Optex Systems Holdings Inc
Form 10-Q
May 11, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 27, 2016

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

For the transition period from ______to______.

OPTEX SYSTEMS HOLDINGS, INC.

(Exact Name of Registrant as Specified in Charter)

Delaware	**000-54114**	**90-0609531**
(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer Identification No.)

1420 Presidential Drive, Richardson, TX	75081-2439
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: (972) 764-5700

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the issuer was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

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

Large Accelerated Filer ¨ Accelerated Filer ¨ Non-Accelerated Filer ¨ Smaller Reporting Company x

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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 x No ¨

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

Yes ¨ No x

State the number of shares outstanding of each of the issuer’s classes of common equity, as of May 10, 2016: 1,621,145 shares of common stock.

State the issuer’s public float as of March 27, 2016; $564,473.

OPTEX SYSTEMS HOLDINGS, INC.

FORM 10-Q

For the period ended March 27, 2016

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Part 1. Financial Information

Item 1. Consolidated Financial Statements

OPTEX SYSTEMS HOLDINGS, INC.

UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

AS OF MARCH 27, 2016

Optex Systems Holdings, Inc.

Condensed Consolidated Balance Sheets

	(Thousands, except share data) March 27, 2016 (Unaudited)	September 27, 2015
ASSETS		
Current Assets		
Cash and Cash Equivalents	$ 596	$ 683
Accounts Receivable, Net	1,658	2,866
Net Inventory	7,197	5,713
Prepaid Expenses	122	170
Current Assets	9,573	9,432
Property and Equipment, Net	1,817	1,971
Other Assets		
Prepaid Royalties - Long Term	105	120
Security Deposits	23	23
Other Assets	128	143
Total Assets	$ 11,518	$ 11,546
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts Payable	$ 1,474	$ 575
Accrued Expenses	758	812
Accrued Warranties	28	28
Customer Advance Deposits - Short Term	824	1,091
Credit Facility	784	817
Current Liabilities	3,868	3,323
Customer Advance Deposits - Long Term	-	65
Total Liabilities	3,868	3,388
Stockholders' Equity		
	-	-

Preferred Stock Series A ($0.001 par 5,000 authorized, 546 and 1,001 issued and outstanding, respectively)		
Preferred Stock Series B ($0.001 par 1,010 authorized, 969 and 994 issued and outstanding, respectively)	-	-
Common Stock – ($0.001 par, 2,000,000,000 authorized, 1,581,145 and 314,867 shares issued and outstanding, respectively)	2	-
Additional Paid-in-capital	26,440	26,394
Accumulated Deficit	(18,792)	(18,236)
Stockholders' Equity	7,650	8,158
Total Liabilities and Stockholders' Equity	$ 11,518	$ 11,546

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

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Optex Systems Holdings, Inc.

Condensed Consolidated Statements of Operations

(Unaudited)

	(Thousands, except share data)			
	Three months ended		Six months ended	
	March 27, 2016	March 29, 2015	March 27, 2016	March 29, 2015
Revenue	$3,216	$ 3,403	$6,429	$ 5,501
Cost of Sales	2,701	3,430	5,448	5,149
Gross Margin	515	(27)	981	352
General and Administrative Expense	828	810	1,522	1,496
Operating Loss	(313)	(837)	(541)	(1,144)
Gain on Purchased Asset	-	-	-	2,110
Change in Fair Value - Derivatives	-	(847)	-	-
Interest Income (Expense)	3	5,326	(15)	(153)
Other Income and (Expense)	3	4,479	(15)	1,957
(Loss) Income Before Taxes	(310)	3,642	(556)	813
Deferred Income Taxes (Benefit)	-	-	-	-
Net (Loss) Income After Taxes	(310)	3,642	(556)	813
Preferred stock dividend/premium	-	(6,441)	-	(6,441)
Net loss applicable to common shareholders	$(310)	$ (2,799)	$(556)	$ (5,628)
Basic and diluted loss per share	$(0.90)	$ (9.00)	$(1.66)	$ (18.10)
Weighted Average Common Shares Outstanding - basic and fully diluted	344,881	310,867	335,625	310,867

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

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

(Unaudited)

	(Thousands) Six months ended	
	March 27, 2016	March 29, 2015
Cash flows from operating activities:		
Net (loss) income	$(556)	$ 813
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:		
Depreciation and amortization	172	158
Noncash interest expense	(12)	143
Stock compensation expense	48	91
(Increase) decrease of intangible assets	-	(171)
(Increase) decrease in accounts receivable	1,209	(1,018)
(Increase) decrease in inventory (net of progress billed)	(1,484)	(389)
(Increase) decrease in prepaid expenses	49	(15)
(Increase) decrease in security deposits	-	(1)
Increase (decrease) in accounts payable and accrued expenses	843	441
Increase (decrease) in accrued warranty costs	-	3
Increase (decrease) in customer advance deposits	(332)	(582)
Total adjustments	493	(1,340)
Net cash used in operating activities	(63)	(527)
Cash flows from investing activities		
Purchases of property and equipment	(19)	(2,094)
Decrease in prepaid royalties - long term	15	15
Net cash used in investing activities	(4)	(2,079)
Cash flows from financing activities		
Proceeds from convertible notes issued	-	1,560
Debt issuance fees	-	(74)
Proceeds (to) from credit facility (net)	(20)	550
Net cash (used in) provided by financing activities	(20)	2,036
Net (decrease) in cash	(87)	(570)
Cash at beginning of period	683	1,685
Cash at end of period	$596	$ 1,115

Supplemental cash flow information:

Cash paid for interest	$28	$ 10
Exchange of convertible note and accrued interest to series B preferred stock	-	1,629
Beneficial Conversion Feature on series B preferred stock	-	4,887
Beneficial Conversion Feature on series A preferred stock	-	1,554
Exchange of preferred stock for common stock	3,165	-

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

Note 1 - Organization and Operations

Optex Systems Holdings’ operations are based in Dallas and Richardson, Texas in leased facilities comprising approximately 93,733 square feet. As of March 27, 2016, Optex Systems Holdings operated with 95 full-time equivalent employees.

