex Systems, Inc. (Delaware) exchanged their shares of common stock for shares of common stock of Optex Systems Holdings as follows: (i) the outstanding 85,000,000 shares of Optex Systems, Inc. (Delaware) common stock were exchanged by Optex Systems Holdings for 113,333,282 shares of Optex Systems Holdings common stock, (ii) the outstanding 1,027 shares of Optex Systems, Inc. (Delaware) Series A preferred stock were exchanged by Optex Systems Holdings for 1,027 shares of Optex Systems Holdings Series A preferred stock, and (iii) the 8,131,667 shares of Optex Systems, Inc. (Delaware) common stock purchased in the private placement were exchanged by Optex Systems Holdings for 8,131,667 shares of Optex Systems Holdings common stock. Optex Systems, Inc. (Delaware) has remained a wholly-owned subsidiary of Optex Systems Holdings. The common shares above are presented at their pre reverse split share quantities to preserve historical information. Optex Systems Holdings effected a 1000:1 reverse stock split on October 7, 2015.

As a result of the reorganization, Optex Systems Holdings changed its name from Sustut Exploration Inc. to Optex Systems Holdings, Inc., and its year end from December 31 to a fiscal year ending on the Sunday nearest September 30.

Optex Systems, Inc. (Delaware) manufactures optical sighting systems and assemblies, primarily for Department of Defense applications. Its products are installed on various types of U.S. military land vehicles, such as the Abrams and Bradley fighting vehicles, light armored and armored security vehicles and have been selected for installation on the Stryker family of vehicles. Optex Systems, Inc. (Delaware) also manufactures and delivers numerous periscope configurations, rifle and surveillance sights and night vision optical assemblies. Optex Systems, Inc. (Delaware) products consist primarily of build-to-customer print products that are delivered both directly to the armed services and to other defense prime contractors. Less than 1% of today's revenue is related to the resale of products substantially manufactured by others. In this case, the product would likely be a simple replacement part of a larger system previously produced by Optex Systems, Inc. (Delaware).

A majority of our contracts are prime or subcontracted directly with the Federal government and, as such, are subject to Federal Acquisition Regulation Subpart 49.5, "Contract Termination Clauses" and more specifically Federal Acquisition Regulation clauses 52.249-2 "Termination for Convenience of the Government Fixed-Price)", and 49.504 "Termination of fixed-price contracts for default". These clauses are standard clauses on our prime military contracts and generally apply to us as subcontractors. It has been our experience that the termination for convenience is rarely invoked, except where it is mutually beneficial for both parties. We are currently not aware of any pending terminations for convenience or for default on our existing contracts.

By way of background, the Federal Acquisition Regulation is the principal set of regulations that govern the acquisition process of government agencies and contracts with the U.S. government. In general, parts of the Federal Acquisition Regulation are incorporated into government solicitations and contracts by reference as terms and conditions effecting contract awards and pricing solicitations.

In the event a termination for convenience were to occur, Federal Acquisition Regulation clause 52.249-2 provides for full recovery of all contractual costs and profits reasonably occurred up to and as a result of the terminated contract. In the event a termination for default were to occur, we could be liable for any excess cost incurred by the government to acquire supplies from another supplier similar to those terminated from us. We would not be liable for any excess costs if the failure to perform the contract arises from causes beyond the control and without the fault or negligence of the company as defined by Federal Acquisition Regulation clause 52.249-8. In addition, the Government may require us to transfer title and deliver to the Government any completed supplies, partially completed supplies and materials, parts, tools, dies, jigs, fixtures, plans, drawings, information, and contract rights that we have specifically produced or acquired for the terminated portion of this contract. The Government shall pay contract price for completed supplies delivered and accepted, and we and the Government would negotiate an agreed upon amount of payment for manufacturing materials delivered and accepted and for the protection and preservation of the property. Failure to agree on an amount for manufacturing materials is subject to the Federal Acquisition Regulation Disputes clause 52.233-1.

Many of our contracts allow for government contract financing in the form of contract progress payments pursuant to Federal Acquisition Regulation 52.232-16, "Progress Payments". As a small business, and subject to certain limitations, this clause provides for government payment of up to 90% of incurred program costs prior to product delivery. To the extent our contracts allow for progress payments, we intend to utilize this benefit, thereby minimizing the working capital impact on Optex Systems Holdings for materials and labor required to complete the contracts.

Our contracts allow for Federal Acquisition Regulation 52.243-1 which entitles the contractor to an “equitable adjustment” to the contract if the contract changes result in a change in contract costs or time of performance. In essence, an equitable price adjustment request is a request for a contract price modification (generally an increase) that allows for the contractor to be “made whole” for additional costs incurred which were necessitated by some modification of the contract effort. This modification may come from an overt change in U.S. Government requirements or scope, or it may come from a change in the conditions surrounding the contract (e.g., differing site conditions or late delivery of U.S. Government-furnished property) which result in statement of work additions, deletions, part substitutions, schedule or other changes to the contract which impact the contractor’s overall cost to complete. During 2010, Optex Systems Holdings realized increased losses against the Howitzer programs of \$1.1 million of which \$0.8 million related specifically to production issues encountered on our Howitzer product line. Increased losses were primarily attributable to manufacturing issues on our U.S. government Howitzer Aiming Circles culminating in higher material scrap and labor hours, combined with a reduction in total production volume in 2010 which further impacted production efficiencies across all product lines. Optex Systems Holdings requested an equitable adjustment on this program due to significant design issues impacting the manufacturability of the product. As there was no guarantee that the request would be granted in part or in full, we realized the entire loss in fiscal year 2010. The initial equitable adjustment claim was formally rejected by the contracting agency on May 31, 2012; however, Optex Systems Holdings appealed the decision with the Armed Services Board of Contract Appeals (ASBCA). In September 2015, the U.S. Government agreed to a \$0.9 million settlement against the claim for the Aiming Circle contract number W52H09-06-D-0229. The settlement is the result of a negotiation and fact gathering process managed through the Armed Services Board of Contract Appeals (ASBCA). A contract modification was issued on September 23, 2015 increasing the total contract price by the agreed amount. As the respective units were shipped complete in 2011, the contract was essentially complete on execution of the modification and the entire amount was recorded as revenue for the twelve months ended September 27, 2015.

In some cases, we may receive an “undefinitized” (i.e., price, specifications and terms are not agreed upon before performance commenced) contract award for contracts that exceed the \$750,000, which is the federal government simplified acquisition threshold. These contracts are considered firm contracts at an undefinitized, but not to exceed specified limits threshold. Cost Accounting Standards Board covered contracts are subject to the Truth in Negotiations Act disclosure requirements and downward only price negotiation. As of October 2, 2016, none of our outstanding backlog fell under this criterion.

We manufacture optical sighting systems and assemblies, primarily for Department of Defense applications. Its products are installed on various types of U.S. military land vehicles, such as the Abrams and Bradley fighting vehicles, light armored and armored security vehicles and have been selected for installation on the Stryker family of vehicles. We also manufacture and deliver numerous periscope configurations, rifle and surveillance sights and night vision optical assemblies. We have capabilities which include machining, bonding, painting engraving and assembly and can perform both optical and environmental testing in-house. Our products consist primarily of build-to-customer print products that are delivered both directly to the armed services and to other defense prime contractors. We are both a prime and sub-prime contractor to the Department of Defense. Sub-prime contracts are typically issued through major defense contractors such as General Dynamics Land Systems, Raytheon Corp., BAE, NorcaTec and others. We are also a military supplier to foreign governments such as Israel, Australia and NAMSA and South American countries and as a subcontractor for several large U.S. defense companies serving foreign governments.

## Recent Orders

- In February 2016, we received a \$1.2 million award from General Dynamics Land Systems.
- In April 2016, we received \$841,000 in initial orders for advanced laser protected periscopes from U.S. Army Contracting Command.
- In May 2016, we received a new \$1.12 million purchase order from a domestic customer.
- In June 2016, we completed shipment of \$518,000 of periscopes to Brazil.
- In July 2016, we secured a five-year contract with the Defense Logistics Agency with a value of \$5.99 million.



In September 2016, we received two orders from the Defense Logistics Agency: a \$450,000 order for collimators for the Abrams Main Battle Tank and a \$570,000 order for cable periscopes.

In October 2016, we received a \$765,000 order from L-3 Communications for night vision goggle laser interference filter assemblies.

In October 2016, we were awarded a \$1.3 million portion of a commercial multi-year strategic supplier agreement with a domestic manufacturer of premium optical devices to supply its optical assemblies.

In December 2016, we were awarded a \$1.5 million purchase order from one of the world's largest defense companies for laser protected periscopes. The periscopes will be delivered over the next three years for installation into Light Armored Vehicles in the Middle East.

## **New Product Development**

We continue to field new product opportunities from both domestic and international customers. Given continuing unrest in multiple global hot spots, the need for precision optics continues to increase. Most of these requirements are for observation and situational awareness applications; however, we continue to see requests for higher magnification and custom reticles in various product modifications. The basic need to protect the soldier while providing information about the mission environment continues to be the primary driver for these requirements.

We do not believe that the change in government administration will cause a major change in the direction of funding or product need for the U.S. military. Maintenance will still be required, and the opportunities for us to upgrade existing systems with higher performing systems will continue to present themselves. Spending levels may change, but given the mix between foreign spending, domestic/prime demand, and the more recent commercial opportunities, we do not expect any negative trends arising from political domestic changes into fiscal 2017.

During the first six months of 2015, we released a new digital spotting scope called Red Tail (patent pending). This device is targeted towards long range observation and image recording used by military, border patrol, and select consumer/commercial applications. The device is designed to deliver high definition images with military grade resolution, but at commercial "off the shelf" pricing. Using high grade optics to deliver a 45X magnified image onto a 5 megapixel CMOS sensor, the Red Tail device then transmits this image via Wi-Fi to the user's smartphone or tablet. Digital still images or videos can then be captured and/or emailed using a custom Red Tail app available for either iOS or Android devices. We demonstrated this device in April 2015 at the Border Security Expo in Phoenix, Arizona and received positive feedback from U.S. border agents, police officers, and other Expo attendees.

On November 10, 2015, we entered into a retail sales relationship with Cabela's Inc., to distribute our Red Tail Digital Spotting Scope as well as our new Stabilized Monocular. We are presently in negotiations to make these devices available via General Services Administration schedules for government personnel.

## **Results of Operations**

### *Segment Information*

We have presented the operating results by segment to provide investors with an additional tool to evaluate our operating results and to have a better understanding of the overall performance of each business segment and its ability to perform in subsequent periods. Management of Optex Systems Holdings uses the selected financial measures by segment internally to evaluate its ongoing segment operations and to allocate resources within the organization accordingly. Segments are determined based on differences in products, location, internal reporting and how operational decisions are made. Management has determined that the Optex Systems, Richardson plant, and the Applied Optics Center, Dallas plant, which was acquired on November 3, 2014, are separately managed, organized, and internally reported as separate business segments. The table below provides a summary of selective statement of operations data by operating segment for the years ended October 2, 2016 and September 27, 2015 reconciled to the Audited Consolidated Results of Operations as presented in Item 8, "Financial Statements and Supplementary Data".

Results of Operations Selected Financial Info by Segment  
(Thousands)

|  | Twelve months ending<br>October 2, 2016 |                                       |  | September 27, 2015 |                     |  | Other<br>(non<br>allocated<br>costs<br>and<br>eliminations) | Consolidated |
|--|---|---------------------------------------|--|--------------------|---------------------|--|---|--------------|
|  | Optex<br>Richardson                     | Applied<br>Optics<br>Center<br>Dallas | Other<br>(non<br>allocated<br>costs and<br>eliminations) | Consolidated       | Optex<br>Richardson | Applied<br>Optics<br>Center<br>Dallas <sup>(1)</sup> |   |              |
| Revenue from<br>External<br>Customers      | \$11,052                                | \$ 6,227                              | \$ -   | \$ 17,279          | \$8,172             | \$ 4,831   | \$ -  | \$ 13,003    |
| Intersegment<br>Revenues                   | -                                       | 1,892                                 | (1,892 )   | -                  | -                   | 526  | (526 )  | -            |
| Total Segment<br>Revenue                   | 11,052                                  | 8,119                                 | (1,892 )   | 17,279             | 8,172               | 5,357  | (526 )  | 13,003       |
| Cost of Goods<br>Sold from<br>Inventory    | 8,891                                   | 7,229                                 | (1,892 )   | 14,228             | 6,403               | 4,923  | (526 )  | 11,326       |
| Intangible<br>Amortization -<br>COS        | -                                       | -                                     | -  | -                  | -                   | 291  | -   | 291          |
| Total Cost of<br>Sales                     | 8,891                                   | 7,229                                 | (1,892 )   | 14,228             | 6,929               | 5,214  | (526 )  | 11,617       |
| Gross Margin                               | 2,161                                   | 890                                   | -  | 3,051              | 1,243               | 143  | -   | 1,386        |
| Gross Margin %                             | 19.6 %                                  | 11.0 %                                | 0.0 %  | 17.7 %             | 15.2 %              | 3.0 %  | 0.0 %   | 10.7 %       |
| General and<br>Administrative<br>Expense   | 2,744                                   | 507                                   | -  | 3,251              | 2,061               | 714  | -   | 2,775        |
| Intangible<br>Amortization -<br>G&A        | -                                       | -                                     | -  | -                  | -                   | 51   | -   | 51           |
| Segment<br>Allocated G&A<br>Expense        | (728 )                                  | 728                                   | -  | -                  | (387 )              | 387  | -   | -            |
| Net General &<br>Administrative<br>Expense | 2,016                                   | 1,235                                 | -  | 3,251              | 1,674               | 1,152  | -   | 2,826        |
| Operating Profit<br>(Loss)                 | 145                                     | (345 )                                | -  | (200 )             | (431 )              | (1,009 )   | -   | (1,440 )     |

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|                                |        |   |         |    |        |   |         |    |         |    |          |    |         |   |        |    |
|--------------------------------|--------|---|---------|----|--------|---|---------|----|---------|----|----------|----|---------|---|--------|----|
| Operating Profit (Loss) %      | 1.3    | % | (4.2    | %) | 0.0    | % | (1.2    | %) | (5.3    | %) | (18.8    | %) | 0.0     | % | (11.1  | %) |
| Gain on Purchased Asset        | -      |   | -       |    | -      |   | -       |    | -       |    | 2,110    |    | -       |   | 2,110  |    |
| Interest Expense               | -      |   | -       |    | (36    | ) | (36     | )  | -       |    | -        |    | (179    | ) | (179   | )  |
| Net Income (Loss) before taxes | \$ 145 |   | \$ (345 | )  | \$ (36 | ) | \$ (236 | )  | \$ (431 | )  | \$ 1,101 |    | \$ (179 | ) | \$ 491 |    |
| Net Income (Loss) %            | 1.3    | % | (5.5    | %) | 0.0    | % | (1.4    | %) | (5.3    | %) | 22.8     | %  | 0.0     | % | 3.8    | %  |

(1) The Applied Optics Center was acquired on November 3, 2014.

Our total revenues increased by \$4.3 million, or 33.1%, in 2016 over the 2015 revenue levels. The Optex Systems Richardson segment realized a \$2.9 million, or 35.4%, increase in revenue and the Applied Optics Center segment which was acquired on November 4, 2014, realized an increase of \$1.4 million, or 29.2%, in revenue over the prior year period. Intersegment revenues increased by \$1.4 million during the 2016 year, from \$0.5 million to \$1.9 million. Intersegment revenues relate primarily to coated filters provided by the Applied Optics Center to Optex Systems in support of the Optex Systems periscope line.

Both the gross margin and the gross margin percentages increased significantly in 2016 for both the Optex Systems and Applied Optics Center segments over 2015. In 2016 compared to 2015 the gross margin increased by \$1.7 million and the gross margin percent increased by 7.0% points. U.S. government military spending has a significant impact on our product lines as our products directly support various types of U.S. military land vehicle procurements. Reduced military spending in 2015 resulted in revenues below the required levels necessary to cover fixed plant operating costs against our contracts. The reduced revenue, and corresponding contribution margins toward fixed costs, resulted in lower gross margin percentages for both the Optex and Applied Optics Centers during the 2015 fiscal year. In addition, the prior year cost of sales included \$0.3 million of intangible amortization associated with the Applied Optics Center acquisition on November 3, 2014, which was not included in the year ending 2016. During 2016, the gross margin percentage on Optex Systems revenue increased from 15.2% to 19.6% over the prior year, whereas the Applied Optics Center gross margin percentage increased from 3.0% to 15.2%, inclusive of the intersegment sales to Optex Systems. We expect these higher margin rates to continue to grow for both segments as we our revenues on our higher margin Optex Systems periscopes increase and production efficiencies on the Applied Optics Center commercial optical assemblies improve through new vendor management and quality controls.

During the year ending 2016, the Applied Optics Center absorbed (\$0.7) million of fixed general and administrative costs incurred by Optex Systems for support services, as compared to (\$0.4) million in the prior year period. These expenses cover accounting, executive, human resources, information technology, board fees and other corporate expenses paid by Optex Systems and shared across both operating segments.



Our operating loss also decreased significantly, by \$1.2 million, in 2016, to (\$0.2) million, as compared to the prior year operating loss of (\$1.4) million. We experienced improvements in both operating segments year over year, with Optex Systems increasing operating profit by \$0.6 million, from a prior year operating loss of (\$0.4) million to a \$0.2 million operating profit in 2016. The Applied Optics Center operating profit increased by \$0.7 million, from a prior year operating loss of (\$1.0) million to a 2016 operation loss of (\$0.3) million.

Net income before taxes decreased from the prior year by (\$0.7) million, from a prior year net income before taxes of \$0.5 million to a current year net loss before taxes of (\$0.2) million. The decline in net income year over year is primarily due to a nonrecurring \$2.1 million gain recognized in 2015 on the acquisition of the Applied Optics Center on November 3, 2014.

As a result of lower U.S. government spending trends from 2011 levels, the Company has continued to explore other revenue opportunities for manufacturing outside of our traditional product lines for products which could be manufactured using our existing lines in order to fully utilize our existing capacity. Further, we continue to look for additional strategic businesses to acquire that will strengthen our existing product line, expand our operations, and enter new markets.

### Backlog

Backlog as of October 2, 2016 was \$12.0 million as compared to a backlog of \$11.7 million as of September 27, 2015, representing an increase of 2.6%. The following table depicts the current expected delivery by quarter of all contracts awarded as of October 2, 2016.

| Product Line                      | (Millions)   |               |               |               | 2017<br>Delivery | 2018<br>Delivery | Total<br>Backlog<br>10/02/2016 | Total<br>Backlog<br>9/27/2015 | Variance      | % Chg        |
|-----------------------------------|--------------|---------------|---------------|---------------|------------------|------------------|--------------------------------|-------------------------------|---------------|--------------|
|                                   | Q1<br>2017   | Q2<br>2017    | Q3<br>2017    | Q4<br>2017    |                  |                  |                                |                               |               |              |
| Periscopes                        | 1.8          | 0.9           | 0.5           | 0.1           | \$ 3.3           | 0.1              | \$ 3.4                         | \$ 3.7                        | \$ (0.3 )     | -8.1 %       |
| Sighting Systems                  | 0.1          | -             | 1.4           | 1.5           | 3.0              | 0.2              | 3.2                            | 4.6                           | (1.4 )        | (30.4 )%     |
| Other                             | 0.5          | 0.6           | 1.1           | 0.1           | 2.3              | -                | 2.3                            | 0.3                           | 2.0           | 666.7 %      |
| Optex Systems -<br>Richardson     | 2.4          | 1.5           | 3.0           | 1.7           | 8.6              | 0.3              | 8.9                            | 8.6                           | 0.3           | 3.5 %        |
| Applied Optics Center -<br>Dallas | 2.3          | 0.8           | -             | -             | 3.1              | -                | 3.1                            | 3.1                           | -             | 0.0 %        |
| <b>Total Backlog</b>              | <b>\$4.7</b> | <b>\$ 2.3</b> | <b>\$ 3.0</b> | <b>\$ 1.7</b> | <b>\$ 11.7</b>   | <b>\$ 0.3</b>    | <b>\$ 12.0</b>                 | <b>\$ 11.7</b>                | <b>\$ 0.3</b> | <b>2.6 %</b> |

During 2016, Optex Systems Holdings received new orders totaling \$17.6 million, a 26.6% increase, as compared to new orders of \$13.9 million during the prior year. The 2016 orders consist of \$7.8 million in support of our periscope product line, \$6.2 million attributable to the Applied Optics Center and \$3.6 million attributable to other products. Approximately 48.4% or \$8.5 million of the orders received in fiscal year 2016 were delivered within the year, with the remaining balance to be delivered in fiscal year 2017. As of October 2, 2016 our shippable backlog for fiscal year 2017 is \$11.7 million. As of December 14, 2016, Optex Systems Holdings, Inc. has received additional new orders of \$6.2 million, which includes \$3.5 million in periscopes, \$0.5 million in Optex other and \$2.2 million of Applied Optics Center products for deliveries in fiscal year 2017. We expect our orders during fiscal year 2017 to meet or exceed the fiscal year 2016 orders, with a substantial portion, approximately 45-50%, to be deliverable within the fiscal year 2017 period.

The Bipartisan Budget Act of 2015 eased the strict spending caps established in the 2011 sequestration and set forth federal spending through the 2016 and 2017 fiscal years. The plan lifted the caps on the appropriated spending each year by \$50 billion in 2016 and will lift the cap another \$30 billion in 2017, evenly divided between defense and domestic programs and provides an additional \$16 billion each year in the form of inflated war spending, evenly split between the Defense and State departments. We believe that the defense industry effects of the sequestration from 2011 have reached a plateau and we will begin to see small but steady increases in defense military procurement orders in the coming year. As of December 7, 2017 the National Defense Authorization funding for fiscal year 2017 has been approved by Congress, pending Presidential approval. The approved estimates on the fiscal year 2017 spending are up slightly, 2%, from 2016 levels to \$619 billion. It is further anticipated that the new administration will request a defense supplemental to increase defense spending above the current compromised amounts within its first 100 days of office.

The U.S. military supply industry has become highly competitive as suppliers fight for increased market share to offset the impacts of the reduced government spending. We compete with other suppliers on the basis of quality, delivery, price, and overall customer service, among other things. Our competitors include a number of suppliers, some of which have established strong relationships with the defense contracting agencies. Competition can lead to price reductions, reduced margins and an inability to gain or hold market share. We are aggressively pursuing additional periscope market share in both foreign and domestic defense contractor markets in order to mitigate the effect the reduced U.S. military orders has on our operations.

*Optex Systems - Richardson:*

Backlog for our periscope product line has decreased (8.1%) or (\$0.3) million to \$3.4 million, from our ending 2015 fiscal year level of \$3.7 million. We attribute the lower backlog to delayed timing of U.S. government contract awards during the fourth quarter of 2016. Our total periscope contract awards for fiscal 2016 totaled \$7.8 million as compared to \$6.6 million in the fiscal year 2015. Optex Systems, Inc. has experienced an increase in US government demand for laser protected periscopes in support of ongoing maintenance of US combat vehicles in addition to increased orders for foreign markets in support of Saudi Arabia's Light Armored Vehicle, Morocco's conversion of M1A1 vehicles to the situational awareness configuration and US Department of State Foreign Military Sales (FMS) in support of the M113 Periscope Upgrade program for Brazil. As of December 9, 2016, our new periscope awards for the first quarter of 2017 are \$3.5 million and have already exceeded our first quarter awards for 2016 by \$2.1 million. On November 10, 2016 Optex Systems received its first purchase order of \$1.5 million for its laser protected periscopes from Defense Logistics Agency (DLA). The purchase order is the first task order delivery executed against a five year Indefinite Delivery, Indefinite Quantity (IDIQ) contract with DLA totaling \$6 million which was awarded in July 2016. On December 14, 2016, we were awarded a \$1.5 million purchase order from one of the world's largest defense companies for laser protected periscopes. The periscopes will be delivered over the next three years for installation into Light Armored Vehicles in the Middle East. We continue to quote periscopes as a U.S. military prime and subcontracted supplier on an ongoing basis and expect additional awards throughout the next fiscal year to meet or exceed our 2016 orders. We anticipate our acquisition of the Applied Optics Center, combined with our expanded footprint into foreign vehicle platforms has positioned Optex Systems Inc. to effectively compete for the domestic market and foreign defense market share as the best value supplier for laser protected periscopes.

Sighting Systems backlog decreased by (\$1.4) million or (30.4%) in the last twelve months as we continued to deliver against our existing M36 DDAN contract. We anticipate the possibility of new sighting systems orders for DDANs as well as similar sighting systems for delivery beyond 2017. Our current sighting system backlog deliveries have been rescheduled for the second half of fiscal 2017.

Our backlog increased by \$2.0 million or 666.7% on other products in the last twelve months due to new orders booked for collimator assemblies of \$1.3 million in support of the U.S government and General Dynamics, and periscope cable assemblies of \$0.7 million for the U.S. Government.



*Applied Optics Center – Dallas*

The Applied Optics Center backlog remained flat at \$3.1 million for the year ending 2016 as compared to the year ending 2015, although we have seen a significant shift in external revenues from our military filter business toward commercial optical assemblies. Our commercial backlog for Nightforce optical assembly products has increased \$1.5 million from the prior year level. The increase was offset by reductions in U.S. military laser filters of \$1.5 million. New orders booked for fiscal year 2016 were \$6.2 million, an increase of 5.1%, as compared to \$5.9 million in the prior year. As of December 9, 2016, the Applied Optics Center new orders for fiscal year 2017 has already reached the 2016 first quarter order value of \$2.2 million.

The Applied Optics Center also serves as a primary filter supplier to the Optex Systems – Richardson plant. During the fiscal year 2016, the Applied Optex Center received intracompany orders for laser coated filters in support of Optex periscopes of \$1.9 million, as compared to \$0.5 million in the prior year. The increased volume in support of Optex Systems – Richardson, has offset the decline in AOC filter volume from external customers and mitigated the impact to the coating production lines.

The AOC acquisition has expanded our ability to bring our technology and products into commercial markets. Commercial optical products around the world use thin film coatings to create product differentiation. These coatings can be used for redirecting light (mirrors), blocking light (laser protection), absorbing select light (desired wavelengths), and many other combinations. They are used in telescopes, rifle scopes, binoculars, microscopes, range finders, protective eyewear, photography, etc. Given this broad potential, the commercial applications are a key opportunity going forward. Further, the AOC acquisition has strengthened our overall position by decreasing the bargaining power of our suppliers through backwards integration of a key supplier and most importantly, creates additional barriers of entry of potential competitors. Overall, the customer base and the competition have seen the acquisition as creating a stronger Optex Systems Holdings.

Optex Systems Holdings continues to aggressively pursue international and commercial opportunities in addition to maintaining its current footprint with U.S. vehicle manufactures, with existing as well as new product lines. We continue exploring new market opportunities for our M17 day/thermal periscopes and digital optics for commercial applications. We are also reviewing potential products, outside our traditional product lines, which could be manufactured using our current production facilities in order to capitalize on our existing capacity. Further, we continue to look for strategic businesses to acquire that will strengthen our existing product line, expand our operations, and enter new markets.

#### Twelve month period ended October 2, 2016 compared to the twelve month period ended September 27, 2015

##### Revenues:

The table below details the revenue changes by segment and product line for the year ended October 2, 2016 as compared to the year ended September 27, 2015.

| Product Line                   | Twelve months ended<br>(Millions) |                    | Variance | % Chg   |
|--------------------------------|-----------------------------------|--------------------|----------|---------|
|                                | October<br>2,<br>2016             | September 27, 2015 |          |         |
| Periscopes                     | \$ 8.1                            | \$ 4.5             | \$ 3.6   | 80.00   |
| Sighting Systems               | 1.8                               | 2.2                | (0.4 )   | (18.2 ) |
| Howitzer / Aiming Circle       | -                                 | 0.9                | (0.9 )   | (100.0) |
| Other                          | 1.2                               | 0.6                | 0.6      | 100.0   |
| Optical Systems - Richardson   | 11.1                              | 8.2                | 2.9      | 35.4    |
| Applied Optics Center - Dallas | 6.2                               | 4.8                | 1.4      | 29.2    |

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|               |         |         |        |        |
|---------------|---------|---------|--------|--------|
| Total Revenue | \$ 17.3 | \$ 13.0 | \$ 4.3 | \$33.1 |
|---------------|---------|---------|--------|--------|

Our total revenues increased by \$4.3 million, or 33.1%, in 2016 over the 2015 revenue levels. The Optex Systems Richardson segment realized a \$2.9 million, or 35.4%, increase in revenue and the Applied Optics Center segment which was acquired on November 4, 2014, realized an increase of \$1.4 million, or 29.2%, in revenue over the prior year period. Approximately 50% of our total revenue recognized during the fiscal year was from new orders booked during the twelve months ending October 2, 2016.

