Optex Systems Holdings Inc
Form 10-Q
August 13, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended July 1, 2018

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 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

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 No

Indicate by check mark whether the registrant is an emerging growth company as defined in Rule 405 of the Securities Act of 1933 (§230.405 of this chapter) or Rule 12b-2 of the Securities Exchange Act of 1934 (§240.12b-2 of this chapter).

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to section 13(a) of the Exchange Act.

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

Yes No

State the number of shares outstanding of each of the issuer's classes of common equity, as of August 13, 2018: 8,246,003 shares of common stock.

OPTEX SYSTEMS HOLDINGS, INC.

FORM 10-Q

For the period ended July 1, 2018

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Part 1. Financial Information

Item 1. Consolidated Financial Statements

OPTEX SYSTEMS HOLDINGS, INC.

UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

AS OF JULY 1, 2018

Optex Systems Holdings, Inc.

Condensed Consolidated Balance Sheets

	(Thousands, except share and per share data)	
	July 1, 2018 (Unaudited)	October 1, 2017
ASSETS		
Cash and Cash Equivalents	$1,639	$1,682
Accounts Receivable, Net	2,554	3,125
Net Inventory	7,477	7,614
Prepaid Expenses	147	63
Current Assets	11,817	12,484
Property and Equipment, Net	1,254	1,460
Other Assets		
Prepaid Royalties - Long Term	38	60
Security Deposits	23	23
Other Assets	61	83
Total Assets	$13,132	$14,027
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts Payable	$842	$1,362
Dividends Payable	—	261
Federal Income Taxes Payable	54	—
Accrued Expenses	1,178	1,450
Accrued Warranties	163	174
Customer Advance Deposits - Short Term	235	927
Credit Facility	300	300
Current Liabilities	2,772	4,474
Warrant Liability	1,597	3,607
Customer Advance Deposits - Long Term	330	—
Total Liabilities	4,699	8,081
Commitments and Contingencies		

Stockholders' Equity		
Preferred Stock Series C ($0.001 par 400 authorized, 54 and 174 issued and outstanding, respectively)	—	—
Common Stock – ($0.001 par, 2,000,000,000 authorized, 8,546,003 and 8,190,101 shares issued and outstanding, respectively)	9	8
Additional Paid-in-capital	26,297	26,411
Accumulated Deficit	(17,873)	(20,473)
Stockholders' Equity	8,433	5,946
Total Liabilities and Stockholders' Equity	$13,132	$14,027

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 and per share data)			
	Three months ended		Nine months ended	
	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Revenue	$6,124	$4,386	$15,451	$11,938
Cost of Sales	4,628	3,500	11,846	9,511
Gross Margin	1,496	886	3,605	2,427
General and Administrative Expense	773	821	2,332	2,505
Operating Income (Loss)	723	65	1,273	(78)
Gain (Loss) on Change in Fair Value of Warrants	4	(1,024)	2,010	(666)
Interest Expense	(4)	(4)	(16)	(14)
Other (Expense) Income	—	(1,028)	1,994	(680)
Income (Loss) Before Taxes	723	(963)	3,267	(758)
Current Income Tax Expense	(137)	—	(144)	—
Net income (loss) applicable to common shareholders	$586	$(963)	$3,123	$(758)
Basic income (loss) per share	$0.07	$(0.12)	$0.37	$(0.09)
Weighted Average Common Shares Outstanding - basic	8,586,662	7,743,947	8,517,069	8,035,949
Diluted income (loss) per share	$0.07	$(0.12)	$0.36	$(0.09)
Weighted Average Common Shares Outstanding - Diluted	8,818,426	7,743,947	8,750,068	8,035,949

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

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

(Unaudited)

	(Thousands) Nine months ended July 1, 2018	July 2, 2017
Cash flows from operating activities:		
Net income (loss)	$3,123	$(758)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	241	253
(Gain) loss on change in fair value of warrants	(2,010)	666
Stock compensation expense	117	171
(Gain) loss on sale of fixed assets	—	(27)
Accounts receivable	570	272
Inventory	137	(1,159)
Prepaid expenses	(84)	28
Accounts payable and accrued expenses	(791)	67
Federal income taxes payable	54	—
Accrued warranty costs	(11)	—
Prepaid royalties - long term	22	22
Customer advance deposits	(362)	130
Total adjustments	(2,117)	423
Net cash provided by (used in) operating activities	1,006	(335)
Cash flows (used in) provided by investing activities		
Purchases of property and equipment	(35)	(130)
Proceeds from sale of fixed assets	—	27
Net cash used in investing activities	(35)	(103)
Cash flows used in financing activities		
Dividends paid	(784)	—
Cash paid for taxes withheld on net settled restricted stock unit share issue	(30)	(15)
Proceeds (to) stock repurchase	(200)	(518)
Net cash used in financing activities	(1,014)	(533)
Net decrease in cash and cash equivalents	(43)	(971)
Cash and cash equivalents at beginning of period	1,682	2,568
Cash and cash equivalents at end of period	$1,639	$1,597