Optex Systems Holdings manufactures optical sighting systems and assemblies, primarily for Department of Defense and foreign military applications. 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. Optex Systems Holdings is an ISO 9001:2008 certified company. On November 3, 2014, Optex Systems, Inc. purchased the assets comprising the Applied Optics Products Line of L-3 Communications, Inc. (“L-3”), a thin film coating manufacturer for lenses used primarily in the defense industry.

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, we have 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.

On October 7, 2015, we effected a 1:1000 reverse split of our issued and outstanding shares of common stock and all share numbers in these consolidated financial statements have been adjusted to give effect to this reverse split.

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.

The condensed consolidated financial statements of Optex Systems Holdings included herein have been prepared by Optex Systems Holdings, without audit, pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in financial statements prepared in conjunction with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although Optex Systems Holdings believes that the disclosures are adequate to make the information presented not misleading.

These condensed consolidated financial statements should be read in conjunction with the annual audited consolidated financial statements and the notes thereto included in the Optex Systems Holdings' Form 10-K for the year ended September 27, 2015 and other reports filed with the SEC.

The accompanying unaudited interim consolidated financial statements reflect all adjustments of a normal and recurring nature which are, in the opinion of management, necessary to present fairly the financial position, results of operations and cash flows of Optex Systems Holdings for the interim periods presented. The results of operations for these periods are not necessarily comparable to, or indicative of, results of any other interim period or for the fiscal year taken as a whole. Certain information that is not required for interim financial reporting purposes has been omitted.

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. Management estimates include bad debt allowances, depreciable asset lives, accrued warranties, valuations of derivatives, stock compensation expenses, inventory valuation reserves, as well as estimated contract costs at completion used to derive cost of sales. Actual results could differ from the estimates.

Inventory: Inventory is recorded at the lower of cost or market value, and adjusted, as necessary, 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. There were no unliquidated progress payments as of March 27, 2016 and September 27, 2015. As of March 27, 2016 and September 27, 2015, inventory included:

	(Thousands)	
	March 27, 2016	September 27, 2015
Raw Material	$3,959	$ 4,545
Work in Process	4,203	2,456
Finished Goods	627	304
Gross Inventory	$8,789	$ 7,305
Less: Inventory Reserves	(1,592)	(1,592)
Net Inventory	$7,197	$ 5,713

Net inventory increased by $1.5 million during the six months ending March 27, 2016 in support of higher revenues planned during in the second half of the current fiscal year.

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.

Optex Systems Holdings may at times have contracts that allow for invoicing based on achievement of milestone events. In such cases, Optex Systems Inc. recognizes revenue based on the milestone method in accordance with FASB ASC 605-28, as applicable. On October 24, 2011, Optex Systems, Inc. was awarded an $8.0 million contract with General Dynamics Land Systems - Canada that provided for milestone invoices up to a total of $3.9 million. The terms of the contract extend through 2017 during which time we are required to purchase the necessary materials to fulfill the delivery of products required by the contract. Currently, there are no additional contracts providing for milestone payments. In accordance with FASB 605-28, Optex Systems, Inc. recognizes milestone payments as revenue upon completion of a substantive milestone as commensurate with the following guidelines: our performance to achieve the milestone, the milestone relates solely to past performance and is reasonable relative to all of the deliverables and payment terms within the arrangement. Milestones are not considered as substantive if any portion of the associated milestone consideration relates to the remaining deliverables in the unit of accounting. Non-substantive milestone payments are reported as a liability on the balance sheet as Short Term and Long Term Customer Advance Deposits.

Pursuant to the contract, all substantive milestones events were completed as of September 30, 2012 and as such, there was zero revenue recognized for milestones in the three and six months ending March 27, 2016 and March 29, 2015 and no unpaid/invoiced customer deposits related to the completed milestone events, respectively.

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 March 27, 2016, Optex Systems, Inc. had a balance of $0.8 million in short term customer advance deposits for deliveries to occur within the next twelve months on non-substantive milestone billings.

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 consolidated 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.

The Company's 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.

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. See Note 4 below regarding segment reporting for the company.

Derivative Financial Instruments: The company accounts for conversion options embedded in convertible notes payable in accordance with ASC 815 *"Derivatives and Hedging"*. Further, subtopic ASC 815-15 *"Embedded Derivatives"* generally requires companies to bifurcate conversion options embedded in the convertible notes from their host instruments and to account for them as free standing derivative financial instruments. Derivative liabilities are recognized in the consolidated balance sheet at fair value as "Derivative Liabilities" and based on the criteria specified in FASB ASC 815-40 *"Derivatives and Hedging – Contracts in Entity's own Equity"*. The estimated fair value of the derivative liabilities is calculated using either the Black-Scholes-Merton, Binomial Lattice, or Monte Carlo simulation models where applicable and such estimates are revalued at each balance sheet date, with changes recorded to other income or expense as "Change in Fair Value – Derivatives" in the consolidated statement of operations. The classification of derivative instruments, including whether such instruments should be recorded as liabilities or equity, is evaluated at the instrument origination date and reviewed at the end of each event date (i.e. conversions, payments, etc.) and the measurement period end date for financial reporting, as applicable. Derivative instrument liabilities are classified on the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument would be required within twelve months of the balance sheet date.

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

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