HOLLY ENERGY PARTNERS LP
Form S-3
November 21, 2008

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As filed with the Securities and Exchange Commission on November 21, 2008

Registration No. 333-

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form S-3

REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

Holly Energy Partners, L.P.
Holly Energy Finance Corp.*
(Exact Name of Registrants as Specified in Their Charters)

Delaware	**4610**	**20-0833098**
Delaware	**4610**	**20-2263311**
(State or Other Jurisdiction of Incorporation or Organization)	*(Registrants Primary Standard Industrial Classification Code Number)*	*(I.R.S. Employer Identification No.)*

100 Crescent Court, Suite 1600
Dallas, Texas 75201
(214) 871-3555
(Address, Including Zip Code, and Telephone Number, Including Area Code, of each of the Registrants Principal Executive Offices)

Denise C. McWatters
Vice President, Secretary and General Counsel
Holly Energy Partners, L.P.
100 Crescent Court, Suite 1600
Dallas, Texas 75201
(214) 871-3555
(Name, Address, Including Zip Code, and Telephone Number, Including Area Code, of each of the Registrants Agent for Service)

Copy to:

Alan J. Bogdanow
Christopher R. Rowley
Vinson & Elkins L.L.P.
Trammell Crow Center
2001 Ross Avenue, Suite 3700
Dallas, Texas 75201
(214) 220-7700

Approximate date of commencement of proposed sale to the public: From time to time after this registration statement becomes effective.

If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. þ

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the Commission pursuant to Rule 462(e) under the Securities Act, check the following box. o

If this form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box. o

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting Company o

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered	Proposed Maximum Offering Price per Unit	Proposed Maximum Aggregate Offering Price(1)	Amount of Registration Fee(6)
Primary Offering				
Common units representing limited partner interests(2)(3)				
Preferred units representing limited partner interests(2)(3)				
Debt securities(2)(4)				
Guarantees of debt securities(5)				
Total Primary Offering			**$1,000,000,000(2)**	$0
Total				

(1) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(o) under the Securities Act of 1933, as amended (the Securities Act).

(2) The amount of securities registered in the primary offering consists of $1,000,000,000 of an indeterminate number or amount of common units of Holly Energy Partners, L.P. (Holly Energy Partners), preferred units of Holly Energy Partners, debt securities of Holly Energy Partners, which may be co-issued by its subsidiary, Holly Energy Finance Corp. (Holly Energy Finance), and guarantees of such debt securities as set forth in Note 5 below.

(3)

There are being registered hereunder an indeterminate number of common units of Holly Energy Partners that may be issued upon conversion of preferred units or debt securities registered hereunder. No separate consideration will be received for common units that are issued upon conversion of preferred units or debt securities registered hereunder.

(4) If any debt securities are issued at an original issue discount, then the offering price of such debt securities shall be in such amount as shall result in an aggregate initial offering price not to exceed the amount identified in Note 2 above, less the dollar amount of any registered securities previously issued.

(5) Each of the subsidiaries of Holly Energy Partners identified on the following pages may guarantee any series of debt securities issued under this prospectus and any prospectus supplement. No separate consideration will be paid in respect of any guarantees. Pursuant to Rule 457(n) of the Securities Act, no separate fee is payable with respect to the guarantees of any debt securities.

(6) Registration fees of $94,160 for up to $800,000,000 net aggregate principal amount of securities were paid previously by Holly Energy Partners in connection with the Registration Statement filed on Form S-3 (File No. 333-128101) on September 2, 2005. Pursuant to Rule 457(p) under the Securities Act, the fees of $39,300 with respect to $800,000,000 aggregate initial offering price of securities that were previously registered and not sold are being carried forward and are being applied against the registration fees of $39,300 for the up to $1,000,000,000 aggregate initial offering price of securities being offered under this registration statement. The remaining unused $54,860 may be used to offset future registration fees in accordance with Rule 457(p).

The Registrants hereby amend this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrants shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act or until the Registration Statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.

* Additional Registrants are identified on the following pages

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ADDITIONAL REGISTRANTS

The additional Registrants listed below are subsidiaries of Holly Energy Partners and may guarantee the debt securities.

HEP Logistics GP, L.L.C.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**51-0504692**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

Holly Energy Partners Operating, L.P.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**51-0504696**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Pipeline GP, L.L.C.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**72-1583767**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Refining GP, L.L.C.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**71-0968297**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Mountain Home, L.L.C.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**71-0968300**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Pipeline, L.L.C.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**71-0968296**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Refining, L.L.C.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**71-0968299**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Woods Cross, L.L.C.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**72-1583768**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Navajo Southern, L.P.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**57-1207829**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Pipeline Assets, Limited Partnership
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**51-0512050**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Refining Assets, L.P.
(Exact Name of Registrant As Specified In Its Charter)

Delaware	**51-0512052**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*

HEP Fin Tex/Trust River, L.P.
(Exact Name of Registrant As Specified In Its Charter)

Texas	**20-2161011**
(State or Other Jurisdiction of	*(I.R.S. Employer*

Incorporation or Organization)	*Identification Number)*

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The information in this prospectus is not complete and may be changed. Securities may not be sold pursuant to this prospectus until a registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell securities and it is not soliciting an offer to buy securities in any jurisdiction where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED NOVEMBER 21, 2008

PROSPECTUS

Holly Energy Partners, L.P.
Holly Energy Finance Corp.

$1,000,000,000

COMMON UNITS
PREFERRED UNITS
DEBT SECURITIES

We may from time to time offer the following securities under this prospectus:

common units representing limited partner interests in Holly Energy Partners, L.P.;

preferred units representing limited partner interests in Holly Energy Partners, L.P.; and

debt securities of Holly Energy Partners, L.P.

Holly Energy Finance Corp. may act as co-issuer of the debt securities and certain other subsidiaries of Holly Energy Partners, L.P. may guarantee the debt securities.