Supplemental cash flow information:		
Exchange of common stock for non-trade accounts receivable	$—	$155
Exchange of preferred stock for common stock	600	210
Dividends declared and unpaid	—	261
Cash paid for taxes	90	—
Cash paid for interest	16	14

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

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Note 1 - Organization and Operations

Optex Systems Holdings, Inc. (“the Company”) 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. The Company’s consolidated revenues are derived from the U.S. government, 39%, one major U.S defense contractor, 27%, one commercial customer, 22%, and all other customers, 12%. Approximately 83% of the total company revenue is generated from domestic customers and 17% is derived from Canada. Optex Systems Holdings’ operations are based in Dallas and Richardson, Texas in leased facilities comprising 93,967 square feet. As of July 1, 2018, Optex Systems Holdings operated with 88 full-time equivalent employees.

Note 2 - Accounting Policies

Basis of Presentation

Principles of Consolidation: The consolidated financial statements include the accounts of the Company 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 Securities and Exchange Commission (“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 the Company 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 October 1, 2017 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. Actual results could differ from the estimates.

Inventory: As of July 1, 2018 and October 1, 2017, inventory included:

	(Thousands)	
	July 1, 2018	October 1, 2017
Raw Material	$4,876	$5,931
Work in Process	3,766	2,859
Finished Goods	458	441
Gross Inventory	$9,100	$9,231
Less: Inventory Reserves	(1,623)	(1,617)
Net Inventory	$7,477	$7,614

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Warranty Costs: As of July 1, 2018 and October 1, 2017, the Company had warranty reserve balances of $163 thousand and $174 thousand, respectively. During the three and nine months ending July 1, 2018 the Company recognized $62 thousand and $273 thousand in warranty expenses related to quality issues encountered on Applied Optics Center optical assemblies for returned products requiring repairs or replacements. There were no warranty expenses recognized during the three and nine months ending July 2, 2017. We believe we have made sufficient improvements to the production process to minimize the return rate on future shipments but we will continue to review and monitor the reserve balances related to this product line against any existing warranty backlog and current trend data on an interim basis until the current warranty backlog is depleted.

Fair Value of Financial Instruments: 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 cash and cash equivalents, accounts payable, accrued liabilities, and notes payable, are carried at, or approximate, fair value as of the reporting date because of their short-term nature. Fair values for the Company's warrant liabilities and derivatives are estimated by utilizing valuation models that consider current and expected stock prices, volatility, dividends, market interest rates, forward yield curves and discount rates. Such amounts and the recognition of such amounts are subject to significant estimates that may change in the future.

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value and requires that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market-based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs reflecting the reporting entity's own assumptions.

The accounting guidance establishes a hierarchy which requires an entity to maximize the use of quoted market prices and minimize the use of unobservable inputs. An asset or liability's level is based on the lowest level of input that is significant to the fair value measurement. Fair value estimates are reviewed at the origination date and again at each applicable measurement date and interim or annual financial reporting dates, as applicable for the financial instrument, and are based upon certain market assumptions and pertinent information available to management at those times.

Each of the measurements is considered a Level 2 or Level 3 measurement based on the availability of market data and inputs and the significance of any unobservable inputs as of the measurement date. The methods and significant inputs and assumptions utilized in estimating the fair value of the warrant liabilities, as well as the respective hierarchy designations are discussed further in Note 6 “Warrant Liabilities”.

Income Tax/Deferred Tax: As of July 1, 2018 Optex Systems, Inc. has a deferred tax asset valuation allowance of ($2.7) million against deferred tax assets of $2.7 million, as compared to a valuation allowance of ($4.6) million against deferred tax assets of $4.6 million as of October 1, 2017. The valuation allowance has been established due to historical losses resulting in a Net Operating Loss Carryforward for each of the fiscal years 2010 through 2016. During the nine months ended July 1, 2018, our deferred tax assets and corresponding valuation account decreased by $1.9 million. During the nine months ended July 1, 2018, the Company recognized a $1.7 million reduction in the deferred tax assets as a result of the Tax Cuts and Jobs Act of 2017 enacted on December 22, 2017 which changed the Corporate tax rate from 34% to 21% effective as of January 1, 2018, and $0.2 million related to current year tax adjustments for amortization expenses and the applied net operating loss carryforward. We intend to continue maintaining a full valuation allowance on our deferred tax assets until there is sufficient evidence to support the reversal of all or some portion of these allowances.