Revenues increased by \$3.6 million or 80% on our periscope line during the twelve months ended October 2, 2016 as compared to the twelve months ended September 27, 2015. During the period, Optex Systems, Inc. experienced higher revenue across all periscope types due to increased customer demand for the U.S. government as well as foreign military sales during the year. Optex Systems, Inc. has experienced an increase in US government demand for laser protected periscopes in support of ongoing maintenance of US combat vehicles in addition to increased orders for foreign markets in support of Saudi Arabia's Light Armored Vehicle, Morocco's conversion of M1A1 vehicles to the situational awareness configuration and US Department of State Foreign Military Sales (FMS) in support of the M113 Periscope Upgrade program for Brazil. Based on our ending September backlog of \$3.4 million and new orders of \$2.0 million received in the first quarter of fiscal 2017, we expect these higher revenue levels to continue through the next year as we continue to bid new contracts on both foreign and domestic periscope business.

Revenues on sighting systems declined by (\$0.4) million, or (18.2%) from the prior year period due to software issues causing a delay in the required video controller equipment necessary to ship complete units during the year. While the software issues have been resolved, delays in video controller equipment, combined with a customer request to push out scheduled contract delivery, we expect the sighting systems revenue to decline over the next six months, with increased production deliveries occurring in the second half of fiscal year 2017.

Revenues on Howitzer Aiming Circles declined by (\$0.9) million, or (100%) from the prior year period, this is due to revenue recognized in the fiscal year 2015 for the settlement of a \$0.9 million equitable adjustment claim with the U.S. government on a contract which had previously completed in 2011. We are currently not in production for additional Howitzers and as such do not anticipate additional revenues on this program in the near term.

Revenue on other product lines increased by \$0.6 million, or 100%, compared to revenues in the prior year. The increased revenue in the year ending October 2, 2016 as compared to the prior year period relate to increased shipments in the year ending October 2, 2016 for big eye binoculars of \$0.1 million to assorted customers, periscope cable assemblies of \$0.4 million to the U.S. government, and \$0.1 million in spare orders to multiple customers. We continue to bid on smaller miscellaneous spare orders on an ongoing basis.

The Applied Optics Center external revenue increased by \$1.4 million, or 29.2%, during the 2016 fiscal year as compared to the prior year period. The increased revenue was primarily attributable to increases in commercial sales of \$1.2 million for Nightforce optical assemblies. The U.S. military shipments increased by \$1.3 million due to shipments against a new ACOG laser filter contract shipped during the year; however, reductions in laser interface filters supplied to other U.S military contractors declined by \$1.2 million. Applied Optics Center also serves as a primary supplier of laser coated filters to the Optex Systems Richardson site in support of Optex Systems periscope orders. During the fiscal year ending 2016, intracompany revenues to Optex Systems-Richardson increased by \$1.4 million, to \$1.9 million in 2016, from the prior year amount of \$0.5 million. During the year ending in 2016, approximately 50% of the revenue recognized was derived from new orders booked during the 2016 fiscal year. Based on the ending Applied Optics Center backlog of \$3.1 million as of October 2, 2016, combined with an additional \$2.2 million in new orders booked through December 9, 2016, we expect continued growth into 2017 Applied Optics Center product lines.

*Gross Margin.* The gross margin during the period ending October 2, 2016 was 17.7% of revenue as compared to a gross margin of 10.7% of revenue for the period ending September 27, 2015. The increase in cost of sales of \$2.6 million, and increase in gross margin percentage of 7.0% pts., is primarily attributable to costs associated with the increased revenue of \$4.3 million, or 33.1% over the prior year period, combined with changes in product mix and higher efficiencies on our periscope, and Applied Optics Center product lines. The 2015 reductions in military spending created excess and idle capacity, whereas Optex Systems Holdings was unable to fully absorb the fixed manufacturing overhead against our contracts. As the factory labor and overhead costs are relatively fixed at low production rates, idle and excess capacity associated with the lower Optex periscope and Applied Optics Center revenues contributed to lower gross margins on our contracts during the 2015 year. In addition, the prior year cost of

sales included \$0.3 million of intangible amortization associated with the Applied Optics Center acquisition on November 3, 2014, which was not included in the year ending 2016.

*G&A Expenses.* During the fiscal year ended October 2, 2016, we recorded operating expenses of \$3.3 million as opposed to \$2.8 million during the period ending September 27, 2015, an increase of \$0.5 million or 17.9%. The increased general and administrative expenses in the current year period over the prior year period is primarily due to the write off of costs attributable to the suspended capital raise during the first half of the fiscal year 2016 of \$0.2 million, increased costs for investor relations of \$0.2 million, and increased board of director fees of \$0.1 million in the current year as compared to the prior year period.

*Operating Income (Loss).* During the period ending October 2, 2016, we recorded, an operating loss of (\$0.2) million as compared to an operating loss of (\$1.4) million during the period ending September 27, 2015. The \$1.2 million decrease in operating loss in the current year over the prior year is primarily due to the increased gross margin of \$1.7 million on higher revenue which is partially offset with higher general and administrative costs of (\$0.5).

*Net loss applicable to common shareholders.* During the year ended October 2, 2016, we recorded a net loss applicable to common shareholders of (\$1.0) million as compared to net loss applicable to common shareholders of (\$6.0) million during the year ended September 27, 2015. The decreased loss of \$5.0 million is primarily attributable to a decrease in operating losses of \$1.2 million, a decrease in interest expense of \$0.2 million and decreased premiums on preferred stock for the beneficial conversion features recognized on Series A and Series B preferred shares of \$5.7 million in the current year as compared to the prior year. In addition, during 2015 we recognized a gain on asset purchase of (\$2.1) million which was associated with the acquisition of the Applied Optics Center on November 3, 2014.

## **Liquidity and Capital Resources**

As of October 2, 2016, Optex Systems Holdings had working capital of \$8.6 million, as compared to \$6.1 million as of September 27, 2015. During the year ended October 2, 2016, the Company experienced a net loss of (\$0.2) million as compared to a net loss of \$(6.0) million, and an increase in revenues of \$4.3 million, or 33.1%, up to \$17.3 million, from \$13.0 million, as compared to the prior year ended September 27, 2015. New orders increased 26.6% to \$17.6 million, as compared to new orders of \$13.9 million during the prior year. Backlog has increased by \$0.3 million, or 2.6% to 12.0 million over the prior year backlog. Approximately 50% of annual revenue is derived from new orders booked during the fiscal year.

U.S. military spending has been significantly reduced from the 2011 spending levels as a result a decrease in military operations in Iraq and Afghanistan and as a result of the Congressional sequestration cuts to defense spending, which began in fiscal year 2013. As a result of lower U.S. government spending, the Company has continued to explore other opportunities for manufacturing outside of our traditional product lines for products which could be manufactured using our existing lines in order to fully utilize our existing capacity. During the 2016 fiscal year, as the U.S. government The Bipartisan Budget Act of 2015 eased the strict spending caps established in the 2011 sequestration and set forth increased federal spending through the 2016 and 2017 fiscal years. We do not anticipate the recent change in the government administration to adversely affect the established spending plan set forth in the recently approved National Defense Authorization Act for 2017. Further, we continue to look for additional strategic businesses to acquire that will strengthen our existing product line, expand our operations, and enter new markets.

The Company has historically funded its operations through operations, convertible notes, common and preferred stock offerings and bank debt. The Company's ability to generate positive cash flows depends on a variety of factors,

including the continued development and successful marketing of the Company's products. At October 2, 2016, the Company had approximately \$2.6 million in cash and an outstanding payable balance of \$0.3 million against our working line of credit. The line of credit allows for borrowing up to a maximum of \$2.2 million, which fluctuates based on our open accounts receivable balance. As of October 2, 2016, our outstanding accounts receivable was \$2.1 million. We expect the accounts to be collected during the first quarter of fiscal 2017. The Company expects to continue to incur net losses into the first half of fiscal year 2017, but anticipates that the 2017 fiscal year will be profitable based on projected revenue growth. Successful transition to attaining profitable operations is dependent upon achieving a level of revenue adequate to support the Company's cost structure. Management intends to manage operations commensurate with its level of working capital and facilities line of credit during the next twelve months; however, uneven revenue levels driven by changes in customer delivery demands, first article inspection requirements or other program delays could create a working capital shortfall. In the event the Company does not successfully implement its ultimate business plan, certain assets may not be recoverable.

On August 26, 2016, we consummated a public offering of 2,291,000 Class A units consisting of common stock and warrants and 400 Class B units consisting of shares of Series C convertible stock and warrants for a total gross purchase price of \$4.8 million. The net proceeds of the offering were \$4.2 million after underwriter expenses. We used \$0.3 million of the proceeds for offering expenses paid by Optex Systems Holdings and \$1.7 million of the proceeds for the redemption of Series A and Series B preferred shares which were a condition of the offering. The remaining \$2.2 million of funds will be used to fund working capital needs to support revenue growth and acquisitions.

### **Period from September 27, 2015 through October 2, 2016**

*Cash and Cash Equivalents.* As of October 2, 2016, we had cash and cash equivalents of \$2.6 million as compared to \$0.7 million as of September 27, 2015, and increase in cash and cash equivalents of \$1.9 million.

*Net Cash (Used by) Provided by Operating Activities.* Net cash provided by operating activities during the period beginning September 27, 2015 and ending October 2, 2016 totaled \$0.2 million. The primary source of cash was collections against in accounts receivable of \$0.8 million which was offset by a net loss of (\$0.2) million and increases in inventory purchases associated with higher revenue of (\$0.5) million and other working capital changes of \$0.1 million

*Net Cash (Used) by Investing Activities.* In the twelve months ended October 2, 2016, cash used by investing activities was \$0.0 million.

*Net Cash (Used) by Financing Activities.* Net cash provided by financing activities was \$1.7 million during the twelve months ended October 2, 2016 due to net proceeds of \$4.2 million for investments received by Optex Systems Holdings Inc., as a result of our public offering in August 2016, which was offset by (\$1.7) million in cash paid for redemptions of preferred Series A and Series B shares, (\$0.3) of public offering expenses paid by Optex, and (\$0.5) million of cash used to pay down the line of credit. As of October 2, 2016, the outstanding line of credit balance was \$0.3 million.

### **Critical Accounting Policies**

**Revenue Recognition:** Optex Systems Holdings recognizes revenue based on the modified percentage of completion method utilizing the units-of-delivery method, in accordance with FASB ASC 605-35:



The units-of-delivery method recognizes as revenue the contract price of units of a basic production product delivered during a period and as the cost of earned revenue the costs allocable to the delivered units. Costs allocable to undelivered units are reported in the balance sheet as inventory or work in progress. The method is used in circumstances in which an entity produces units of a basic product under production-type contracts in a continuous or sequential production process to buyers' specifications.

Optex Systems Holdings contracts are fixed price production type contracts whereby a defined order quantity is delivered to the customer during a continuous or sequential production process tailored to the buyer's specifications (build to print). Optex Systems Holdings' deliveries against these contracts generally occur in monthly increments across fixed delivery periods spanning from 3 to 36 months.

***Estimated Costs at Completion and Accrued Loss on Contracts:*** Optex Systems Holdings reviews and reports on the performance of its contracts and production orders against the respective resource plans for such contracts/orders. These reviews are summarized in the form of estimates at completion. Estimates at completion include Optex Systems Holdings' incurred costs to date against the contract/order plus management's current estimates of remaining amounts for direct labor, material, other direct costs and subcontract support and indirect overhead costs based on the completion status and future contractual requirements for each order.

If an estimate at completion indicates a potential overrun against budgeted resources for a fixed price contract/order, management first attempts to implement lower cost solutions that will profitably meet the requirements of the fixed price contract. If such solutions do not appear practicable, management makes a determination whether to seek renegotiation of contract or order requirements from the customer. If neither cost reduction nor renegotiation appears probable, an accrual for the contract loss/overrun is recorded against earnings and the loss is recognized in the first period the loss is identified based on the most recent estimates at completion of the particular contract or product order. As of October 2, 2016 there was \$0 in contract loss reserves. As of September 27, 2015 the contract loss reserves were \$54 thousand.

During 2010, Optex Systems Holdings realized increased losses against the Howitzer programs of \$1.1 million of which \$0.8 million related specifically to production issues encountered on our Howitzer product line. Increased losses were primarily attributable to manufacturing issues on our U.S. government Howitzer Aiming Circles culminating in higher material scrap and labor hours, combined with a reduction in total production volume in 2010 which further impacted production efficiencies across all product lines. Optex Systems Holdings requested an equitable adjustment on this program due to significant design issues impacting the manufacturability of the product. As there was no guarantee that the request would be granted in part or in full, we realized the entire loss in fiscal year 2010. The initial equitable adjustment claim was formally rejected by the contracting agency on May 31, 2012; however, Optex Systems Holdings appealed the decision with the Armed Services Board of Contract Appeals (ASBCA). In September 2015, the U.S. Government agreed to an \$850,000 settlement against the claim for the Aiming Circle contract number W52H09-06-D-0229. The settlement is the result of a negotiation and fact gathering process managed through the Armed Services Board of Contract Appeals (ASBCA). A contract modification was issued on September 23, 2015 increasing the total contract price by the agreed amount. As the respective units were shipped complete in 2011, the contract was essentially complete on execution of the modification and the entire amount was recorded as revenue for the twelve months ended September 27, 2015.

***Stock-Based Compensation:*** FASB ASC 718 establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, but primarily focuses on transactions whereby an entity obtains employee services for share-based payments. FASB ASC 718 requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.

Optex Systems Holdings' accounting policy for equity instruments issued to consultants and vendors in exchange for goods and services follows the provisions of FASB ASC 505-50. The measurement date for the fair value of the equity instruments issued is determined at the earlier of (i) the date at which a commitment for performance by the consultant or vendor is reached or (ii) the date at which the consultant or vendor's performance is complete. In the case of equity instruments issued to consultants, the fair value of the equity instrument is recognized over the term of the consulting agreement. Stock-based compensation related to non-employees is accounted for based on the fair value of the related stock or options or the fair value of the services, whichever is more readily determinable in accordance with FASB ASC 718.

***Beneficial Conversion Features of Convertible Securities:*** Conversion options that are not bifurcated as a derivative pursuant to ASC 815 and not accounted for as a separate equity component under the cash conversion guidance are evaluated to determine whether they are beneficial to the investor at inception (a beneficial conversion feature) or may become beneficial in the future due to potential adjustments. The beneficial conversion feature guidance in ASC 470-20 applies to convertible stock as well as convertible debt which are outside the scope of ASC 815. A beneficial conversion feature is defined as a nondetachable conversion feature that is in the money at the commitment date. In addition, our preferred stock issues contain conversion terms that may change upon the occurrence of a future event, such as antidilution adjustment provisions. The beneficial conversion feature guidance requires recognition of the conversion option's in-the-money portion, the intrinsic value of the option, in equity, with an offsetting reduction to the carrying amount of the instrument. The resulting discount is amortized as a dividend over either the life of the instrument, if a stated maturity date exists, or to the earliest conversion date, if there is no stated maturity date. If the earliest conversion date is immediately upon issuance, the dividend must be recognized at inception. When there is a subsequent change to the conversion ratio based on a future occurrence, the new conversion price may trigger the recognition of an additional beneficial conversion feature on occurrence.

Optex Systems Holdings has preferred stock, convertible into common shares, containing beneficial conversion features at inception as well as potential beneficial conversion features that could be triggered by future adjustments to the conversion price. Because our preferred stock is perpetual, with no stated maturity date, and the conversions may occur any time from inception, the dividend is recognized immediately when a beneficial conversion exists at issuance. During the twelve months ending September 27, 2015, Optex Systems Holdings recognized preferred stock dividends of \$6.4 million on Series A and Series B preferred stock related to the beneficial conversion feature arising from a common stock conversion rate of \$2.50 versus the commitment date price of \$10.00 per common share (post-split). During the twelve months ending October 2, 2016, Optex Systems Holdings recognized an additional preferred stock dividend of \$0.8 million as a result of the August 26, 2016 public offering which reset the preferred stock conversion rate from \$2.50 per common share to \$1.20 per common share and resulted in an additional beneficial conversion for the series A and Series b preferred shares.

***Intangible Assets:*** Optex Systems Holdings has acquisition-related intangible assets which include the fair market value of customer order backlog as of the acquisition date. We determine the fair value of intangible assets using the income approach methodology of valuation that includes the discounted cash flow method as well as other generally accepted valuation methodologies, which requires some judgment by management. Amortization of acquisition-related intangible assets is expensed to total operating expenses as cost of sales and general and administrative expenses on a straight-line basis over their estimated useful lives, unless such lives are deemed indefinite. Amortizable intangible assets are tested for impairment based on undiscounted cash flows and, if impaired, written down to fair value based on either discounted cash flows or appraised values. The residual values and useful lives are reviewed at each balance sheet date and adjusted, if appropriate. Optex Systems Holdings identified intangible assets of \$342 thousand from the acquisition of the Applied Optics Center from L3 on November 3, 2014 which consisted primarily of customer backlog, with an initial useful life of less than one year. As of October 2, 2016 the unamortized balance of the intangible assets was zero. See Note 6.

Intangible assets with indefinite lives are tested annually for impairment, during the fiscal fourth quarter and between annual periods, if impairment indicators exist, and are written down to fair value as required.

***Income Tax/Deferred Tax:*** FASB ASC 740 requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on differing treatment of items for financial reporting and income tax reporting purposes. The deferred tax balances are adjusted to reflect tax rates by tax jurisdiction, based on currently enacted tax laws, which will be in effect in the years in which the temporary differences are expected to reverse. Under FASB ASC 740, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for certain deferred tax assets if it is more likely than not that Optex Systems Holdings will not realize tax assets through future operations. When assessing the recoverability of deferred tax assets, management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies. Based on those estimates, management has determined that the deferred tax assets may not be realized and has established a valuation allowance against the deferred tax asset balance. As of October 2, 2016 Optex Systems Inc. has a deferred tax asset valuation allowance of (\$4.7) million against deferred tax assets of \$4.7 million.

***Recent Accounting Pronouncements***

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 reduces diversity in practice in how certain transactions are classified in the statement of cash flows. The amendments in ASU 2016-15 provide guidance on specific cash flow issues including debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, and distributions received from equity method investees. ASU 2016-15 is effective for annual and interim periods beginning after December 15, 2017. We are currently assessing the potential impact of ASU 2016-15 on our consolidated financial statements and results of operations.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses (“ASU 2016-13”). ASU 2016-13 changes the impairment model for most financial assets and certain other instruments, including trade and other receivables, held-to-maturity debt securities and loans, and requires entities to use a new forward-looking expected loss model that will result in the earlier recognition of allowance for losses. This update is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for a fiscal year beginning after December 15, 2018, including interim periods within that fiscal year. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. We are currently assessing the potential impact of ASU 2016-13 on our consolidated financial statements and results of operations.

In March 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-09 amending several aspects of share-based payment accounting. This guidance requires all excess tax benefits and tax deficiencies to be recorded in the income statement when the awards vest or are settled, with prospective application required. The guidance also changes the classification of such tax benefits or tax deficiencies on the statement of cash flows from a financing activity to an operating activity, with retrospective or prospective application allowed. Additionally, the guidance requires the classification of employee taxes paid when an employer withholds shares for tax-withholding purposes as a financing activity on the statement of cash flows, with retrospective application required. This ASU is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. Early adoption is permitted. We are currently evaluating the impact of the new guidance on our consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) (“ASU 2016-08”). ASU 2016-08 does not change the core principle of Topic 606 but clarifies the implementation guidance on principal versus agent considerations. ASU 2016-08 is effective for the annual and interim periods beginning after December 15, 2017. We are currently assessing the potential impact of ASU 2016-08 on our consolidated financial statements and results of operations.

In February 2016, FASB issued ASU 2016-02—*Leases (Topic 842)*. The update is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in this update is permitted. Optex Systems Holdings is currently evaluating the impact of FASB ASU 2016-02 and expects the adoption thereof will have a material effect on Optex Systems Holdings’ presentation of balance sheet assets and liabilities based on the present value of future lease payments, but does not expect a material effect on the presentation of expenses and cash flows

In July 2015, FASB issued ASU 2015-11—*Inventory (Topic 330): “Simplifying the Measurement of Inventory”*. The update is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The amendments in this Update should be applied prospectively with earlier application permitted as of the

beginning of an interim or annual reporting period. The update is part of FASB's Simplification Initiative, the objective of which is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced. Pursuant to the update, an entity should measure inventory at the lower of cost and net realizable value. The amendments in the update more closely align the measurement of inventory in GAAP with the measurement of inventory in International Financial Reporting Standards (IFRS). . Optex Systems Holdings is currently evaluating the impact of FASB ASU 2015-11 but does not expect the adoption thereof to have a material effect on Optex Systems Holdings' financial statements.

In August 2015, FASB Issued ASU 2015-14—"Revenue from Contracts with Customers (Topic 606): *Deferral of the Effective Date*" The amendments in this update defer the effective date of ASU 2014-09 for all entities by one year. Public business entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. See also ASU 2014-09 issued in May 2014.

In August 2014, FASB issued ASU 2014-15—Presentation of Financial Statements—Going Concern (ASC Subtopic 205-40): "*Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*". The update requires management to assess a company's ability to continue as a going concern and to provide related footnote disclosures in certain circumstances. All entities are required to apply the new requirements in annual periods ending after December 15, 2016, and interim periods thereafter. Early application is permitted. As such, Optex Systems Holdings is required to adopt these provisions for the annual period ending October 1, 2017. Optex Systems Holdings is currently evaluating the impact of FASB ASU 2014-15 but does not expect the adoption thereof to have a material effect on Optex Systems Holdings' financial statements.

In May 2014, FASB issued ASU 2014-09—Revenue from Contracts with Customers (Topic 606): “*Section A—Summary and Amendments That Create Revenue from Contracts with Customers, (Topic 606) and Other Assets and Deferred Costs—Contracts with Customers (Subtopic 340-40), Section B—Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables, Section C—Background Information and Basis for Conclusions*”. The guidance in this update affects any entity that enters into contracts with customers to transfer goods or services and supersedes the revenue recognition requirements in Topic 605, Revenue Recognition. The update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. As such, Optex Systems Holdings is required to adopt these provisions as of October 2, 2017, the beginning of the annual period ending September 30, 2018 and at the beginning of all interim periods ending after October 1, 2017. Optex Systems Holdings is currently evaluating the impact of FASB ASU 2014-09 but does not expect the adoption thereof to have a material effect on Optex Systems Holdings’ financial statements. See also ASU 2015-14 issued in August, 2015.

### **Cautionary Factors That May Affect Future Results**

This Report on Form 10-K and other written reports and oral statements made from time to time by Optex Systems Holdings may contain so-called “forward-looking statements,” all of which are subject to risks and uncertainties. You can identify these forward-looking statements by their use of words such as “expects,” “plans,” “will,” “estimates,” “forecasts,” “projects” and other words of similar meaning. You can identify them by the fact that they do not relate strictly to historical or current facts. These statements are likely to address Optex Systems Holdings’ growth strategy, financial results and product and development programs. You must carefully consider any such statement and should understand that many factors could cause actual results to differ from Optex Systems Holdings’ forward-looking statements. These factors include inaccurate assumptions and a broad variety of other risks and uncertainties, including some that are known and some that are not. No forward-looking statement can be guaranteed and actual future results may vary materially.

We do not assume the obligation to update any forward-looking statement. You should carefully evaluate such statements in light of factors described in this annual report. In this annual report Optex Systems Holdings has identified important factors that could cause actual results to differ from expected or historic results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider any such list to be a complete list of all potential risks or uncertainties.



**Item 8 Financial Statements and Supplementary Data**

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and

Stockholders of Optex Systems Holdings, Inc.

Richardson, Texas

We have audited the accompanying consolidated balance sheets of Optex Systems Holdings, Inc. (the Company) as of October 2, 2016 and September 27, 2015, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended. The Company's management is responsible for these consolidated financial statements. 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 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 audit 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit 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 Optex Systems Holdings, Inc. as of October 2, 2016, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

/s/PMB Helin Donovan, LLP

PMB Helin Donovan, LLP

December 22, 2016

46

**Optex Systems Holdings, Inc.****Condensed Consolidated Balance Sheets**

|   | (Thousands, except share data) |                       |
|---|--------------------------------|-----------------------|
|   | October 2,<br>2016             | September 27,<br>2015 |
| <b>ASSETS</b>                               |                                |                       |
| Current Assets                              |                                |                       |
| Cash and Cash Equivalents                   | \$ 2,568                       | \$ 683                |
| Accounts Receivable, Net                    | 2,095                          | 2,866                 |
| Net Inventory                               | 6,214                          | 5,713                 |
| Prepaid Expenses                            | 120                            | 170                   |
| Current Assets                              | 10,997                         | 9,432                 |
| Property and Equipment, Net                 | 1,651                          | 1,971                 |
| Other Assets                                |                                |                       |
| Prepaid Royalties - Long Term               | 90                             | 120                   |
| Security Deposits                           | 23                             | 23                    |
| Other Assets                                | 113                            | 143                   |
| Total Assets                                | \$ 12,761                      | \$ 11,546             |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                                |                       |
| Current Liabilities                         |                                |                       |
| Accounts Payable                            | \$ 706                         | \$ 575                |
| Accrued Expenses                            | 810                            | 812                   |
| Accrued Warranties                          | 28                             | 28                    |
| Customer Advance Deposits - Short Term      | 559                            | 1,091                 |
| Credit Facility                             | 300                            | 817                   |
| Current Liabilities                         | 2,403                          | 3,323                 |
| Customer Advance Deposits - Long Term       | -                              | 65                    |
| Total Liabilities                           | 2,403                          | 3,388                 |
| Stockholders' Equity                        | -                              | -                     |

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|   |           |           |
|---|-----------|-----------|
| Preferred Stock Series A (\$0.001 par 5,000 authorized, 0 and 1,001 issued and outstanding, respectively)                 |           |           |
| Preferred Stock Series B (\$0.001 par 1,010 authorized, 0 and 994 issued and outstanding, respectively)                   | -         | -         |
| Preferred Stock Series C (\$0.001 par 400 authorized, 360 and 0 issued and outstanding, respectively)                     | -         | -         |
| Common Stock – (\$0.001 par, 2,000,000,000 authorized, 8,266,601 and 314,867 shares issued and outstanding, respectively) | 8         | -         |
| Additional Paid-in-capital  | 29,583    | 26,394    |
| Accumulated Deficit   | (19,233 ) | (18,236 ) |
| Stockholders' Equity  | 10,358    | 8,158     |
| Total Liabilities and Stockholders' Equity  | \$ 12,761 | \$ 11,546 |

*The accompanying notes are an integral part of these financial statements*

**Optex Systems Holdings, Inc.****Consolidated Statements of Operations**

|  | <b>(Thousands, except share data)</b> |                    |
|--|---------------------------------------|--------------------|
|  | Twelve months ended                   |                    |
|  | October 2, 2016                       | September 27, 2015 |
| Revenue  | \$ 17,279                             | \$ 13,003          |
| Cost of Sales  | 14,228                                | 11,617             |
| Gross Margin   | 3,051                                 | 1,386              |
| General and Administrative Expense                                   | 3,251                                 | 2,826              |
| Operating Income (Loss)  | (200 )                                | (1,440 )           |
| Gain on Purchased Asset  | -                                     | 2,110              |
| Interest Income (Expense)  | (36 )                                 | (179 )             |
| Other (Expense) and Income   | (36 )                                 | 1,931              |
| Income (Loss) Before Taxes   | (236 )                                | 491                |
| Current Income Taxes (Benefit)                                       | -                                     | -                  |
| Deferred Income Taxes (Benefit)                                      | -                                     | -                  |
| Net Income (Loss) After Taxes  | (236 )                                | 491                |
| Preferred stock dividend/premium                                     | (761 )                                | (6,441 )           |
| Net income (loss) applicable to common shareholders                  | \$ (997 )                             | \$ (5,950 )        |
| Basic and diluted income (loss) per share                            | \$ (0.64 )                            | \$ (19.06 )        |
| Weighted Average Common Shares Outstanding - basic and fully diluted | 1,546,774                             | 312,219            |