This prospectus provides you with a general description of the securities we may offer. Each time we sell securities we will provide a prospectus supplement that will contain specific information about the terms of that offering. The amount of any securities offered and the price at which those securities are offered will be determined at the time of each offering. Any prospectus supplement may also add, update or change information contained in this prospectus. You should read carefully this prospectus and any prospectus supplement before you invest. You should also read the documents we have referred you to in the Where You Can Find More Information section of this prospectus for information about us, including our financial statements.

Our common units are listed on the New York Stock Exchange under the trading symbol HEP. We will provide information in the prospectus supplement for the expected trading market, if any, for any preferred units or debt securities that we issue.

Unless otherwise specified in a prospectus supplement, any of our senior debt securities, when and if issued, will be unsecured and will rank equally with our other unsecured and unsubordinated indebtedness, and any of our subordinated debt securities, when and if issued, will be subordinated in right of payment to our senior debt.

Limited partnerships are inherently different from corporations. You should review carefully each of the factors referred to under Risk Factors beginning on page 3 of this prospectus and contained in the applicable prospectus supplement and in the documents incorporated by reference herein and therein for a discussion of important risks you should consider before investing in our securities.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

This prospectus may not be used to consummate sales of securities by the Registrants unless accompanied by a prospectus supplement.

The date of this prospectus is November , 2008.

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You should rely only on the information contained or incorporated by reference in this prospectus or any prospectus supplement. We have not authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. You should not assume that the information incorporated by reference or provided in this prospectus or any prospectus supplement is accurate as of any date other than the date on the front of each document.

Our, we, us and Holly Energy Partners as used in this prospectus refer to Holly Energy Partners, L.P. or to Holly Energy Partners, L.P. and certain of its subsidiaries collectively, including its subsidiary Holly Energy Finance Corp., as the context requires.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission (the Commission) using a shelf registration process. Under this shelf registration process, we may offer from time to time up to $1,000,000,000 of our securities. Each time we offer securities, we will provide you with a prospectus supplement that will describe, among other things, the specific amounts and prices of the securities being offered and the terms of the offering. Any prospectus supplement may add, update or change information contained in this prospectus. Any statement that we make in this prospectus will be modified or superseded by any inconsistent statement made by us in any prospectus supplement. The information in this prospectus is accurate as of its date. Therefore, before you invest in our securities, you should carefully read this prospectus and any prospectus supplement relating to the securities offered to you together with the additional information described under the heading Where You Can Find More Information.

WHO WE ARE

Holly Energy Partners, L.P. is a Delaware limited partnership engaged principally in the business of operating a system of petroleum product and crude oil pipelines in Texas, New Mexico, Oklahoma and Utah, distribution terminals in Texas, New Mexico, Arizona, Utah, Idaho and Washington and refinery tankage in New Mexico and Utah. We generate revenues by charging tariffs for transporting petroleum products and crude oil through our pipelines and by charging fees for terminalling petroleum products and other hydrocarbons, and storing and providing other services at our storage tanks and terminals. We do not take ownership of products that we transport or terminal; therefore, we are not directly exposed to changes in commodity prices. We serve Holly Corporation s refineries in New Mexico and Utah under three 15-year pipeline, tankage and terminal agreements expiring in July 2019, July 2020 and February 2023 and Alon USA, Inc. s (Alon) Big Spring Refinery under a separate pipelines and terminals agreement expiring in February 2020. We are dedicated to generating stable cash flows and growing our business. Our assets include:

Pipelines:

- approximately 780 miles of refined product pipelines, including 340 miles of leased pipelines, that transport gasoline, diesel and jet fuel principally from Holly Corporation s Navajo Refinery in New Mexico to Holly Corporation s customers in the metropolitan and rural areas of Texas, New Mexico, Arizona, Colorado, Utah and northern Mexico;

- approximately 510 miles of refined product pipelines that transport refined products from Alon s Big Spring refinery in Texas to customers in Texas and Oklahoma;

- two parallel 65-mile pipelines that transport intermediate feedstocks and crude oil from Holly Corporation s Lovington, New Mexico refining facilities to Holly Corporation s Artesia, New Mexico refining facilities;

- a 36-mile jet fuel pipeline which runs from Artesia to Roswell, New Mexico;

- approximately 10 miles of crude and refined product pipelines which service Holly Corporation s Woods Cross refinery;

- approximately 860 miles of crude oil trunk, gathering and lease connection pipelines which service Holly Corporation s Lovington and Artesia refining facilities; and a 70% interest in Rio Grande Pipeline Company, a joint venture that owns a 249-mile refined product pipeline that transports liquid petroleum gases, or LPGs, from West Texas to the Texas/Mexico border near El Paso for further transport into northern Mexico.

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Refined Product Terminals:

four refined product terminals, located in El Paso, Texas; Moriarty and Bloomfield, New Mexico; and Tucson, Arizona, with an aggregate capacity of approximately 1 million barrels, that are integrated with our refined product pipeline system that serves Holly Corporation s Navajo Refinery;

three refined product terminals (two of which are 50% owned), located in Burley and Boise, Idaho, and Spokane, Washington, with an aggregate capacity of approximately 500,000 barrels, that serve third-party common carrier pipelines;

one refined product terminal near Mountain Home, Idaho, with a capacity of 120,000 barrels, that serves a nearby United States Air Force Base;

two refined product terminals, located in Wichita Falls and Abilene, Texas, and one tank farm in Orla, Texas with aggregate capacity of 480,000 barrels, that are integrated with our refined product pipelines that serve Alon s Big Spring, Texas refinery;

two refined product truck loading racks, one located within Holly Corporation s Navajo Refinery and one located within Holly Corporation s Woods Cross Refinery near Salt Lake City, Utah; and

a Roswell, New Mexico jet fuel terminal leased through September 2011.

Crude Oil Storage:

approximately 600,000 barrels of on-site crude oil tankage at Holly Corporation s Navajo and Woods Cross Refineries.

Holly Energy Finance Corp. (Holly Energy Finance) is a Delaware corporation and wholly-owned subsidiary of Holly Energy Partners organized for the sole purpose of co-issuing certain of our debt securities. Holly Energy Finance does not have any operations of any kind and does not generate any revenue other than as may be incidental to its activities as a co-issuer of any of our debt securities.

