

Optex Systems Holdings Inc
Form 424B3
May 31, 2011

Prospectus Supplement No. 2
(To Prospectus dated February 10,
2011)

Filed Pursuant to Rule 424(b)(3)
Registration No. 333-159334

Optex Systems Holdings, Inc.
11,784,177 Shares of Common Stock

This prospectus supplement relates to the offer and sale from time to time of up to 11,784,177 shares of common stock of Optex Systems Holdings, Inc., a Delaware corporation, by the selling stockholders named in the prospectus dated February 10, 2011 (the "Prospectus"). The Prospectus relates to the offer and sale of up to 11,784,177 shares of common stock registered on Registration Statement No. 333-159334. You should read this prospectus supplement in conjunction with the Prospectus, and this prospectus supplement is qualified in its entirety by reference to the Prospectus, except to the extent that the information contained in this prospectus supplement supersedes or supplements the information contained in the Prospectus.

The information contained herein supplements the information in the Prospectus related to the Financial Statements and Supplementary Data by including our audited financial statements and related notes for the three months ended April 3, 2011. This prospectus supplement also contains certain other information included in our report on Form 10-Q for the quarter ended April 3, 2011.

Our report on Form 10-Q for the quarter ended April 3, 2011, reflects a total of 139,444,940 shares of our common stock issued and outstanding as of April 3, 2011.

Investing in our common stock is speculative and involves a high degree of risk. See "Risk Factors" beginning on page 4 of the Prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if the Prospectus or this prospectus supplement is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is May 29, 2011.

Item 1. Financial Information

OPTEX SYSTEMS HOLDINGS, INC.
UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
AS OF APRIL 3, 2011

| | |
|--|-----|
| BALANCE SHEETS AS OF APRIL 3, 2011 (UNAUDITED) AND OCTOBER 3, 2010 | F-1 |
| STATEMENTS OF OPERATIONS FOR THE THREE AND SIX MONTHS ENDED APRIL 3, 2011 AND THE THREE AND SIX MONTHS ENDED MARCH 28, 2010 (UNAUDITED) | F-2 |
| STATEMENTS OF CASH FLOWS FOR THE SIX MONTHS ENDED APRIL 3, 2011 AND FOR THE SIX MONTHS ENDED MARCH 28, 2010 (UNAUDITED) | F-3 |
| FINANCIAL STATEMENT FOOTNOTES (UNAUDITED) | F-4 |

Optex Systems Holdings, Inc.
Condensed Consolidated Balance Sheets

| | (Thousands) | |
|---|----------------|------------------|
| | April 3, 2011 | October 3, 2010 |
| ASSETS | | |
| Current Assets | | |
| Cash | \$712 | \$ 1,030 |
| Accounts Receivable | 2,004 | 2,375 |
| Federal Income Tax Receivable | 376 | - |
| Deferred Tax Asset - Short Term | - | 376 |
| Net Inventory | 5,913 | 5,890 |
| Prepaid Expenses | 56 | 245 |
| Total Current Assets | \$9,061 | \$ 9,916 |
| Property and Equipment | | |
| Property Plant and Equipment | \$1,479 | \$ 1,457 |
| Accumulated Depreciation | (1,194) | (1,161) |
| Total Property and Equipment | \$285 | \$ 296 |
| Other Assets | | |
| Deferred Tax Asset - Long Term | \$597 | \$ 617 |
| Security Deposits | 21 | 21 |
| Total Other Assets | \$618 | \$ 638 |
| Total Assets | \$9,964 | \$ 10,850 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Accounts Payable | \$912 | \$ 763 |
| Accrued Expenses | 752 | 574 |
| Accrued Warranties | 25 | 25 |
| Accrued Contract Losses | 732 | 1,357 |
| Credit Facility | 436 | 1,107 |
| Total Current Liabilities | \$2,857 | \$ 3,826 |
| Total Liabilities | \$2,857 | \$ 3,826 |
| Stockholders' Equity | | |
| Optex Systems Holdings, Inc. – (par \$0.001, 200,000,000 authorized, 139,444,940 shares issued and outstanding) | \$139 | \$ 139 |
| Optex Systems Holdings, Inc. Preferred Stock (0.001 par 5,000 authorized, 1027 series A preferred issued and outstanding) | - | - |
| Additional Paid-in-capital | 17,415 | 17,162 |
| Retained Earnings (Deficit) | (10,447) | (10,277) |

Edgar Filing: Optex Systems Holdings Inc - Form 424B3

| | | |
|--|---------|-----------|
| Total Stockholders' Equity | \$7,107 | \$ 7,024 |
| Total Liabilities and Stockholders' Equity | \$9,964 | \$ 10,850 |

The accompanying notes are an integral part of these financial statements

F-1

Optex Systems Holdings, Inc.
Condensed Consolidated Statements of Operations (Unaudited)

(Thousands)

| | Three months ended | | Six months ended | |
|--|--------------------|----------------|------------------|----------------|
| | April 3, 2011 | March 28, 2010 | April 3, 2011 | March 28, 2010 |
| Revenues | \$3,756 | \$ 6,318 | \$8,740 | \$ 12,233 |
| Total Cost of Sales | 3,164 | 5,587 | 7,485 | 10,747 |
| Gross Margin | \$592 | \$ 731 | \$1,255 | \$ 1,486 |
| General and Administrative | | | | |
| General Expenses | 589 | 664 | 1,149 | 1,272 |
| Amortization of Intangible Assets | - | 80 | - | 160 |
| Total General and Administrative | \$589 | \$ 744 | \$1,149 | \$ 1,432 |
| Operating Income (Loss) | \$3 | \$ (13) | \$106 | \$ 54 |
| Other Expenses | | | | |
| Interest (Income) Expense - Net | 30 | 35 | 53 | 39 |
| Total Other | \$30 | \$ 35 | \$53 | \$ 39 |
| Income (Loss) Before Taxes | \$(27) | \$ (48) | \$53 | \$ 15 |
| Deferred Income Taxes (Benefit) | (10) | (56) | 20 | (74) |
| Net Income (Loss) After Taxes | \$(17) | \$ 8 | \$33 | \$ 89 |
| Less preferred stock dividend | \$(102) | \$ (97) | \$(203) | \$ (192) |
| Net loss applicable to common shareholders | \$(119) | \$ (89) | \$(170) | \$ (103) |
| Basic and diluted loss per share | \$(0.00) | \$ (0.00) | \$(0.00) | \$ (0.00) |

The accompanying notes are an integral part of these financial statements

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

(Thousands)
Six months ended
April 3, 2011 March 28, 2010

| | | |
|---|----------|-------------|
| Cash flows from operating activities: | | |
| Net income (loss) | \$33 | \$ 89 |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 34 | 553 |
| Provision for allowance for inventory valuation | - | 18 |
| Noncash interest expense | 19 | 4 |
| Stock option compensation expense | 50 | 47 |
| (Increase) decrease in accounts receivable | 371 | (652) |
| (Increase) decrease in federal income tax receivable | (376) | - |
| (Increase) decrease in inventory (net of progress billed) | (23) | 283 |
| (Increase) decrease in prepaid expenses | 177 | 7 |
| (Increase) decrease in deferred tax asset (net of valuation allowance) | 396 | (74) |
| Increase (decrease) in accounts payable and accrued expenses | 319 | (936) |
| Increase (decrease) in accrued warranty costs | - | (57) |
| Increase (decrease) in accrued estimated loss on contracts | (625) | (268) |
| Increase (decrease) in income taxes payable | - | - |
| Total adjustments | \$342 | \$ (1,075) |
| Net cash (used)/provided by operating activities | \$375 | \$ (986) |
| Cash flows from investing activities: | | |
| Purchased of property and equipment | (22) | (6) |
| Net cash (used in) provided by investing activities | \$(22) | \$ (6) |
| Cash flows from financing activities: | | |
| Proceeds from / Repayment (to) credit facility | (671) | 849 |
| Proceeds from loans payable | - | 250 |
| Repayments on loans payable | - | (125) |
| Net cash (used In) provided by financing activities | \$(671) | \$ 974 |
| Net increase (decrease) in cash and cash equivalents | \$(318) | \$ (18) |
| Cash and cash equivalents at beginning of period | 1,030 | 915 |
| Cash and cash equivalents at end of period | \$712 | \$ 897 |
| Noncash Investing and Financing Activities: | | |
| Issuance of Warrants as Debt Issuance Cost | | |
| Additonal Paid in Capital (1,100,000 warrants) | \$- | \$ 32 |
| Supplemental cash flow information: | | |
| Cash Paid for Interest | \$34 | 35 |

The accompanying notes are an integral part of these financial statements

F-3

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. 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.