*The accompanying notes are an integral part of these financial statements*

**Optex Systems Holdings, Inc.****Consolidated Statements of Cash Flows**

|   | (Thousands)         |                       |
|---|---------------------|-----------------------|
|   | Twelve months ended |                       |
|   | October<br>2, 2016  | September 27,<br>2015 |
| Cash flows from operating activities:   |                     |                       |
| Net (loss) income   | \$ (236 )           | \$ 491                |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                     |                       |
| Depreciation and amortization   | 345                 | 334                   |
| Noncash interest expense  | (17 )               | 154                   |
| Stock compensation expense  | 192                 | 140                   |
| Provision for inventory valuation   | 60                  | 247                   |
| Loss on sale of fixed assets  | 5                   | -                     |
| (Increase) decrease in accounts receivable  | 771                 | (2,135 )              |
| (Increase) decrease in inventory (net of progress billed)                                 | (562 )              | (49 )                 |
| (Increase) decrease in prepaid expenses   | 51                  | (130 )                |
| (Increase) decrease in security deposits  | -                   | 3                     |
| Increase (decrease) in accounts payable and accrued expenses                              | 129                 | 622                   |
| Increase (decrease) in accrued warranty costs   | -                   | 3                     |
| Decrease in prepaid royalties - long term   | 30                  | 30                    |
| Increase (decrease) in customer advance deposits  | (597 )              | (898 )                |
| Total adjustments   | 407                 | (1,679 )              |
| Net cash provided by (used in) operating activities                                       | 171                 | (1,188 )              |
| Cash flows from investing activities  |                     |                       |
| Purchases of property and equipment   | (34 )               | (2,100 )              |
| Proceeds from sale of fixed assets  | 4                   | -                     |
| Net cash used in investing activities   | (30 )               | (2,100 )              |
| Cash flows from financing activities  |                     |                       |
| Net proceeds from sale of common stock  | 4,247               | -                     |
| Redemption of preferred stock   | (1,751 )            | -                     |
| Deferred public offering costs  | (252 )              | -                     |
| Proceeds from convertible notes issued  | -                   | 1,560                 |
| Debt issuance fees  | -                   | (74 )                 |
| Proceeds (to) from credit facility (net)  | (500 )              | 800                   |
| Net cash provided by financing activities   | 1,744               | 2,286                 |

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|   |          |        |   |
|---|----------|--------|---|
| Net increase (decrease) in cash and cash equivalents                          | 1,885    | (1,002 | ) |
| Cash and cash equivalents at beginning of period                              | 683      | 1,685  |   |
| Cash and cash equivalents at end of period                                    | \$ 2,568 | \$ 683 |   |
| Supplemental cash flow information:   |          |        |   |
| Cash paid for interest  | \$ 53    | \$ 25  |   |
| Exchange of convertible note and accrued interest to series B preferred stock | -        | 1,629  |   |
| Beneficial conversion feature on Series A and Series B preferred stock        | 761      | 6,441  |   |
| Exchange of preferred stock for common stock                                  | 6,939    | 10     |   |

*The accompanying notes are an integral part of these financial statements*

**Optex Systems Holdings, Inc.**

**Consolidated Statement of Stockholders' Equity**

(Thousands, except share data)

|   | Common<br>Shares<br>Outstanding | Series<br>A<br>Preferred<br>Shares | Series<br>B<br>Preferred<br>Shares | Series<br>C<br>Preferred<br>Shares | Common<br>Stock | Preferred<br>Series<br>A<br>Stock | Preferred<br>Series<br>B<br>Stock | Additional<br>Paid in<br>Capital | Retained<br>Earnings | Total<br>Stockholders<br>Equity |
|---|---------------------------------|------------------------------------|------------------------------------|------------------------------------|-----------------|-----------------------------------|-----------------------------------|----------------------------------|----------------------|---------------------------------|
| Balance at September 28, 2014 (post split(1))   | 310,867                         | 1,001                              | -                                  | -                                  | \$ -            | \$ -                              | \$ -                              | \$ 18,184                        | \$(12,286)           | \$ 5,898                        |
| Stock Option Compensation Expense   | -                               | -                                  | -                                  | -                                  | -               | -                                 | -                                 | 140                              | -                    | 140                             |
| Preferred Series B Issued in Exchange of Convertible Notes                              | -                               | -                                  | 1,000                              | -                                  | -               | -                                 | -                                 | 1,629                            | -                    | 1,629                           |
| Conversion of Preferred Series B Beneficial Conversion Feature on Series A and Series B | 4,000                           | -                                  | (6 )                               | -                                  | -               | -                                 | -                                 | -                                | -                    | -                               |
| Preferred Stock - Dividend/Premium  | -                               | -                                  | -                                  | -                                  | -               | -                                 | -                                 | 6,441                            | (6,441 )             | -                               |
| Net Income  | -                               | -                                  | -                                  | -                                  | -               | -                                 | -                                 | -                                | 491                  | 491                             |
| Balance at September 27, 2015   | 314,867                         | 1,001                              | 994                                | -                                  | \$ -            | \$ -                              | \$ -                              | \$ 26,394                        | \$(18,236)           | \$ 8,158                        |
| Stock Compensation Expense  | -                               | -                                  | -                                  | -                                  | -               | -                                 | -                                 | 192                              | -                    | 192                             |
| Issue of Shares - DTC/CEDE fractional roundup correction for reverse split 12/8/15      | 247                             | -                                  | -                                  | -                                  | -               | -                                 | -                                 | -                                | -                    | -                               |
| Conversion of Preferred Series B (10/23/15)   | 16,031                          | -                                  | (25 )                              | -                                  | -               | -                                 | -                                 | -                                | -                    | -                               |
|   | 1,250,000                       | (456 )                             | -                                  | -                                  | 2               | -                                 | -                                 | (2 )                             | -                    | -                               |



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|  |           |        |        |       |      |      |      |           |            |           |
|--|-----------|--------|--------|-------|------|------|------|-----------|------------|-----------|
| Conversion of Preferred Series A (3/27/16)   |           |        |        |       |      |      |      |           |            |           |
| Conversion of Preferred Series B (7/6/16)  | 109,291   | -      | (167 ) | -     | -    | -    | -    | -         | -          | -         |
| Conversion of Preferred Series A (8/10/16)   | 25,000    | (9 )   |        | -     | -    | -    | -    | -         | -          | -         |
| Issue of Common Shares for Investor Relations (IRTH)   | 40,000    |        |        |       |      |      | -    | -         |            | -         |
| Issuance of Common Stock 8/26/2016   | 2,291,900 | -      | -      | 400   | 2    | -    | -    | 4,245     | -          | 4,247     |
| Fees on Share Offering paid by Optex   | -         | -      | -      | -     | -    | -    | -    | (252 )    | -          | (252 )    |
| Redemption of Series A & Series B Preferred Shares 8/26/2016   | -         | (66 )  | (796 ) | -     | -    | -    | -    | (1,751 )  | -          | (1,751 )  |
| Conversion of Series A & Series B Preferred Shares 8/26/2016   | 2,698,431 | (470 ) | (6 )   | -     | 3    | -    | -    | (3 )      | -          | -         |
| Conversions of Series C Preferred Shares   | 166,667   | -      | -      | (40 ) | -    | -    | -    | -         | -          | -         |
| Ratchet on Preferred Series A 3/27/16 Conversion (10/18/16)  | 1,354,167 | -      | -      | -     | 1    | -    | -    | (1 )      | -          | -         |
| Beneficial Conversion Feature on Series A and Series B Preferred Stock - Dividend/Premium Net (loss) | -         | -      | -      | -     | -    | -    | -    | 761       | (761 )     | -         |
|  | -         | -      | -      | -     | -    | -    | -    | -         | (236 )     | (236 )    |
| Balance at October 2, 2016   | 8,266,601 | -      | -      | 360   | \$ 8 | \$ - | \$ - | \$ 29,583 | \$(19,233) | \$ 10,358 |

(1) Reverse split effective on October 7, 2015 of 1000:1 shares, inclusive of round up lot quantity of 139,953 shares for holders of less than 100,000 shares, pre-split. Holders of less than 100,000 shares were rounded up to whole lots of 100 post split.

***The accompanying notes are an integral part of these financial statements***

## Note 1 — Organization and Operations

On March 30, 2009, Optex Systems Holdings, Inc. (formerly known as Sustut Exploration, Inc.), a Delaware corporation (“Optex Systems Holdings”), along with Optex Systems, Inc., a privately held Delaware corporation (“Optex Systems, Inc.”), which is a wholly-owned subsidiary of Optex Systems Holdings, entered into a reorganization agreement, pursuant to which Optex Systems, Inc. was acquired by Optex Systems Holdings in a share exchange transaction. Optex Systems Holdings became the surviving corporation. At the closing, there was a name change from Sustut Exploration, Inc. to Optex Systems Holdings, Inc., and its year end changed from December 31 to a fiscal year ending on the Sunday nearest September 30.

On October 14, 2008, certain senior secured creditors of Irvine Sensors Corporation, Longview Fund, L.P. (Longview) and Alpha Capital Anstalt formed Optex Systems, Inc., which acquired all of the assets and assumed certain liabilities of Optex Systems, Inc., a Texas corporation (“Optex Systems, Inc. (Texas)”), and a wholly-owned subsidiary of Irvine Sensors Corporation, in a transaction that was consummated via purchase at a public auction. Following this asset purchase, Optex Systems, Inc. (Texas) remained a wholly-owned subsidiary of Irvine Sensors Corporation.

On February 20, 2009, Sileas Corporation (Sileas), a newly-formed Delaware corporation, owned by present members of Optex Systems Holdings’ management, purchased 100% of Longview’s equity and debt interest in Optex Systems, Inc. (Longview’s interest in Optex Systems, Inc. then representing 90% of the issued and outstanding common equity interests in Optex Systems, Inc.), in a private transaction.

Optex Systems, Inc. operated as a privately-held Delaware corporation until March 30, 2009, when, as a result of a reverse merger transaction consummated pursuant to a reorganization agreement dated March 30, 2009, it became a wholly-owned subsidiary of Optex Systems Holdings. Sileas is the majority owner (parent) of Optex Systems Holdings, owning approximately 46.9% of the issued and outstanding equity interests in Optex Systems Holdings. The financial statements of Optex Systems Holdings represent subsidiary statements and do not include the accounts of its majority owner.

Optex Systems Holdings’ operations are based in Dallas and Richardson, Texas in leased facilities comprising 93,967 square feet. As of October 2, 2016, Optex Systems Holdings operated with 91 full-time equivalent employees.

Optex Systems Holdings manufactures optical sighting systems and assemblies, for the U.S. Department of Defense, foreign military applications and commercial markets. Its products are installed on a variety of U.S. military land vehicles, such as the Abrams and Bradley fighting vehicles, light armored and advanced security vehicles, and have

been selected for installation on the Stryker family of vehicles. Optex Systems Holdings also manufactures and delivers numerous periscope configurations, rifle and surveillance sights and night vision optical assemblies. Optex Systems Holdings' products consist primarily of build to customer print products that are delivered both directly to the military and to other defense prime contractors or commercial customers.

In February 2009, Optex Systems Holdings' ISO certification status was upgraded from 9001:2000 to 9001:2008, bringing Optex Systems Holdings into compliance with the new ISO standards rewritten to align with ISO 14001.

On November 3, 2014, Optex Systems, Inc. entered into a Purchase Agreement with L-3 Communications, Inc. ("L-3") pursuant to which Optex purchased from L-3 the assets comprising L-3's Applied Optics Center (AOC) Products Line ("Purchased Assets"), which is engaged in the production and marketing and sales of precision optical assemblies utilizing thin film coating capabilities for optical systems and components primarily used for military purposes. See Note 4 Acquisition of L-3's Applied Optics Center.

U.S. military spending has been significantly reduced as a result of the Congressional sequestration cuts to defense spending, which began in fiscal year 2013. As a result of lower U.S. government spending, the Company has continued to explore other opportunities for manufacturing outside of our traditional product lines for products which could be manufactured using our existing lines in order to fully utilize our existing capacity. Further, we continue to look for additional strategic businesses to acquire that will strengthen our existing product line, expand our operations, and enter new markets.

## Note 2 — Accounting Policies

### Basis of Presentation

**Principles of Consolidation:** The consolidated financial statements include the accounts of Optex Systems Holdings and its wholly-owned subsidiary, Optex Systems, Inc. All significant inter-company balances and transactions have been eliminated in consolidation.

**Use of Estimates:** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statement and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from the estimates.

**Segment Reporting:** FASB ASC 280 requires that a public business enterprise report financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally, financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments. Segments are determined based on differences in products, internal reporting and how operational decisions are made. Management has determined that the Optex Systems, Richardson plant, and the Applied Optics Center, Dallas plant, which was acquired on November 3, 2014, are separately managed, organized, and internally reported as separate business segments. The FASB ASC 280 requires that a public business enterprise report a measure of segment profit or loss, certain specific revenue and expense items, and segment assets. It requires reconciliations of total segment revenues, total segment profit or loss, total segment assets, and other amounts disclosed for segments to corresponding amounts in the enterprise's general-purpose financial statements.

**Fiscal Year:** Optex System Holdings' fiscal year ends on the Sunday nearest September 30. Fiscal year 2016 ended on October 2, 2016 and included 53 weeks. Fiscal year 2015 ended on September 27, 2015 and included 52 weeks.

**Fair Value of Financial Instruments:** FASB ASC 825-10 requires disclosure of fair value information about certain financial instruments, including, but not limited to, cash and cash equivalents, accounts receivable, refundable tax credits, prepaid expenses, accounts payable, accrued expenses, notes payable to related parties and convertible debt-related securities. Fair value estimates discussed herein are based upon certain market assumptions and pertinent information available to management as of fiscal years ended October 2, 2016 and September 27, 2015. The carrying

value of the balance sheet financial instruments included in Optex Systems Holdings' consolidated financial statements approximated their fair values.

**Cash and Cash Equivalents:** For financial statement presentation purposes, Optex Systems Holdings considers those short-term, highly liquid investments with original maturities of three months or less to be cash or cash equivalents. Optex Systems Holdings' has \$2,568 thousand in cash on deposit with our bank. Only a portion of the cash, currently \$250 thousand, would be covered by federal deposit insurance and the uninsured balances are substantially greater than the insured amounts. We are exploring options to invest a portion of the excess cash into short term treasuries covered by federal deposit insurance in the near term.

**Concentration of Credit Risk:** Optex Systems Holdings' revenues and accounts receivables for fiscal year ended October 2, 2016 are derived from sales to U.S. government agencies (45%), General Dynamics (18%), Nightforce Optics, Inc. (15%) and all other contractors (22%). Optex Systems Holdings does not believe that this concentration results in undue credit risk because of the financial strength of the obligees.

**Accounts Receivable:** Optex Systems Holdings records its accounts receivable at the original sales invoice amount less liquidations for previously collected advance/progress bills and an allowance for doubtful accounts. An account receivable is considered to be past due if any portion of the receivable balance is outstanding beyond its scheduled due date. On a quarterly basis, Optex Systems Holdings evaluates its accounts receivable and establishes an allowance for doubtful accounts, based on its history of past write-offs and collections, and current credit conditions. No interest is accrued on past due accounts receivable. As of October 2, 2016 and September 27, 2015, Optex Systems Holdings had an allowance for doubtful accounts of \$42 thousand and \$8 thousand, for non U.S. government account balances greater than 120 days. As the customer base is primarily U.S. government and government prime contractors, Optex Systems Holdings allowance for doubtful accounts is minimal. Optex Systems Holdings charges uncollectible accounts to bad debt expense in the period as they are first deemed uncollectible. In the fiscal year 2016 there was \$36 thousand, and in 2015, there was \$5 thousand in bad debt expenses associated with uncollectable accounts.

**Inventory:** Inventory is recorded at the lower of cost or market, and adjusted as appropriate for decreases in valuation and obsolescence. Adjustments to the valuation and obsolescence reserves are made after analyzing market conditions, current and projected sales activity, inventory costs and inventory balances to determine appropriate reserve levels. Cost is determined using the first-in first-out method. Under arrangements by which progress payments are received against certain contracts, the customer retains a security interest in the undelivered inventory identified with these contracts. Payments received for such undelivered inventory are classified as unliquidated progress payments and deducted from the gross inventory balance. As of October 2, 2016 and September 27, 2015 inventory included:

|                    | (Thousands)                 |                             |
|--------------------|-----------------------------|-----------------------------|
|                    | As of<br>October<br>2, 2016 | As of<br>September 27, 2015 |
| Raw Materials      | \$4,655                     | \$ 4,545                    |
| Work in Process    | 2,830                       | 2,456                       |
| Finished Goods     | 380                         | 304                         |
| Gross Inventory    | 7,865                       | 7,305                       |
| Less:              |                             |                             |
| Inventory Reserves | (1,651)                     | (1,592)                     |
| Net Inventory      | \$6,214                     | \$ 5,713                    |

Net inventory increased \$501 thousand during the year ended October 2, 2016. The increase in net inventory is primarily in support of higher backlog and revenue in the current year over the prior year.

**Warranty Costs:** Some of Optex Systems Holdings' customers require that the company warrant the quality of its products to meet customer requirements and be free of defects for up to fifteen months subsequent to delivery. Future warranty costs are based on the estimated cost of replacement for expected returns based upon our most recent experience rate of defects as a percentage of warranty covered sales. Throughout the year, warranty costs are expensed

as incurred, and as of each year end, Optex Systems Holdings reviews the prior 15 month warranty experience rate and may adjust the warranty accrual as required to cover any additional anticipated warranty costs related to prior shipments. As of October 2, 2016 and September 27, 2015, the existing warranty reserve balances of \$28 thousand and \$28 thousand, respectively, were reviewed and determined to be adequate to satisfy any future warranty claims that may have existed as of the end of each fiscal year for shipments occurring in the prior 15 months.

***Property and Equipment:*** Property and equipment are recorded at cost. Depreciation is computed using the straight line method over the estimated useful lives of the assets, ranging from three to seven years. Expenditures for renewals and betterments are capitalized. Expenditures for minor items, repairs and maintenance are charged to operations as incurred. Gain or loss upon sale or retirement due to obsolescence is reflected in the operating results in the period the event takes place.

***Revenue Recognition:*** Optex Systems Holdings recognizes revenue based on the modified percentage of completion method utilizing the units-of-delivery method, in accordance with FASB ASC 605-35:

The units-of-delivery method recognizes as revenue the contract price of units of a basic production product delivered during a period and as the cost of earned revenue the costs allocable to the delivered units. Costs allocable to undelivered units are reported in the balance sheet as inventory or work in progress. The method is used in circumstances in which an entity produces units of a basic product under production-type contracts in a continuous or sequential production process to buyers' specifications.

Optex Systems Holdings contracts are fixed price production type contracts whereby a defined order quantity is delivered to the customer during a continuous or sequential production process tailored to the buyer's specifications (build to print). Optex Systems Holdings' deliveries against these contracts generally occur in monthly increments across fixed delivery periods spanning from 3 to 36 months.

**Customer Advance Deposits:** Customer advance deposits represent amounts collected from customers in advance of shipment or revenue recognition which relate to undelivered product due to non-substantive milestone payments or other cash in advance payment terms. As of October 2, 2016, Optex Systems, Inc. had a balance of \$559 thousand in customer advance deposits related to a 2011 customer contract. The terms of the contract extend through 2018 during which time we are required to purchase the necessary materials to fulfill the delivery of products required by the contract. Of the total collected customer advance deposits, \$559 thousand related to short term customer advance deposits for deliveries to occur within the next twelve months.

**Estimated Costs at Completion and Accrued Loss on Contracts:** Optex Systems Holdings reviews and reports on the performance of its contracts and production orders against the respective resource plans for such contracts/orders. These reviews are summarized in the form of estimates at completion. Estimates at completion include Optex Systems Holdings' incurred costs to date against the contract/order plus management's current estimates of remaining amounts for direct labor, material, other direct costs and subcontract support and indirect overhead costs based on the completion status and future contractual requirements for each order.

If an estimate at completion indicates a potential overrun against budgeted resources for a fixed price contract/order, management first attempts to implement lower cost solutions that will profitably meet the requirements of the fixed price contract. If such solutions do not appear practicable, management makes a determination whether to seek renegotiation of contract or order requirements from the customer. If neither cost reduction nor renegotiation appears probable, an accrual for the contract loss/overrun is recorded against earnings and the loss is recognized in the first period the loss is identified based on the most recent estimates at completion of the particular contract or product order. As of October 2, 2016 there was \$0 in contract loss reserves. As of September 27, 2015 the contract loss reserves were \$54 thousand.

During 2010, Optex Systems Holdings realized increased losses against the Howitzer programs of \$1.1 million of which \$0.8 million related specifically to production issues encountered on our Howitzer product line. Increased losses were primarily attributable to manufacturing issues on our U.S. government Howitzer Aiming Circles culminating in higher material scrap and labor hours, combined with a reduction in total production volume in 2010 which further impacted production efficiencies across all product lines. Optex Systems Holdings requested an equitable adjustment on this program due to significant design issues impacting the manufacturability of the product. As there was no guarantee that the request would be granted in part or in full, we realized the entire loss in fiscal year 2010. The initial equitable adjustment claim was formally rejected by the contracting agency on May 31, 2012; however, Optex Systems Holdings appealed the decision with the Armed Services Board of Contract Appeals (ASBCA). In September 2015, the U.S. Government agreed to an \$850,000 settlement against the claim for the



Aiming Circle contract number W52H09-06-D-0229. The settlement is the result of a negotiation and fact gathering process managed through the Armed Services Board of Contract Appeals (ASBCA). A contract modification was issued on September 23, 2015 increasing the total contract price by the agreed amount. As the respective units were shipped complete in 2011, the contract was essentially complete on execution of the modification and the entire amount was recorded as revenue for the twelve months ended September 27, 2015.

**Government Contracts:** Many of Optex Systems Holdings' contracts are prime or subcontracted directly with the Federal government and as such, are subject to Federal Acquisition Regulation (Federal Acquisition Regulation) Subpart 49.5, "Contract Termination Clauses" and more specifically Federal Acquisition Regulation clauses 52.249-2 "Termination for Convenience of the Government (Fixed-Price)", and 49.504 "Termination of fixed-price contracts for default". These clauses are standard clauses on prime military contracts and are generally, "flowed down" to Optex Systems Holdings as subcontractors on other military business. It has been Optex Systems Holdings' experience that the termination for convenience is rarely invoked, except where it has been mutually beneficial for both parties. Optex Systems Holdings is not currently aware of any pending terminations for convenience or default on its existing contracts.

In the event a termination for convenience were to occur, these Federal Acquisition Regulation clause 52.249-2 provides for full recovery of all contractual costs and profits reasonably incurred up to and as a result of the terminated contract. In the event a termination for default were to occur, Optex Systems Holdings could be liable for any excess cost incurred by the government to acquire supplies from another supplier similar to those terminated from Optex Systems Holdings. Optex Systems Holdings would not be liable for any excess costs if the failure to perform the contract arises from causes beyond its control and without its fault or negligence as defined by Federal Acquisition Regulation clause 52.249-8. In addition, the government may require Optex Systems Holdings to transfer title and deliver to the government any completed supplies, partially completed supplies and materials, parts, tools, dies, jigs, fixtures, plans, drawings, information, and contract rights that Optex Systems Holdings has specifically produced or acquired for the terminated portion of this contract. The government shall pay contract price for completed supplies delivered and accepted, and Optex Systems Holdings and the government would negotiate an agreed upon amount of payment for manufacturing materials delivered and accepted and for the protection and preservation of the property. Failure to agree on an amount for manufacturing materials is subject to the Federal Acquisition Regulation Disputes clause 52.233-1.

In some cases, Optex Systems Holdings may receive orders subject to subsequent price negotiation on contracts exceeding the federal government simplified acquisition threshold of \$750,000. These “undefinitized” contracts are considered firm contracts but as Cost Accounting Standards Board covered contracts, they are subject to the Truth in Negotiations Act disclosure requirements and downward only price negotiation. As of October 2, 2016 and September 27, 2015, Optex Systems had no booked orders that fell under this criterion.

***Impairment or Disposal of Long-Lived Assets:*** Optex Systems Holdings follows the provisions of FASB ASC 360-10, “*Accounting for the Impairment or Disposal of Long-lived Assets*”. This standard requires, among other things, that long-lived assets be reviewed for potential impairment whenever events or circumstances indicate that the carrying amounts may not be recoverable. The assessment of possible impairment is based on the ability to recover the carrying value of the asset from the expected future pre-tax cash flows (undiscounted and without interest charges) of the related operations. If these cash flows are less than the carrying value of such assets, an impairment loss is recognized for the difference between estimated fair value and carrying value. The measurement of impairment requires management to estimate future cash flows and the fair value of long-lived assets. No impairment of long-lived assets was recorded for the periods presented.

***Stock-Based Compensation:*** FASB ASC 718 establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, but primarily focuses on transactions whereby an entity obtains employee services for share-based payments. FASB ASC 718 requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity’s equity instruments or that may be settled by the issuance of those equity instruments.

Optex Systems Holdings' accounting policy for equity instruments issued to consultants and vendors in exchange for goods and services follows the provisions of FASB ASC 505-50. The measurement date for the fair value of the equity instruments issued is determined at the earlier of (i) the date at which a commitment for performance by the consultant or vendor is reached or (ii) the date at which the consultant or vendor's performance is complete. In the case of equity instruments issued to consultants, the fair value of the equity instrument is recognized over the term of the consulting agreement. Stock-based compensation related to non-employees is accounted for based on the fair value of the related stock or options or the fair value of the services, whichever is more readily determinable in accordance with FASB ASC 718.

**Beneficial Conversion Features of Convertible Securities:** Conversion options that are not bifurcated as a derivative pursuant to ASC 815 and not accounted for as a separate equity component under the cash conversion guidance are evaluated to determine whether they are beneficial to the investor at inception (a beneficial conversion feature) or may become beneficial in the future due to potential adjustments. The beneficial conversion feature guidance in ASC 470-20 applies to convertible stock as well as convertible debt which are outside the scope of ASC 815. A beneficial conversion feature is defined as a nondetachable conversion feature that is in the money at the commitment date. In addition, our preferred stock issues contain conversion terms that may change upon the occurrence of a future event, such as antidilution adjustment provisions. The beneficial conversion feature guidance requires recognition of the conversion option's in-the-money portion, the intrinsic value of the option, in equity, with an offsetting reduction to the carrying amount of the instrument. The resulting discount is amortized as a dividend over either the life of the instrument, if a stated maturity date exists, or to the earliest conversion date, if there is no stated maturity date. If the earliest conversion date is immediately upon issuance, the dividend must be recognized at inception. When there is a subsequent change to the conversion ratio based on a future occurrence, the new conversion price may trigger the recognition of an additional beneficial conversion feature on occurrence.

Optex Systems Holdings has preferred stock, convertible into common shares, containing beneficial conversion features at inception as well as potential beneficial conversion features that could be triggered by future adjustments to the conversion price. Because our preferred stock is perpetual, with no stated maturity date, and the conversions may occur any time from inception, the dividend is recognized immediately when a beneficial conversion exists at issuance. During the twelve months ending September 27, 2015, Optex Systems Holdings recognized preferred stock dividends of \$6.4 million on Series A and Series B preferred stock related to the beneficial conversion feature arising from a common stock conversion rate of \$2.50 versus a current market price of \$10.00 per common share (post-split). During the twelve months ending October 2, 2016, Optex Systems Holdings recognized an additional preferred stock dividend of \$0.8 million as a result of the August 26, 2016 public offering which reset the preferred stock conversion rate from \$2.50 per common share to \$1.20 per common share and resulted in an additional beneficial conversion for the series A and Series B preferred shares.

**Intangible Assets:** Optex Systems Holdings has acquisition-related intangible assets which include the fair market value of customer order backlog as of the acquisition date. We determine the fair value of intangible assets using the income approach methodology of valuation that includes the discounted cash flow method as well as other generally accepted valuation methodologies, which requires some judgment by management. Amortization of acquisition-related intangible assets is expensed to total operating expenses as cost of sales and general and administrative expenses on a straight-line basis over their estimated useful lives, unless such lives are deemed indefinite. Amortizable intangible assets are tested for impairment based on undiscounted cash flows and, if impaired, written down to fair value based on either discounted cash flows or appraised values. The residual values and useful lives are reviewed at each balance sheet date and adjusted, if appropriate. Optex Systems Holdings identified intangible assets of \$342 thousand from the acquisition of the Applied Optics Center from L3 on November 3, 2014 which consisted primarily of customer backlog, with an initial useful life of less than one year. As of October 2, 2016 the unamortized balance of the intangible assets was zero. See Note 6.

Intangible assets with indefinite lives are tested annually for impairment, during the fiscal fourth quarter and between annual periods, if impairment indicators exist, and are written down to fair value as required.