Our principal executive offices are located at 100 Crescent Court, Suite 1600, Dallas, Texas 75201, and our telephone number is (214) 871-3555. Our website is located at http://www.hollyenergypartners.com. We make our periodic reports and other information filed with or furnished to the Commission available, free of charge, through our website, as soon as reasonably practicable. Information on our website or any other website, is not incorporated by reference into this prospectus and does not constitute a part of this prospectus unless specifically so designated and filed with the Commission.

THE SUBSIDIARY GUARANTORS

Throughout this prospectus, we refer to each of the following subsidiaries of Holly Energy Partners as the Subsidiary Guarantors : HEP Logistics GP, L.L.C., Holly Energy Partners Operating, L.P., HEP Pipeline GP, L.L.C., HEP Refining GP, L.L.C., HEP Mountain Home, L.L.C., HEP Pipeline, L.L.C., HEP Refining, L.L.C., HEP Woods Cross, L.L.C., HEP Navajo Southern, L.P., HEP Pipeline Assets, Limited Partnership, HEP Refining Assets, L.P. and HEP Fin Tex/Trust River, L.P. Each of the Subsidiary Guarantors may jointly and severally and unconditionally guarantee our payment obligations under any series of debt securities offered by this prospectus and any prospectus supplement.

RISK FACTORS

An investment in our securities involves risks. Before you invest in our securities you should carefully consider those risk factors included in our most recent Annual Report on Form 10-K, as supplemented by our Quarterly Reports on Form 10-Q, each of which is incorporated herein by reference, and those risk factors that may be included in the applicable prospectus supplement together with all of the other information included in this prospectus, any prospectus supplement and the documents we incorporate by reference in evaluating an investment in our securities. This prospectus also contains forward-looking statements that involve risks and uncertainties. Please read Forward-Looking Statements. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of certain factors, including the risks described in the foregoing documents and the other information included in, or incorporated by reference into, this prospectus. If any of these risks occur, our business, financial condition or results of operations could be adversely affected. In that case, we may be unable to pay distributions to our untiholders, or to pay interest on, or the principal of, any debt securities. In that event, the trading price of our securities could decline and you could lose all or part of your investment. When we offer and sell any securities pursuant to a prospectus supplement, we may include additional risk factors relevant to such securities in the prospectus supplement.

FORWARD-LOOKING STATEMENTS

This prospectus and some of the documents we incorporate by reference contain various forward-looking statements and information that are based on our beliefs and those of our general partner, as well as assumptions made by and information currently available to us. These forward-looking statements are identified as any statement that does not relate strictly to historical or current facts. When used in this prospectus or the documents we have incorporated herein or therein by reference, words such as anticipate, project, expect, plan, goal, forecast, intend, could, b similar expressions and statements regarding our plans and objectives for future operations, are intended to identify forward-looking statements. Although we and our general partner believe that such expectations reflected in such forward-looking statements are reasonable, neither we nor our general partner can give assurances that such expectations will prove to be correct. Such statements are subject to a variety of risks, uncertainties and assumptions. If one or more of these risks or uncertainties materialize, or if underlying assumptions prove incorrect, our actual results may vary materially from those anticipated, estimated, projected or expected. Among the key risk factors that may have a direct bearing on our results of operations and financial condition are:

Risks and uncertainties with respect to the actual quantities of petroleum products and crude oil shipped on our pipelines and/or terminalled in our terminals;

The economic viability of those Holly Corporation subsidiaries we contract with as well as Alon USA, Inc. and our other customers;

The demand for refined petroleum products in markets we serve;

Our ability to successfully purchase and integrate additional operations in the future;

Our ability to complete previously announced pending or contemplated acquisitions;

The availability and cost of additional debt and equity financing;

The possibility of reductions in production or shutdowns at refineries utilizing our pipeline and terminal facilities;

The effects of current and future government regulations and policies;

Our operational efficiency in carrying out routine operations and capital construction projects;

The possibility of terrorist attacks and the consequences of any such attacks;

General economic conditions; and

Other financial, operations and legal risks and uncertainties detailed from time to time in our Securities and Exchange Commission filings.

Other factors described herein, or factors that are unknown or unpredictable, could also have a material adverse effect on future results. You should not put undue reliance on any forward-looking statements. Please review the risk factors described under Risk Factors in this prospectus and any prospectus supplement and in the Risk Factors section of our most recent Annual Report on Form 10-K and, to the extent applicable, our Quarterly Reports on Form 10-Q. Except as required by securities laws, we do not intend to update these forward-looking statements and information.

USE OF PROCEEDS

Except as otherwise provided in the applicable prospectus supplement, we will use the net proceeds from any sale of securities described in this prospectus for general partnership purposes, which may include, among other things, funding acquisitions of assets or businesses, working capital, capital expenditures, investments in subsidiaries, the retirement of existing debt and/or the repurchase of common units or other securities. The prospectus supplement for any particular offering of securities using this prospectus will disclose the actual use of the net proceeds from the sale of such securities. The exact amounts to be used and when the net proceeds will be applied to partnership purposes will depend on a number of factors, including our funding requirements and the availability of alternative funding sources.

RATIO OF EARNINGS TO FIXED CHARGES

For purposes of calculating the ratio of earnings to fixed charges, earnings represent income before income tax expense before deducting fixed charges. Fixed charges include interest and 30% of the total operating lease rental expense, which is the portion deemed to be interest. Our ratio of earnings to fixed charges for each of the periods indicated is as follows:

	Nine Months Ended September 30,	Years Ended December 31,				
	2008	2007	2006	2005	2004	2003
Ratio of earnings to fixed charges	2.22	3.67	2.91	3.43	16.13	1.27

DESCRIPTION OF DEBT SECURITIES

Holly Energy Partners may issue debt securities in one or more series and Holly Energy Finance may be a co-issuer of one or more series of such debt securities. When used in this section, references to we, us and our refer to Holly Energy Partners and, if Holly Energy Finance co-issues any debt securities, Holly Energy Finance. References to an Indenture refer to the particular Indenture under which we issue a series of debt securities.