In accordance with FASB ASC 805 Optex Systems, Inc.’s purchase of substantially all of the assets and assumption of certain liabilities represented the acquisition of a business. FASB ASC 805 outlines the guidance in determining whether a “business” has been acquired in a transaction. For a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set of assets is separated from the transferor, which include the ability to sustain a revenue stream by providing its outputs to customers. Optex Systems, Inc. obtained the inputs and processes necessary for normal operations.

On February 20, 2009, Sileas Corporation, 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 73.5% 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 Richardson, Texas in a leased facility comprising 49,100 square feet. As of April 3, 2011, Optex Systems Holdings operated with 81 full-time equivalent employees.

Optex Systems Holdings manufactures optical sighting systems and assemblies, primarily for Department of Defense 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.

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.

F-4

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.

These financial statements have been presented as subsidiary-only financial statements, reflecting the statements of operations and cash flows of the subsidiary as a stand-alone entity.

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 financial statements and the notes thereto included in the Optex Systems Holdings' Form 10-K and other reports filed with the SEC.

The accompanying unaudited interim 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: 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. As of April 3, 2011 and October 3, 2010, inventory included:

| | (Thousands) | |
|--------------------------------|--|-----------------------------|
| | As of April 3, 2011 (unaudited) | As of October 3, 2010 |
| Raw Materials | \$ 4,597 | \$ 4,343 |
| Work in Process | 2,103 | 2,824 |
| Finished Goods | 163 | 366 |
| Gross Inventory | \$ 6,863 | \$ 7,533 |
| Less: | | |
| Unliquidated Progress Payments | (524) | (1,217) |
| Inventory Reserves | (426) | (426) |
| Net Inventory | \$ 5,913 | \$ 5,890 |

Stock-Based Compensation: In December 2004, FASB issued FASB ASC 718. 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.

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.

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 the Company will not realize tax assets through future operations. Optex Systems Holdings has recognized deferred income tax benefits on net operating loss carry-forwards to the extent Optex Systems Holdings believes it will be able to utilize them in future tax filings. The difference between the income tax expense and pretax accounting income is primarily attributable to \$5 thousand of non deductible expenses representing permanent timing differences between book income and taxable income during the six months ended April 3, 2011. The tax effect of this permanent timing difference is an increase in income tax expense of \$2 thousand for the six months ended April 3, 2011. There are no permanent timing differences resulting from goodwill amortization due to the full impairment of goodwill as of the fiscal year ending October 3, 2010.

On March 1, 2011, Optex Systems Inc. filed an amendment to Form 1139 with the Internal Revenue Service to claim a refund related to the net operating loss incurred for the fiscal year ended October 2, 2010. The total refund related to the net operating loss carry-back was \$376 thousand. The refund due has been recorded as of April 3, 2011 as a federal income tax receivable, and payment was received from the Internal Revenue Service in April 2011

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 three and six months ended April 3, 2011, 1,027 shares of Series A preferred stock, 2,572,649 stock options and 9,948,667 warrants were excluded as anti-dilutive. For the three and six months ended March 28, 2010, there were 2,665,649 stock options and 9,948,667 warrants excluded as anti-dilutive.

Reclassification: Certain expenses reflected in the financial statements for the six months ended April 3, 2011 have been reclassified to conform with the current year presentation. Prior to the six months ending April 3, 2011, financial statements had been presented in whole dollars. Effective October 4, 2010 (the beginning of the current fiscal year), all financials have been converted and presented to the nearest thousand. The company reclassified \$376 thousand of deferred tax asset – long term, to deferred tax asset – short term in the current asset section of the balance sheet, for the net operating loss carry back portion of the deferred tax asset that was applied to the prior year tax liabilities paid. The amount is also reflected as federal income tax receivable in the current asset section as of period ending April 2, 2011 and the refund was subsequently received in April 2011. This adjustment affected the balance sheet classification of current vs. noncurrent assets only and had no impact to the net loss for year ending October 3, 2010.

Note 3 - Commitments and Contingencies

Leases

Pursuant to a lease amendment effective January 4, 2010, Optex Systems Holdings leases its office and manufacturing facilities under a non-cancellable operating lease expiring July 31, 2015, in addition to maintaining several non-cancellable operating leases for office and manufacturing equipment. Total expense under facility lease agreements as of the three and six months ended April 3, 2011 was \$74 and \$145 thousand, respectively, and total expense for manufacturing and office equipment was \$11 and \$20 thousand, respectively. Total expense under facility lease agreements for the three and six months ended March 28, 2010 was \$65 and \$142 thousand, respectively. Total expense for manufacturing and office equipment for the three and six months ended March 28, 2010 was \$7 and \$15 thousand, respectively.

As of April 3, 2011, the remaining minimum lease payments under the non-cancelable operating leases for equipment, office and facility space are as follows:

Operating
Leases

(Thousands)

| Fiscal Year | |
|------------------------------|----------|
| 2011 \$ | 125 |
| 2012 | 236 |
| 2013 | 232 |
| 2014 | 242 |
| 2015 | 201 |
| Total minimum lease payments | \$ 1,036 |

F-7

Pursuant to the terms of the amendment to the facilities lease, there was no base rent payment due from January 1, 2010 through July 31, 2010, and the total value of this rent abatement was \$134 thousand. The value of the deferred rent expense will be amortized monthly at a rate of \$2 thousand per month over the life of the lease. The total unamortized deferred rent as of April 3, 2011 was \$104 thousand. Commencing on August 1, 2010, the base rent payment was \$19 thousand per month.

Note 4 - Debt Financing

Short Term Note Payable/Longview Fund (Related Party) - On October 27, 2009, Optex Systems Holdings borrowed \$250 thousand from the Longview Fund, a related party, pursuant to a promissory note, with an original maturity date of December 1, 2009, which was extended to July 15, 2010 pursuant to an allonge dated January 5, 2010. The note carried an interest rate of 10% per annum, and all accrued and unpaid interest thereon was due upon maturity. The note required Optex Systems Holdings to make a prepayment equal to 50% of the then outstanding principal amount plus accrued and unpaid interest thereon upon the closing of a credit facility or other equity or debt financing from which the net proceeds to Optex Systems Holdings were at least \$900 thousand, with any remaining unpaid balance due on July 15, 2010. In exchange for the allonge, Optex Systems Holdings granted Longview a warrant to purchase 100,000 shares of its restricted common stock with an exercise price of \$0.15 per share and with a term of three years. In conjunction with the Peninsula Bank financing (below) on March 22, 2010, Optex Systems Holdings paid to Longview a principal prepayment of \$125 thousand and \$10 thousand in accrued interest. The remaining principal amount of the note of \$125 thousand plus all accrued and unpaid interest thereon was paid in full on June 4, 2010.

Credit Facility - Peninsula Bank Business Funding

Effective March 4, 2010, Optex Systems, Inc. entered into a Loan and Security Agreement (“Agreement”) with Peninsula Bank Business Funding, a division of the Private Bank of the Peninsula (“Lender”).