***Income Tax/Deferred Tax:*** FASB ASC 740 requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on differing treatment of items for financial reporting and income tax reporting purposes. The deferred tax balances are adjusted to reflect tax rates by tax jurisdiction, based on currently enacted tax laws, which will be in effect in the years in which the temporary differences are expected to reverse. Under FASB ASC 740, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for certain deferred tax assets if it is more likely than not that Optex Systems Holdings will not realize tax assets through future operations. When assessing the recoverability of deferred tax assets, management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies. Based on those estimates, management has determined that the deferred tax assets may not be realized and has established a valuation allowance against the deferred tax asset balance. As of October 2, 2016 Optex Systems Inc. has a deferred tax asset valuation allowance of (\$4.7) million against deferred tax assets of \$4.7 million.

***Earnings per Share:*** Basic earnings per share is computed by dividing income available for common shareholders (the numerator) by the weighted average number of common shares outstanding (the denominator) for the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

The potentially dilutive securities that Optex Systems Holdings has outstanding are convertible preferred stock, stock options and warrants. In computing the dilutive effect of convertible preferred stock, the numerator is adjusted to add back any convertible preferred dividends, and the denominator is increased to assume the conversion of the number of additional common shares. Optex Systems Holdings uses the Treasury Stock Method to compute the dilutive effect of stock options and warrants. Convertible preferred stock, stock options and warrants that are anti-dilutive are excluded from the calculation of diluted earnings per common share.

For the twelve months ended October 2, 2016, 4,125,200 warrants, 360 Series C preferred stock and 52,840 stock options were excluded as anti-dilutive due to the net loss attributable to common shareholders during the years. For the twelve months ended September 27, 2015, 1,001 shares of Series A preferred stock, 994 shares of Series B preferred stock, 62,858 stock options and 1,000 warrants were excluded as anti-dilutive due to the net loss attributable to common shareholders during the years.

### **Note 3 — Recent Accounting Pronouncements**

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 reduces diversity in practice in how certain transactions are classified in the statement of cash flows. The amendments in ASU 2016-15 provide guidance on specific cash flow issues including debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, and distributions received from equity method investees. ASU 2016-15 is effective for annual and interim periods beginning after December 15, 2017. We are currently assessing the potential impact of ASU 2016-15 on our consolidated financial statements and results of operations.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses ("ASU 2016-13"). ASU 2016-13 changes the impairment model for most financial assets and certain other instruments, including trade and other receivables, held-to-maturity debt securities and loans, and requires entities to use a new forward-looking expected loss model that will result in the earlier recognition of allowance for losses. This update is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for a fiscal year beginning after December 15, 2018, including interim periods within that fiscal year. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. We are currently assessing the potential impact of ASU 2016-13 on our consolidated financial statements and results of operations.

In March 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-09 amending several aspects of share-based payment accounting. This guidance requires all excess tax benefits and tax deficiencies to be recorded in the income statement when the awards vest or are settled, with prospective application required. The guidance also changes the classification of such tax benefits or tax deficiencies on the statement of cash flows from a financing activity to an operating activity, with retrospective or prospective application allowed. Additionally, the guidance requires the classification of employee taxes paid when an employer withholds shares for tax-withholding purposes as a financing activity on the statement of cash flows, with retrospective application required. This ASU is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. Early adoption is permitted. We are currently evaluating the impact of the new guidance on our consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) (“ASU 2016-08”). ASU 2016-08 does not change the core principle of Topic 606 but clarifies the implementation guidance on principal versus agent considerations. ASU 2016-08 is effective for the annual and interim periods beginning after December 15, 2017. We are currently assessing the potential impact of ASU 2016-08 on our consolidated financial statements and results of operations.

In February 2016, FASB issued ASU 2016-02—*Leases (Topic 842)*. The update is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in this update is permitted. Optex Systems Holdings is currently evaluating the impact of FASB ASU 2016-02 and expects the adoption thereof will have a material effect on Optex Systems Holdings' presentation of balance sheet assets and liabilities based on the present value of future lease payments, but does not expect a material effect on the presentation of expenses and cash flows

In July 2015, FASB issued ASU 2015-11—*Inventory (Topic 330): "Simplifying the Measurement of Inventory"*. The update is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The amendments in this Update should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The update is part of FASB's Simplification Initiative, the objective of which is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced. Pursuant to the update, an entity should measure inventory at the lower of cost and net realizable value. The amendments in the update more closely align the measurement of inventory in GAAP with the measurement of inventory in International Financial Reporting Standards (IFRS). Optex Systems Holdings is currently evaluating the impact of FASB ASU 2015-11 but does not expect the adoption thereof to have a material effect on Optex Systems Holdings' financial statements.

In August 2015, FASB Issued ASU 2015-14—"Revenue from Contracts with Customers (Topic 606): *Deferral of the Effective Date*" The amendments in this update defer the effective date of ASU 2014-09 for all entities by one year. Public business entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. See also ASU 2014-09 issued in May 2014.

In August 2014, FASB issued ASU 2014-15—Presentation of Financial Statements—Going Concern (ASC Subtopic 205-40): "*Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*". The update requires management to assess a company's ability to continue as a going concern and to provide related footnote disclosures in certain circumstances. All entities are required to apply the new requirements in annual periods ending after December 15, 2016, and interim periods thereafter. Early application is permitted. As such, Optex Systems Holdings is required to adopt these provisions for the annual period ending October 1, 2017. Optex Systems Holdings is currently evaluating the impact of FASB ASU 2014-15 but does not expect the adoption thereof to have a material effect on Optex Systems Holdings' financial statements.

In May 2014, FASB issued ASU 2014-09—Revenue from Contracts with Customers (Topic 606): "*Section A—Summary and Amendments That Create Revenue from Contracts with Customers, (Topic 606) and Other Assets and Deferred Costs—Contracts with Customers (Subtopic 340-40), Section B—Conforming Amendments to Other Topics and Subtopics*"



*in the Codification and Status Tables, Section C—Background Information and Basis for Conclusions*". The guidance in this update affects any entity that enters into contracts with customers to transfer goods or services and supersedes the revenue recognition requirements in Topic 605, Revenue Recognition. The update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. As such, Optex Systems Holdings is required to adopt these provisions as of October 2, 2017, the beginning of the annual period ending September 30, 2018 and at the beginning of all interim periods ending after October 1, 2017. Optex Systems Holdings is currently evaluating the impact of FASB ASU 2014-09 but does not expect the adoption thereof to have a material effect on Optex Systems Holdings' financial statements. See also ASU 2015-14 issued in August, 2015.

#### **Note 4 - Purchase of L-3's Applied Optics Products Center**

On November 3, 2014, Optex Systems, Inc. entered into a Purchase Agreement with L-3 pursuant to which Optex Systems, Inc. purchased from L-3 the assets comprising L-3's Applied Optics Products Line ("Purchased Assets"). The Applied Optics Center is primarily engaged in the production, marketing and sales of precision optical assemblies utilizing thin film coating capabilities for optical systems and components primarily used for military purposes. The Purchased Assets consist of personal property, inventory, books and records, contracts, prepaid expenses and deposits, intellectual property, and governmental contracts and licenses utilized in the business comprised of the Purchased Assets.

The purchase price for the Purchased Assets was \$1,013.1 thousand, which was paid in full at closing, plus the assumption of certain liabilities associated with the Purchased Assets in the amount of \$270.7. The source of funds for the acquisition consisted of Optex Systems, Inc.'s working capital of \$213.1 thousand and an advance of \$800 thousand from accredited investors which was subsequently consummated on November 17, 2014 through the private placement of convertible notes issued by Optex Systems Holdings in a transaction exempt from registration under Section 4(2) of the Securities Act. See Note 11 "Issuance of Convertible Notes".

The asset acquisition met the definition of a business for business combinations under ASC 805-10-20. The following table reconciles the fair value of the acquired assets and assumed liabilities to the total purchase price of the Applied Optics Center Acquisition (in thousands):

|                            | Fair Values as of<br>November 3, 2014 |
|----------------------------|---------------------------------------|
| Fixed Assets               | \$ 2,064.7                            |
| Inventory                  | 940.1                                 |
| Prepaid Assets/Other       | 47.1                                  |
| Liabilities                | (270.7 )                              |
| Net Assets Acquired        | 2,781.2                               |
| Intangible Asset:          |                                       |
| Customer Contracts/Backlog | 342.2                                 |
| Total Assets Acquired      | 3,123.4                               |
| Less: Cash Consideration   | (1,013.1 )                            |
| Gain on Bargain Purchase   | \$ 2,110.3                            |

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values. The total assets acquired exceeded the total consideration paid, thus there is no goodwill associated with the asset purchase and the acquisition has been determined as a bargain purchase which requires immediate recognition of a gain on the purchased assets. The gain is reflected in earnings in Other Income on the Consolidated Statement of Operations as "Gain on Purchased Asset".

The intangible assets include finite-life intangibles associated with undelivered customer backlog as of the acquisition date and was valued using the income approach methodology that includes the discounted cash flow method as well as other generally accepted valuation methodologies, which requires significant judgment by management. The cash flow projections took into effect the expected net sales from the customer backlog as of November 3, 2014 and the corresponding expenses against those sales in the respective periods. The shipments against the customer backlog

were delivered completed between January and June of 2015, and as such, the intangible amortization against those shipments was complete by June 28, 2015. As of October 2, 2016 the balance in unamortized intangible assets was zero.

The respective estimated fair values for property plant & equipment, and fixed assets were determined by an independent third-party appraisal firm. The appraisal methods employed by the firm in arriving at the final values on all of the equipment included a combination of the “Cost Approach” the “Market Data Approach” as well as “Income Approach” on specific high historical cost assets as presented by the seller. Certain assets which had very specific military manufacturing applications were operating at less than optimal capacity due to significantly reduced government spending from historical levels related to those processes. The excess or “idle” capacity on these unique assets was considered in the appraiser’s valuation, and the appraised values adjusted downward accordingly, in consideration of the reduced revenue and corresponding limited cash flow that could reasonably be generated from these assets under the current market conditions.

Separate from the appraisal analysis, Optex Systems, Inc. completed a physical inventory of all raw material, work in process and finished goods inventories in their various stages of production as of the acquisition date, and conducted a thorough revaluation and review of the counted inventory carrying values giving downward consideration to any excess, obsolete, or other product inventories which were valued in excess of the expected net realizable values given the depressed market conditions. Based on the supplemental inventory review, combined with the income approach used on the excess and idle capacity assets applied by the appraiser, the company was satisfied that the third party appraisal fairly valued those assets. The total fair value appraisal for the purchased assets, before intangible assets and assumed liabilities approximated 73% of the net carrying values of those same assets on the sellers closing balance sheet as of November 3, 2014.

Optex Systems Holdings believes that it was able to acquire the Applied Optics Center for less than the fair value of its assets because of (i) its unique position as a market leader in the industry sector that directly utilizes the manufactured components specific to the Applied Optics Center, (ii) a previous customer/supplier relationship with the acquisition target, (iii) L-3's intent to exit the optical coating operations, and (iv) L-3's desire to provide for continued employment of the Applied Optics Center workforce. The Applied Optics Center had a recent history of losses, and the seller approached Optex Systems, Inc. in an effort to sell the product line and exit the optical coating manufacturing business that no longer fit its strategy. With the seller's intent to exit the business segment and Optex's position as a market leader within the same industry sector utilizing the product line capability, Optex Systems, Inc. was able to agree on a favorable purchase price with L-3 Communications.

As a result of the asset purchase, the company has incurred additional acquisition-related costs of approximately \$40.2 thousand for legal, accounting and valuation consulting fees which have been expensed to general administrative costs in 2015.

#### **Note 5 Segment Reporting**

Optex Systems Holdings, Inc. has two reportable segments which include Optex Systems (OPX)-Richardson, and Applied Optics Center (AOC) – Dallas. The accounting policies for each segment are the same as those described in the summary of significant accounting policies. Optex Systems Holdings, Inc. evaluates performance based on profit and loss from operations before income taxes excluding nonrecurring gains and losses.

The Optex Systems Holdings reportable segments are strategic businesses offering similar products to similar markets and customers; however the companies are operated and managed separately due to differences in manufacturing technology, equipment, geographic location, and specific product mix. The Applied Optics Center was acquired as a unit, and the management at the time of the acquisition was retained.

The Applied Optics Center segment also serves as the key supplier of the laser coated filters used in the production of periscope assemblies at the Optex Systems Richardson segment. Intersegment sales and transfers are accounted for at annually agreed to pricing rates based on estimated segment product cost, which includes segment direct manufacturing and general and administrative costs, but exclude profits that would apply to third party external customers.

Optex Systems – Dallas, serves as the home office for both segments and shared general and administrative costs attributable to both segments are allocated directly to the segments based on the government costs accounting standard, CAS 403 – “Allocation of Home Office Expenses to Segments”. The purpose of CAS 403 is to provide criteria for allocating home office expenses to the segments of an organization based on the beneficial or causal relationships between the expenses and the receiving segments. Based on CAS 403, Optex Systems Holdings allocates home office expenses based on a three factor formula which is the average of the following three percentages for the each segments fiscal year:

- (1) The percentage of segment payroll dollars to total payroll dollars of all segments;
- (2) The percentage of the segment’s operating revenue to the total operating revenue of all segments
- (3) The percentage of the average net book value of the sum of the segment’s tangible capital assets plus inventories to the total average net book value of such assets of all segments.

**Optex Systems (OPX) – Richardson, Texas**

Optex Systems, Inc. manufactures optical sighting systems and assemblies, primarily for Department of Defense applications. Its products are installed on various types of U.S. military land vehicles, such as the Abrams and Bradley fighting vehicles, light armored and armored security vehicles and have been selected for installation on the Stryker family of vehicles. Optex Systems, Inc. also manufactures and delivers numerous periscope configurations, rifle and surveillance sights and night vision optical assemblies. We have capabilities which include machining, bonding, painting engraving and assembly and can perform both optical and environmental testing in-house. Optex Systems, Inc. products consist primarily of build-to-customer print products that are delivered both directly to the armed services and to other defense prime contractors. Optex Systems in Richardson is both a prime and sub-prime contractor to the Department of Defense. Sub-prime contracts are typically issued through major defense contractors such as General Dynamics Land Systems, Raytheon Corp., BAE, NorcaTec and others. Optex Systems is also a military supplier to foreign governments such as Israel, Australia and NAMSAs and South American countries and as a subcontractor for several large U.S. defense companies serving foreign governments.

During the year ended October 2, 2016, 99% of Optex Systems – Richardson revenues were in support of prime and subcontracted military customers. The Optex Systems segment serves domestic military customers, 71%, foreign military customers, 28%, and domestic commercial customers of 1%. The Optex Systems segment revenue for the year ending October 2, 2016 was derived from external customers consisting of General Dynamics, 27%, the U.S. government, 57%, International Parts Supply Corp. 5%, and other external customers, 11%.

Optex Systems is located in Richardson Texas, with leased premises consisting of approximately 49,100 square feet. As of October 2, 2016, the Richardson facility operated with 53 full time equivalent employees in a single shift operation. Optex Systems in Richardson serves as the home office for both the Optex Systems (OPX) and Applied Optics Center (AOC) segments.

**Applied Optics Center (AOC) – Dallas**

On November 3, 2014, Optex Systems, Inc. entered into a Purchase Agreement with L-3 pursuant to which Optex Systems, Inc. purchased from L-3 the assets comprising L-3's Applied Optics Center Products Line (see note 4). Applied Optics Center is engaged in the production, marketing and sales of precision optical assemblies and components which utilize thin film coating technologies. Most of the AOC products and services are directly related to the deposition of thin-film coatings. AOC is both a prime and sub-prime contractor to the Department of Defense. Sub-prime contracts are typically issued through major defense contractors such as General Dynamics Land Systems, Raytheon Corp., L-3 Communications, Excelis Inc. and others. AOC also creates a new sector of opportunity for commercial products. Globally, commercial optical products use thin film coatings to create product differentiation and performance levels. These coatings can be used for redirecting light (mirrors), blocking light (laser protection), absorbing select light (desired wavelengths), and many other combinations. They are used in telescopes, rifle scopes, binoculars, microscopes, range finders, protective eyewear, photography, etc. The Applied Optics Center is a key supplier to Nightforce Optics, Inc. and provides optical assembly components to their markets of interest in commercial sporting optics and select military optics. Given this broad potential, the commercial applications are a

key opportunity going forward. The Applied Optics Center segment also serves as the key supplier of the laser coated filters used in the production of periscope assemblies at the Optex Systems Richardson segment.

The Applied Optics Center serves primarily domestic U.S. customers. Approximately 77% of the Applied Optics Center revenue for the year ending October 2, 2016 was derived from external customers consisting of Nightforce Optics, Inc., 43%, the U.S. government, 24%, L3 Communications, 10%, Excelis Inc., 15%, and other external customers, 8%. Sales to commercial customers represent 48% and military sales to prime and subcontracted customers represent 52% of the total segment revenue. Intersegment sales to Optex Systems – Richardson during the year ended October 2, 2016, comprised 23% of the total segments revenue and was primarily in support of military contracts.

The Applied Optics Center (AOC), is located in Dallas, Texas with leased premises consisting of approximately 56,633 square feet of space, of which 12,000 square feet was subleased to L3 Mobile Vision through September 30, 2016. As of October 2, 2016, AOC operated with 38 full time equivalent employees in a single shift operation.

The financial table below presents the information for each of the reportable segments profit or loss as well as segment assets for each year. Optex Systems Holdings, Inc. does not allocate interest expense, income taxes or unusual items to segments.

Reportable Segment Financial Information  
(thousands)

Twelve months ending October 2, 2016

|   | Optex<br>Systems<br>Richardson | Applied Optics Center<br>Dallas | Other<br>(non allocated costs<br>and intersegment<br>eliminations) | Consolidated<br>Total |
|---|--------------------------------|---------------------------------|--|-----------------------|
| Revenues from external customers              | \$ 11,052                      | \$ 6,227                        | \$ -   | \$ 17,279             |
| Intersegment revenues                         | -                              | 1,892                           | (1,892)  | -                     |
| Total Revenue                                 | \$ 11,052                      | \$ 8,119                        | \$ (1,892)   | ) \$ 17,279           |
| Interest (income) expense                     | \$ -                           | \$ -                            | \$ 36  | \$ 36                 |
| Depreciation and Amortization                 | \$ 73                          | \$ 272                          | \$ -   | \$ 345                |
| Income (Loss) before taxes                    | \$ 145                         | \$ (345)                        | ) \$ (36)  | ) \$ (236)            |
| Other significant noncash items:              |                                |                                 |  |                       |
| Allocated home office expense                 | \$ (728)                       | ) \$ 728                        | \$ -   | \$ -                  |
| Stock compensation expense                    | \$ 192                         | \$ -                            | \$ -   | \$ 192                |
| Royalty expense amortization                  | \$ 30                          | \$ -                            | \$ -   | \$ 30                 |
| Provision for (use of) contract loss reserves | \$ -                           | \$ (54)                         | ) \$ -   | \$ (54)               |
| Segment Assets                                | \$ 8,861                       | \$ 3,900                        | \$ -   | \$ 12,761             |
| Expenditures for segment assets               | \$ (16)                        | ) \$ (18)                       | ) \$ -   | \$ (34)               |

Reportable Segment Financial Information  
(thousands)

Twelve months ending September 27, 2015

|                                  | Optex<br>Systems<br>Richardson | Applied Optics Center<br>Dallas (1) | Other<br>(non allocated costs<br>and intersegment<br>eliminations) | Consolidated<br>Total |
|----------------------------------|--------------------------------|-------------------------------------|--|-----------------------|
| Revenues from external customers | \$ 8,172                       | \$ 4,831                            | \$ -   | \$ 13,003             |
| Intersegment revenues            | -                              | 526                                 | (526)  | -                     |
| Total Revenue                    | \$ 8,172                       | \$ 5,357                            | \$ (526)   | ) \$ 13,003           |



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|   |           |             |           |             |
|---|-----------|-------------|-----------|-------------|
| Interest (income) expense                     | \$ -      | \$ -        | \$ 179    | \$ 179      |
| Depreciation and Amortization                 | \$ 88     | \$ 246      | \$ -      | \$ 334      |
| Income (Loss) before taxes                    | \$ (431 ) | \$ 1,101    | \$ (179 ) | \$ 491      |
| Other significant noncash items:              |           |             |           |             |
| Allocated home office expense                 | \$ (387 ) | \$ 387      | \$ -      | \$ -        |
| (Gain) on purchased asset - AOC               | \$ -      | \$ (2,110 ) | \$ -      | \$ (2,110 ) |
| Amortization of intangible assets             | \$ -      | \$ 342      | \$ -      | \$ 342      |
| Stock option compensation expense             | \$ 140    | \$ -        | \$ -      | \$ 140      |
| Provision for excess & obsolete inventories   | \$ 132    | \$ 115      | \$ -      | \$ 247      |
| Royalty expense amortization                  | \$ 30     | \$ -        | \$ -      | \$ 30       |
| Provision for (use of) contract loss reserves | \$ (11 )  | \$ 54       | \$ -      | \$ 43       |
| Segment Assets                                | \$ 7,537  | \$ 4,009    | \$ -      | \$ 11,546   |
| Expenditures for segment assets               | \$ 30     | \$ 2,070    | \$ -      | \$ 2,100    |

(1) The Applied Optics Center was acquired on November 3, 2014.

**Note 6 – Intangible Assets**

On November 3, 2014, Optex Systems, Inc. purchased the Applied Optics Center Products line in exchange for \$1,013.1 thousand and the assumption of approximately \$270.7 thousand of liabilities (see Note 4). Optex Systems, Inc. has allocated the consideration for the acquisition of the purchased assets among tangible and intangible assets acquired and liabilities assumed based upon their fair values as of the acquisition date. Assets that met the criteria for recognition as intangible assets apart from goodwill were also valued at their fair values.

The purchase price was assigned to the acquired interest in the assets and liabilities of Optex Systems Holdings as of November 3, 2014 as follows:

|   | (Thousands) |
|---|-------------|
| Assets:   |             |
| Current assets, consisting primarily of inventory of \$940.1 thousand and prepaid assets of \$47.1 thousand         | \$ 987.2    |
| Identifiable intangible assets  | 342.2       |
| Other non-current assets, principally property and equipment  | 2,064.7     |
| Total assets  | \$ 3,394.1  |
| Liabilities:  |             |
| Current liabilities, consisting of accounts payable of \$119.4 thousand and accrued liabilities of \$151.3 thousand | \$ (270.7 ) |
| Acquired net assets   | \$ 3,123.4  |

The fair values of the intangible assets as of the asset transfer date consisted primarily of \$342.2 thousand of undelivered customer order backlog with contracted delivery dates that were essentially fulfilled as of June 28, 2015. The amortization of identifiable intangible assets associated with the acquisition has been amortized on a straight line basis over the six month period beginning on December 29, 2014 and ending June 28, 2015 at a rate of \$57.0 thousand per month pursuant to the order deliveries. The intangible amortization was allocable to operating expenses as manufacturing cost of sales and general and administrative expenses at a rate of \$48.5 thousand and \$8.5 thousand per month, respectively, through June 28, 2015. The identifiable intangible assets are amortized over 15 years for income tax purposes.

During the twelve months ending September 27, 2015, \$291.1 thousand has been amortized to cost of sales, and \$51.1 thousand had been amortized to general and administrative expenses. There were no unamortized intangible assets or amortization expenses incurred in the twelve months ending October 2, 2016. As of September 27, 2015 and October 2, 2016, the total unamortized balance of intangible assets was zero.

**Note 7 — Property and Equipment**

A summary of property and equipment at October 2, 2016 and September 27, 2015 is as follows:

|                                     |                       | (Thousands)                      |                                  |
|-------------------------------------|-----------------------|----------------------------------|----------------------------------|
|                                     | Estimated Useful Life | Year Ended<br>October<br>2, 2016 | Year Ended<br>September 27, 2015 |
| <b>Property and Equipment</b>       |                       |                                  |                                  |
| Furniture and Fixtures              | 3-5yrs                | \$ 356                           | \$ 322                           |
| Machinery and Equipment             | 5 yrs                 | 3,233                            | 3,247                            |
| Leasehold Improvements              | 7 yrs                 | 276                              | 276                              |
| Less: Accumulated Depreciation      |                       | (2,214)                          | (1,874)                          |
| <b>Net Property &amp; Equipment</b> |                       | <b>\$1,651</b>                   | <b>\$ 1,971</b>                  |
| <br>                                |                       |                                  |                                  |
| <b><i>Depreciation Expense</i></b>  |                       | <b>\$345</b>                     | <b>\$ 334</b>                    |

During the twelve months ending October 2, 2016, Optex Systems Holdings' purchased \$34 thousand in new furniture and fixtures, and sold machinery and equipment with a net book value of \$9 thousand for \$4 thousand in proceeds resulting in a loss on asset sales of \$5 thousand.

**Note 8 — Accrued Expenses**

The components of accrued liabilities for the years ended October 2, 2016 and September 27, 2015 are summarized below:

|                             | (Thousands)                         |                                     |
|-----------------------------|-------------------------------------|-------------------------------------|
|                             | Year Ended<br>October<br>2,<br>2016 | Year Ended<br>September 27,<br>2015 |
| Deferred Rent Expense       | \$ 108                              | \$ 106                              |
| Accrued Vacation            | 330                                 | 315                                 |
| Property Taxes              | 101                                 | 81                                  |
| Operating Expenses          | 144                                 | 81                                  |
| Reserve for Contract Losses | -                                   | 54                                  |
| Payroll & Payroll Related   | 127                                 | 175                                 |
| Total Accrued Expenses      | <b>\$ 810</b>                       | <b>\$ 812</b>                       |

**Note 9 — Commitments and Contingencies**

***Rental Payments under Non-cancelable Operating Leases***

Optex Systems Holdings leases its office and manufacturing facilities for the Optex Systems, Inc, Richardson address and the Applied Optics Center Dallas address, under non-cancellable operating leases.

The leased facility under Optex Systems Inc. at 1420 Presidential Drive, Richardson, Texas consists of 49,100 square feet of space and expires March 31, 2021. Pursuant to the terms of the most recent amendment to the Richardson site facilities lease, there was no base rent payment due from January 1, 2014 through March 31, 2014, with payments beginning April 2014, and annual rental payment increases occurring each year beginning in 2016. As of October 2,

2016 the unamortized deferred rent was \$108 thousand as compared to \$106 thousand as of September 27, 2015. Deferred rent expense is amortized monthly over the life of the lease.

The leased facility under the Applied Optics Center at 9839 and 9827 Chartwell Drive, Dallas, Texas, consists of 56,633 square feet of space at the premises. Approximately 12,000 square feet of the facility is subleased through September 30, 2016 to L-3 Communications Mobile Vision Inc. under a separate Memorandum of Understanding dated October 27, 2014, which was not renewed. The term of the Applied Optics Center facility lease expired September 30, 2016, and was renewed for 44,867 square feet, excluding the portion formerly subleased by L-3 Communications Mobile Vision Inc. The new lease term will expire on September 30, 2021, with three remaining renewal options available to the tenant, each with a renewal term duration of five years.

As of October 2, 2016, the remaining minimum base lease and estimated common area maintenance (CAM) payments under the non-cancelable office and facility space leases are as follows:

**Non-cancellable Operating Leases Minimum Payments**

(Thousands)

| Fiscal Year                  | Optex Systems<br>Richardson |                 | Applied Optics Center<br>Dallas (1) |                 | Total<br>Payments |
|------------------------------|-----------------------------|-----------------|-------------------------------------|-----------------|-------------------|
|                              | Lease<br>Payments           | CAM<br>Estimate | Lease<br>Payments                   | CAM<br>Estimate |                   |
| 2017                         | \$266                       | \$ 88           | \$ 214                              | \$ 60           | \$ 628            |
| 2018                         | 271                         | 90              | 240                                 | 61              | 662               |
| 2019                         | 281                         | 92              | 248                                 | 62              | 683               |
| 2020                         | 291                         | 94              | 255                                 | 63              | 703               |
| 2021                         | 147                         | 48              | 262                                 | 64              | 521               |
| 2022                         | -                           | -               | 22                                  | 65              | 87                |
| Total minimum lease payments | \$ 1,256                    | \$ 412          | \$ 1,241                            | \$ 375          | \$ 3,284          |

(1) Includes new countersigned facility lease dated October 21, 2016 and countersigned by the landlord on November 17, 2016 for 44,867 square feet for the Applied Optics Center. The lease expires on October 31, 2021 (with a lease term which commenced retroactive to October 1, 2016). See Note 16- Subsequent Events.

Total facilities rental and CAM expenses for both facility lease agreements as of the twelve months ended October 2, 2016 was \$627 thousand. Total expense under facility lease agreements as of the twelve months ended September 27, 2015 was \$589 thousand.