The following description sets forth the general terms and provisions that will apply to any of our debt securities. Each prospectus supplement will state the particular terms that will apply to any debt securities included in the supplement.

General

The Indentures

We will issue our debt securities under either a Senior Indenture or a Subordinated Indenture, among us, a trustee that we will name in the related prospectus supplement and, as applicable, any Subsidiary Guarantors. The term Trustee as used in this prospectus shall refer to the trustee under any Indenture. Any debt securities will be governed by the applicable provisions of the Indenture and those made part of the Indenture by reference to the Trust Indenture Act of 1939. We, the Trustee and, as applicable, the Subsidiary Guarantors, may enter into supplements to the applicable Indenture from time to time. The debt securities will be either senior debt securities or subordinated debt securities.

Neither Indenture contains provisions that would afford holders of debt securities protection in the event of a sudden and significant decline in our credit quality or a takeover, recapitalization or highly leveraged or similar transaction. Accordingly, we could in the future enter into transactions that could increase the amount of indebtedness outstanding at that time or otherwise adversely affect our capital structure or credit rating.

This description is a summary of the material provisions of the debt securities and the Indentures. We urge you to read the forms of Senior Indenture and Subordinated Indenture filed as exhibits to the registration statement of which this prospectus is a part because those Indentures, and not this description, govern your rights as a holder of our debt securities.

The Debt Securities

Any series of debt securities that we issue:

- will be the general obligations of Holly Energy Partners and Holly Energy Finance, if Holly Energy Finance co-issues such debt securities;
- will be general obligations of the Subsidiary Guarantors, if guaranteed by them; and
- may be subordinated to our Senior Indebtedness and that of any Subsidiary Guarantors.

The Indenture does not limit the total amount of debt securities that we may issue. We may issue debt securities under the Indenture from time to time in separate series, up to the aggregate amount authorized for each such series.

Specific Terms of Each Series of Debt Securities to be Described in the Prospectus Supplement

We will prepare a prospectus supplement and either a supplemental indenture, or authorizing resolutions of the board of directors of our general partner s general partner, accompanied by the officers certificate, relating to any series of debt securities that we offer, which will include specific terms relating to some or all of the following:

- the form and title of the debt securities;
- the total principal amount of the debt securities;
- the date or dates on which the debt securities may be issued;
- whether the debt securities are senior or subordinated debt securities;
- the currency or currencies in which principal and interest will be paid, if not in U.S. dollars;
- the portion of the principal amount which will be payable if the maturity of the debt securities is accelerated;
- any right we may have to defer payments of interest by extending the dates payments are due and whether interest on those deferred amounts will be payable;
- the dates on which the principal and premium, if any, of the debt securities will be payable;
- the interest rate or rates which the debt securities will bear, or by which the debt securities will accrete in value, and the interest payment dates for the debt securities;
- any conversion or exchange provisions;

any optional redemption provisions;

any sinking fund or other provisions that would obligate us to repurchase or otherwise redeem the debt securities;

whether the debt securities are (i) to be co-issued by Holly Energy Finance and (ii) entitled to the benefits of any guarantees by the Subsidiary Guarantors;

whether the debt securities may be issued in amounts other than $1,000 each or multiples thereof;

any changes to or additional events of default or covenants;

any changes to the defeasance or discharge provisions of the Indenture;

the subordination, if any, of the debt securities and any changes to the subordination provisions of the Subordinated Indenture; and

any other terms of the debt securities.

This description of debt securities will be deemed modified, amended or supplemented by any description of any series of debt securities set forth in a prospectus supplement related to that series.

The prospectus supplement also will describe any material United States federal income tax consequences or other special considerations regarding the applicable series of debt securities, including, without limitation, those relating to:

debt securities with respect to which payments of principal, premium or interest are determined with reference to an index or formula, including changes in prices of particular securities, currencies or commodities;

Gross Profit:

For the years ended December 31, 2010 and 2009, we had gross profit of $11.4 million and $5.8 million, respectively. Gross profit as a percentage of net sales was 11.5% and 7.2% for the years ended December 31, 2010 and 2009, respectively. The year over year increase in gross profit as a percentage of net sales was a direct result of the increase in sales volume in 2010 and the restructuring which occurred in the third quarter of 2009 resulting in better utilization of our fixed cost structure.

Selling:

Selling expenses were $3.1 million or 3.1% of net sales for the year ended December 31, 2010 and $4.4 million or 5.6% of net sales for the year ended December 31, 2009. The majority of the $1.3 million decrease was due to approximately $0.7 million less commissions and $0.6 million in cost reductions.

General and Administrative:

General and administrative expenses were $7.0 million or 7.0% of net sales for the year ended December 31, 2010 and $5.9 million or 7.3% of net sales for the year ended December 31, 2009. The 2010 increase of $1.1 million is mainly attributed to the reversal of wage decreases and the re-instatement of merit increases, 401K matching and incentive programs on July 1, 2010.

Restructuring and Impairment Charges:

We recognized $0.1 million and $1.0 million of restructuring and impairment charges in Income (Loss) from Operations during the years ended December 31, 2010 and 2009, respectively. The 2010 costs relate to the impairment of a Fairmont building that is held for

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sale. The 2009 restructuring and impairment costs included $0.5 million in non-cash impairment charges for property and equipment that are no longer being used in operations and $0.5 million related to employee benefits, contract termination costs, and other expenses incurred to relocate production. The 2009 restructuring and impairment charges were the result of the facility closings and consolidation efforts taken throughout the year to better align our capacity to current customer demand levels.

Other Income (Expense):

Other expense for the years ended December 31, 2010 and 2009 was approximately $0.3 million and $0.7 million, respectively. Interest expense and foreign exchange transaction losses make up the majority of the other expense in 2010.