The Agreement provides for a revolving line of credit of up to \$2 million, based upon advances to be made against percentages of eligible receivables as set forth in the Agreement. The material terms of the Agreement are as follows:

- The interest rate for all advances shall be the greater of 8.5% and the then in effect prime rate plus 3.5% and subject to a minimum quarterly interest payment of \$16 thousand.
- Interest shall be paid monthly in arrears.
- The expiration date of the Agreement is March 4, 2011, at which time any outstanding advances, and accrued and unpaid interest thereon, will be due and payable.
- In connection with the entry into the Agreement by the Lender, Optex Systems, Inc. paid the Lender a facility fee of \$20 thousand and issued a warrant to Lender to purchase 1,000,000 shares of its common stock. The warrant bears an exercise price of \$0.10 per share and expires on March 3, 2016.
- The obligations of Optex Systems, Inc. to the Lender 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 the Lender.
- The Agreement contains affirmative and negative covenants that require Optex Systems, Inc. to maintain certain minimum cash and EBITDA levels on a quarterly basis and contains other customary covenants. The Agreement also contains customary events of default. Upon the occurrence of an event of default that remains uncured after any applicable cure period, the Lender’s commitment to make further advances may terminate, and the Lender 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 Lender, Optex Systems Holdings has guaranteed all obligations of Optex Systems, Inc. to Lender.

On February 15, 2011, Peninsula Bank Business Funding agreed to a third amendment to its credit facility agreement with us to extend the maturity date to April 15, 2011. The maximum amount of the revolving credit line was reduced

to \$1 million, section 2.3(a)(ii) was amended so that the minimum quarterly interest payment is \$8.5 thousand, and the minimum EBITDA requirement was deleted in its entirety.

F-8

On March 22, 2011, Peninsula Bank Business Funding and Optex Systems, Inc. (the "Company"), the wholly-owned subsidiary of Optex Systems Holdings, Inc., entered into a fourth amendment to the existing credit facility agreement between them to extend the maturity date to March 15, 2012. Section 1.1 was amended to: (i) define "Borrowing Base" as \$175,000, (ii) delete the definition of "EBITDA", and (iii) amend subsection (i) of the definition of "Eligible Accounts" so as to exclude any accounts for any account debtor (other than GDLS) which exceed 30% of all accounts and for GDLS to exclude those total obligations that exceed the lesser of 50% of all accounts or the aggregate sum of \$500,000. Section 2.3(a)(ii) was amended so that the minimum semi annual interest payment is \$20,000, and Section 6.8 was amended in its entirety so as to require the Company to maintain a zero balance on the credit facility for a period of at least 30 consecutive days during the period from March 15, 2011 to March 15, 2012.

As of April 3, 2011, the outstanding balance on the line of credit was \$436 thousand.

Note 5-Stock Based Compensation

Option Agreements:

On March 26, 2009, the Board of Directors of Optex Systems Holdings adopted the 2009 Stock Option Plan providing for the issuance of up to 6,000,000 shares to Optex Systems Holdings' officers, directors, employees and independent contractors who provide services to Optex Systems Holdings.

Options granted under the 2009 Stock Option Plan vest as determined by the Board of Directors of Optex Systems Holdings or any committee set up to act as a compensation committee of the Board of Directors and terminate after the earliest of the following events: (i) expiration of the option as provided in the option agreement, (ii) 90 days following the date of termination of the employee, or (iii) ten years from the date of grant (five years from the date of grant for incentive options granted to an employee who owns more than 10% of the total combined voting power of all classes of Optex Systems Holdings stock at the date of grant). In some instances, granted stock options are immediately exercisable into restricted shares of common stock, which vest in accordance with the original terms of the related options. Optex Systems Holdings recognizes compensation expense ratably over the requisite service period.

The option price of each share of common stock is determined by the Board of Directors or compensation committee (when one is established), provided that with respect to incentive stock options, the option price per share will in all cases be equal to or greater than 100% of the fair value of a share of common stock on the date of the grant, except an incentive stock option granted under the 2009 Stock Option Plan to a shareholder that owns more than 10% of the total combined voting power of all classes of Optex Systems Holdings' stock, will have an exercise price of not less than 110% of the fair value of a share of common stock on the date of grant. No participant may be granted incentive stock options, which would result in shares with an aggregate fair value of more than \$100.0 thousand first becoming exercisable in one calendar year.

On March 30, 2009, 1,414,649 stock options with an exercise price of \$0.15 per share were granted to an officer of Optex Systems Holdings. These options vest as follows: 34% after the first year, and 33% each after the second and third years. These options have a seven year term from the date of issuance. On May 14, 2009, 1,267,000 stock options were issued to other Optex Systems Holdings employees, including options to purchase 250,000 shares to one executive officer.

These stock options vest 25% per year after each year of employment and have a seven year term from the date of issuance. For shares granted as of May 14, 2009, Optex Systems Holdings currently anticipates an annualized employee turnover rate of approximately 5% per year during the next few years. As a result, it anticipates that only 1,116,349 of the 1,267,000 stock options will vest by the end of the contract term. As of April 3, 2011, 1,237,315 of

the total awarded stock options had vested and 109,000 stock options had been forfeited due to employee turnover.

Optex Systems Holdings recorded compensation costs for options and shares granted under the plan amounting to \$25 and \$50 thousand for the three and six months ended April 3, 2011, respectively, as compared to \$25 and \$47 thousand for the three and six months ended March 28, 2010, respectively. The impact of these expenses is immaterial to the basic and diluted net loss per share for the three and six months ended April 3, 2011 and March 28, 2010. A deduction is not allowed for income tax purposes until nonqualified options are exercised. The amount of this deduction will be the difference between the fair value of Optex Systems Holdings' common stock and the exercise price at the date of option exercise. No tax deduction is allowed for incentive stock options. Accordingly, no deferred tax asset is recorded for GAAP expense related to these options.

F-9

Management has valued the options at their date of grant utilizing the Black-Scholes-Merton option pricing model. The fair value of the underlying shares was determined based on the closing price of Optex Systems Holdings' publicly-traded shares on the grant date. The expected volatility was calculated using the historical volatility of a diversified index of companies in the defense, homeland security, and space industry in accordance with FASB ASC 718-10-S99-1. In making this determination and trying to identify comparable companies, Optex Systems Holdings considered the industry, stage of life cycle, size and financial leverage of such other entities. Based on the development stage of Optex Systems Holdings, similar companies with sufficient historical data were not available. Optex Systems Holdings utilized the three year volatility of the SPADE Defense Index, which is a diversified index of 58 companies in the same industry as Optex Systems Holdings. The risk-free interest rate is based on the implied yield available on U.S. Treasury issues with an equivalent term approximating the expected life of the options depending on the date of the grant and expected life of the options. The expected life of options used was based on the contractual life of the option grant. Optex Systems Holdings determined the expected dividend rate based on the assumption and expectation that earnings generated from operations are not expected to be adequate to allow for the payment of dividends in the near future and the assumption that the company does not presently have any intention of paying cash dividends on its common stock

Optex Systems Holdings has granted stock options to officers and employees as follows:

| Date of Grant | Shares Granted | Exercise Price | Shares Outstanding As of 4/03/11 | Expiration Date | Vesting Date |
|---------------|----------------|----------------|----------------------------------|-----------------|--------------|
| 03/30/09 | 480,981 | \$ 0.15 | 480,981 | 03/29/2016 | 03/30/2010 |
| 03/30/09 | 466,834 | \$ 0.15 | 466,834 | 03/29/2016 | 03/30/2011 |
| 03/30/09 | 466,834 | \$ 0.15 | 466,834 | 03/29/2016 | 03/30/2012 |
| 05/14/09 | 316,750 | \$ 0.15 | 289,500 | 05/13/2016 | 05/14/2010 |
| 05/14/09 | 316,750 | \$ 0.15 | 289,500 | 05/13/2016 | 05/14/2011 |
| 05/14/09 | 316,750 | \$ 0.15 | 289,500 | 05/13/2016 | 05/14/2012 |
| 05/14/09 | 316,750 | \$ 0.15 | 289,500 | 05/13/2016 | 05/14/2013 |
| Total | 2,681,649 | | 2,572,649 | | |