**Note 10 — Transactions with a Related Party**

As of October 2, 2016, accounts receivable includes \$132 thousand of non trade receivables due from Sileas Corporation, a related party, for operating expenses paid by Optex Systems on their behalf. The amount is to be settled in stock within the next quarter. See Note 16-Subsequent Events.

In the twelve months ending October 2, 2016, Sileas Corporation converted 926 shares of Optex Systems Series A preferred stock at a total stated value of \$6.4 million for 5,293,896 common shares. The common shares include 1,354,167 of additional common shares issued on October 18, 2016 as a result of a downward adjustment on the preferred Series A conversion price triggered by the public offering price in August 2016 on Sileas Corporation's previously converted preferred Series A shares. These additional shares have been retroactively reflected in the ending common shares outstanding as of October 2, 2016. As a result, Optex has recorded an additional beneficial conversion amount of \$0.8 million to reflect the common stock conversion rate change from \$2.50 to \$1.20 in 2016.

There were no other transactions with Related Parties during fiscal years 2016 or 2015 except as described below in Note 11 Debt Financing.

## **Note 11 — Debt Financing**

### **Related Parties**

#### ***Acquisition by Sileas Corporation on February 20, 2009***

On February 20, 2009, Sileas purchased 100% of the equity and debt interest held by Longview, which represented 90% of the Optex Systems, Inc. (Delaware) outstanding equity on that date. Currently, Sileas is the majority owner of Optex Systems Holdings.

#### ***Sileas Secured Promissory Note Due on May 29, 2021 to Longview Fund, LP***

As a result of the transaction described above between Sileas and Longview on February 20, 2009, Sileas, the new majority owner of Optex Systems, Inc. (Delaware), executed and delivered to Longview, a Secured Promissory Note due February 20, 2012 in the principal amount of \$13,524,405. The Note bears simple interest at the rate of 4% per annum, and the interest rate upon an event of default increases to 10% per annum. In the event that a Major Transaction occurs prior to the maturity date resulting in the Borrower receiving Net Consideration with a fair market value in excess of the principal and interest due under the terms of this Secured Note, then in addition to paying the principal and interest due, Sileas shall also pay an amount equal to 90% of the consideration. “Major Transaction” refers to a transaction whereby Optex Systems, Inc. (Delaware) would consolidate or merge into or sell or convey all or substantially all of its assets to a third party entity for more than nominal consideration, and “Net Consideration” refers to the fair market value of the consideration received in connection with a Major Transaction less all outstanding liabilities of Optex Systems, Inc. (Delaware).

On November 22, 2011 Sileas Corp and Longview Fund, LP entered into an amendment to the Secured Promissory Note that extended the maturity date for an additional two year period ending on February 20, 2014. In exchange for the extension, Sileas Corp agreed to pay Longview Fund an extension fee equal to 2% of the principal amount of this Secured Note. As a result of the agreement, the principal amount of the Note was increased \$270 thousand to \$13.8 million as of November 22, 2011.

On November 27, 2013 Sileas Corp. and the Longview Fund, LP entered into an amendment to the Secured Promissory Note that extended the maturity date for an additional two year period ending on February 20, 2016. In exchange for the extension, Sileas Corp. agreed to pay the Longview Fund an extension fee equal to 2% of the



principal amount of this Secured Note. As a result of the amendment, the principal amount of the Note was increased by \$275 thousand to \$14.1 million as of November 27, 2013.

On June 5, 2015, Sileas Corp. amended its Secured Note, with Longview Fund, L.P., as lender, as follows:

- The principal amount was increased to \$18,022,329 to reflect the original principal amount plus all accrued and unpaid interest to date, and the Secured Note ceased to bear interest as of that date;
- The maturity date of the note was extended to May 29, 2021; and
- A conversion feature was added to the Secured Note by which the principal amount of the Secured Note can be converted into our Series A preferred stock, which is owned by Sileas, at the stated value of our Series A preferred stock.

Simultaneously therewith, Sileas entered into a Blocker Agreement with us pursuant to which the Series A preferred stock shall not be convertible by Sileas into our common stock, and we shall not effect any conversion of the Series A Stock or otherwise issue any shares of our common stock pursuant hereto, to the extent (but only to the extent) that after giving effect to such conversion or other share issuance hereunder Sileas (together with its affiliates) would beneficially own in excess of 9.99% our common stock. Sileas also agreed to not vote any of its shares of Series A preferred stock in excess of 9.99% of our common stock.

On August 4, 2016, Longview Fund, L.P. converted \$250 thousand of the note principal for 100,000 shares of Optex Systems Holdings common stock pursuant to the note conversion terms. The Sileas note balance to the Longview Fund, LP as of October 2, 2016 is \$17.8 million.

In the twelve months ending October 2, 2016, Sileas Corporation converted all their Optex Systems Holdings, Inc. Series A preferred stock, 926 shares, at a total stated value of \$6.4 million for 5,293,896 common shares. The total common shares held by Sileas as of October 2, 2016 is 5,296,081. The common shares outstanding include 1,354,167 of additional common shares issued on October 18, 2016 as a result of a downward adjustment on the preferred Series A conversion price triggered by the public offering price in August 2016 for Sileas Corporation's previously converted preferred Series A shares. These additional shares have been retroactively reflected in the ending common shares outstanding as of October 2, 2016.

### **Credit Facility — Avidbank**

On April 20, 2016, the Company amended its revolving credit facility with Avidbank. The new renewable revolving maturity date is January 22, 2018. The facility provides up to \$2 million in financing against eligible receivables and is subject to meeting certain covenants including an asset coverage ratio test for up to twenty months. The material terms of the amended revolving credit facility are as follows:

The interest rate for all advances shall be the then in effect prime rate plus 2.5% and is subject to a minimum interest payment requirement per six month period of \$10,000.

Interest shall be paid monthly in arrears.

A facility fee of (0.5%) of the revolving line (\$10,000) is due on May 22, 2016 and each anniversary thereof for so long as the revolving credit facility is in effect.

The loan period is from April 20 through January 22, 2018 at which time any outstanding advances, and accrued and unpaid interest thereon, will be due and payable.

The obligations of Optex Systems, Inc. to Avidbank are secured by a first lien on all of its assets (including intellectual property assets should it have any in the future) in favor of Avidbank.

The facility contains customary events of default. Upon the occurrence of an event of default that remains uncured after any applicable cure period, Avidbank's commitment to make further advances may terminate, and Avidbank would also be entitled to pursue other remedies against Optex Systems, Inc. and the pledged collateral.

Pursuant to a guaranty executed by Optex Systems Holdings in favor of Avidbank, Optex Systems Holdings has guaranteed all obligations of Optex Systems, Inc. to Avidbank.

As of October 2, 2016, the outstanding principal on the line of credit was \$300 thousand. For the years ended October 2, 2016 and September 27, 2015, the total interest expense against the outstanding line of credit balance was \$36 thousand and \$33 thousand, respectively.

### **Issuance of Convertible Notes**

On November 17, 2014, Optex Systems Holdings entered into a Subscription Agreement (the “Agreement”) to sell up to \$2.1 million principal amount of convertible promissory notes (“Notes”) to several accredited investors (the “Investors”) in a private placement pursuant to which the Investors purchased a series of Notes with an aggregate principal amount of \$1,550 thousand. An additional convertible promissory note for \$10 thousand was issued to the placement agency in consideration for placement services on the transaction.

Optex Systems, Inc. incurred \$74 thousand in debt issuance costs, for investment banking, legal and placements fee services, inclusive of the \$10 thousand supplemental convertible note issued for placement fees. These costs are reflected in the balance sheet and cash flow statement as debt issuance costs and are amortized to interest expense across the term of the notes based on the effective interest method.

On March 29, 2015, the holders of the Company’s \$1,560,000 principal amount of convertible promissory notes, issued on or about November 17, 2014, converted the entire principal amount thereof and all accrued and unpaid interest thereon, into 1,000 shares of the Company’s Series B Preferred Stock.

For the twelve months ending September 27, 2015 the amortized interest expense related to the debt was \$146 thousand. As of September 27, 2015 the unamortized debt issuance costs was zero.

**Note 12 — Stock Based Compensation**

The Optex Systems Holdings 2009 Stock Option Plan provides for the issuance of up to 75,000 shares to Optex Systems Holdings officers, directors, employees and to independent contractors who provide services to Optex Systems Holdings as either incentive or nonstatutory stock options determined at the time of grant. As of October 2, 2016, Optex Systems Holdings has granted stock options to officers and employees as follows (as adjusted for the 1000:1 reverse stock split on common shares effective October 7, 2015):

| <b>Date of Grant</b> | <b>Shares Granted</b> | <b>Exercise Price</b> | <b>Shares Outstanding As of 10/02/16</b> | <b>Expiration Date</b> | <b>Vesting Period</b> |
|----------------------|-----------------------|-----------------------|--|------------------------|-----------------------|
| 12/09/11             | 46,070                | \$ 10.00              | 35,370                                   | 12/08/2018             | 4 years               |
| 12/19/13             | 25,000                | \$ 10.00              | 25,000                                   | 12/18/2020             | 4 years               |
| <b>Total</b>         | <b>71,070</b>         |                       | <b>60,340</b>                            |                        |                       |

The following table summarizes the status of Optex Systems Holdings' aggregate stock options granted under the incentive stock option plan (as adjusted for the 1000:1 reverse stock split on common shares effective October 7, 2015):

|   | <b>Number of Shares Remaining Options</b> | <b>Weighted Average Fair Value</b> | <b>Weighted Average Life (Years)</b> | <b>Aggregate Value (Thousands)</b> |
|---|---|------------------------------------|--------------------------------------|------------------------------------|
| <b>Subject to Exercise</b>                  |   |                                    |                                      |                                    |
| <b>Outstanding as of September 28, 2014</b> | 62,912                                    | \$ —                               | 3.41                                 | \$ —                               |
| Granted – 2015                              | —   |                                    |                                      |                                    |
| Forfeited – 2015                            | (54 )                                     |                                    |                                      |                                    |
| Exercised – 2015                            | —   |                                    |                                      |                                    |
| <b>Outstanding as of September 27, 2015</b> | 62,858                                    | \$ —                               | 2.32                                 | \$ —                               |
| Granted – 2016                              | —   |                                    |                                      |                                    |
| Forfeited – 2016                            | (2,518 )                                  |                                    |                                      |                                    |
| Exercised – 2016                            | —   |                                    |                                      |                                    |
| <b>Outstanding as of October 2, 2016</b>    | 60,340                                    | \$ —                               | 1.40                                 | \$ —                               |
| <b>Exercisable as of September 27, 2015</b> | 40,266                                    | \$ —                               | 1.45                                 | \$ —                               |
| <b>Exercisable as of October 2, 2016</b>    | 52,840                                    | \$ —                               | 1.07                                 | \$ —                               |

There were no options granted in the twelve months ended October 2, 2016 and September 27, 2015.

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The following table summarizes the status of Optex Systems Holdings' aggregate non-vested shares granted under the 2009 Stock Option Plan:

|  | <b>Number of<br/>Non-vested<br/>Shares<br/>Subject to<br/>Options</b> | <b>Weighted-<br/>Average<br/>Grant-<br/>Date<br/>Fair Value</b> |
|--|---|---|
| <b>Non-vested as of September 28, 2014</b>         | <b>42,710</b>   | \$ 7.58   |
| Non-vested granted — year ended September 27, 2015 | —   | \$ —  |
| Vested — year ended September 27, 2015             | (20,064   | ) \$ 7.50   |
| Forfeited — year ended September 27, 2015          | (54   | ) \$ —  |
| <b>Non-vested as of September 27, 2015</b>         | <b>22,592</b>   | <b>\$ 7.66</b>  |
| Non-vested granted — year ended October 2, 2016    | —   | —   |
| Vested — year ended October 2, 2016                | (12,575   | ) 7.33  |
| Forfeited — year ended October 2, 2016             | (2,518  | ) —   |
| <b>Non-vested as of October 2, 2016</b>            | <b>7,500</b>  | <b>\$ 8.00</b>  |

### **Restricted Stock Units issued to Officers and Employees**

On June 14, 2016, the Compensation Committee (“Committee”) of the Board of Directors of Optex Systems Holdings, Inc. approved the Company’s 2016 Restricted Stock Unit Plan (the “Plan”). The Plan provides for the issuance of stock units (“RSU”) for up to 1,000,000 shares of the Company’s common stock to Optex Systems Holdings officers and employees. Each RSU constitutes a right to receive one share of the Company’s common stock, subject to vesting, which unless otherwise stated in an RSU agreement, shall vest in equal amounts on the first, second and third anniversary of the grant date. Shares of the Company’s common stock underlying the number of vested RSUs will be delivered as soon as practicable after vesting. During the period between grant and vesting, the RSUs may not be transferred, and the grantee has no rights as a shareholder until vesting has occurred. If the grantee’s employment is terminated for any reason (other than following a change in control of the Company or a termination of an officer other than for cause), then any unvested RSUs under the award will automatically terminate and be forfeited. If an officer grantee’s employment is terminated by the Company without cause or by the grantee for good reason, then, provided that the RSUs have not been previously forfeited, the remaining unvested portion of the RSUs will immediately vest as of the officer grantee’s termination date. In the event of a change in control, the Company’s obligations regarding outstanding RSUs shall, on such terms as may be approved by the Committee prior to such event, immediately vest, be assumed by the surviving or continuing company or cancelled in exchange for property (including cash).

On June 15, 2016, the Company issued 150,000 RSUs to its Chief Executive Officer, Danny Schoening, and 50,000 RSUs to its Chief Financial Officer, Karen Hawkins. The RSUs issued to Mr. Schoening and Ms. Hawkins vest as follows: 34% on January 1, 2017, 33% on January 1, 2018 and 33% on January 1, 2019. The total market value of the restricted stock units based on the shares price of \$1.85 as of June 15, 2016 is \$372 thousand. The cost of the shares is amortized on a straight line basis across the vesting periods.

As of October 2, 2016, none of the restricted stock units had vested.

### **Consulting and Vendor Equity Issues**

On April 29, 2016, Optex Systems Holdings, Inc. issued 40,000 common “restricted” shares at a market price of \$2.35 per share (\$94,000) in support of the IRTH Communications agreement (See note 6). The cost of the shares is amortized on a straight line basis through April 2017. There were no other equity instruments issued to consultants and vendors during the twelve months ended October 2, 2016.

### **Stock Based Compensation Expense**

Equity compensation is amortized based on a straight line basis across the vesting or service period as applicable. The recorded compensation costs for options and shares granted and restricted stock units awarded as well as the unrecognized compensation costs are summarized in the table below:

|                          | <b>Stock Compensation<br/>(thousands)</b>  |                           | <b>Unrecognized Compensation Expense</b> |                           |
|--------------------------|--|---------------------------|--|---------------------------|
|                          | <b>Recognized Compensation<br/>Expense</b> |                           | <b>As of period ending</b>               |                           |
|                          | <b>Twelve months ended</b>                 |                           |  |                           |
|                          | <b>October<br/>2, 2016</b>                 | <b>September 27, 2015</b> | <b>October 2, 2016</b>                   | <b>September 27, 2015</b> |
| Stock Options            | \$ 52                                      | \$ 140                    | \$ 48                                    | \$ 100                    |
| Restricted Stock Units   | 93   | -                         | 279                                      | -                         |
| Consultant Shares (IRTH) | 47   | -                         | 47                                       | -                         |
| Total Stock Compensation | \$ 192                                     | \$ 140                    | \$ 374                                   | \$ 100                    |

**Note 13 — Stockholders Equity**

The table below depicts the Optex Systems Holdings stock equity transactions and ending share balances by equity class for the twelve months ending September 27, 2015 and October 2, 2016, respectively.

|  | Optex Systems Holdings Inc.<br>Stockholder Equity Shares Outstanding |          |          |          |           |
|--|--|----------|----------|----------|-----------|
|  | Common   | Series A | Series B | Series C | Warrants  |
| Shares outstanding September 28, 2014 (post split)   | 310,867  | 1,001    | -        | -        | -         |
| Conversion of Notes to Series B Preferred shares June 28, 2015 <sup>(1)</sup>  |  |          | 1,000    |          |           |
| Conversion of Series B Preferred shares May 27, 2015 <sup>(2)</sup>  | 4,000  | -        | (6 )     | -        | -         |
| Common shares outstanding as of September 27, 2015   | 314,867  | 1,001    | 994      | -        | -         |
| Conversion of Series B Preferred shares October 23, 2015 <sup>(3)</sup>  | 16,031   | -        | (25 )    | -        | -         |
| Issuance of shares on December 8, 2015 for DTC roundup correction <sup>(4)</sup>   | 247  | -        | -        | -        | -         |
| Conversion of Series A Preferred shares March 27, 2016 <sup>(5)(14)</sup>  | 1,250,000  | (456 )   | -        | -        | -         |
| Issuance IRTH consulting common shares on April 29, 2016 <sup>(6)</sup>  | 40,000   | -        | -        | -        | -         |
| Conversion of Series B Preferred shares on July 6, 2016 <sup>(7)</sup>   | 109,291  | -        | (167 )   | -        | -         |
| Conversion of Series A Preferred shares on August 10, 2016 <sup>(8)</sup>  | 25,000   | (9 )     | -        | -        | -         |
| Public offering issuance of common stock on August 26, 2016 <sup>(9)</sup>   | 2,291,900  | -        | -        | 400      | 3,958,700 |
| Underwriter warrants issued with offering on August 26, 2016 <sup>(10)</sup>   | -  | -        | -        | -        | 166,500   |
| Redemption of Series A and Series B Preferred shares on August 26, 2016 <sup>(11)</sup>  | -  | (66 )    | (796 )   | -        | -         |
| Conversion of Series A and Series B Preferred shares on August 26, 2016 <sup>(12)</sup>  | 2,698,431  | (470 )   | (6 )     | -        | -         |
| Conversion of Series C Preferred shares on August 10, 2016 <sup>(13)</sup>   | 166,667  | -        | -        | (40 )    | -         |
| Additional shares issued on October 18, 2016 for downward price adjustment for previous converted 456 share Series A Preferred dated March 27, 2016 <sup>(14)(5)</sup> | 1,354,167  | -        | -        | -        | -         |
| Common shares outstanding as of October 2, 2016  | 8,266,601  | -        | -        | 360      | 4,125,200 |

*Notes:*

1. On June 28, 2015, the holders of the Company's \$1,560,000 principal amount of convertible promissory notes, issued on or about November 17, 2014, converted the entire principal amount thereof and all accrued and unpaid interest thereon, into 1,000 shares of the Company's Series B Preferred Stock.

2. On May 27, 2015 a private investor converted \$10 thousand, or 6 shares of the Series B preferred stock at a stated value of \$1,629 per share, for 4,000 shares of common stock



3. *On October 23, 2015 a private investor converted \$40 thousand, or 25 shares of the Series B preferred stock at a stated value of \$1,629 per share, for 16,031 shares of common stock.*
4. *On December 7, 2015, 247 common shares issued to certain beneficial holders to correct Depository Trust and Clearing Corporation (DTC) rounding errors occurring from the October 7, 2015 reverse split*
5. *On March 27, 2016, Sileas Corporation converted \$3,125 thousand or 456 shares of the Series A preferred stock at a stated value of \$6,860 per share, for 1,250,000 shares of common stock.*
6. *On April 29, 2016, Optex Systems Holdings, Inc. issued 40,000 common "restricted" shares at a market price of \$2.35 per share (\$94 thousand) in support of the IRTH Communications agreement (See note 12).*
7. *On July 6, 2016 a private investor converted \$273 thousand, or 167 shares of the Series B preferred stock at a stated value of \$1,629 per share, for 109,291 shares of common stock.*
8. *On August 10, 2016, a private investor converted \$62.5 thousand, or 9 shares, of the Series A preferred stock at a stated value of \$6860 per share for 25,000 shares of common stock.*

*On August 26, 2016, we consummated a public offering of 2,291,000 Class A units consisting of common stock and warrants and 400 Class B units consisting of shares of Series C convertible stock and warrants for a total gross purchase price of \$4,750,280. The offering is comprised of Class A Units, priced at a public offering price of \$1.20 per unit, with each unit consisting of one share of common stock and one five-year warrant to purchase one share of common stock with an exercise price of \$1.50 per share (each, a "warrant"), and Class B Units, priced at a public offering price of \$5,000 per unit, with each unit comprised of one share of preferred stock with a conversion price of \$1.20 which is convertible into 4,167 shares of common stock and warrants to purchase 4,167 shares of common stock. The securities comprising the units are immediately separable and will be issued separately.*
10. *On August 26, 2016, 166,500 five-year warrants to purchase one share of common stock with an exercise price of \$1.50 per share were issued to the underwriter in connection with the offering.*

11. *On August 26, 2016, 66 Series A and 796 preferred shares were redeemed for \$1.75 million, as a condition of the offering.*  
*On August 26, 2016, 470 shares of Series A preferred stock at a stated value of \$6,860 were converted for 2,689,729 shares of common stock and 6 shares of Series B preferred stock at a stated value of \$1,629 were*
12. *converted for 8,702 shares of common stock, for a total of 2,698,431 shares of common stock based on a conversion price of \$1.20 per share, as a condition of the offering.*  
*On August 26, 2016, 28 shares of Series C preferred stock, and on August 29, 2016 12 shares of Series C preferred*
13. *stock were converted at a stated value of \$5000 per share, for a total value of \$200 thousand, into 166,667 common shares at a per share conversion price of \$1.20.*  
*Pursuant to a board of directors meeting held on August 4, 2016, 1,354,167 additional shares of common stock were issued to Sileas Corporation as a result of a downward price adjustment on the conversion rate of Series A preferred shares which was triggered by the August 26, 2016 public offering. The conversion price adjustment*
14. *applied to 456 Series A preferred shares which had been previously converted on March 27, 2016. The conversion price was reset to the public offering price \$1.20 per common share from the prior conversion price of \$2.50 per common share. As a result of the adjustment the additional common shares were issued on October 18, 2016 and retroactively included in the ending outstanding shares as of October 2, 2016.*

### **Common stock**

On August 31, 2015, the Optex Systems Holdings board of directors approved a reverse stock split of our common stock, in a ratio to be determined by the board of directors, of not less than 1-for-400 nor more than 1-for-1000. On October 6, 2015, 20 calendar days had passed since the mailing to our shareholders of the Definitive Schedule 14C filed on September 11, 2015 regarding the approval by the board of the reverse stock split. On October 7, 2015, we effected a 1-for-1000 reverse split of our common stock. Pursuant to the reverse split, all shareholders of less than 100,000 pre-split common shares, were issued a round lot quantity of 100 common shares post-split. The total share round up quantity related to the reverse split resulted in an additional issue of 139,953 common shares post-split. All share and related option information has been retroactively adjusted to reflect the decrease in shares resulting from this action. Additional funds were reclassified from the common stock to additional paid in capital to reflect the change in total par value represented by the lower common shares after the reverse split. The par value of the common stock outstanding shall remain at \$0.001 per share subsequent to the reverse split action.

As of September 28, 2014, Optex Systems Holdings had 170,914 common shares outstanding. Pursuant to an October 7, 2015 reverse split, there was an additional 139,953 shares issued to preserve round lots of 100 shares for all lot holders holding less than 100,000 pre-split, or 100 post-split shares common shares. An adjustment to common stock par value and additional paid in capital was recorded to reflect the change in values as a result of the reverse split. The outstanding common shares as of September 28, 2014, have been retrospectively stated as 310,867 shares, reflective of the additional roundup quantity, post split.

During the twelve months ending September 27, 2015, Optex Systems Holdings issued 4,000 common shares due to conversions of Series B preferred stock. As of September 27, 2015, Optex Systems had 314,867 common shares

outstanding.

On August 26, 2016, 2,291,900 Class A units consisting of common stock and warrants and 400 Class B units consisting of shares of Series C convertible stock and warrants were issued pursuant to a public offering. The offering is comprised of Class A Units, priced at a public offering price of \$1.20 per unit, with each unit consisting of one share of common stock and one five-year warrant to purchase one share of common stock with an exercise price of \$1.50 per share (each, a "warrant"), and Class B Units, priced at a public offering price of \$5,000 per unit, with each unit comprised of one share of preferred stock with a conversion price of \$1.20 which is convertible into 4,167 shares of common stock and warrants to purchase 4,167 shares of common stock. The net proceeds from the offering were \$4,247 thousand (Gross proceeds of \$4,752 thousand less underwriter expenses of \$505 thousand). Deferred public offering costs incurred by Optex in connection with the offering was \$252 thousand.

During the twelve months ending October 2, 2016, Optex Systems Holdings issued 5,619,587 common shares due to conversions of Series A, Series B and Series C preferred stock, 2,291,900 shares were issued in connection with the public offering, 247 common shares were issued to correct Depository Trust and Clearing Corporation (DTC) rounding errors occurring from the October 7, 2015 reverse split and 40,000 common shares were issued to a vendor (See note 12). As of October 2, 2016, the outstanding common shares are 8,266,601. The issued and outstanding shares above have been retroactively adjusted to include 1,354,167 common shares issued on October 18, 2016 pursuant to a ratchet triggered on previously converted Series A preferred shares.

There were no other issuances of common or preferred stock during the twelve months ended October 2, 2016.

*Series A preferred stock*

Optex Systems Holdings has filed a Certificate of Designation with the Secretary of State of the State of Delaware authorizing a series of preferred stock, under its articles of incorporation, known as “Series A preferred stock”. The Certificate of Designation currently sets forth the following terms for the Series A preferred stock: (i) number of authorized shares: 1,027; (ii) per share stated value: \$6,860; (iii) liquidation preference per share: stated value; (iv) conversion price: \$150.00 per share, (\$0.15 per share, pre split) as adjusted from time to time; and (v) voting rights: votes along with the common stock on an as converted basis with one vote per share (vi) par value \$0.001 per share. The conversion price was subsequently reset to \$10.00 per share as discussed below.

The Series A preferred stock entitles the holders to receive cumulative dividends at the rate of 6% per annum, payable in cash at the discretion of Board of Directors. Each share of preferred stock is immediately convertible into common shares at the option of the holder which entitles the holder to receive the equivalent number of common shares equal to the stated value of the preferred shares divided by the conversion price, which was initially set at \$150.00 per share. The dividends were subsequently waived and the price per share was reset to \$10.00 on February 21, 2012 as discussed below. On November 17, 2014 an exercise price per share ratchet was triggered by the issuance of convertible notes with a lower conversion price and the exercise price was reset to a pre split value of \$0.0025, or \$2.50 post split per common share. Effective as of October 7, 2015, the conversion price has been reset to \$2.50 per share pursuant to the 1000:1 reverse stock split on common shares and effective on August 22, 2016, the conversion price has been reset to \$1.20 pursuant to a public offering of common shares at \$1.20 per share.

Holders of preferred shares receive preferential rights in the event of liquidation. Additionally the preferred stock shareholders are entitled to vote together with the common stock on an “as-converted” basis.

As of April 1, 2012, the preferred shareholders agreed to waive the past dividends in arrears through June 29, 2014 of \$884 thousand in exchange for an increase in the stated value to \$6,860. On February 21, 2012, in connection with the purchase of the 5,000 shares of common stock of Optex Systems Holdings by Alpha Capital, the preferred shareholders executed an irrevocable waiver for any and all previously accrued and outstanding dividends and the right to receive any future dividends on the Series A Preferred Stock. The per share conversion price of the Optex Systems Holdings’ Series A Preferred Stock was automatically reset to \$10.00 per share in accordance with the reset provision as set forth in paragraph 4(d)(ii) of the Series Designation for the Optex Systems Holdings’ Series A Preferred Stock. The total amount of dividends waived as a result of the February 21, 2012 waiver is \$213 thousand. As of October 2, 2016 and September 27, 2015 as a result of the executed waiver dated February 21, 2012, there were no dividends in arrears on preferred shares and no future dividends will accrue on the preferred shares.

On October 7, 2015, we effected a 1-for-1000 reverse split of our common stock. Based on the price reset to \$2.50 per common share, there were 1,001.5 shares of preferred stock with a beneficial conversion feature, “in the money”, which

were subject to conversion at the discretion of the holder. In the twelve months ending September 27, 2015, Optex Systems Holdings recognized a \$5.2 million adjustment to retained earnings for dividends for the intrinsic value of the beneficial conversion feature on the convertible preferred shares. During the twelve months ending October 2, 2016, Optex System Holdings recognized an additional \$0.8 million adjustment to retained earnings for dividends due to a beneficial conversion feature on 926 Series A preferred shares, whereas the conversion price reset from \$2.50 per common share to \$1.20 per common share as a result of the public offering price on August 26, 2016.