Income Taxes:

Income tax expense for the year ended December 31, 2010 was $375,000. Due to the loss incurred in 2009, we recorded an income tax benefit of $2.4 million for the year ended December 31, 2009. The effective tax rate for fiscal 2010 was 42.5% compared to 38.4% in fiscal 2009. The increase in effective tax rate from 2009 to 2010 relates primarily to the true-up of our net operating loss (NOL) carryback which resulted in additional tax expense of approximately $103,000 partially offset by state and federal research credits.

Net Income (Loss):

Our net income in 2010 was $506,766 or $0.18 per diluted common share compared to net loss of $3,835,041 or $1.40 per diluted common share in 2009. We returned to profitability in 2010 primarily due to increased sales and the cost reductions experienced from the prior year restructuring activities.

FINANCIAL CONDITION AND LIQUIDITY

We believe that our existing financing arrangements and anticipated cash flows from operations will be sufficient to satisfy our working capital needs, capital expenditures, investments, and debt repayments for the foreseeable future.

Credit Facility:

On May 27, 2010 we entered into a third amended and restated credit and security agreement with Wells Fargo Bank which provides a $12 million line of credit through May 31, 2013 and a real estate note maturing on May 31, 2012. On January 6, 2011, we entered into the first amendment to this agreement which provides a $13.5 million line of credit through May 31, 2013, a new $475,000 equipment term loan tied to equipment purchased in the recent acquisition announced January 3, 2011 and a new term loan of up to $1.0 million for capital expenditures to be made in 2011. Under the new agreement, both the line of credit and real estate term note are subject to variations in the LIBOR rate. Advances on our line of credit will bear interest at three-month LIBOR + 4.00% (4.30% at December 31, 2010). The weighted-average interest rate on our line of credit and other long-term debt was 4.63% and 5.04%, respectively for the year ended December 31, 2010.

The line of credit and other installment debt with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. The availability under the line is subject to borrowing base requirements, and advances are at the discretion of the lender. The line is secured by substantially all of our assets. This commitment is summarized as described below:

Other Commercial Commitment	Total Amount Committed	Outstanding at December 31, 2010	Date of Expiration
Line of credit	$ 13,500,000	$ 5,615,121	May 31, 2013

As of December 31, 2010 we have net unused availability under our line of credit agreement of approximately $5.2 million as supported by our borrowing base. Under the terms of our new agreement, our unused availability increased to $6.5 million on January 6, 2011.

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Cash Flow:

	December 31 2010		December 31 2009	
Cash flows provided by (used in):				
Operating activities	$	2,890,254	$	(853,495)
Investing activities		(1,029,599)		(76,609)
Financing activities		(1,876,092)		371,860
Effect of exchange rate changes on cash		638		584
Net decrease in cash and cash equivalents	$	(14,799)	$	(557,660)

On December 31, 2010, we had working capital of approximately $13.1 million as compared to $13.2 million at the end of 2009. During 2010, we generated approximately $2.9 million of cash flow from operating activities. The cash flow from operations is primarily due to net income of $0.5 million plus $2.1 million of noncash charges, including depreciation, amortization, property and equipment impairment charges, restructuring charges, the change in deferred taxes and other miscellaneous noncash expenses. The cash flow from operating assets and liabilities was $0.3 million. This was driven by a decrease in income taxes receivable of $2.1 million and an increase in accounts payable and accruals of $1.8 million offset in part by a $3.5 million increase in accounts receivable.

Our net cash used in investing activities of $1.0 million is due to $0.6 million of capital equipment purchases and $0.4 million for the acquisition in May 2010. Net cash used in financing activities of $1.9 million consisted of $2.0 million reduction of long-term debt offset by $0.1 million line of credit increase.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

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DECEMBER 31, 2010 AND 2009

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders
Nortech Systems Incorporated and Subsidiary

We have audited the accompanying consolidated balance sheets of Nortech Systems Incorporated and Subsidiary as of December 31, 2010 and 2009, and the related consolidated statements of operations, shareholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Nortech Systems Incorporated and Subsidiary as of December 31, 2010 and 2009, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ McGladrey & Pullen, LLP

Minneapolis, Minnesota
March 11, 2011

See accompanying Notes to Consolidated Financial Statements.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2010 AND 2009

ASSETS	**2010**	**2009**
CURRENT ASSETS		
Cash and Cash Equivalents	$ 230,582	$ 245,381
Accounts Receivable, Less Allowance for Uncollectible Accounts	15,562,277	12,021,378
Inventories	16,108,773	15,806,669
Prepaid Expenses	596,363	542,643
Income Taxes Receivable	376,001	2,515,906
Deferred Income Taxes	594,000	753,000
Total Current Assets	33,467,996	31,884,977
Property and Equipment, Net	7,157,543	8,239,161
Finite Life Intangible Assets, Net of Accumulated Amortization	202,150	343,549
Deferred Income Taxes	219,000	348,000
Other Assets	514,235	313,518
Total Assets	$ 41,560,924	$ 41,129,205

See accompanying Notes to Consolidated Financial Statements.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS (Continued)

DECEMBER 31, 2010 AND 2009

LIABILITIES AND SHAREHNOLDERS' EQUITY	2010	2009
CURRENT LIABILITIES		
Line of Credit	$ 5,615,121	$ 5,490,607
Current Maturities of Long-Term Debt	841,760	1,013,920
Accounts Payable	10,727,907	9,050,684
Accrued Payroll and Commissions	2,584,108	1,449,528
Accrued Health and Dental Claims	35,000	310,000
Other Accrued Liabilities	599,655	1,354,438
Total Current Liabilities	20,403,551	18,669,177
LONG-TERM LIABILITIES		
Long-Term Debt (Net of Current Maturities)	1,731,318	3,572,264
Other Long-Term Liabilities	137,236	160,912
Total Long-Term Liabilities	1,868,554	3,733,176
Total Liabilities	22,272,105	22,402,353
SHAREHOLDERS' EQUITY		
Preferred Stock, $1 par value; 1,000,000 Shares Authorized; 250,000 Shares Issued and Outstanding	250,000	250,000
Common Stock $0.01 par value; 9,000,000 Shares Authorized; 2,742,992 and 2,738,992 Shares Issued and Outstanding at December 31, 2010 and 2009, respectively	27,430	27,390
Additional Paid-In Capital	15,698,348	15,654,160
Accumulated Other Comprehensive Loss	(62,936)	(73,909)
Retained Earnings	3,375,977	2,869,211
Total Shareholders' Equity	19,288,819	18,726,852
Total Liabilities and Shareholders' Equity	$ 41,560,924	$ 41,129,205