The following table summarizes the status of Optex Systems Holdings' aggregate stock options granted under the incentive stock option plan:

| Subject to Exercise | Number of Shares Remaining Options | Weighted Average Intrinsic Price | Weighted Average Life (Years) | Aggregate Value |
|-----------------------------------|------------------------------------|----------------------------------|-------------------------------|-----------------|
| Outstanding as of October 3, 2010 | 2,598,649 | \$ - | 4.13 | \$ - |
| Granted – 2011 | - | \$ - | - | - |
| Forfeited – 2011 | (26,000) | \$ - | - | - |
| Exercised – 2011 | - | \$ - | - | - |
| Outstanding as of April 3, 2011 | 2,572,649 | \$ - | 3.63 | \$ - |
| Exercisable as of April 3, 2011 | 1,237,315 | \$ - | 2.89 | \$ - |

There were no new options granted or exercised during the three and six months ended April 3, 2011. The total intrinsic value of options forfeited during the three and six months ended April 3, 2011 was \$0.

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

| | Number of Non- vested Shares Subject to Options | Weighted- Average Grant- Date Fair Value |
|--|--|---|
| Non-vested as of October 3, 2010 | 1,821,668 | \$ 0.14 |
| Non-vested granted — Six Months ended April 3, 2011 | - | \$ 0.00 |
| Vested — Six Months ended April 3, 2011 | (466,834) | \$ 0.14 |
| Forfeited — Six Months ended April 3, 2011 | (19,500) | \$ 0.14 |
| Non-vested as of April 3, 2011 | 1,335,334 | \$ 0.14 |

As of April 3, 2011, the unrecognized compensation cost related to non-vested share based compensation arrangements granted under the plan was approximately \$162 thousand. This cost is expected to be recognized on a straight line basis from March 30, 2009 through May 13, 2013. The total fair value of options and shares vested during the six months ended April 3, 2011 was \$0.

Warrant Agreements:

Optex Systems Holdings calculates the fair value of warrants issued with debt or preferred stock using the Black-Scholes-Merton valuation method. The total proceeds received in the sale of debt or preferred stock and related warrants are allocated among these financial instruments based on their relative fair values. The discount arising from assigning a portion of the total proceeds to the warrants issued is recognized as interest expense for debt from the date of issuance to the earlier of the maturity date of the debt or the conversion dates using the effective yield method.

As of April 3, 2011, Optex Systems Holdings had the following warrants outstanding:

| | Grant Date | Warrants Granted | Exercise Price | Outstanding as of 01/02/11 | Expiration Date | Term |
|---|------------|---------------------|-------------------|----------------------------------|--------------------|---------|
| Private Placement Stock Holders | 3/30/2009 | 8,131,667 | \$ 0.450 | 8,131,667 | 3/29/2014 | 5 years |
| Finder Fee on Private Placement | 3/30/2009 | 717,000 | \$ 0.165 | 717,000 | 3/29/2014 | 5 years |
| Longview Fund Allonge Agreement | 1/5/2010 | 100,000 | \$ 0.150 | 100,000 | 1/4/2013 | 3 years |
| Peninsula Bank Business Funding - Line of Credit | 3/4/2010 | 1,000,000 | \$ 0.100 | 1,000,000 | 3/3/2016 | 6 years |
| Total Warrants | | 9,948,667 | | 9,948,667 | | |

During the three and six months ended April 3, 2011 Optex Systems Holdings recorded a total of \$5 and \$13 thousand in interest expense, respectively, related to the outstanding warrants. As of April 3, 2011 the interest expense on outstanding warrants was fully amortized. These warrants are not included in the computation of weighted average of shares as it would be anti-dilutive. See Note 8 for a discussion of a temporary reduction in the warrant exercise price for certain of our warrants.

F-11

Note 6—Stockholders Equity

Series A preferred stock

On March 24, 2009, 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 A preferred stock”. This Certificate of Designation was approved by Optex Systems Holdings’ Board of Directors and Shareholders at a Board Meeting and Shareholders Meeting held on February 25, 2009. The Certificate of Designation sets forth the following terms for the Series A preferred stock: (i) number of authorized shares: 1,027; (ii) per share stated value: \$6,000; (iii) liquidation preference per share: stated value; (iv) conversion price: \$0.15 per share 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.

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. Accumulated unpaid dividends accrue and cumulate dividends at the annual rate of 6%. 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 \$0.15 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 the three and six months ended April 3, 2011, Optex Systems Holdings recorded preferred dividends payable of \$102 and \$203 thousand, respectively, and as of the three and six months ended March 28, 2010, Optex Systems Holdings recorded preferred dividends payable of \$97 and \$192 thousand of dividends, respectively. As of April 3, 2011 there was a total of \$779 thousand of dividends in arrears on the preferred shares. The preferred shareholders have agreed to waive all existing and future dividends – see Note 8

Note 7— Reduction in Force

On April 1, 2010 and June 24, 2010, the Company reduced its workforce by approximately 9 and 15 full-time regular employees, respectively, who were solely or partially dedicated to its periscope production line and supporting functions. The Company also eliminated 2 full-time contract labor employees during April 2010. These reductions in force were made in anticipation of decreased production quantities on its periscope lines in the next fiscal quarter and are intended to reduce the monthly cash burn while maintaining current profit margins on the remaining periscope business. On March 7, 2011 the company reduced its workforce by 8 full time employees, as a result of the wind-down and completion of one of the Company’s major Howitzer contracts in March 2011.

Note 8 – Subsequent Events

On April 14, 2011, pursuant to a Written Consent in Lieu of a Meeting of Shareholders, Sileas Corporation, holder of approximately 73.3% of the Company's Common Stock, approved an amendment to the Company's Certificate of Incorporation to increase the number of authorized shares of its Common Stock from 200,000,000 to 2,000,000,000. This Written Consent is the subject of a Schedule 14C Information Statement filed with the Securities and Exchange Commission on April 18, 2011.

On April 14, 2011 Optex filed a Registration Statement on Form S-1 which provides for the sale of up to 25,000,000 shares of our Common Stock at a fixed price (currently anticipated to be \$0.01 per share), which will trigger the ratchet provision of the Series A preferred stock and reduce the conversion price to \$.01 per share. The S-1 also contemplates a reduction in the warrant exercise price to \$.01 per share for the 2009 private placement investors and a waiver of all existing and future dividends from the Series A preferred shareholders.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's Discussion and Analysis or Plan of Operations

This management's discussion and analysis reflects information known to management as at April 3, 2011 and through the date of this filing. This MD&A is intended to supplement and complement our audited financial statements and notes thereto for the fiscal year ended October 3, 2010 and the quarter ended April 3, 2011, prepared in accordance with U.S. generally accepted accounting principles (GAAP). You are encouraged to review our financial statements in conjunction with your review 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 non-GAAP measures are used in this MD&A, they are clearly identified as non-GAAP measures 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, 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. 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.

In accordance with FASB ASC 805 Optex Systems, Inc.'s purchase of substantially all of the assets and assumption of certain liabilities represented the acquisition of a business. FASB ASC 805 outlines the guidance in determining whether a "business" has been acquired in a transaction. For a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set of assets is separated from the transferor, which include the ability to sustain a revenue stream by providing its outputs to customers. Optex Systems, Inc. obtained the inputs and processes necessary for normal operations.