During the twelve months ending September 27, 2015 there were no conversions and no new issues of Series A preferred shares. Optex Systems Holdings had 1,001 of preferred shares outstanding as of September 27, 2015.

During the twelve months ending October 2, 2016 there were conversions of 935 preferred Series A shares, or \$6,415 thousand, into 5,318,896 common shares, and cash redemptions for \$455 thousand of 66 Series A preferred shares. The 5,318,896 converted common shares above have been retroactively adjusted to include 1,354,167 common shares subsequently issued on October 18, 2016 pursuant to a ratchet triggered on conversions of 456 of Series A preferred shares which had occurred on March 27, 2016.

As of October 2, 2016 there were zero preferred Series A shares outstanding.

### *Series B Preferred Stock*

On March 26, 2015, Optex Systems Holdings filed a Certificate of Designation with the Secretary of State of the State of Delaware authorizing a series of preferred stock, under its articles of incorporation, known as “Series B preferred stock”. The Certificate of Designation currently sets forth the following terms for the Series B preferred stock: (i) number of authorized shares: 1,010; (ii) per share stated value: \$1,629 (iii) liquidation preference per share, other than Series A preferred stock: stated value; (iv) conversion price: \$0.0025 per share, pre split, as adjusted from time to time; (v) voting rights: votes along with the common stock on an as converted basis with one vote per share; and (vi) par value of \$0.001 per share. Effective as of October 7, 2015, the conversion price has been reset to \$2.50 per share pursuant to the 1000:1 reverse stock split on common shares.

On June 28, 2015, the holders of the Company’s \$1,560,000 principal amount of convertible promissory notes, issued on or about November 17, 2014, converted the entire principal amount thereof and all accrued and unpaid interest thereon, into 1,000 shares of the Company’s Series B Preferred Stock.

Each share of preferred stock is immediately convertible into common shares at the option of the holder which entitles the holder to receive the equivalent number of common shares equal to the stated value of the preferred shares divided by the conversion price, which is initially set at \$0.0025 per share and was reset to \$2.50 per share pursuant to the October 7, 2015 1000:1 reverse stock split. Effective on August 22, 2016, the conversion price has been reset to \$1.20 pursuant to a public offering of common shares at \$1.20 per share.

At the time of issuance, the market value of the common stock was \$10.00 (\$0.01 pre split). As the conversion rate of \$2.50 (\$0.0025 pre split) was below the market price, the issued preferred series B stock contained a beneficial conversion feature. As the series B preferred stock is immediately convertible with no stated maturity date, Optex Systems Holdings recognized a retained earnings and additional paid in capital adjustment for the intrinsic value, “in the money portion”, of the conversion options at inception. For the twelve months ending September 27, 2015 Optex Systems Holdings recognized a retained earnings dividends and additional paid in capital adjustment of \$1.2 million, which represented the intrinsic value of the options at the commitment date. During the twelve months ending October 2, 2016 there were no dividends booked to retained earnings related to the beneficial conversion feature on Series B preferred shares as the conversion price remained at or above the market price.

During the twelve months ending September 27, 2015, 6 shares of the Series B preferred stock had been converted to common stock. As of September 27, 2015, there were 994 shares of Series B preferred shares outstanding.

During the twelve months ending October 2, 2016 there were conversions of 198 preferred Series B shares, or \$324 thousand, into 134,024 common shares, and cash redemptions of 796 Series B preferred shares for \$1,296 thousand. As of October 2, 2016 there were zero preferred Series B shares outstanding.

### *Series C Preferred Stock*

Our board of directors designated 400 shares of our preferred stock as Series C convertible preferred stock (“Series C preferred stock”). The preferences and rights of the Series C preferred stock are set forth in a Certificate of Designation (the “Series C Certificate of Designation”).

Pursuant to a transfer agency agreement between us and Equity Stock Transfer, as transfer agent, the Series C preferred stock will be issued in book-entry form and shall initially be represented only by one or more global certificates deposited with The Depository Trust Company, or DTC, and registered in the name of Cede & Co., a nominee of DTC, or as otherwise directed by DTC.

In the event of a liquidation, the holders of Series C preferred stock are entitled to participate on an as-converted-to-Common Stock basis with holders of the Common Stock in any distribution of assets of the Company to the holders of the Common Stock. The Series C Certificate of Designation provides, among other things, that we shall not pay any dividends on shares of Common Stock (other than dividends in the form of Common Stock) unless and until such time as we pay dividends on each Series C preferred share on an as-converted basis. Other than as set forth in the previous sentence, the Series C Certificate of Designation provides that no other dividends shall be paid on Series C preferred stock.

With certain exceptions, as described in the Series C Certificate of Designation, the Series C preferred stock have no voting rights. However, as long as any shares of Series C preferred stock remain outstanding, the Series C Certificate of Designation provides that we shall not, without the affirmative vote of holders of a majority of the then-outstanding Series C preferred stock, (a) alter or change adversely the powers, preferences or rights given to the Series C preferred stock or alter or amend the Series C Certificate of Designation, (b) increase the number of authorized shares of Series C preferred stock or (c) amend our certificate of incorporation in any manner that adversely affects the rights of holders of Series C preferred stock.

Each Series C preferred share is convertible at any time at the holder's option into a number of shares of common stock equal to \$5,000 divided by the Series C Conversion Price. The "Series C Conversion Price" is initially \$1.20 and is subject to adjustment for stock splits, stock dividends, distributions, subdivisions and combinations. Notwithstanding the foregoing, the Series C Certificate of Designation further provides that we shall not effect any conversion of Series C preferred stock, with certain exceptions, to the extent that, after giving effect to an attempted conversion, the holder of Series C preferred stock (together with such holder's affiliates, and any persons acting as a group together with such holder or any of such holder's affiliates) would beneficially own a number of shares of Common Stock in excess of 4.99% of the shares of our Common Stock then outstanding after giving effect to such exercise (the "preferred stock Beneficial Ownership Limitation"); provided, however, that upon notice to the Company, the holder may increase or decrease the preferred stock Beneficial Ownership Limitation, provided that in no event shall the preferred stock Beneficial Ownership Limitation exceed 9.99% and any increase in the preferred stock Beneficial Ownership Limitation will not be effective until 61 days following notice of such increase from the holder to us.

We do not intend to apply for listing of the Series C preferred stock on any securities exchange or other trading system.

During the twelve months ending October 2, 2016 there were 400 preferred Series C shares issued, at a total stated value of \$2 million, pursuant to the public offering on August 26, 2016, and conversions of 40 preferred Series C shares, or \$200 thousand, into 166,667 common shares. As of October 2, 2016 there were 360 preferred Series C shares outstanding.

### ***Warrants***

On August 26, 2016, Optex Systems Holdings Inc. issued 4,125,200 warrants to new shareholders and the underwriter, in connection with a public share offering. The warrants entitle the holder to purchase one share of our common stock at an exercise price equal to \$1.50 per share at any time on or after August 26, 2016 (the "Initial Exercise Date") and on or prior to the close of business on August 26, 2021 (the "Termination Date").



Pursuant to a warrant agreement between Optex Systems Inc. and Equity Stock Transfer, LLC, as warrant agent, the warrants will be issued in book-entry form and shall initially be represented only by one or more global warrants deposited with the warrant agent, as custodian on behalf of The Depository Trust Company, or DTC, and registered in the name of Cede & Co., a nominee of DTC, or as otherwise directed by DTC.

The exercise price and number of shares of common stock issuable upon exercise of the warrants may be adjusted in certain circumstances, including in the event of a stock split, stock dividend, extraordinary dividend on or recapitalization, reorganization, merger or consolidation. For one year following the issuance date of the warrants, the exercise price of the warrants will also be adjusted for issuances of common stock at a price below their exercise price, on the date of issuance of any option to purchase, or sell or grant any right to reprice, or otherwise dispose of or issue (or announce any offer, sale, grant or any option to purchase or other disposition) any common stock or common stock equivalents, at an effective price per share less than the exercise price then in effect. Under such adjustment, the exercise price of the warrants shall be reduced to that lower issuance price per share. Under the terms of the Warrants, there can only be one such price reset during the term of the warrant.

Under the terms of the warrant agreement, Optex Systems Holdings Inc. has agreed to use their best efforts to maintain the effectiveness of the registration statement and current prospectus relating to common stock issuable upon exercise of the warrants until the expiration of the warrants. During any period Optex fails to have maintained an effective registration statement covering the shares underlying the warrants, the warrant holder may exercise the warrants on a cashless basis. The warrant holders do not have the rights or privileges of holders of common stock and any voting rights until they exercise their warrants and receive shares of common stock, except as set forth in the warrants. After the issuance of shares of common stock upon exercise of the warrants, each holder will be entitled to one vote for each share held of record on all matters to be voted on by stockholders.

Subject to limited exceptions, a holder of warrants will not have the right to exercise any portion of its warrants if the holder (together with such holder's affiliates, and any persons acting as a group together with such holder or any of such holder's affiliates) would beneficially own a number of shares of common stock in excess of 4.99% of the shares of our common stock then outstanding after giving effect to such exercise (the "Beneficial Ownership Limitation"); provided, however, that, upon notice to the Company, the holder may increase or decrease the Beneficial Ownership Limitation, provided that in no event shall the Beneficial Ownership Limitation exceed 9.99% and any increase in the Beneficial Ownership Limitation will not be effective until 61 days following notice of such increase from the holder to us.

No fractional shares of common stock will be issued upon exercise of the warrants. If, upon exercise of the warrants, a holder would be entitled to receive a fractional interest in a share, Optex Systems Holdings Inc. will, upon exercise, round up to the nearest whole number of shares of common stock to be issued to the warrant holder. If multiple warrants are exercised by the holder at the same time, Optex Systems Holdings Inc. will aggregate the number of whole shares issuable upon exercise of all the warrants. There is no established trading market for the warrants. The warrants have been approved for quotation on the OTCQB.

In the event of a fundamental transaction (as defined in warrant), then the Company or any successor entity will pay at the holder's option, exercisable at any time concurrently with or within 30 days after the consummation of the fundamental transaction, an amount of cash equal to the value of the remaining unexercised portion of the warrants on the date of consummation of the fundamental transaction as determined in accordance with the Black Scholes option pricing model.

During the twelve months ending October 2, 2016, zero warrants had been exercised. As of October 2, 2016 the outstanding warrants were 4,125,200.

#### **Note 14 — Income Taxes**

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The income tax provisions as of October 2, 2016 and September 27, 2015 include the following:

|  | (Thousands) |       |
|--|-------------|-------|
|  | 2016        | 2015  |
| Current income tax expense:                    |             |       |
| Federal  | \$—         | \$—   |
| State  | —           | —     |
| Deferred income tax provision (benefit):       |             |       |
| Federal  | (65)        | (539) |
| State  | —           | —     |
| Change in valuation allowance                  | 65          | 539   |
| Provision for (Benefit from) income taxes, net | \$-0-       | \$-0- |

The income tax provision for Optex Systems as of October 2, 2016 differs from those computed using the statutory federal tax rate of 34%, due to the following permanent differences:

|   | 2016   | %    | 2015  | %     |
|---|--------|------|-------|-------|
| Tax provision (benefit) at statutory federal rate | \$(80) | 34   | \$167 | 34    |
| Nondeductible expenses                            | 15     | 25   | 11    | 2     |
| Gain on asset purchase (Applied Optics Center)    | —      | —    | (717) | (146) |
| Change in valuation and other                     | 65     | (59) | 539   | 110   |
| Provision for (Benefit from) income taxes, net    | \$-0-  | -0-  | \$-0- | -0-   |

Deferred income taxes recorded in the balance sheets results from differences between financial statement and tax reporting of income and deductions. A summary of the composition of the deferred income tax assets (liabilities) follows:

|  | (Thousands)                    |               |
|--|--------------------------------|---------------|
|  | Deferred Tax Asset — Long Term |               |
|  | As of                          | As of         |
|  | October 2,                     | September 27, |
|  | 2016                           | 2015          |
| Stock Options                            | \$ 308                         | \$ 242        |
| Inventory Reserve                        | 332                            | 312           |
| Unicap                                   | 41                             | 37            |
| Contract Loss Reserve                    | (279 )                         | (260 )        |
| Fixed assets                             | 89                             | 48            |
| Goodwill Amortization                    | 1,289                          | 1,451         |
| Intangible Asset Amortization            | 641                            | 732           |
| Net Operating Losses                     | 2,244                          | 2,058         |
| Other                                    | (14 )                          | (34 )         |
| Subtotal                                 | \$ 4,651                       | \$ 4,586      |
| Valuation allowance                      | (4,651 )                       | (4,586 )      |
| Net deferred asset (liability)-long term | \$ -0-                         | \$ -0-        |

As of October 2, 2016, the Company has a net operating loss carryforward of \$6,601 thousand as compared to net loss carryforwards of \$6,049 thousand available as of September 27, 2015.

As of September 27, 2015 management assessed the recoverability of deferred tax assets and determined due to recent and projected loss conditions and the downturn in the defense budget spending, that the balance of deferred tax assets may not be realized. The valuation allowance reserve was decreased by \$65 thousand during the twelve months ended October 2, 2016, consistent with the 2016 change in deferred tax assets. As of October 2, 2016 Optex Systems Inc. has a deferred tax asset valuation allowance of (\$4.7) million against a deferred tax asset of \$4.7 million.

As the result of the application of the FASB ASC 740-10, Optex Systems Holdings has no unrecognized tax benefits. By statute, the tax years ending in October 2, 2016, September 27, 2015 and September 28, 2014 are open to examination by the major taxing jurisdictions to which the Optex Systems Holdings is subject.

There were no income taxes paid during the fiscal years ended October 2, 2016 or September 27, 2015.

**Note 15 — Defined Contribution Plan**

The Company sponsors a defined contribution pension plan under Section 401(k) of the Internal Revenue Code for all employees. Company contributions are voluntary and are determined annually at the discretion of the Board of Directors at the beginning of each fiscal year. For the fiscal years ending October 2, 2016 and September 27, 2015, the company offered a qualified automatic contribution arrangement (QACA) with a 100% match of the first 1% and 50% matching of the next 5% and a 2 year vesting requirement. The Company's contribution expense for the fiscal years ended October 2, 2016 and September 27, 2015 were \$133 thousand and \$110 thousand, respectively.

## **Note 16 — Subsequent Events**

### ***Lease Renewal***

The premises for the business unit which we acquired from L-3 Communications, Inc., the Applied Optics Center, in November 2014 consists of approximately 56,633 square feet of space, of which approximately 12,000 square feet was subleased through September 30, 2016 to L-3 Communications Mobile Vision Inc. under a separate Memorandum of Understanding dated October 27, 2014, which was not renewed. On November 17, 2016, we received a countersigned new lease for the Applied Optics Center from the landlord for 44,867 square feet, dated October 21, 2016, which lease expires on October 31, 2021 (with a lease term which commenced retroactive to October 1, 2016).

The monthly base rent is \$19.4 thousand through September 30, 2017 and escalates approximately 3% October 1, each year thereafter through 2021. The monthly rent includes approximately \$4.9 thousand for additional Common Area Maintenance fees and taxes (CAM), to be adjusted annually based on actual expenses incurred by the landlord. The initial rent including CAM is \$24.3 thousand beginning November 1, 2016.

The lease includes a one month base rent abatement for October 1 through October 31, 2016 for \$19.4 thousand. There are two renewal terms which are each five years in duration. Our obligations to make payments under the lease are secured by a \$250,000 standby letter of credit which we can reduce to \$125,000 on October 31, 2019.

Our monthly base rent (including payment for operating expenses) under the new lease is \$24,340.35.

### ***Credit Facility — Avidbank***

In order to meet the security requirement under the lease, we entered into a letter of credit with Avidbank on October 17, 2016 in the amount of \$250,000, which expires on October 17, 2017 and is renewable by us for successive one year periods unless the bank notifies us no later than 60 days prior to the end of the initial or any extended term that it shall not renew the letter of credit.

In order to accommodate this letter of credit, Avidbank, on the same date, increased our line of credit to \$2.2 million from \$2.0 million.

### ***Equity Transactions – Related Party***

On October 31, 2016, Longview Fund, L.P. converted \$2.7 million of the Sileas note principal in exchange for 800,000 shares of Optex Systems Holdings common stock. The Sileas note balance to the Longview Fund, LP as of October 31, 2016 is \$15.1 million.

On October 31, 2016, Longview Fund L.P. authorized the return to Optex Systems Holdings' treasury of 197,299 common shares, held by Sileas Corporation in settlement of \$157 thousand of accounts receivable due for expenses paid by Optex Systems Inc. on behalf of the Sileas Corporation. The shares were subsequently cancelled in satisfaction of the outstanding accounts receivable balance as of October 31, 2016.

### **Executive Compensation**

On November 4, 2016 the Optex Systems Holdings Board of Directors approved executive bonus payments of \$35.7 thousand to Karen Hawkins, CFO and \$48.9 thousand to Danny Schoening CEO pursuant to their respective employment agreements. The \$84.6 thousand of bonuses were paid on December 9, 2016.

**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

As of October 2, 2016, management performed, with the participation of our Principal Executive Officer and Principal Financial Officer, an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act. Our disclosure controls and procedures are designed to ensure that information required to be disclosed in the report we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's forms, and that such information is accumulated and communicated to our management including our Principal Executive Officer and our Principal Financial Officer, to allow timely decisions regarding required disclosures. Based on the evaluation, our Principal Executive Officer and our Principal Financial Officer concluded that, as of October 2, 2016, our disclosure controls and procedures were effective.

*Management's Report on Internal Control Over Financial Reporting*

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with GAAP. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projection of any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management has conducted, with the participation of our Principal Executive Officer and our Principal Financial Officer, an assessment, including testing of the effectiveness, of our internal control over financial reporting as of October 2, 2016. Management's assessment of internal control over financial reporting was conducted using the criteria in *Internal Control over Financial Reporting - Guidance for Smaller Public Companies* issued by the Committee of Sponsoring Organizations of the Treadway Commission.



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 our annual or interim financial statements will not be prevented or detected on a timely basis. In connection with our management's assessment of our internal control over financial reporting as required under Section 404 of the Sarbanes-Oxley Act of 2002, we have not identified any material weaknesses in our internal control over financial reporting as of October 2, 2016. We have thus concluded that our internal control over financial reporting was effective as of October 2, 2016.

## **PART III**

### **Item 10 Directors, Executive Officers and Corporate Governance**

Our board of directors directs the management of the business and affairs of our company as provided in our certificate of incorporation, our by-laws and the General Corporation Law of Delaware. Members of our board of directors keep informed about our business through discussions with senior management, by reviewing analyses and reports sent to them, and by participating in board and committee meetings.

Our company is led by Danny Schoening, who has served as COO since 2009 and was appointed CEO in 2013, and Peter Benz who was appointed as a Director by its Board of Directors and was also elected as Chairman of the Board of Directors on November 19, 2014.

As of October 27, 2016, our board of directors consists of five directors which includes three independent directors and two non independent directors as discussed below.

Our board leadership structure is used by other smaller public companies in the United States, and we believe that this leadership structure is effective for us. We believe that having a separate Chief Executive Officer (principal executive officer) and Chairman is the correct form of leadership for us. We believe that due to our small size bifurcating the leadership role provides for a second point of view and oversight rather than consolidating the role in one individual, who is also tasked with our day to day affairs. We believe that our directors provide effective oversight of the risk management function, especially through dialogue between the full board and our management. Our directors serve for a one year term and if there is no election until their successors are elected and duly qualify. We intend to have our majority holders re-elect the Board in fiscal 2016 as a formality.

We do not currently consider diversity in identifying nominees for director. Due to our small size, the priority has been in attracting qualified directors, and issues such as diversity have not yet been considered.

On August 4, 2016, our Board of Directors approved election of our current board of directors to serve another one year term (or until the 2017 Annual Meeting, whichever is later) and if there is no reelection by that time, to serve until their successors are elected and duly qualify. On August 17, 2016, our majority shareholder, Sileas Corporation, elected our current Board of Directors to serve another one year term (or until the 2017 Annual Meeting, whichever is later) and if there is no reelection by that time, to serve until their successors are elected and duly qualify. We filed a Definitive Schedule 14C with the SEC on August 26, 2016 and mailed such Definitive Schedule 14C to our shareholders promptly thereafter.

## **Directors and Executive Officers**

The following table sets forth information regarding the members of our board of directors and our executive officers and other significant employees. All of our current officers and directors were appointed on March 30, 2009, the closing date of the reorganization, except as otherwise noted.

The following table sets forth certain information with respect to our directors and executive officers:

| <b>Name</b>                  | <b>Age</b> | <b>Position</b>                    |
|------------------------------|------------|------------------------------------|
| Peter T. Benz <sup>(2)</sup> | 56         | Chairman of the Board and Director |

|                                  |    |   |
|----------------------------------|----|---|
| Stanley Hirschman <sup>(4)</sup> | 69 | President (resigned)  |
| David Kittay <sup>(3)</sup>      | 52 | Director  |
| Owen Naccarato <sup>(3)</sup>    | 67 | Director  |
| Charles Trego <sup>(3)</sup>     | 66 | Director  |
| Danny Schoening                  | 52 | Chief Executive Officer, Chief Operating Officer and Director |
| Karen L. Hawkins <sup>(1)</sup>  | 51 | Chief Financial Officer                                       |

(1) *Effective November 19, 2014, Karen Hawkins, formerly our Vice President of Finance and Controller, was appointed as our Chief Financial Officer.*

(2) *Also effective November 19, 2014, Peter Benz was appointed as a Director by our Board of Directors and was also elected as our Chairman of the Board of Directors.*

(3) *Elected as a director effective as of May 27, 2015 and is an independent director as such term is defined under NASDAQ Listing Rule 5605(b)(2) and Exchange Act Rule 10A-3.*

(4) *Effective November 4, 2015, Stanley Hirschman resigned as one of our directors.*

**Peter T. Benz.** On November 19, 2014, Peter Benz was appointed as one of our Directors and was also elected as our Chairman of the Board of Directors. Mr. Benz serves as Chairman and Chief Executive Officer of Viking Asset Management, LLC and is a member of the Investment Committee. His responsibilities include assuring a steady flow of candidate deals, making asset allocation and risk management decisions and overseeing all business and investment operations. He has more than 25 years of experience specializing in investment banking and corporate advisory services for small growth companies in the areas of financing, merger/acquisition, funding strategy and general corporate development. Prior to founding Viking in 2001, Mr. Benz founded Bi Coastal Consulting Company where he advised hundreds of companies regarding private placements, initial public offerings, secondary public offerings and acquisitions. Mr. Benz currently serves as a director for usell.com, Inc, Starboard Resources, Embark Holdings and IDI, Inc. Prior to founding Bi Coastal Consulting, Mr. Benz was responsible for private placements and investment banking activities at Gilford Securities in New York, NY. Mr. Benz is a graduate of Notre Dame University. The Board of Directors has determined that Mr. Benz is suited to be a director because of his capital markets experience.

**David Kittay**, is an experienced investment banker and asset manager. Mr. Kittay is Senior Vice President of North View Investment Banking Group responsible for facilitating the investment banking activities of the firm including relationship cultivation, mergers and acquisitions, capital formation, financial structuring and solutions. In October 2008 he co-founded Summerline Asset Management, a specialty investment firm, with which he has been involved on a continuous basis since 2008, which works with non-investment grade public and private companies requiring financing ranging from \$5 to \$100 million. Mr. Kittay holds a Bachelors of Arts from Ithaca College, Ithaca, New York and is a graduate of New York Law School holding his Juris Doctorate degree.

Our board of directors has determined that Mr. Kittay is suited to sit on our Board because of his long term experience with the capital markets.

**Owen Naccarato, Esq., CPA and MBA**, has for the last sixteen years been a practicing attorney, with his own firm, specializing in corporate and securities law. Mr. Naccarato specializes in SEC matters. Prior to practicing law, Mr. Naccarato has over twenty years of experience holding various high level financial and accounting positions with Fortune 500 and smaller firms in the manufacturing, leasing, consumer/commercial financing and real estate industries. Mr. Naccarato is a member of the ABA, the California State Bar, the Los Angeles County Bar and the Orange County Bar. Mr. Naccarato also earned a BS in Accounting from Northern Illinois University, an MBA from DePaul University and was a certified public accountant, having articulated in the State of Illinois. Our board of directors has determined that Mr. Naccarato is suited to sit on our Board because of his long standing capital markets experience.

**Charles R. Trego**, is currently a director (and former chief financial officer) of Axion Power International, Inc., a battery technology company based in New Castle, PA, and has served in various positions with Axion since 2010. He most recently served as Executive Vice President and Chief Financial Officer of Minrad International, an Amex-listed pharmaceutical and medical device company in Orchard Park, NY. Minrad was acquired by India's Piramal Healthcare in early 2009, and Trego was an integral part of the acquisition strategy and managed the bridge financing through the transition. He served as a consultant providing financial management services to several companies from April 2009 to February 2010. Prior to that, from 2005 to 2008, he was Senior Vice President and Chief Financial Officer of Elmira NY-based Hardinge Inc, a Nasdaq-listed global machine tool company (\$327 million in annual revenue), and from 2003 to 2005 he was Chief Financial Officer and Treasurer of Latham NY-based Latham International (\$180 million in annual revenue), a privately held manufacturer and marketer of swimming pool components, His career began with a position as Senior Auditor with Ernst & Whinney in Dayton, and continued with financial officer positions with increasing responsibility with Ponderosa Inc., Bojangles of America, Rich Sea Pak, Rymer Foods and Rich Products Corporation. During his 14-year tenure as Chief Financial Officer at Rich Products, revenue increased from \$650 million to more than \$1.8 billion. He has over 30 years of experience as a financial officer of global middle businesses across several industries and includes private (family), public and private equity ownership structures. He has served as the chief financial officer of startup, turnaround, restructuring and growth businesses with revenue ranging from \$25 million to \$2 billion. Trego graduated from the University of Dayton in 1972 (BS in Accounting) and in 1978 (MBA). He achieved his CPA designation in 1973 from the State of Ohio. The Company has determined that Mr. Trego should serve as a director due to his long term finance and accounting experience.



**Danny Schoening.** Mr. Schoening joined Optex Systems, Inc. (Texas) in January 2008. Upon the acquisition of the assets of Optex Systems, Inc. (Texas) by Optex Systems, Inc. (Delaware), Mr. Schoening became the COO of Optex Systems, Inc. (Delaware) (as of September 28, 2008) and he commenced service with Optex Systems Holdings as its Chief Operating Officer as of the date of the reorganization, March 30, 2009 and was appointed Chief Executive Officer and as a Director in 2013. He has been instrumental in establishing the systems and infrastructure required to continue Optex System's rapid growth. This activity was rewarded with Optex System's recent ISO 9001:2000 Certification. From February 2004 to January 2008, Danny was the Vice President of Operations for The Finisar Corporation AOC Division for 4 years where he led a team of up to 200 employees to produce vertical cavity lasers for the data communications industry at production rates of hundreds of thousands of units per week. Prior to Finisar, Danny was the Director of Operations for multiple divisions of Honeywell International. Serving the Automotive, Medical, Aerospace, and Consumer Commercial Markets. During this 17-year period, Danny was recognized with Honeywell's Lund Award, their highest award for developing employee resources. Danny has a broad experience level in the following technologies: Mechanical Assembly Processes, Micro-Electronic Assembly Processes, Laser Manufacturing, Plastic Molding, Metal Machining, Plating, Thick Film Printing, Surface Mount Technology, Hall Effect Technology and MEMS based Pressure Devices. Danny received a Bachelor's of Science in Manufacturing Engineering Technology from the University of Nebraska, an MBA from Southern Methodist University, and holds three U.S. patents. The Board of Directors has determined that Mr. Schoening is suited to sit on our Board because of his industry experience and as he is the CEO.

**Karen L. Hawkins.** On November 19, 2014, Karen Hawkins was appointed as our Chief Financial Officer. Ms. Hawkins had previously served as our Vice President, Finance and Controller, since the date of the reorganization, March 30, 2009 and was the controller of Optex Systems, Inc. (Delaware), effective September 28, 2009. She began her employment with Optex Systems, Inc. (Texas) in April 2007. Ms. Hawkins has over 25 years' experience in Financial Accounting and Management, primarily focused in the Defense and Transportation Industries. She has a strong background in both Financial & Cost Accounting, with extensive Government Pricing, Financial Analysis, and Internal Auditing experience. Her past history also includes Program Management, Materials Management and Business Development. She brings over 18 years' direct experience in Government Contracting with a strong knowledge of Cost Accounting Standards Board and Federal Acquisition Regulation. Her previous employment includes General Dynamics — Ordinance and Tactical Division, Garland (formerly known as Intercontinental Manufacturing) for over 13 years from November, 1994 through March, 2007. During her tenure there she served in the roles of Controller (Accounting & IT), Program Manager over a \$250M 3-year Army Indefinite Delivery/Indefinite Quantity (Indefinite Delivery/Indefinite Quantity) type contract, as well as Materials Manager with oversight of Purchasing, Production Control & Warehousing functions. Prior to her employment at General Dynamics, Ms. Hawkins served in various finance and accounting positions at Luminator, a Mark IV Industries Co, and Johnson Controls, Battery Division - Garland. Karen received her Bachelor's Degree in Business Administration in Accounting from Stephen F. Austin State University in Texas in 1986 and became a Certified Public Accountant in 1992.