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 Company has potentially dilutive securities outstanding which include convertible preferred stock, unvested restricted stock units, 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. The Company uses the Treasury Stock Method to compute the dilutive effect of any dilutive shares. Convertible preferred stock, unvested restricted stock units, stock options and warrants that are anti-dilutive are excluded from the calculation of diluted earnings per common share.

For the three and nine months ended July 1, 2018, 54 preferred Series C preferred shares (which converts to 225,000 common shares), and 33,000 unvested restricted stock units were included in the diluted earnings per share calculation and 66,000 unvested restricted stock units, 60,000 stock options and 4,125,200 warrants were excluded from the earnings per share calculation as they were antidilutive. For the three and nine months ended July 2, 2017, 318 preferred Series C shares (which converts to 1,325,000 common shares) were included in the diluted earnings per share calculation, respectively, and 182,000 unvested restricted stock units, 56,260 stock options and 4,125,200 warrants were excluded from the earnings per share calculation as they were antidilutive.

Note 3 - Segment Reporting

The Company’s 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. Applied Optics Center was acquired as a unit, and the management at the time of the acquisition was retained. Both the Applied Optics Center and Optex Systems – Richardson operate as reportable segments under the Optex Systems, Inc. corporate umbrella.

The Applied Optics Center segment also serves as the key supplier of laser coated filters used in the production of periscope assemblies for the Optex Systems-Richardson (“Optex Systems”) 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 (OPX) – Richardson, Texas

Optex Systems revenues are primarily in support of prime and subcontracted military customers. Approximately 71% of the Optex Systems segment revenue is comprised of domestic military customers, 29% is comprised of foreign military customers and 1% is attributable to commercial customers. The Optex Systems segment revenue from the U.S. government and one other major U.S. defense contractor represent approximately 28% and 17% of the

Company's consolidated revenue, respectively.

Optex Systems is located in Richardson Texas, with leased premises consisting of approximately 49,100 square feet. As of July 1, 2018, the Richardson facility operated with 52 full time equivalent employees in a single shift operation. Optex Systems, Richardson serves as the home office for both the Optex Systems and Applied Optics Center segments.

Applied Optics Center (AOC) – Dallas, Texas

The Applied Optics Center serves primarily domestic U.S. customers. Sales to commercial customers represent 61% and military sales to prime and subcontracted customers represent 39% of the total segment revenue. Approximately 83% of the AOC revenue is derived from external customers and approximately 17% is related to intersegment sales to Optex Systems in support of military contracts. The AOC segment revenue from the U.S. government and one major commercial customer represents approximately 10% and 22% of the Company's consolidated revenue, respectively.

The Applied Optics Center is located in Dallas, Texas with leased premises consisting of approximately 44,867 square feet of space. As of July 1, 2018, AOC operated with 36 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. The Company does not allocate interest expense, income taxes or unusual items to segments.

	Reportable Segment Financial Information (thousands) Three months ended July 1, 2018			
	Optex Systems Richardson	Applied Optics Center Dallas	Other (non-allocated costs and intersegment eliminations)	Consolidated Total
Revenues from external customers	$4,114	$2,010	$—	$6,124
Intersegment revenues	—	436	(436)	—
Total Revenue	$4,114	$2,446	$(436)	$6,124
Interest expense	$—	$—	$4	$4
Depreciation and Amortization	$9	$71	$—	$80
Income before taxes	$558	$201	$(36)	$723
Other significant noncash items:				
Allocated home office expense	$(159)	$159	$—	$—
Gain on change in fair value of warrants	$—	$—	$(4)	$(4)
Stock compensation expense	$—	$—	$36	$36
Royalty expense amortization	$8	$—	$—	$8
Segment Assets	$9,145	$3,987	$—	$13,132
Expenditures for segment assets	$18	$—	$—	$18

	Optex Systems Richardson	Applied Optics Center Dallas	Other (non-allocated costs and intersegment eliminations)	Consolidated Total
Reportable Segment Financial Information (thousands) Three months ended July 2, 2017				
Revenues from external customers	$3,105	$1,281	$—	$4,386
Intersegment revenues	—	563	(563)	—
Total Revenue	$3,105	$1,844	$(563)	$4,386
Interest expense	$—	$—	$4	$4
Depreciation and Amortization	$14	$72	$—	$86
Income (Loss) before taxes(1)	$17	$91	$(1,071)	$(963)