On February 20, 2009, Sileas Corporation, 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 73.5% 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 Richardson, Texas in a leased facility comprising 49,100 square feet. As of April 3, 2011, Optex Systems Holdings operated with 81 full-time equivalent employees.

Optex Systems Holdings manufactures optical sighting systems and assemblies, primarily for Department of Defense 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.

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.

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.

Results of Operations

During the second half of calendar 2010, we experienced reductions in forecasted sales volume due to changes in incremental funding commitments by federal agencies. Approval of the 2011 Congressional budget for the fiscal year beginning on October 1, 2010 and ending September 30, 2011, was obtained in mid-April, although current U.S. government spending continues to be based upon appropriations at 2010 levels. The first presidential draft of the fiscal year 2012 budget was released in mid February and does not show any material increases proposed in defense spending, so it is unlikely that there will be any increase or rebound as to the future appropriation levels of Abrams tanks, Bradley fighting vehicles and Stryker wheeled vehicles, as well as other significant armored tank programs. We will continue to evaluate the impact of changes in government defense spending to Optex Systems Holdings as the information becomes available, although based upon information currently available we do not anticipate any material changes. Due to new periscope orders from non-traditional sources and an aggressive pursuit of increased market share for all of our existing product lines, we expect to mitigate some of the current decreased U.S. government requirements with other new business. We also continue 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.

The table below summarizes our quarterly and year to date operating results in terms of both a GAAP net income measure and a non GAAP EBITDA measure. We use EBITDA as an additional measure for evaluating the performance of our business as "net income" historically included the significant impact of noncash intangible amortization on our income performance. Consequently, in order to have a meaningful measure of our operating performance on a continuing basis, we need to evaluate an income measure which does not take into account this intangible amortization. We have summarized the quarterly revenue and margin below along with a reconciliation of

the GAAP net loss to the non GAAP EBITDA calculation for comparative purposes below. We believe that including both measures allows the reader to have a “complete picture” of our overall performance.

Edgar Filing: Optex Systems Holdings Inc - Form 424B3

Qtr 1 ending Qtr 2 ending Six months ending Qtr 1 ending Qtr 2 ending Six months ending
January 2, 2011 April 3, 2011 April 3, 2011 December 27, 2009 March 28, 2010 March 28, 2010

| Net Loss Applicable to Common Shareholders - GAAP | \$ (0.05) | \$ (0.12) | \$ (0.17) | \$ - | \$ (0.10) | \$ (0.10) |
|---|------------|------------|------------|---------|------------|------------|
| Add: | | | - | | | - |
| Interest Expense | 0.02 | 0.03 | 0.05 | - | - | - |
| Preferred Stock Dividend | 0.10 | 0.10 | 0.20 | 0.10 | 0.10 | 0.20 |
| Federal Income Taxes (Benefit) | 0.03 | (0.01) | 0.02 | - | (0.10) | (0.10) |
| Depreciation & Amortization | 0.02 | 0.02 | 0.04 | 0.30 | 0.30 | 0.60 |
| EBITDA - Non GAAP | \$ 0.12 | \$ 0.02 | \$ 0.14 | \$ 0.40 | \$ 0.20 | \$ 0.60 |

Our EBITDA declined by \$0.46 million for the six months ended April 3, 2011 as compared to the prior year performance for the same period. The EBITDA reduction for the period was primarily attributable to a 28.7% or \$3.5 million reduction in revenue over the prior year. Optex was able to minimize the impact of lower revenues through cost improvements resulting in a 2.2% increase in the gross margin percentages, and a 9.7% reduction in general and administrative spending. We continue to pursue cost efficiencies in the production and general and administrative areas.

Product mix is dictated by customer contracted delivery dates and volume of each product to be delivered on such delivery dates. Shifts in gross margin from quarter to quarter are primarily attributable to the differing product mix recognized as revenues during each respective period. In fiscal year 2010, we completed existing contracts which were awarded in 2003 for legacy loss and low margin periscope orders. In the six months ending April 3, 2011, our gross margins on the remaining periscopes business has increased 19% over the gross margins rates for these products in the same period of the prior year. We expect our gross margins on these types of periscopes to continue to improve as new orders are booked and additional cost reduction initiatives are implemented.

We are currently experiencing losses on all of our U.S government Howitzer programs awarded from in August 2005 through September 2010 as a result of unanticipated manufacturing costs due to design and technical data package issues impacting product manufacturability. We entered fiscal 2011 with a historically higher percentage of loss Howitzer contracts, to total shippable backlog and a reduced visibility into the anticipated orders in other product groups to be booked in the current year. Our current backlog on these loss programs as of April 3, 2011 is \$3.4 million with contract loss reserves of \$0.7 million. We completed contract deliveries on one of our major Howitzer programs in March 2011, with the remaining two contracts expected to complete within the next 6-12 months, pending an expected contract delivery schedule change to one of the remaining programs. We continue to pursue cost reductions in our production and general and administrative areas to mitigate any further margin impacts and to improve overall product profitability. Optex Systems Holdings has requested an equitable adjustment on one of the howitzer loss programs due to significant design issues impacting the manufacturability of the product. We are currently in negotiations regarding the equitable adjustment and expect to have final resolution on the request within the next three to six months. As there is no guarantee that the request will be granted in whole or in part, Optex Systems Holdings recognized the entire estimated loss in fiscal year 2010. In the event we are unsuccessful in obtaining an equitable adjustment, future margins on these revenues are expected to be zero as these losses have been previously recognized to the extent identified.

We are aggressively pursuing additional, potentially higher margin business in periscopes, sighting systems and howitzer programs. In April 2011, Optex Systems hired a Vice President-Business Development with an effective

start date of May 16, 2011. Responsibilities of the position include the pursuit of new business opportunities through product development and customer growth within the current and future defense programs. New orders booked in the six months ending April 3, 2011 were \$3.5 million consisting primarily of \$2.4 million in foreign and domestic periscopes orders from several major defense contractors combined with foreign Howitzer unit orders of \$0.3 million and other product group orders of \$0.8 million.

As a result of the October 14, 2008 acquisition of the assets of Optex Systems, Inc. (Texas), Optex Systems, Inc.'s amortizable intangible assets increased significantly in 2009 over prior years. In fiscal year 2010, the amortization rate of intangible assets was \$0.26 million per fiscal quarter. We reviewed the fair market value of our goodwill and intangible assets as of October 3, 2010 and based on significant reductions in anticipated government military spending, a reduction in customer order trends, and lower contract backlog, we determined that that goodwill was impaired. The review was based on a projected cash flow analysis of our future operations. As of the year ended October 3, 2010, after impairment, the total balance of unamortized intangible assets and goodwill was zero, and as such there was no intangible asset amortization expense during the six months ending April 3, 2011.

As of April 3, 2011, backlog was \$13.8 million as compared to a backlog of \$22.5 million as of March 28, 2010. The following table depicts the current expected delivery by quarter of all contracts awarded as of April 3, 2011.

| Program Backlog (millions) | 2011 | | 2012 | | | | 2013 | | | Total |
|----------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|-------------|
| | Qtr 3 | Qtr 4 | Qtr 1 | Qtr 2 | Qtr 3 | Qtr 4 | Qtr 1 | Qtr 2 | Qtr 3 | |
| Howitzers | 2.6 | 0.8 | - | - | - | - | - | - | - | 3.4 |
| Periscopes | 2.1 | 1.7 | 2.0 | 1.7 | 1.2 | 0.4 | 0.1 | 0.1 | 0.1 | 9.4 |
| Sighting Systems | 0.1 | - | 0.1 | - | - | - | - | - | - | 0.2 |
| All Other | 0.3 | 0.2 | - | 0.1 | 0.1 | - | 0.1 | - | - | 0.8 |
| Total | 5.1 | 2.7 | 2.1 | 1.8 | 1.3 | 0.4 | 0.2 | 0.1 | 0.1 | 13.8 |

Virtually all 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, Federal Acquisition Regulation is the principal set of regulations that govern the acquisition process of government agencies and contracts with the federal government. In general, parts of the Federal Acquisition Regulation are incorporated into government solicitations and contracts by reference as terms and conditions affecting 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 incurred 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 federal government may require us to transfer title and deliver to the federal 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 federal government shall pay the contract price for completed supplies delivered and accepted, and we 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, 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 \$700,000, 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 April 3, 2011, none of our outstanding backlog fell under this criterion.