**Stanley A. Hirschman.** (Resigned as a director effective November 4, 2015) Mr. Hirschman served as a Director and President of Optex Systems, Inc. (Delaware) since September 28, 2008 and assumed the same roles on behalf of us on March 30, 2009, in which roles he is committed to providing Optex his management experience and provides direction and oversight of other executive officers and management. From 1997 to 2009, he was president of CPointe Associates, Inc., a Plano, Texas consulting group, and provided consulting and governance services to small public

companies. Since February 2009 he has been the majority beneficial owner of Sileas Corp, our majority shareholder. During the past five years, Mr. Hirschman has also sat on the Board of Directors of Axion Power International, Inc. Prior to establishing CPointe Associates, he was Vice President Operations, Software Etc., Inc., a 396 retail software store chain, from 1989 until 1996. He has also held executive positions with T.J. Maxx, Gap Stores and Banana Republic. Mr. Hirschman is a member of the National Association of Corporate Directors, regularly participates in the KMPG Audit Committee Institute and is a graduate of the Harvard Business School Audit Committees in the New Era of Governance symposium. He is active in community affairs and serves on the Advisory Board of the Salvation Army Adult Rehabilitation Centers. Our Board has determined that Mr. Hirschman is suitable for our Board due to his long term management and corporate governance experience.

### **Family Relationships**

There are no family relationships among the officers and directors.

### **Presiding Director**

Our Chairman, Merrick Okamoto, as Chairman, acted as the presiding director at meetings of our board of directors during the fiscal years ended 2014 and 2013. Effective as of November 19, 2014, Peter Benz took over as the Chairman and presiding director of the board meetings. In the event that the Chairman is unavailable to serve at a particular meeting, responsibility for the presiding director function will rotate among the directors in attendance.

### **Corporate Governance**

Our board of directors believes that sound governance practices and policies provide an important framework to assist them in fulfilling their duty to stockholders. Our board of directors actively supports management's adoption and implementation of many "best practices" in the area of corporate governance, including annual review of internal control changes, compensation practices, executive management and auditor retention. In 2015 and 2014, all directors attended a minimum of 75% of the meetings of the board of directors.

### **Code of Ethics**

Our board of directors has adopted a Code of Ethics which has been distributed to all directors, and executive officers, and will be distributed to employees and will be given to new employees at the time of hire. The Financial Code of Ethics contains a number of provisions that apply principally to our Principal Executive Officer, Principal Financial Officer and other key accounting and financial personnel. A copy of our Code of Business Conduct and Ethics can be found under the "Investor Relations" section of our website ([www.optexsys.com](http://www.optexsys.com)) under the section for corporate governance. We also intend to disclose any amendments or waivers of our Code on our website.

### **Board Meetings**

We are incorporated under the laws of the State of Delaware. The interests of our stockholders are represented by the board of directors, which oversees our business and management.

The board of directors meets regularly during the year and holds special meetings and acts by unanimous written consent whenever circumstances require. The board held two meetings (including special meetings) and took action



by unanimous written consent three times during our fiscal year ended October 2, 2016.

## **Board Committees**

On July 14, 2015, our board of directors confirmed the appointment of the following independent directors to serve on the following committees of our board of directors:

Audit Committee: Charles Trego (Chair) and David Kittay

Compensation Committee: Owen Naccarato (Chair) and David Kittay

Nominating Committee: David Kittay (Chair), Owen Naccarato and Charles Trego.

Kerry Craven, who was a member of the Board of Directors and a member of the Audit Committee, Compensation Committee and Nominating Committee, resigned from the Board of Directors on May 26, 2016.

The board also acknowledged the charters for each committee which are approved.

Mr. Trego has also been determined to be the Audit Committee financial expert, a position for which he qualifies as a long time chief financial officer of public reporting companies. Due to Ms. Craven's resignation on May 26, 2016, the Committees remain the same although each has one less member.

## **Board nominations**

Stockholders wishing to bring a nomination for a director candidate before a stockholders meeting must give written notice to our Corporate Secretary, either by personal delivery or by United States mail, postage prepaid. The stockholder's notice must be received by the Corporate Secretary not later than (a) with respect to an Annual Meeting of Stockholders, 90 days prior to the anniversary date of the immediately preceding annual meeting, and (b) with respect to a special meeting of stockholders for the election of directors, the close of business on the tenth day following the date on which notice of the meeting is first given to stockholders. The stockholder's notice must set forth all information relating to each person whom the stockholder proposes to nominate that is required to be disclosed under applicable rules and regulations of the SEC, including the written consent of the person proposed to be nominated to being named in the proxy statement as a nominee and to serving as a director if elected. The stockholder's notice must also set forth as to the stockholder making the nomination (i) the name and address of the stockholder, (ii) the number of shares held by the stockholder, (iii) a representation that the stockholder is a holder of record of stock of the Optex Systems Holdings, entitled to vote at the meeting and intends to appear in person or by proxy at the meeting to nominate the person named in the notice, and (iv) a description of all arrangements or understandings between the stockholder and each nominee.

## **Stockholder Communications with the Board of Directors**

Stockholders may communicate directly with the board of directors or any board member by writing to them at Optex Systems Holdings, Inc., 1420 Presidential Drive, Richardson, TX 75081. The outside of the envelope should prominently indicate that the correspondence is intended for the board of directors or for a specific director. The secretary will forward all such written communications to the director to whom it is addressed or, if no director is specified, to the entire board of directors.

## **Director Attendance at Annual Meetings of Stockholders**

Directors are encouraged to attend annual meetings, although such attendance is not required.

## **Board Independence**

Our board of directors has determined that four of our directors would meet the independence requirements of the Nasdaq Capital Market, if such standards applied to the Company. In reaching its conclusions, the board of directors

considered all relevant facts and circumstances with respect to any direct or indirect relationships between the Company and each of the directors, including those discussed under the caption “Certain Relationships and Related Transactions” below. Our board of directors determined that any relationships that exist or existed in the past between the Company and each of the independent directors were immaterial on the basis of the information set forth in the above-referenced sections.

### **Director Compensation**

See table below under “Executive Compensation — Director Compensation.”

### **Item 11 Executive Compensation**

The board of directors administers our option compensation plan. Our Principal Executive Officer and other members of management regularly discuss our compensation issues with the Board of Directors. Subject to Board review, modification and approval, Mr. Hirschman typically makes recommendations respecting bonuses and equity incentive awards for the other members of the executive management team. The Board establishes all bonus and equity incentive awards for Mr. Hirschman in consultation with other members of the management team.

## Summary Compensation Table

The following table sets forth, for the years indicated, all compensation paid, distributed or accrued for services, including salary and bonus amounts, rendered in all capacities by our principal executive officer, principal financial officer and all other executive officers who received or are entitled to receive remuneration in excess of \$100,000 during the stated periods. These officers are referred to herein as the “named executive officers.” Except as provided below, none of our executive officers received annual compensation in excess of \$100,000 during the last two fiscal years.

| Name and Principal Position        | Year | Salary<br>(\$) | Bonus<br>(\$) | Stock<br>Awards<br>(\$) <sup>(2)</sup> | Option<br>Awards<br>(\$) <sup>(1)</sup> | All Other<br>Compensation<br>(\$) | Total<br>(\$) |
|------------------------------------|------|----------------|---------------|--|---|-----------------------------------|---------------|
| Stanley A. Hirschman,<br>President | 2016 | \$33,231       | \$—           | \$—                                    | \$ 11,729                               | \$ —                              | \$44,960      |
|                                    | 2015 | 61,084         | —             | —                                      | 14,971                                  | —                                 | 76,055        |
|                                    | 2014 | 61,033         | —             | —                                      | 15,766                                  | —                                 | 76,799        |
| Danny Schoening,<br>CEO            | 2016 | \$254,066      | \$14,872      | \$ 69,750                              | \$ 23,457                               | \$ —                              | \$362,145     |
|                                    | 2015 | 213,754        | —             | —                                      | 29,941                                  | —                                 | 243,695       |
|                                    | 2014 | 225,261        | 42,375        | —                                      | 31,531                                  | —                                 | 299,167       |
| Karen Hawkins<br>CFO               | 2016 | \$182,755      | \$7,500       | \$ 23,250                              | \$ 11,729                               | \$ —                              | \$225,234     |
|                                    | 2015 | 162,571        | —             | —                                      | 14,971                                  | —                                 | 177,542       |
|                                    | 2014 | 160,422        | 11,931        | —                                      | 15,766                                  | —                                 | 188,119       |

The amounts in the “Option awards” column reflect the dollar amounts recognized as the executive portion of compensation expense for financial statement reporting purposes for each named executive officer during fiscal (1)2014 through fiscal 2016, as required by FASB ASC 718, disregarding any estimates for forfeitures relating to service-based vesting conditions. For the assumptions relating to these valuations, see note 10 to our fiscal 2014 audited financial statements.

On June 15, 2016, the Company issued 150,000 RSUs to its Chief Executive Officer, Danny Schoening, and 50,000 RSUs to its Chief Financial Officer, Karen Hawkins. The RSUs issued to Mr. Schoening and Ms. Hawkins vest as follows: 34% on January 1, 2017, 33% on January 1, 2018 and 33% on January 1, 2019. The total market value of the restricted stock units based on the shares price of \$1.86 as of June 15, 2016 is \$372 thousand. The (2)cost of the shares is amortized on a straight line basis across the vesting periods. The amounts in the “Stock awards” column reflect the dollar amounts recognized as the executive portion of compensation expense for financial statement reporting purposes for each named executive officer during the fiscal years, as required by FASB ASC 718 (prior authoritative literature SFAS 123(R), disregarding any estimates for forfeitures relating to service-based vesting conditions.

## Option Grants in Last Fiscal Year

On December 19, 2013, our Board of Directors authorized an amendment to our Stock Option Plan to increase the number of issuable shares from 50,000 to 75,000 and authorized the grant of 20,000 options to three board members and a grant of 5,000 to an officer. The options are exercise prices of \$10 per share with each grant to vest 25% per year over four years for each year with which the grantee is still employed by or serving as a director of us, Inc. (with all unvested options automatically expiring on the date of termination of employment by or service as a director of us, Inc.) and all unvested options immediately vesting upon a change of control due to a merger or acquisition of us. There were no other plan based awards made to our named executive officers during the fiscal year ended October 2, 2016 or for the fiscal year ended September 27, 2015.

### **Employment Agreements - Danny Schoening**

We entered into an employment agreement with Danny Schoening dated December 1, 2008. The term of the agreement commenced as of December 1, 2008 and the current term has automatically renewed through December 1, 2016. The term of the agreement shall be automatically extended for successive 18 month periods, unless we shall provide a written notice of termination at least ninety (90) days, or Mr. Schoening shall provide a written notice of termination at least 90 days, prior to the end of the initial term or any extended term, as applicable. During the first eighteen months of the term of the agreement, we paid to Schoening a base salary at the annual rate of \$190,000, and his base salary for the first renewal term has continued at the same rate. On December 9, 2011, the Board of Directors authorized a six percent increase in Schoening's base salary effective January 1, 2012. On December 19, 2013, the Board of Directors of us authorized a five percent increase in Schoening's base salary effective January 1, 2014. Schoening was paid a one-time bonus of \$10,000 at the commencement of the employment agreement in December 2008 and was granted 1,415 options to purchase common stock at an exercise price of \$150 per share at the time of the closing of the reorganization.

On each subsequent renewal date of the commencement of employment, Schoening's base salary shall be reviewed by the Board and may be increased to such rate as the Board, in its sole discretion, may hereafter from time to time determine. During the term of the agreement, Schoening shall be entitled to receive bonuses of up to 30% of his base salary per year at the discretion of our Board of Directors pursuant to performance objectives to be determined by the Board of Directors. Any bonuses shall be payable in cash and shall be paid within ninety (90) days of any year anniversary of the date of the agreement. Upon closing of the reorganization, we granted Schoening stock options equal to 1% of the issued and outstanding shares immediately after giving effect to the reorganization, with 34% of the options having vested on March 30, 2010, and 33% of the options having vested on March 31, 2011 and 33% of the options having vested on March 31, 2012.

The employment agreement events of termination consist of: (i) death of Mr. Schoening; (ii) termination by us for cause (including conviction of a felony, commission of fraudulent acts, willful misconduct by Mr. Schoening, continued failure to perform duties after written notice, violation of securities laws and breach of the employment agreement), (iii) termination without cause by us and (iv) termination by Mr. Schoening for good reason (including breach by us of its obligations under the agreement, the requirement for Mr. Schoening to move more than 100 miles away for his employment without consent, and merger or consolidation that results in more than 66% of the combined voting power of the then outstanding securities of us or our successor changing ownership or a sale of all or substantially all of our assets, without the surviving entity assuming the obligations under the agreement). For a termination by us for cause or upon death of Mr. Schoening, Mr. Schoening shall be paid salary and bonus earned through the date of termination. For a termination by us without cause or by Mr. Schoening with good reason, Mr. Schoening shall also be paid six months' base salary in effect and all granted stock options shall remain exercisable for a period of two years after such termination, with all unvested stock options immediately vesting. The agreement contains a standard non-solicitation and non-compete agreement that extends for one year subsequent to termination thereof.

On December 19, 2013, pursuant to the compensation bonus agreement in the Board of Directors Resolution dated January 3, 2013, Danny Schoening, CEO, was awarded an executive compensation incentive bonus payout in the sum of \$42 thousand.

On December 19, 2013, our Board of Directors approved a performance based compensation bonus agreement for Danny Schoening, CEO, for the fiscal year ending September 28, 2013 with payout milestones from 5% to 25% for achieved revenues of \$13 million through \$20 million and EBITDA targets of \$0 to \$800 thousand.

On December 19, 2013 the Board of Directors authorized salary increase of 5% to Danny Schoening, CEO, effective January 1, 2014.

**Karen Hawkins**

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On August 4, 2016, our Board of Directors approved an employment agreement for Karen Hawkins, Chief Financial Officer, dated as of August 1, 2016. This agreement has the following salient terms:

The term of the agreement commenced on August 1, 2016 and expires on January 31, 2018 and automatically renews for subsequent 18 month periods unless Ms. Hawkins or we give notice of termination at least 90 days before the end of the term then in effect.

The base salary thereunder is \$178,496, and Ms. Hawkins is entitled to annual bonuses of up to 30% of her base salary as approved by the Board.

Ms. Hawkins is entitled to 15 days' vacation and all other benefits accorded to our other senior executives.

The employment agreement events of termination consist of: (i) death of Ms. Hawkins; (ii) termination by us for cause (including conviction of a felony, commission of fraudulent acts, willful misconduct by Ms. Hawkins, continued failure to perform duties after written notice, violation of securities laws and breach of the employment agreement), (iii) termination without cause by us and (iv) termination by Ms. Hawkins for good reason (including breach by us of its obligations under the agreement, the requirement for Ms. Hawkins to move more than 100 miles away for her employment without consent, and merger or consolidation that results in more than 66% of the combined voting power of the then outstanding securities of us or our successor changing ownership or a sale of all or substantially all of our assets, without the surviving entity assuming the obligations under the agreement). For a termination by us for cause or upon death of Ms. Hawkins, Ms. Hawkins shall be paid salary and bonus earned through the date of termination. For a termination by us without cause or by Ms. Hawkins with good reason, Ms. Hawkins shall also be paid six months' base salary in effect and all granted stock options shall remain exercisable for a period of two years after such termination, with all unvested stock options immediately vesting. The agreement contains a standard non-solicitation and non-compete agreement that extends for one year subsequent to termination thereof.

We do not have any other employment agreements with our executive officers and directors.

### Equity Compensation Plan Information

We currently have an option compensation plan covering the issuance of both incentive and nonstatutory options, determined at the time of grant, for the purchase of up to 75,000 shares, which was increased from 50,000 shares on December 19, 2013. The purpose of the Plan is to assist us in attracting and retaining highly competent employees and to act as an incentive in motivating selected officers and other employees of us and our subsidiaries, and directors and consultants of us and our subsidiaries, to achieve long-term corporate objectives. On December 19, 2013, the Board of Directors authorized the grant of 20,000 options to three board members and a grant of 5,000 to an officer. There are 75,000 shares of common stock reserved for issuance under this Plan. As of October 2, 2016, we had issued 73,752 share options under this Plan of which 8,412 shares had forfeited and 57,840 shares had vested, and 5,000 shares had been exercised as of October 2, 2016.

The outstanding options include 52,840 options that are currently vested and exercisable as of October 2, 2016, and 3,750 options vested on December 18, 2016 and 300 options forfeited on December 5, 2016. The vested options represent potential future cash proceeds to our company of \$562,900. There are no additional options that will become vested and exercisable within 60 days. The remaining 3,750 options will vest and become exercisable on December 18, 2017. The following table provides summary information on our outstanding options as of December 18, 2016.

|  | Vested Option Grants |       |          | Unvested Option Grants |       |          |
|--|----------------------|-------|----------|------------------------|-------|----------|
|  | Shares               | Price | Proceeds | Shares                 | Price | Proceeds |
| FY2012 Employee & officer plan options | 10,040               | 10.00 | 100,400  | —                      | 10.00 | \$—      |



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|   |        |         |           |       |         |          |
|---|--------|---------|-----------|-------|---------|----------|
| FY2012 Directors plan options                 | 25,000 | 10.00   | 250,000   | —     | 10.00   | —        |
| FY2014 Directors plan options                 | 17,500 | 10.00   | 175,000   | 2,500 | 10.00   | 25,000   |
| FY2014 Employee & officer plan options        | 3,750  | 10.00   | 37,500    | 1,250 | 10.00   | 12,500   |
| Non-plan options to consultants and employees | —      | —       | —         | —     | —       | —        |
| Total   | 56,290 | \$16.29 | \$562,900 | 3,750 | \$10.00 | \$37,500 |

The holders of options are not required to exercise their rights at any time and we are unable to predict the amount and timing of any future option exercises. We reserve the right to temporarily reduce the exercise prices of our options from time to time in order to encourage the early exercise of the options.

**Outstanding Director and Officer Equity Awards as of December 18, 2016**

| Name            | Option Awards<br>Number of shares underlying unexercised options |                         | Equity Incentive Plan Awards |                   | Expiration Date | Footnotes |
|-----------------|--|-------------------------|------------------------------|-------------------|-----------------|-----------|
|                 | Non-Plan<br>Number<br>Exercisable                                | Number<br>Unexercisable | Total<br>Granted             | Exercise<br>Price |                 |           |
| Danny Schoening | 10,000   | —                       | 10,000                       | 10.00             | 12/8/2018       | (1 )      |
|                 | 7,500  | 2,500                   | 10,000                       | 10.00             | 12/18/2020      | (2 )      |
| Karen Hawkins   | 5,000  | —                       | 5,000                        | 10.00             | 12/8/2018       | (1 )      |
|                 | 3,750  | 1,250                   | 5,000                        | 10.00             | 12/18/2020      | (2 )      |
| Stan Hirschman  | 5,000  | —                       | 5,000                        | 10.00             | 12/8/2018       | (1 )      |
|                 | 5,000  | —                       | 5,000                        | 10.00             | 12/18/2020      | (2 )(3)   |
| Merrick Okamoto | 5,000  | —                       | 5,000                        | 10.00             | 12/8/2018       | (1 )      |
|                 | 5,000  | —                       | 5,000                        | 10.00             | 12/18/2020      | (2 )(3)   |

*Options granted on December 9, 2011 pursuant to employee stock option compensation plan. Shares vest over 4 (1) years at a rate of 25% per year each respective anniversary date subsequent to 2011 and expire after seven years. As of December 9, 2015 100% of the options had vested and become exercisable.*

*Options granted on December 19, 2013 pursuant to employee stock option compensation plan. Shares vest over 4 (2) years at a rate of 25% per year each respective anniversary date subsequent to 2013 and expire after seven years. As of October 2, 2016 50% of the options had vested and an additional 25%, 3,750 of the total granted options vested and become exercisable on December 18, 2016.*

*Merrick Okamoto resigned as an officer on November 19, 2014, upon resignation, the board approved vesting of (3) 100% of his outstanding unvested options. Stan Hirschman resigned as a director effective on November 4, 2015, On December 8, 2015, the board of directors approved vesting of 100% of his outstanding unvested options effective on his resignation.*

**Restricted Stock Units issued to Officers and Employees**

On June 14, 2016, the Compensation Committee (“Committee”) of the Board of Directors of Optex Systems Holdings, Inc. approved the Company’s 2016 Restricted Stock Unit Plan (the “Plan”). The Plan provides for the issuance of stock units (“RSU”) for up to 1,000,000 shares of the Company’s common stock to Optex Systems Holdings officers and employees. Each RSU constitutes a right to receive one share of the Company’s common stock, subject to vesting, which unless otherwise stated in an RSU agreement, shall vest in equal amounts on the first, second and third anniversary of the grant date. Shares of the Company’s common stock underlying the number of vested RSUs will be delivered as soon as practicable after vesting. During the period between grant and vesting, the RSUs may not be transferred, and the grantee has no rights as a shareholder until vesting has occurred. If the grantee’s employment is

terminated for any reason (other than following a change in control of the Company or a termination of an officer other than for cause), then any unvested RSUs under the award will automatically terminate and be forfeited. If an officer grantee's employment is terminated by the Company without cause or by the grantee for good reason, then, provided that the RSUs have not been previously forfeited, the remaining unvested portion of the RSUs will immediately vest as of the officer grantee's termination date. In the event of a change in control, the Company's obligations regarding outstanding RSUs shall, on such terms as may be approved by the Committee prior to such event, immediately vest, be assumed by the surviving or continuing company or cancelled in exchange for property (including cash).

On June 15, 2016, the Company issued 150,000 RSUs to its Chief Executive Officer, Danny Schoening, and 50,000 RSUs to its Chief Financial Officer, Karen Hawkins. The RSUs issued to Mr. Schoening and Ms. Hawkins vest as follows: 34% on January 1, 2017, 33% on January 1, 2018 and 33% on January 1, 2019. The total market value of the restricted stock units based on the shares price of \$1.85 as of June 15, 2016 is \$372 thousand. The cost of the shares is amortized on a straight line basis across the vesting periods.

As of October 2, 2016, none of the 200,000 restricted stock units had vested. During the twelve months ending October 2, 2016, \$93 thousand has been recognized as stock compensation expense, and \$279 thousand represents unamortized stock compensation expense to be recognized through December 2018.

### Consulting and Vendor Equity Compensation

On April 29, 2016, Optex Systems Holdings, Inc. issued 40,000 common “restricted” shares at a market price of \$2.35 per share (\$94,000) in support of the IRTH Communications agreement (See note 6). The cost of the shares is amortized on a straight line basis through April 2017. There were no other equity instruments issued to consultants and vendors during the twelve months ended October 2, 2016. During the twelve months ending October 2, 2016, \$47 thousand has been expensed to stock compensation, and \$47 thousand represents unamortized stock option compensation.

### Nonqualified deferred compensation

We had no non-qualified deferred compensation plans during year ended October 2, 2016.

### Post-Termination Compensation

We have not entered into change in control agreements with any of our named executive officers or other members of the executive management team other than the provision with respect to Mr. Schoening and Ms. Hawkins described above. No awards of equity incentives under our 2009 Stock Option Plan provide for immediate vesting upon a change in control. However, our Board of Directors has the full and exclusive power to interpret the plans, including the power to accelerate the vesting of outstanding, unvested awards. A “change in control” is generally defined as (1) the acquisition by any person of 66% or more of the combined voting power of our outstanding securities or (2) the occurrence of a transaction requiring stockholder approval and involving the sale of all or substantially all of our assets or the merger of us with or into another corporation.

### Director Compensation

The following table provides information regarding compensation paid to directors for services rendered during the year ended October 2, 2016.

| Name | Fees<br>Earned or<br>Paid in<br>Cash | Stock<br>Awards<br>(\$) | <b>Option<br/>Awards<br/>(\$)<sup>(1)</sup></b> | Non-Equity<br>Incentive Plan<br>Compensation<br>(\$) | Nonqualified<br>Deferred<br>Compensation<br>Earnings | All Other<br>Compensation<br>(\$) | Total<br>(\$) |
|------|--------------------------------------|-------------------------|---|--|--|-----------------------------------|---------------|
|------|--------------------------------------|-------------------------|---|--|--|-----------------------------------|---------------|

|                                     | (\$)    |   | (\$) |   |   |         |
|-------------------------------------|---------|---|------|---|---|---------|
| Danny Schoening <sup>(3)</sup>      | —       | — | —    | — | — | —       |
| Peter Benz <sup>(3)</sup>           | 100,000 | — | —    | — | — | 100,000 |
| Chuck Trego <sup>(2)</sup>          | 15,000  | — | —    | — | — | 15,000  |
| David Kittay <sup>(2)</sup>         | 15,500  | — | —    | — | — | 15,500  |
| Owen Naccarato <sup>(2)</sup>       | 13,000  | — | —    | — | — | 13,000  |
| Kerry Craven <sup>(2)</sup>         | 10,500  | — | —    | — | — | 10,500  |
| Stanley A. Hirschman <sup>(3)</sup> | —       | — | —    | — | — | —       |

*The amounts in the “Option awards” column reflect the dollar amounts recognized as the director fee portion of compensation expense for financial statement reporting purposes for each named director executive officer during fiscal 2015, as required by FASB ASC 718, disregarding any estimates for forfeitures relating to service-based vesting conditions. For the assumptions relating to these valuations, see note 10 to our fiscal 2014 audited financial statements. Stanley A. Hirschman and Danny Schoening option awards have been separately reported as Executive Compensation on the summary compensation table. Includes compensation cost related to early vesting of 3,750 shares on resignation effective November 19, 2014. Mr. Hirschman resigned as a director effective November 4, 2015.*

*Director fees paid quarterly from September 2015 through September 2016. Each independent director receives \$1,000 for each month served, paid quarterly, and \$500 for each meeting attended. From October through September 2016, there was two board meetings, four audit committee meetings, and one compensation committee meeting held. Ms. Craven resigned as a director as of May 26, 2016.*

*Peter Benz is serving as a non-independent director and receives \$10,000 for his services for each month served, effective as of December 1, 2015. Danny Schoening is serving as a non-independent director and as such received no board fees in 2016. Mr. Hirschman was a non-independent director and resigned effective November 4, 2015.*

The members of our board of directors are actively involved in various aspects of our business ranging from relatively narrow board oversight functions to providing hands-on guidance to our executives and scientific staff with respect to matters within their personal experience and expertise. We believe that the active involvement of all directors in our principal business and policy decisions increases our board of directors' understanding of our needs and improves the overall quality of our management decisions.

With the exception of Stan Hirschman and Danny Schoening, our directors are compensated separately for service as members of our board of directors. As of February 1, 2010, Mr. Hirschman was paid a salary from Optex Systems Holdings as disclosed in the executive compensation table above. Mr. Hirschman resigned as a director effective November 4, 2015.

**Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

On December 22, 2016, we had 8,144,302 shares of common stock, 342 shares of Series C preferred shares (convertible into 1,425,000 shares of common stock), 4,125,200 warrants, and 56,290 vested and exercisable stock options. The following table sets forth certain information with respect to the beneficial ownership of our securities as of December 18, 2016, for (i) each of our directors and executive officers; (ii) all of our directors and executive officers as a group (not noting our four new directors who have not yet been issued any stock or options which have vested); and (iii) each person who we know beneficially owns more than 5% of our common stock.

Beneficial ownership data in the table has been calculated based on Commission rules that require us to identify all securities that are exercisable or convertible into shares of our common stock within 60 days of December 22, 2016 and treat the underlying stock as outstanding for the purpose of computing the percentage of ownership of the holder.

Except as indicated by the footnotes following the table, and subject to applicable community property laws, each person identified in the table possesses sole voting and investment power with respect to all capital stock held by that person. The address of each named executive officer and director, unless indicated otherwise by footnote, is c/o our corporate headquarters.