See accompanying Notes to Consolidated Financial Statements.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
Net Sales	$ 99,820,069	$ 79,939,839
Cost of Goods Sold	88,389,803	74,141,269
Gross Profit	11,430,266	5,798,570
Operating Expenses:		
Selling Expenses	3,120,202	4,449,184
General and Administrative Expenses	7,024,087	5,865,380
Restructuring Charges	55,786	967,991
Total Operating Expenses	10,200,075	11,282,555
Income (Loss) From Operations	1,230,191	(5,483,985)
Other Income (Expense)		
Miscellaneous Income (Expense)	80,698	(225,784)
Interest Expense	(429,123)	(512,272)
Total Other Expense	(348,425)	(738,056)
Income (Loss) Before Income Taxes	881,766	(6,222,041)
Income Tax Expense (Benefit)	375,000	(2,387,000)
Net Income (Loss)	$ 506,766	$ (3,835,041)
Earnings (Loss) Per Common Share:		
Basic and Diluted	$ 0.18	$ (1.40)
Weighted Average Number of Common Shares Outstanding	2,742,389	2,738,982

See accompanying Notes to Consolidated Financial Statements.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

	Preferred Stock	Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders' Equity
BALANCE DECEMBER 31, 2008	$ 250,000	$ 27,390	$ 15,525,981	$ (89,598)	$ 6,704,252	$ 22,418,025
Net loss					(3,835,041)	(3,835,041)
Issuance of stock upon exercise of stock options			132			132
Compensation on stock-based awards			128,047			128,047
Translation gain, net of tax				15,689		15,689
BALANCE DECEMBER 31, 2009	250,000	27,390	15,654,160	(73,909)	2,869,211	18,726,852
Net income					506,766	506,766
Issuance of stock upon exercise of stock options		40	12,460			12,500
Compensation on stock-based awards			31,728			31,728
Translation gain, net of tax				10,973		10,973
BALANCE DECEMBER 31, 2010	$ 250,000	$ 27,430	$ 15,698,348	$ (62,936)	$ 3,375,977	$ 19,288,819

See accompanying Notes to Consolidated Financial Statements.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

DECEMBER 31, 2010 AND 2009

	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (Loss)	$ 506,766	$ (3,835,041)
Adjustments to Reconcile Net Income (Loss) to Net Cash Provided by (Used in) Operating Activities:		
Depreciation	1,554,577	1,773,917
Amortization	141,399	150,121
Compensation on Stock-Based Awards	31,728	128,047
Interest on Swap Valuation	(27,772)	(18,893)
Restructuring Charges		466,455
Fixed Asset Impairment	55,786	501,536
Deferred Income Taxes	288,000	188,000
Loss on Disposal of Property and Equipment	901	4,955
Foreign Currency Transaction Loss	8,333	10,131
Changes in Current Operating Items, Net of Effects of Business Acquisition		
Accounts Receivable	(3,532,471)	1,146,371
Inventories	865	4,896,475
Prepaid Expenses and Other Assets	(53,207)	203,114
Income Taxes Receivable	2,139,543	(2,095,733)
Accounts Payable	1,674,954	(1,696,872)
Accrued Payroll and Commissions	1,127,119	(1,973,657)
Accrued Health and Dental Claims	(275,000)	(136,102)
Other Accrued Liabilities	(751,267)	(566,319)
Net Cash Provided by (Used in) Operating Activities	2,890,254	(853,495)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from Sale of Property and Equipment		176,350
Restricted Cash		427,500
Business Acquisition	(402,969)	
Purchases of Property and Equipment	(626,630)	(680,459)
Net Cash Used in Investing Activities	(1,029,599)	(76,609)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net Borrowings on Line of Credit	124,514	1,123,045
Proceeds from Long-Term Debt		616,397
Principal Payments on Long-Term Debt	(2,013,106)	(1,367,714)
Proceeds from Issuance of Common Stock	12,500	132
Net Cash Provided by (Used in) Financing Activities	(1,876,092)	371,860
Effect of Foreign Currency Exchange Rate Changes on Cash and Cash Equivalents	638	584
NET DECREASE IN CASH AND CASH EQUIVALENTS	(14,799)	(557,660)
Cash and Cash Equivalents Beginning of Year	245,381	803,041

CASH AND CASH EQUIVALENTS END OF YEAR	$ 230,582	$ 245,381

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2010 AND 2009

NOTE 1 NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

We manufacture wire harnesses, cables and electromechanical assemblies, printed circuit boards and higher-level assemblies for a wide range of commercial and defense industries. We provide a full "turn-key" contract manufacturing service to our customers. All products are built to the customer's design specifications. Products are sold to customers both domestically and internationally. We also provide engineering services separate from the manufacture of a product and repair service on circuit boards used in machines in the medical industry.

Our manufacturing facilities are located in Bemidji, Blue Earth, Merrifield, Milaca and Baxter, Minnesota as well as Augusta, Wisconsin; Monterrey, Mexico; and as of January 1, 2011, Mankato, Minnesota.

A summary of our significant accounting policies follows:

Principles of Consolidation

The consolidated financial statements include the accounts of our wholly owned subsidiary, Manufacturing Assembly Solutions of Monterrey, Inc. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of our consolidated financial statements. Estimates also affect the reported amounts of revenue and expense during the reporting period. Significant items subject to estimates and assumptions include the valuation allowance for inventories, allowance for doubtful accounts and realizability of deferred tax assets. Actual results could differ from those estimates.

Cash and Cash Equivalents

For purposes of reporting cash flows, we consider cash equivalents to be short-term, highly liquid interest-bearing accounts readily convertible to cash and whose original maturity is three months or less.