Three Months Ended April 3, 2011 Compared to the Three Months Ended March 28, 2010

Revenues. In the three months ended April 3, 2011, revenues decreased by 39.7% from the respective prior period in 2010 as set forth in the table below (dollar amounts in thousands):

| Product Line | (In Millions, except for percentages) | | Percent Change |
|-----------------------------|---------------------------------------|-----------------------------------|----------------|
| | Three Months ended April 3, 2011 | Three Months ended March 28, 2010 | |
| Howitzer Programs | \$ 0.8 | \$ 1.6 | \$ -0.8 |
| Periscope Programs | 2.6 | 3.2 | (0.6) |
| Sighting Systems | - | 0.3 | (0.3) |
| All Other | 0.4 | 1.2 | (0.8) |
| Total | \$ 3.8 | \$ 6.3 | \$ (2.5) |
| Percent increase (decrease) | | | (-39.7)% |

Revenues decreased by \$0.6 million, or 18.8%, on our periscope line during the three months ended April 3, 2011 as compared to the three months ended March 28, 2010. Based on our current backlog demand and a recent decline of new federal government orders deliverable in the remaining quarters of fiscal 2011, we expect the periscope product line deliveries to decline by 20-25% in the remaining two quarters of fiscal year 2011 as compared to revenues in the same period in 2010. We continue to quote and receive awards for additional periscopes from multiple customers and are aggressively pursuing increased market share in the periscope market by drawing business away from our competitors; however, we cannot yet determine if we will be successful in gaining sufficient new additional periscope business to offset the downturn caused by the decline in new federal government orders. In order to preserve product margins and mitigate the impact of the reduced periscope revenues since the first half of fiscal 2010, we have implemented several reductions in force during the last 12 months representing a total decline of approximately 24% of our total workforce.

Revenues from the Howitzer programs decreased \$0.8 million, or 50.0%, over the same three months in the prior year. In March 2011, we completed one of our major Howitzer programs. In addition, we have stopped production on another Howitzer program due a delay in receiving specialty glass material to be provided by our customer. We expect to resume production on this line in the next 30-45 days. We are currently negotiating a new contract delivery schedules with our U.S. government customer, which we expect will shift approximately \$1.6 million of current deliverable Howitzer backlog from quarters two through four of fiscal year 2011 into the first two fiscal quarters of 2012. The total impact of the expected contract modification will result in an overall shift of 33.5% of Howitzer revenue between fiscal 2011 and 2012 periods.

Sighting systems revenues decreased \$0.3 million, or 100%, over the same three months in the prior year, due to the completion of U.S. government back up sighting systems and General Dynamics commander weapon sighting systems in fiscal year 2010. We currently do not have a follow-on delivery order for additional sighting units; however, the primary contract ordering period for the U.S. government sighting systems does not expire until December 31, 2012. We continue to ship small sighting systems orders pursuant to other contracts to both federal government and non-U.S. government customers and continue to pursue business on several substantial programs for commander weapon sighting systems and M36 thermal sighting units, which if successfully consummated, would result in fiscal year 2012 deliveries.

Decreases in the other product line of \$0.8 million, or 66.7%, for the three months ending April 3, 2011 are primarily a result of decreased sales of big eye binoculars, mirror assemblies and TVS4 and PVS Objective assembly sales to multiple customers for contracts completed fiscal year 2010.

Currently, we are experiencing losses on our U.S government Howitzer programs as a result of unanticipated manufacturing costs due to design and technical data package issues impacting the product manufacturability. These issues have resulted in increased labor and material costs due to higher scrap and extensive engineering costs incurred during the start up phase of the programs. As of April 3, 2011, Optex Systems Holdings has reserved \$0.7 million in contract loss reserves on these programs with a remaining backlog of \$3.4 million. Pending negotiation of contract delivery schedule changes, we are expecting to ship \$1.7 million of the existing loss contract backlog in fiscal year 2011, with the remaining \$1.7 million expected to ship in the first two quarters of fiscal year 2012. Optex Systems Holdings has requested an equitable adjustment on one of the Howitzer loss programs due to significant design issues impacting the manufacturability of the product. We are currently in negotiations regarding the equitable adjustment and expect to have final resolution on the request within the next three to six months. As there is no guarantee that the request will be granted in part or in full, Optex Systems Holdings recognized the entire estimated loss in fiscal year 2010. In the event we are unsuccessful in obtaining an equitable adjustment, future margins on these revenues are expected to be zero as these losses have been previously recognized to the extent identified.

Cost of Goods Sold. During the three months ended April 3, 2011, we recorded cost of goods sold of \$3.2 million as opposed to \$5.6 million during the three months ended March 28, 2010, a decrease of \$2.4 million or 42.9%. This decrease in cost of goods sold was primarily associated with decreased revenues from the comparable three month period in the prior year, in addition to decreased intangible amortization in the three months ended April 3, 2011 as compared to the three months ended March 28, 2010, due to the write off of intangible assets associated with the Optex Systems, Inc. (Texas) acquisition during the year ending October 3, 2010. The gross margin during the three months ended April 3, 2011 was \$0.6 million or 15.8% of revenues as compared to a gross margin of \$0.7 million or 11.2% for the three months ended March 28, 2010. The increase in gross margin percentage in the first fiscal quarter of 2011 as compared to the prior year is primarily due to the elimination in intangible amortization allocable to cost of goods sold of \$0.2 combined with increased gross margins as a result of cost reductions implemented over the last twelve months.

G&A Expenses. During the three months ended April 3, 2011, we recorded operating expenses of \$0.6 million as opposed to \$0.7 million, during the three months ended March 28, 2010, a decrease of \$0.1 million or 14.3%. Operating expenses decreased primarily due to the elimination of intangible amortization of \$0.1 million attributable to the write off of intangible assets in the last quarter of fiscal year 2010. We expect our operating expenses to continue to decline throughout the fiscal year compared to the prior year, as a result of the elimination of intangible amortization expense combined with other cost reduction initiatives implemented in the last twelve months.

Operating Income (Loss). During the three months ended April 3, 2011, we recorded operating income of \$0.0 million, as compared to an operating loss of \$0.01 million during the three months ended March 28, 2010. Our operating income has increased slightly, despite the reduction in revenues primarily due to the elimination of intangible amortization expense combined with cost reduction initiatives implemented in the last twelve months to mitigate the decline in revenue and maintain our competitive position.

Net Income (Loss) applicable to common shareholders. During the three months ended April 3, 2011, we recorded a net loss applicable to common shareholders of \$0.12 million, as compared to \$0.09 million for the three months ended March 28, 2010, representing an increased loss of \$0.03 million. In the first three months of fiscal 2010 we recognized a tax benefit of \$0.01 million as compared to \$0.05 in the same period of fiscal year 2010. The change in taxes is primarily due to the effect of temporary and permanent timing differences related to intangible amortization and changes in reserve balances. Interest expense decreased by \$0.01 million in the current quarter over the prior year quarter.