Except as otherwise set forth below, the address of each of the persons listed below is our address.

| Title of Class | Name of Beneficial Owner | Number of Shares | Percentage of Outstanding Shares |
|----------------|--------------------------|------------------|----------------------------------|
|----------------|--------------------------|------------------|----------------------------------|

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|   |                                |           |      |   |
|---|--------------------------------|-----------|------|---|
| 5% Holders  | Sileas Corporation (1) (2)     | 4,298,782 | 31.3 | % |
|   | Longview Fund L.P. (4)         | 801,350   | 5.8  | % |
| Directors and Officers:                           | Stanley Hirschman (1) (2)      | 4,308,782 | 31.3 | % |
|   | Danny Schoening (2) (3) (5)    | 4,316,282 | 31.4 | % |
|   | Karen Hawkins (6)              | 8,750     | 0.1  | % |
|   | Peter Benz (Longview Fund) (4) | 801,350   | 5.8  | % |
| Directors and officers as a group (4 Individuals) |                                | 5,126,382 | 37.3 | % |

*Represents shares held by Sileas of which Stanley Hirschman, a prior Director of Optex Systems Holdings, has a controlling interest (80%); therefore, under Rule 13d-3 of the Exchange Act, Mr. Hirschman is deemed to be the beneficial owner, along with Mr. Schoening. Stan Hirschman also holds options to purchase 10,000 shares of our common stock which have vested and are currently exercisable.*

*Sileas' ownership interest in us has been pledged to Longview as security for a loan in connection with the acquisition of Longview's interests in Optex Delaware by Sileas. Investment decisions for Longview are made by its investment advisor, Viking Asset Management, LLC. Mr. Peter Benz is the Chairman, Chief Executive Officer and a Managing Member of Viking Asset Management and may be deemed to control its business activities, including the investment activities of Longview. Mr. Merrick Okamoto who is a director of us is the President and a Managing Member of Viking Asset Management and may be deemed to control its business activities, including the investment activities of Longview. In the event of a default by Sileas on its debt obligation to Longview, the shares held by Sileas may be returned to Longview. Viking and Longview each may be deemed to have shared voting and dispositive authority over the shares of Our common stock if they are returned to Longview. In such an event, Mr. Benz and Mr. Okamoto, as control persons of Viking and/or Longview, may be deemed to beneficially own all such shares; however, they have stated that they would disclaim such beneficial ownership were this to occur. Represents shares held by Sileas of which Mr. Schoening, an Officer of us, has a controlling interest (15%); therefore, under Rule 13d-3 of the Exchange Act, Mr. Schoening is deemed to be the beneficial owner, along with Mr. Hirschman, of those shares.*

*Includes 801,350 shares of Common Stock held by Longview Fund, LP. Investment decisions for Longview are made by its investment advisor, Viking Asset Management, LLC. Mr. Peter Benz is the Chairman, Chief Executive Officer and a Managing Member of Viking Asset Management and may be deemed to control its business activities, including the investment activities of Longview. Peter Benz, as a control person of Viking and/or Longview, may be deemed to beneficially own all such shares; however, he disclaims such beneficial ownership.*

*5 Includes options to purchase 17,500 shares of our common stock which have vested and are currently exercisable.*

*6 Represents options to purchase 8,750 shares of our common stock which have vested and are currently exercisable.*

### **Item 13 Certain Relationships and Related Transactions, and Director Independence**

#### ***Relationship between Optex Systems, Inc. (Texas), Irvine Sensors Corporation and Longview and Alpha***

Longview and Alpha were owed certain debt by Irvine Sensors Corporation including debt evidenced by (i) a December 29, 2006 Term Loan and Security Agreement executed by Irvine Sensors Corporation and Longview and Alpha, and (ii) a series of secured promissory notes purchased by them and issued to them on December 29, 2006, July 19, 2007 and November 28, 2007. As of August 24, 2008, the total amount due under all of the described notes was approximately \$18.4 million. Optex Systems, Inc. (Texas), which was and is a wholly owned subsidiary of Irvine Sensors Corporation, was a guarantor of all of those notes, and pursuant to related security agreements Longview and Alpha had a validly perfected, fully enforceable security interest in all personal property of Optex Systems, Inc. (Texas). On September 19, 2008, pursuant to an Assignment and Stock/Note Issuance Agreement, Alpha and Longview transferred and assigned to Optex Systems, Inc. (Delaware) which assumed, \$15 million of their respective interests and rights in the aforesaid notes and obligations to Optex Systems, Inc. (Delaware) in exchange for \$9 million of equity and \$6 million of debt.

#### ***Acquisition of Assets of Optex Systems, Inc. (Texas) by Optex Systems, Inc. (Delaware) on October 14, 2008***



On October 14, 2008, in a purchase transaction that was consummated via public auction, Optex Systems, Inc. (Delaware) purchased all of the assets of Optex Systems, Inc. (Texas) in exchange for \$15 million of Irvine Sensors Corporation debt owned by it and the assumption of approximately \$3.8 million of certain Optex Systems, Inc. (Texas) liabilities. The \$15 million of Irvine Sensors Corporation debt was contributed by Longview and Alpha to Optex Systems, Inc. (Delaware) in exchange for a \$6 million note payable from Optex Systems, Inc. (Delaware) and a \$9 million equity interest in Optex Systems, Inc. (Delaware). Longview and Alpha owned Optex Systems, Inc. (Delaware) until February 20, 2009, when Longview sold 100% of its interests in Optex Systems, Inc. (Delaware) to Sileas, as discussed below. In referring to these transactions, Optex Systems, Inc. (Delaware) is considered to be the successor entity to Optex Systems, Inc. (Texas), the predecessor entity.

***Secured Promissory Notes and Common Shares Issued in connection with Purchase by Optex Systems, Inc. (Delaware)***

In connection with the public sale of the Optex Systems, Inc. (Texas) assets to Optex Systems, Inc. (Delaware), Optex Systems, Inc. (Delaware) delivered to each of Longview and Alpha a Secured Promissory Note due September 19, 2011 in the principal amounts of \$5,409,762 and \$540,976, respectively. Each Note bears simple interest at the rate of 6% per annum, and the interest rate upon an event of default increases to 8% per annum. After 180 days from the issue date, the principal amount of the Notes and accrued and unpaid interest thereon may be converted into Optex Systems, Inc. (Delaware) common stock at a conversion price of \$1.80 per share (pre-split and pre-reorganization price). The Notes may be redeemed prior to maturity at a price of 120% of the then outstanding principal amount plus all accrued and unpaid interest thereon. The obligations of Optex Systems, Inc. (Delaware) under the Notes are secured by a lien against all of the assets of Optex Systems, Inc. (Delaware) in favor of Longview and Alpha. In addition, Optex Systems, Inc. (Delaware) issued common stock to each of Longview and Alpha in the quantities of 45,081,350 and 4,918,650, respectively (pre reverse split numbers as historical). On October 30, 2008, Alpha sold its Optex Systems, Inc. (Delaware) common stock to Arland Holding, Ltd. On February 20, 2009, Longview sold its Note to Sileas (see below).

***Acquisition by Sileas of Longview's Interests in Optex Systems, Inc. (Delaware) on February 20, 2009***

On February 20, 2009, Sileas purchased 100% of the equity and debt interest held by Longview, representing 90% of Optex Systems, Inc. (Delaware), in a private transaction. The primary reason for the acquisition was to eliminate shareholder control of us by Longview and to limit any perception of control over the day-to-day operations of us, whether or not such control actually existed. While Longview makes investments in a variety of companies, it strives to invest passively and leave the day-to-day operations of the companies in its investment portfolio to the management teams of those companies. In addition, the acquisition allowed Optex Systems Holdings to avoid potential conflicts of interest or other related business issues that might have adversely affected our operations as a result of Longview's investments in other companies.

The purchase price for the acquisition was \$13,524,405. Sileas issued a purchase money note to Longview for the full amount of the purchase price in exchange for 45,081,350 (pre-split as historical) shares of common stock of us (representing 90% of the outstanding shares) and transfer to Sileas of a note dated December 2, 2008, issued by us to Longview in the principal amount of \$5,409,762. No contingent consideration is due the seller in the transaction. The obligations of Sileas under the Note are secured by a security interest in our common and preferred stock owned by Sileas that was granted to Longview pursuant to a Stock Pledge Agreement delivered by Sileas to Longview and also by a lien on all of the assets of Sileas. On March 27, 2009, Sileas and Alpha (which owned the balance of the \$6,000,000 of the notes) exchanged the \$6,000,000 aggregate principal amount of notes, plus accrued and unpaid interest thereon, for 1,027 shares of Optex Systems, Inc. (Delaware) Series A preferred stock.

Sileas has no operations or business activities other than holding the stock and notes described above and has no revenues, and it holds no assets other than the stock and notes described above. The management of Sileas believes that the value of its common stock and preferred stock holdings in Optex Systems Holdings will increase over time. Sileas plans to repay Longview, no later than the maturity date, through some combination of a recapitalization of Sileas equity and debt and partial or full liquidation of its interests in Optex Systems Holdings. Sileas will be limited by the extent of our stock price and limitations on ability to resell the stock it owns in Optex Systems Holdings.

***Secured Promissory Note Due February 20, 2016/Longview Fund, LP***

As a result of the transaction described above between Sileas and Longview on February 20, 2009, Sileas, the new majority owner of Optex Systems, Inc. (Delaware), executed and delivered to Longview, a Secured Promissory Note due February 20, 2012 in the principal amount of \$13,524,405. The Note bears simple interest at the rate of 4% per annum, and the interest rate upon an event of default increases to 10% per annum. In the event that a Major Transaction occurs prior to the maturity date resulting in the Borrower receiving Net Consideration with a fair market value in excess of the principal and interest due under the terms of this Secured Note, then in addition to paying the principal and interest due, Sileas shall also pay an amount equal to 90% of the consideration. "Major Transaction" refers to a transaction whereby Optex Systems, Inc. (Delaware) would consolidate or merge into or sell or convey all or substantially all of its assets to a third party entity for more than nominal consideration, and "Net Consideration" refers to the fair market value of the consideration received in connection with a Major Transaction less all outstanding liabilities of Optex Systems, Inc. (Delaware).

On November 22, 2011 Sileas Corp and Longview Fund, LP entered into an amendment to the Secured Promissory Note that extended the maturity date for an additional two-year period ending on February 20, 2014. In exchange for the extension, Sileas Corp agreed to pay Longview Fund an extension fee equal to 2% of the principal amount of this Secured Note. As a result of the agreement, the principal amount of the Note was increased \$270 thousand to \$13.8 million as of November 22, 2011.

On November 27, 2013 Sileas Corp. and the Longview Fund, LP entered into an amendment to the Secured Promissory Note that extended the maturity date for an additional two-year period ending on February 20, 2016. In exchange for the extension, Sileas Corp. agreed to pay the Longview Fund an extension fee equal to 2% of the principal amount of this Secured Note. As a result of the amendment, the principal amount of the Note was increased by \$275 thousand to \$14.1 million as of November 27, 2013, 2013.

On June 5, 2015, Sileas Corp. amended its Secured Note, with Longview Fund, L.P., as lender, as follows:

The principal amount was increased to \$18,022,329 to reflect the original principal amount plus all accrued and unpaid interest to date, and the Secured Note ceased to bear interest as of that date;

The maturity date of the note was extended to May 29, 2021; and

A conversion feature was added to the Secured Note by which the principal amount of the Secured Note can be converted into our Series A preferred stock, which is owned by Sileas, at the stated value of our Series A preferred stock.

On August 4, 2016, Longview Fund, L.P. converted \$250 thousand of the note principal for 100,000 shares of Optex Systems Holdings common stock pursuant to the note conversion terms. The Sileas note balance to the Longview Fund, LP as of October 2, 2016 is \$17.8 million.

On October 31, 2016, Longview Fund, L.P. converted \$2.7 million of the Sileas note principal in exchange for 800,000 shares of Optex Systems Holdings common stock. The Sileas note balance to the Longview Fund, LP as of December 7, 2016 is \$15.1 million.

### **Alpha Capital Anstalt Stock Purchase and Preferred Shares Conversions**

On February 22, 2012, Alpha Capital Anstalt bought 5,000 shares of our restricted common stock at a purchase price of \$10.00 per share for a total purchase price of \$50,000. As of August 26, 2016 Alpha Capital Anstalt had converted a total 34.6 Series A preferred shares at a stated value of \$6,860 into 42,500 shares of its Common Stock for a total converted value of \$237,497. The Common Stock was purchased or converted by Alpha in private transactions exempt from registration under Section 4(2) of the Securities Act of 1934 and is restricted from resale and the stock certificate issued bears the appropriate restrictive legend. On August 26, 2016 Alpha Capital Anstalt redeemed 66.4 Series A preferred shares for \$455,397.

### **Reorganization/Share Exchange**

On March 30, 2009, a reorganization occurred whereby the then existing shareholders of Optex Systems, Inc. (Delaware) exchanged their shares of common stock with the shares of common stock of us as follows: (i) the outstanding 85,000,000 shares of Optex Systems, Inc. (Delaware) common stock were exchanged by Optex Systems Holdings for 113,333,282 shares (pre-split as historical) of us common stock, (ii) the outstanding 1,027 shares of Optex Systems, Inc. (Delaware) Series A preferred stock were exchanged by Optex Systems Holdings for 1,027 shares of our Series A preferred stock and (iii) the 8,131,667 shares (pre-split as historical) of Optex Systems, Inc. (Delaware) common stock purchased in the private placement, which also occurred on March 30, 2009, were exchanged by Optex Systems Holdings for 8,131,667 shares of the Company's common stock. The per share price in the private placement was \$0.15 per share of common stock, and the closing date was March 30, 2009. Optex Systems, Inc. (Delaware) remains a wholly-owned subsidiary of us.

At the time of the reorganization (all numbers are pre split due to historical context), 25,000,000 shares owned by Andrey Oks, the former CEO, were cancelled. Immediately prior to the closing, 17,449,991 shares of our common stock were outstanding. The 17,449,991 shares derives from the 17,999,995 shares outstanding as of December 31, 2008 plus the 26,999,996 shares issued in conjunction with the 2.5:1 forward stock split authorized by the Sustut Board and shareholders and effected on February 27, 2009 less retirement of Andrey Oks' 25,000,000 shares and cancellation of 3,800,000 shares previously issued to Newbridge Securities Corporation, shares plus issuance of 1,250,000 shares in payment for two investor relations agreements. The total outstanding common shares of us subsequent to the closing of the reorganization is as follows (1):

|   |             |
|---|-------------|
| Existing Sustut Shareholders                                      | 17,449,991  |
| Optex Systems, Inc. (Delaware) shares exchanged                   | 113,333,282 |
| Optex Systems, Inc. (Delaware) Private Placement shares exchanged | 8,131,667   |
| Total Shares after reorganization                                 | 138,914,940 |
| <br>  |             |
| Cancellation of shares – American Capital Ventures                | (700,000 )  |
| Private placement – June 29, 2009                                 | 750,000     |
| Issuance of shares as consideration – ZA Consulting               | 480,000     |
| Shares Outstanding on September 27, 2009                          | 139,444,940 |

Rule 409(b) states: “(b) The registrant shall include a statement either showing that unreasonable effort or expense would be involved or indicating the absence of any affiliation with the person within whose knowledge the information rests and stating the result of a request made to such person for the information.”

We made requests of counsel representing Sustut’s directors and officers to obtain additional information into the principles behind their determination that the securities of the registrant issued in the March 30, 2009 share exchange represented “fair market value” to acquire the business operations of Optex Systems, Inc. (Delaware), and they were not able to provide any information. We confirm that we have no affiliation with Sustut’s former counsel, Anslow & Jacklin, who was our only source of information regarding the prior history of Sustut and that the result of our request was that they stated they had no information and were not able to obtain further information on this issue.

We have not been able to provide further background as to how the merger consideration was determined beyond the fact that it was determined by negotiation between Sustut and Optex Systems, Inc. (Delaware). Thus, we have invoked Rule 409(b) which states: “(b) The registrant shall include a statement either showing that unreasonable effort or expense would be involved or indicating the absence of any affiliation with the person within whose knowledge the information rests and stating the result of a request made to such person for the information.”

#### **Transactions with Executive Management**

See the “Executive Compensation” section for a discussion of the material elements of compensation awarded to, earned by or paid to our named executive officers. Other than as stated in the “Executive Compensation” section, we have not entered into any transactions with executive management.

**Item 14 Principal Accounting Fees and Services**

The following table sets forth the fees paid to date for audit services rendered during fiscal years ended October 2, 2016 and September 27, 2015, respectively.

| Fee Category  | 2016     | 2015   |
|---|----------|--------|
| Audit Fees <sup>(1)</sup>   | \$76,696 | 78,260 |
| Audit-Related Fees-registration statement consents <sup>(2)</sup> | \$39,409 | 13,695 |
| Tax Fees  | \$10,500 | 10,500 |

*Audit Fees are fees for professional services performed for the audit of our annual consolidated financial (1) statements and review of consolidated financial statements included in our 10-Q filings for the fiscal years ended October 2, 2016 and September 27, 2015, respectively.*

*(2) Fees paid in related to consent for S-1 registration statement and procedures associated with SEC comment letter for S-1 registration statement.*

## Item 15 Exhibits

### Exhibits

#### Exhibit No. Description

- 1.1 Form of Underwriting Agreement<sup>(28)</sup>
- 2.1 Agreement and Plan of Reorganization, dated as of the March 30, 2009, by and between registrant, a Delaware corporation and Optex Systems, Inc., a Delaware corporation<sup>(1)</sup>.
- 3.1 Certificate of Incorporation, as amended, of Optex Systems Holdings, Inc<sup>(2)</sup>.
- 3.2 Bylaws of Optex Systems Holdings<sup>(1)</sup>.
- 3.3 Charters of the Audit Committee, Compensation Committee and Nominating Committee<sup>(26)</sup>.
- 4.1 Certificate of Powers, Designations, Preferences and Rights of the Series B Preferred Stock of Optex Systems Holdings, Inc. dated March 26, 2015<sup>(23)</sup>.
- 4.2 Form of Warrant for Offering<sup>(25)</sup>
- 4.3 Form of Underwriter Warrant for Offering<sup>(25)</sup>
- 4.4 Certificate of Designation of Series C Convertible Preferred Stock<sup>(29)</sup>
- 10.1 2009 Stock Option Plan<sup>(1)</sup>.
- 10.2 Employment Agreement with Danny Schoening<sup>(1)</sup>.
- 10.3 Lease for 1420 Presidential Blvd., Richardson, TX<sup>(1)</sup>.
- 10.4 Form of Warrant<sup>(3)</sup>



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- 10.5 Specimen Stock Certificate<sup>(3)</sup>
- 10.6 Contract W52H0905D0248 with Tank-automotive and Armaments Command, dated August 19, 2005<sup>(5)(6)</sup>
- 10.7 Contract W52H0909D0128 with Tank-automotive and Armaments Command, dated March 24, 2009<sup>(5)</sup>
- 10.8 Contract W52H0905D0260 with Tank-automotive and Armaments Command, dated August 3, 2005<sup>(5)(6)</sup>
- 10.9 PO# 40050551 with General Dynamics, dated June 8, 2009<sup>(5)(6)</sup>
- 10.10 Contract 9726800650 with General Dynamics, dated April 9, 2007<sup>(5)(6)</sup>
- 10.11 Form of Subscription Agreement<sup>(4)</sup>

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.12              | Single Source Supplier Purchase Orders with TSP Inc. <sup>(5)</sup>  |
| 10.13              | Single Source Supplier Purchase Orders with SWS Trimac <sup>(5)</sup>  |
| 10.14              | Single Source Supplier Purchase Orders with Danaher Controls <sup>(5)</sup>  |
| 10.15              | Single Source Supplier Purchase Orders with Spartech Polycast <sup>(5)</sup>   |
| 10.16              | Third Amendment to Lease, between Aquiport DFWIP and Optex Systems, Inc., dated January 7, 2010 <sup>(5)</sup>   |
| 10.17              | \$250,000 principal amount Note in favor of the Longview Fund, L.P., dated October 27, 2009 <sup>(9)</sup>   |
| 10.18              | Investor Relations Agreement, dated April 1, 2009 between Optex Systems and American Capital Ventures, Inc. <sup>(9)</sup>                                       |
| 10.19              | Form of Loan and Security Agreement between Optex Systems, Inc. and Peninsula Bank Business Funding, dated March 4, 2010 <sup>(5)</sup>                          |
| 10.20              | Form of Unconditional Guaranty executed by Optex Systems Holdings, Inc. in favor of Peninsula Bank Business Funding, dated March 4, 2010 <sup>(5)</sup>          |
| 10.21              | Form of Warrant issued by Optex Systems Holdings, Inc. to Peninsula Bank Business Funding, dated March 4, 2010 <sup>(5)</sup>                                    |
| 10.22              | Allonge to Promissory Note, dated January 5, 2010 <sup>(9)</sup>   |
| 10.23              | Showcase Agreement between Optex Systems, Inc. and ECON Corporate Services, Inc., dated April 1, 2009 <sup>(9)</sup>   |
| 10.24              | Consulting Agreement dated June 29, 2009, between ZA Consulting, Inc. and Optex Systems, Inc. <sup>(9)</sup>   |
| 10.25              | Purchase Order dated June 28, 2010 with TACOM-Warren <sup>(7)</sup>  |
| 10.26              | First Amendment to Loan and Security Agreement, dated August 3, 2010, by and between Peninsula Bank Business Funding and Optex Systems, Inc. <sup>(8)</sup>      |
| 10.27              | Waiver by Peninsula Bank Business Funding to Optex Systems, Inc., dated November 24, 2010 <sup>(10)</sup>  |
| 10.28              | Second Amendment to Loan and Security Agreement, dated November 29, 2010, by and between Peninsula Bank Business Funding and Optex Systems, Inc. <sup>(10)</sup> |
| 10.29              | Third Amendment to Loan and Security Agreement, dated February 15, 2011, by and between Peninsula Bank Business Funding and Optex Systems, Inc. <sup>(11)</sup>  |
| 10.30              | Fourth Amendment to Loan and Security Agreement, dated March 22, 2011, by and between Peninsula Bank Business Funding and Optex Systems, Inc. <sup>(12)</sup>    |

10.31 Waiver of Series A preferred shareholders<sup>(14)</sup>

10.32 Form of Subscription Agreement<sup>(15)</sup>

95

**Exhibit No. Description**

|       |   |
|-------|---|
| 10.33 | PO# SPRDL1-12-C-0023 with DLA Land-Warren, dated October 24, 2011 <sup>(16)</sup>                                     |
| 10.34 | Agreement with GDLS-Canada, dated as of November 3, 2011 <sup>(19)</sup>  |
| 10.35 | Amendment to 2009 Stock Option Plan <sup>(17)</sup>   |
| 10.36 | Amendment to the Articles of Incorporation <sup>(18)</sup>  |
| 10.37 | Amendment to Credit Facility with Avidbank <sup>(20)</sup>  |
| 10.38 | Purchase Agreement dated November 3, 2014 <sup>(21)</sup>   |
| 10.39 | Assignment of Lease dated October 30, 2014 <sup>(21)</sup>  |
| 10.40 | Form of Subscription Agreement <sup>(22)</sup>  |
| 10.41 | Form of Convertible Note <sup>(22)</sup>  |
| 10.42 | Form of Registration Rights Agreement <sup>(22)</sup>   |
| 10.43 | Form of Make Whole Agreement <sup>(22)</sup>  |
| 10.44 | Supply Agreement, dated May 26, 2015, between Optex Systems Holding, Inc. and Nightforce Optics, Inc. <sup>(24)</sup> |
| 10.45 | First Amendment to Amended and Restated Loan Agreement with Avidbank <sup>(26)</sup>                                  |
| 10.46 | Restricted Stock Unit Plan <sup>(27)</sup>  |
| 10.47 | Form of RSU Agreement <sup>(27)</sup>   |
| 10.48 | Employment Agreement with Karen Hawkins, dated as of August 1, 2016 <sup>(25)</sup>                                   |
| 10.49 | Form of Lease <sup>(30)</sup>   |
| 10.50 | Form of Letter of Credit <sup>(30)</sup>  |
| 10.51 | Form of Second Amendment to Loan Agreement <sup>(30)</sup>  |
| 14.1  | Code of Ethics <sup>(3)</sup>   |
| 21.1  | List of Subsidiaries — Optex Systems, Inc.  |

31.1 and 31.2 Certifications pursuant to Section 302 of Sarbanes Oxley Act of 2002

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32.1 and 32.2 Certifications pursuant to Section 906 of Sarbanes Oxley Act of 2002

EX-101.INS XBRL Instance Document

EX-101.SCHXBRL Taxonomy Extension Schema Document

EX-101.CALXBRL Taxonomy Extension Calculation Linkbase Document

EX-101.DEF XBRL Taxonomy Extension Definition Linkbase Document

EX-101.LABXBRL Taxonomy Extension Label Linkbase Document

EX-101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

(1) Incorporated by reference from our Current Report on Form 8-K dated April 3, 2009.

(2) Incorporated by reference from our Amendment No. 4 to Registration Statement on Form S-1 filed on September 28, 2009

(3) Incorporated by reference from our Registration Statement on Form S-1 filed on May 19, 2009

(4) Incorporated by reference from our Form 10-K for the fiscal year ended September 27, 2009, filed on January 11, 2010

(5) Incorporated by reference from our Amendment No. 4 to Registration Statement on Form S-1 filed on June 14, 2010

This exhibit is missing part of the original bid/solicitation package as such information can only be obtained from third parties with which the registrant has no affiliation, and registrant has made requests from such third parties for such information, and such parties have not been able to provide such information.

(7) Incorporated by reference from our Current Report on Form 8-K dated July 2, 2010

(8) Incorporated by reference from our Form 10-Q for the quarter ended on June 27, 2010, filed on September 11, 2010

(9) Incorporated by reference from our Amendment No. 5 to Registration Statement on Form S-1 filed on September 3, 2010

(10) Incorporated by reference from our Amendment No. 20 to Registration Statement on Form S-1 filed on January 13, 2011

(11) Incorporated by reference from our Form 10-Q for the quarter ended on January 2, 2011, filed on February 16, 2011

(12) Incorporated by reference from our Current Report on Form 8-K filed on March 28, 2011

(13) Intentionally left blank

(14) Incorporated by reference from our Form S-1 filed on August 1, 2011

(15) Incorporated by reference from our Form S-1 filed on September 2, 2011

(16) Incorporated by reference from our Current Report on Form 8-K filed on November 7, 2011

(17) Incorporated by reference from our Form 10-K filed on December 27, 2011

(18) Incorporated by reference from our Amendment No. 5 to Registration Statement on Form S-1 filed on January 27, 2012

(19) Incorporated by reference from our Form 10-K/A for the year ended September 27, 2015, filed on March 27, 2012

(20) Incorporated by reference from our Form 10-Q for the quarter ended on April 1, 2012, filed on May 15, 2012

(21) Incorporated by reference from our Current Report on Form 8-K, dated November 7, 2014

(22) Incorporated by reference from our Current Report on Form 8-K, dated November 18, 2014

(23) Incorporated by reference from our Current Report on Form 8-K, dated April 1, 2015

(24) Incorporated by reference from our Current Report on Form 8-K, dated July 13, 2015

(25) Incorporated by reference from our Current Report on Form 8-K, filed on August 10, 2016

(26) Incorporated by reference from our Current Report on Form 8-K, filed on April 28, 2016

(27) Incorporated by reference from our Current Report on Form 8-K, filed on June 17, 2016

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- (28) Incorporated by reference from our Amendment No. 2 to Form S-1, filed on August 12, 2016
- (29) Incorporated by reference from our Amendment No. 5 to Form S-1, filed on August 22, 2016
- (30) Incorporated by reference from our Current Report on Form 8-K, filed on November 23, 2016

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**OPTEX SYSTEMS HOLDINGS, INC.**

By: /s/ Danny Schoening  
 Danny Schoening, Principal Executive Officer and Director

Date: December 22, 2016

By: /s/ Karen Hawkins  
 Karen Hawkins, Principal Financial Officer and Principal Accounting Officer

Date: December 22, 2016

Pursuant to the requirements of the Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| <b>Signature</b>                       | <b>Title</b>   | <b>Date</b>       |
|--|--|-------------------|
| /s/ Peter Benz<br>Peter Benz           | Chairman and Director  | December 22, 2016 |
| /s/ Danny Schoening<br>Danny Schoening | Principal Executive Officer and Director                     | December 22, 2016 |
| /s/ Karen Hawkins<br>Karen Hawkins     | Principal Financial Officer and Principal Accounting Officer | December 22, 2016 |
| /s/ David Kittay<br>David Kittay       | Director   | December 22, 2016 |
| /s/ Owen Naccarato<br>Owen Naccarato   | Director   |                   |

December  
22, 2016

/s/ Charles Trego

Charles Trego

Director

December  
22, 2016