Accounts Receivable and Allowance for Doubtful Accounts

We grant credit to customers in the normal course of business. Accounts receivable are unsecured and are presented net of an allowance for uncollectible accounts. The allowance for uncollectible accounts was $86,000 and $138,000 at December 31, 2010 and 2009, respectively. We determine our allowance by considering a number of factors, including the length of time accounts receivable are past due, our previous loss history, the customers' current ability to pay their obligations to us, and the condition of the general economy and the industry as a whole. We write-off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for uncollectible accounts.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market (based on the lower of replacement cost or net realizable value). Costs include material, labor, and overhead required in the warehousing and production of our products. Inventory reserves are maintained for the estimated value of the inventory that may have a lower value than stated or quantities in excess of future production needs.

Inventories are as follows:

	2010	2009
Raw materials	$ 11,277,741	$ 11,137,853
Work in process	3,477,236	3,304,725
Finished goods	2,395,843	2,459,521
Reserves	(1,042,047)	(1,095,430)
Total	$ 16,108,773	$ 15,806,669

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 1 NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property, Equipment and Depreciation

Property and equipment are stated at cost less accumulated depreciation. Additions, improvements and major renewals are capitalized, while maintenance, repairs and minor renewals are expensed as incurred. When assets are retired or disposed of, the assets and related accumulated depreciation are removed from the accounts and the resulting gain or loss is reflected in operations. Leasehold improvements are depreciated over the shorter of their estimated use lives or their remaining lease terms. All other property and equipment are depreciated by the straight-line method over their estimated useful lives, as follows:

Buildings	39 Years
Leasehold improvements	3-7 Years
Manufacturing equipment	5-7 Years
Office and other equipment	3-7 Years

Property and equipment at December 31, 2010 and 2009:

	2010	2009
Land	$ 260,000	$ 272,500
Building and Leasehold Improvements	6,316,133	6,543,066
Manufacturing Equipment	11,816,653	11,751,996
Office and Other Equipment	3,523,526	3,827,542
Accumulated Depreciation	(14,758,769)	(14,155,943)
Net Property and Equipment	$ 7,157,543	$ 8,239,161

Assets Held for Sale

Assets held for sale consists of property related to closed facilities that are currently being marketed for disposal. Assets held for sale are reported at the lower of their carrying value or estimated fair value less costs to sell. At December 31, 2010, land of $27,000 and two buildings, net of accumulated depreciation, of $405,000 are classified as held for sale and shown in Other Assets on the balance sheet.

Finite Life Intangible Assets

Finite life intangible assets are primarily related to acquired customer base and bond issuance costs and are amortized on a straight-line basis over their estimated useful lives. Finite life intangible assets at December 31, 2010 and 2009 are as follows:

	December 31, 2010			
	Remaining Lives (Years)	Gross Carrying Amount	Accumulated Amortization Amount	Net Book Value Amount
Bond Issue Costs	11	$ 79,373	$ 23,814	$ 55,559
Customer Base	2	676,557	529,966	146,591
Other intangibles	0	28,560	28,560	
Totals		$ 784,490	$ 582,340	$ 202,150

	December 31, 2009			
	Remaining Lives (Years)	Gross Carrying Amount	Accumulated Amortization Amount	Net Book Value Amount
Bond Issue Costs	12	$ 79,373	$ 18,522	$ 60,851
Customer Base	3	676,557	394,655	281,902
Other intangibles	1	28,560	27,764	796
Totals		$ 784,490	$ 440,941	$ 343,549

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 1 NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Amortization expense related to these assets was as follows:

Year ended December 31, 2010	$ 141,399
Year ended December 31, 2009	150,121

Estimated future annual amortization expense related to these assets for the years ending December 31, is as follows:

2011	$ 141,000
2012	17,000
2013	5,000
2014	5,000
2015	5,000
Thereafter	29,000
	$ 202,000

Impairment Analysis

We evaluate property and equipment and intangible assets with finite lives for impairment and for propriety of the related amortization periods, to determine whether adjustments to these amounts or useful lives are required based on current events and circumstances. The evaluation is based on our projection of the undiscounted future operating cash flows of the underlying assets. To the extent such projections indicate that future undiscounted cash flows are not sufficient to recover the carrying amounts of related assets, a charge might be required to reduce the carrying amount to the asset's estimated fair value. In 2010, we recorded an impairment charge of $56,000 on a building held for sale. In connection with the 2009 restructuring plan, we recorded an impairment charge of approximately $502,000 on certain property and equipment that will no longer be used in operations (see Note 11).

Preferred Stock

Preferred stock issued is non-cumulative and nonconvertible. The holders of the preferred stock are entitled to a non-cumulative dividend of 12% when and as declared. In liquidation, holders of preferred stock have preference to the extent of $1.00 per share plus dividends accrued but unpaid. No preferred stock dividends were declared or paid during the years ended December 31, 2010 and 2009.

Revenue Recognition

We recognize revenue upon shipment of manufactured products to customers, when title has passed, all contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured. We also provide engineering services separate from the manufacture of a product. Revenue for engineering services, which are short term in nature, is recognized upon completion of the engineering process, providing standalone fair value to our customers. In addition, we have another separate source of revenue that comes from short-term repair services, which are recognized upon completion of the repairs, and the repaired products are shipped back to the customer. Shipping and handling costs charged to our customers are included in net sales, while the corresponding shipping expenses are included in cost of goods sold.

Product Warranties

We provide limited warranty for the replacement or repair of defective product at no cost to our customers within a specified time period after the sale. We make no other guarantees or warranties, expressed or implied, of any nature whatsoever as to the goods including, without limitation, warranties to merchantability, fit for a particular purpose or non-infringement of patent or the like unless agreed upon in writing. We estimate the costs that may be incurred under our limited warranty and reserve based on actual historical warranty claims coupled with an analysis of unfulfilled claims at the balance sheet date. Our warranty claims costs are not material given the nature of our products and services which normally result in repair and return in the same accounting period.