Six Months Ended April 3, 2011 Compared to the Six Months Ended March 28, 2010

Revenues. In the six months ended April 3, 2011, revenues decreased by 28.7% from the respective prior period in 2010:

9

| Product Line | (In Millions, except for percentages) | | Percent Change |
|-----------------------------|---------------------------------------|----------------|----------------|
| | Six Months ended April 3, 2011 | March 28, 2010 | |
| Howitzer Programs | \$ 2.4 | \$ 2.6 | \$ -0.2 |
| Periscope Programs | 5.6 | 6.4 | (0.8) |
| Sighting Systems | - | 0.7 | (0.7) |
| All Other | 0.7 | 2.5 | (1.8) |
| Total | \$ 8.7 | \$ 12.2 | \$ (3.5) |
| Percent increase (decrease) | | | (-28.7)% |

Revenues decreased by \$0.8 million, or 12.5%, on our periscope line during the six months ended April 3, 2011 as compared to the six months ended March 28, 2010. Based on our current backlog demand and a recent decline of new federal government orders deliverable in the remaining quarters of fiscal 2011, we expect the periscope product line deliveries to decline by 20-25% in the remaining two quarters of fiscal year 2011 as compared to revenues in the same period in 2010. We continue to quote and receive awards for additional periscopes from multiple customers and are aggressively pursuing increased market share in the periscope market by drawing business away from our competitors; however, we cannot yet determine if we will be successful in gaining sufficient new additional periscope business to offset the downturn caused by the decline in new federal government orders. In order to preserve product margins and mitigate the impact of the reduced periscope revenues since the first half of fiscal 2010, we have implemented several reductions in force during the last 12 months representing a total decrease of approximately 24% of our total workforce.

Revenues from the Howitzer programs decreased by \$0.2 million, or 7.7%, over the prior year period. In March 2011, we completed one of our major Howitzer programs. In addition, we have stopped production on another Howitzer program due a delay in receiving specialty glass material provided by our customer. We expect to resume production on this line in the next 30-45 days. We are currently negotiating new contract delivery schedules with our U.S. government customer, which we expect will shift approximately \$1.6 million of current deliverable Howitzer backlog from quarters two through four of fiscal year 2011 into the first two fiscal quarters of 2012. The total impact of the expected contract modification will result in an overall shift of 33.5% of Howitzer revenue between fiscal 2011 and 2012 periods.

Sighting systems revenues decreased \$0.7 million, or 100%, over the same six months in the prior year, due to the completion of U.S. government back up sighting systems and General Dynamics commander weapon sighting systems in fiscal year 2010. We currently do not have a follow-on delivery order for additional sighting units; however, the primary contract ordering period for the U.S. government sighting systems does not expire until December 31, 2012. We continue to ship small sighting systems orders pursuant to other contracts to both federal government and non-U.S. government customers and continue to pursue business on several substantial programs for commander weapon sighting systems and M36 thermal sighting units, which if successfully consummated, would yield deliveries in fiscal year 2012.

Decreases in other product lines of \$1.8 million, or 72.0%, for the six months ending April 3, 2011 are primarily a result of decreased sales of big eye binoculars, mirror assemblies and TVS4 and PVS Objective assembly sales to multiple customers associated with contracts completed in fiscal year 2010.

Currently, we are experiencing losses on our U.S government Howitzer programs as a result of unanticipated manufacturing costs due to design and technical data package issues impacting the product manufacturability. These issues have resulted in increased labor and material costs due to higher scrap and extensive engineering costs incurred during the start up phase of the programs. As of April 3, 2011, Optex Systems Holdings has reserved \$0.7 million in contract loss reserves on these programs with a remaining backlog of \$3.4 million. Pending negotiation of contract delivery schedule changes, we are expecting to ship \$1.7 million of the existing loss contract backlog in fiscal year 2011, with the remaining \$1.7 million expected to ship in the first two quarters of fiscal year 2012. Optex Systems Holdings has requested an equitable adjustment on one of the howitzer loss programs due to significant design issues impacting the manufacturability of the product. We are currently in negotiations regarding the equitable adjustment and expect to have final resolution on the request within the next three to six months. As there is no guarantee that the request will be granted in part or in full, Optex Systems Holdings recognized the entire estimated loss in fiscal year 2010. In the event we are unsuccessful in obtaining an equitable adjustment, future margins on these revenues are expected to be zero as these losses have been previously recognized to the extent identified.

Cost of Goods Sold. During the six months ended April 3, 2011, we recorded cost of goods sold of \$7.5 million as opposed to \$10.7 million during the six months ended March 28, 2010, a decrease of \$3.2 million or 29.9%. This decrease in cost of goods sold was primarily associated with decreased revenues from the comparable six month period in the prior year, in addition to decreased intangible amortization in the first six months of fiscal 2011 as compared to the first six months of fiscal 2010 due to the write off of intangible assets associated with the Optex Systems, Inc. (Texas) acquisition as of the year ending October 3, 2010. The gross margin during the six months ended April 3, 2011 was \$1.3 million or 15.0% of revenues as compared to a gross margin of \$1.5 million or 12.3% for the six months ended March 28, 2010. The increase in gross margin percentage in the first two fiscal quarters of 2011 as compared to the prior year is primarily due to the elimination in intangible amortization allocable to cost of goods sold of \$0.4 million combined with increased gross margins as a result of cost reductions implemented in the last twelve months.

G&A Expenses. During the six months ended April 3, 2011, we recorded operating expenses of \$1.1 million as opposed to \$1.4 million, during the six months ended March 28, 2010, a decrease of \$0.3 million or 21.5%. Operating expenses decreased primarily due to the elimination of intangible amortization of \$0.2 million attributable to the write off of intangible assets in the last quarter of fiscal year 2010. We expect our operating expenses to continue to decline throughout the fiscal year, as compared to the prior year, due to the elimination of intangible amortization expense combined with other cost reduction initiatives implemented in the last twelve months.

Operating Income (Loss). During the six months ended April 3, 2011, we recorded operating income of \$0.10 million, as compared to operating income of \$0.05 million during the six months ended March 28, 2010. Our operating income has increased by \$0.05 million or 100%, despite the reduction in revenues. The increased operating income is primarily due to the elimination of intangible amortization expense combined with cost reduction initiatives implemented in the last twelve months that mitigated the decline in revenue and helped to maintain our competitive position.

Net Income (Loss) applicable to common shareholders. During the six months ended April 3, 2011, we recorded a net loss applicable to common shareholders of \$0.2 million, as compared to \$0.1 million for the six months ended March 3, 2010, representing an increased loss of \$0.1 million. In the first six months of fiscal 2011 we recognized a tax expense of \$0.02 million as compared to a \$0.08 million tax benefit in the same period of fiscal year 2010. The change in taxes is primarily due to the effect of temporary and permanent timing differences related to intangible amortization and changes in reserve balances. Interest expense increased by \$0.01 million in the first six months of fiscal year 2011 as compared to the prior year due to the line of credit instituted in March 2010.

Liquidity and Capital Resources

On March 10, 2010, the Company entered into a revolving credit facility with Peninsula Bank Business Funding, a division of the Private Bank of the Peninsula, which provides up to \$2.0 million in financing against eligible receivables. The revolving credit facility has allowed Optex the flexibility to more effectively manage the timing of incoming cash from our accounts receivable against our required cash outlay for operating activities. The material terms of the revolving credit facility are as follows:

- The interest rate for all advances shall be the greater of 8.5% and the then in effect prime rate plus 3.5% and subject to a minimum quarterly interest payment of \$16 thousand.
 - Interest shall be paid monthly in arrears.

- The expiration date of the facility is March 4, 2011, at which time any outstanding advances, and accrued and unpaid interest thereon, will be due and payable.
- In connection with the entry into the facility by Peninsula Bank Business Funding, Optex Systems, Inc. paid Peninsula Bank Business Funding a facility fee of \$20 thousand and issued a warrant to Peninsula Bank Business Funding to purchase 1,000,000 shares of its common stock. The warrant bears an exercise price of \$0.10 per share and expires on March 3, 2016.
- The obligations of Optex Systems, Inc. to Peninsula Bank Business Funding 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 Peninsula Bank Business Funding.
- The facility contains affirmative and negative covenants that require Optex Systems, Inc. to maintain certain minimum cash and EBITDA levels on a quarterly basis and contains other customary covenants. The facility also contains customary events of default. Upon the occurrence of an event of default that remains uncured after any applicable cure period, Peninsula Bank Business Funding's commitment to make further advances may terminate, and Peninsula Bank Business Funding 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 Peninsula Bank Business Funding, Optex Systems Holdings has guaranteed all obligations of Optex Systems, Inc. to Peninsula Bank Business Funding.

On August 3, 2010, Peninsula Bank Business Funding agreed to amend Sections 6.8(c) and (d) of the aforesaid agreement to adjust the minimum EBITDA covenant for the fiscal quarter ending October 2, 2010 to \$20 thousand, and for the fiscal quarter ending April 3, 2011 to \$200 thousand.

On November 23, 2010, Peninsula Bank Business Funding waived the Company's requirement to meet the EBITDA requirement set forth in Section 6.8 (c) of the August 3, 2010 amended Agreement for the fourth quarter ended October 3, 2010. In addition, on November 29, 2010 Peninsula Bank Business Funding agreed to a second amendment for Sections 6.8 (d) of the Agreement to adjust the minimum EBITDA covenant for the fiscal quarter ending April 3, 2011 to \$95 thousand.

On March 22, 2011, Peninsula Bank Business Funding and Optex Systems, Inc. (the "Company"), the wholly-owned subsidiary of Optex Systems Holdings, Inc., entered into a fourth amendment (which superseded a third interim amendment) to the existing credit facility agreement between them to extend the maturity date to March 15, 2012. Section 1.1 was amended to: (i) define "Borrowing Base" as \$175,000, (ii) delete the definition of "EBITDA", and (iii) amend subsection (i) of the definition of "Eligible Accounts" so as to exclude any accounts for any account debtor (other than GDLS) which exceed 30% of all accounts and for GDLS to exclude those total obligations that exceed the lesser of 50% of all accounts or the aggregate sum of \$500,000. Section 2.3(a)(ii) was amended so that the minimum semiannual interest payment is \$20,000, and Section 6.8 was amended in its entirety so as to require the Company to maintain a zero balance on the credit facility for a period of at least 30 consecutive days during the period from March 15, 2011 to March 15, 2012.

As of April 3, 2011, the outstanding balance on the line of credit is \$436 thousand and on May 15, 2011, the latest practicable date, the balance was \$378 thousand.

We have historically met our liquidity requirements from a variety of sources, including government and customer funding through contract progress bills, short term loans, notes from related parties, and the sale of equity securities. Based upon our current working capital position and potential for expanded business revenues, we believe that our working capital is sufficient to fund our current operations for at least the next 12 months. However, based on our strategy and the anticipated growth in our business, we believe that our liquidity needs may increase in the future. The amount of such increase will depend on many factors, including the costs associated with the fulfillment of our projects, whether we upgrade our technology, and the amount of inventory required for our expanding business. If our

liquidity needs do increase, we believe additional capital resources will be obtained from a variety of sources including, but not limited to, cash flow from operations and the issuance of our common stock and/or debt, including receivables funding through a commercial lender.

We currently have a pending progress bill of \$1.3 million of incurred contract cost against one of our current Howitzer programs. Our ability to utilize progress billing on this government contract has been temporarily suspended pending completion of a 2011 Defense Contract Audit Agency (DCAA) Accounting System Review. We are working with DCAA to support the ongoing review and expect completion and approval of the outstanding progress bill within the next 60 days. Any unanticipated delays in the completion of the review, or in approval of the outstanding progress bill could have a temporary adverse impact on our working capital during the next quarter. Pending a contract schedule change under current negotiation, we expect to begin shipments under the contract in June or July of 2011.

Cash Flows for the Period from October 4, 2010 through April 3, 2011

Cash and Cash Equivalents. As of April 3, 2011, we had cash and cash equivalents of \$0.7 million. During the period from October 4, 2010 through April 3, 2011, we decreased cash and cash equivalents by \$0.3 million primarily attributable to payments made against the our line of credit.

Net Cash Provided by Operating Activities. Net cash provided by operating activities during the period from October 4, 2010 to April 3, 2011 totaled \$0.4 million. The primary sources of cash during this period relate to collections of accounts receivable of approximately \$0.4 million.

Net Cash (Used) by Investing Activities. In the six months ended April 3, 2011, net cash used by investing activities totaled \$0.02 million and consisted of fixed asset purchases during the period.

Net Cash (Used) by Financing Activities. Net cash used by financing activities totaled \$0.7 million during the six months ended April 3, 2011 due to the repayment of \$0.7 million of the outstanding balance of the revolving credit facility since October 3, 2010.

Critical Policies and Accounting Pronouncements

Our significant accounting policies are fundamental to understanding our results of operations and financial condition. Some accounting policies require that we use estimates and assumptions that may affect the value of our assets or liabilities and financial results. These policies are described in “Critical Policies and Accounting Pronouncements” and Note 2 (Accounting Policies) to Financial Statements in our Annual Report on Form 10-K for the year ended October 3, 2010.

Recent Accounting Pronouncements

None.

Cautionary Factors That May Affect Future Results

This Quarterly Report on Form 10-Q 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.

Optex Systems Holdings does not assume the obligation to update any forward-looking statement. You should carefully evaluate such statements in light of factors described in this Form 10-Q. In various filings 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 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by our Quarterly Report on Form 10-Q for the quarter ended April 3, 2011, 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 upon the evaluation described above, our Principal Executive Officer and our Principal Financial Officer concluded that, as of April 3, 2011, our disclosure controls and procedures were effective.

Changes in Internal Control Over Financial Reporting

During the quarter ended April 3, 2011, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

We are not aware of any litigation pending or threatened by or against the Company.

Item 1A. Risk Factors

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 Form 10-Q, 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

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 April 3, 2011, we had approximately \$0.7 million of loss provision accrued for these fixed price contracts.

Approximately 95% of our contracts contain contract 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 on our results of operations from U.S. military orders by seeking to obtain foreign military orders. We are still engaged in this process and cannot yet determine if our efforts will result in securing sufficient additional orders to mitigate the adverse impact on our results of operations from the slower pace of U.S. military orders.

Conversion of our Series A preferred stock could cause substantial dilution to our existing common stock holders, and certain other rights of the preferred stock holders present other risks to our existing common stock holders.

As of April 3, 2011, we had 139,444,940 shares of our common stock issued and outstanding, as well as 1,027 shares of our Series A preferred stock issued and outstanding. The Series A preferred stock is convertible into 41,080,000 shares of our common stock, and upon conversion, the Series A preferred stock would represent 21.7% of our outstanding common stock. This would greatly dilute the holdings of our existing common stockholders. In addition, the preferred shareholders vote on a one-to-one basis with our common shareholders on an as converted basis.

Furthermore, in the event of a liquidation, the holders of our Series A preferred stock would receive priority liquidation payments before payments to common shareholders equal to the amount of the stated value of the preferred stock before any distributions would be made to our common shareholders. The total stated value of our preferred stock is \$6,162,000, so the preferred shareholders would be entitled to receive that amount before any distributions could be made to common shareholders. The liabilities on our balance sheet exceed the liquidation value of our assets; therefore, upon a liquidation, there would be no assets remaining for distribution to common shareholders.

The preferred shareholders also have the right, by majority vote of the shares of preferred stock, to generally approve any issuances by us of equity and/or indebtedness, which is not ordinary course of trade indebtedness. Therefore, the preferred shareholders can effectively prevent us from entering into a transaction which they feel is not in their best interests, even if the transaction might otherwise be in the best interests of Optex Systems Holdings and its common shareholders.