Advertising

Advertising costs are charged to operations as incurred. The total amount charged to expense was $167,000 and $136,000 for the years ended December 31, 2010 and 2009, respectively.

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 1 NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes

We account for income taxes under the asset and liability method. Deferred income tax assets and liabilities are recognized annually for differences between the financial statement and tax basis of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

Fair Value of Financial Instruments

The carrying amounts of all financial instruments approximate their fair values. The carrying amounts for cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities and the line of credit approximate fair value because of the short maturity of these instruments. Based on the borrowing rates currently available to us for bank loans with similar terms and average maturities, the carrying value of our long-term debt approximates its fair value.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Valuation techniques used to measure fair value maximize the use of observable inputs and minimize the use of unobservable inputs.

The fair value framework requires the categorization of assets and liabilities into one of three levels based on the assumptions (inputs) used in valuing the asset or liability.

Level 1 provides the most reliable measure of fair value, while Level 3 generally requires significant management judgment. The three levels are defined as follows:

Level 1: Unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets or liabilities in inactive markets.

Level 3: Unobservable inputs reflecting management's own assumptions about the inputs used in pricing the asset or liability.

Our assessment of the significance of a particular input to the fair value measurements requires judgment, and may affect the valuation of the assets and liabilities being measured and their placement within the fair value hierarchy. We endeavor to use the best available information in measuring fair value. Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. As of December 31, 2010, our only asset or liability accounted for at fair value is our interest rate swap which is included in Other Long-Term Liabilities. We have determined that the fair value of the swap, based on LIBOR and swap rates, falls within Level 2 in the fair value hierarchy.

Stock-Based Compensation

We account for stock-based compensation in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification 718, *Compensation Stock Compensation*. Stock-based compensation expense was $32,000 ($.01 per diluted common share) for 2010 and $128,000 ($.05 per diluted common share) for 2009. See Note 8 for additional information.

Derivative Financial Instruments

On June 28, 2006, we entered into an interest rate swap agreement to effectively convert our industrial revenue bond debt from a variable rate to a fixed rate. The change in market value of an interest rate swap is recognized in the statements of operations by a charge or credit to interest expense. Further information related to our interest rate swap is disclosed in Note 4.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 1 NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Net Income (Loss) Per Common Share

Basic net income (loss) per common share is computed using the weighted-average number of common shares outstanding. For the years ended December 31, 2010 and 2009, no outstanding options were included in the computation of per-share amounts as the effect of all stock-based awards were antidilutive.

Supplemental Cash Flow and Noncash Investing Information

We received income tax refunds, net of $2,027,951 and $519,397 for the years ended December 31, 2010 and 2009, respectively. We paid interest expense of $450,180 and $548,733 for the years ended December 31, 2010 and 2009, respectively.

We had noncash transfers of certain property and equipment with a value of $201,000 and $231,000 for the years ended December 31, 2010 and 2009, respectively from Property and Equipment to Other Assets due to their classification as held for sale.

Enterprise-Wide Disclosures

Our results of operations for the years ended December 31, 2010 and 2009 represent a single reportable segment referred to as Contract Manufacturing within the Electronic Manufacturing Services industry. We strategically direct production between our various manufacturing facilities based on a number of considerations to best meet our customers' requirements. We share resources for sales, marketing, information services, cash and risk management, banking, credit and collections, human resources, payroll, internal control, audit, taxes, SEC reporting and corporate accounting. Consolidated financial information is available that is evaluated regularly by the chief operating decision maker in assessing performance and allocating resources. Export sales represent approximately 6% and 4% of consolidated sales for each of the years ended December 31, 2010 and 2009, respectively.

Net sales by our major EMS industry markets for the year ended December 31, 2010 and 2009 are as follows:

	Year Ended December 31	
(in thousands)	**2010**	**2009**
Aerospace and Defense	$ 16,152	$ 26,515
Medical	29,329	17,493
Industrial	54,339	35,932
Total Net Sales	$ 99,820	$ 79,940

Noncurrent assets, excluding deferred tax assets, by country are as follows:

	United States	**Mexico**	**Total**
2010			
Net property and equipment	$ 6,965,816	$ 191,727	$ 7,157,543
Other assets	708,659	7,726	716,385
2009			
Net property and equipment	$ 8,038,406	$ 200,755	$ 8,239,161
Other assets	649,341	7,726	657,067

Foreign Currency Translation

During the fourth quarter of 2010, we reevaluated the reporting currency and determined that the functional currency for our operations in Mexico is the U.S. Dollar. As a result, the Company is no longer recording translation adjustments related to assets and liabilities or income and expense items that are transacted in the local currency as a component of accumulated other comprehensive loss in shareholders' equity. Foreign exchange transaction gains and losses attributable to exchange rate movements related to transactions made in the local currency and on intercompany receivables and payables not deemed to be of a long-term investment nature are recorded in other income (expense).

NOTE 2 MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and accounts receivable. With regard to cash, we maintain our excess cash balances in checking accounts at one high-credit quality financial institution. These accounts may at times exceed federally insured limits. We have not experienced any losses in any of the short-term investment instruments we have used for excess cash balances. We do not require collateral on our receivables.

Two divisions of General Electric, Co. (G.E.) accounted for 10% or more of our net sales during the past two years. G.E.'s Medical Division accounted for 19% and 13% of net sales for the years ended December 31, 2010 and 2009, respectively. G.E.'s Transportation Division accounted for 8% and 12% of net sales for the years ended December 31, 2010 and 2009, respectively. Together, G.E.'s Medical and Transportation Divisions accounted for 27% and 25% of net sales for the years ended December 31, 2010 and 2009, respectively. Accounts receivable from G.E.'s Medical and Transportation Divisions at December 31, 2010 and 2009 represented 14% and 16% of total accounts receivable, respectively.

NOTE 3 ACCRUED HEALTH AND DENTAL CLAIMS

In 2009 and through September 2010, we were self-insured for our employee health and dental plans. In September 2010, we entered into a co-employment agreement with Administaff Services, who now provides premium based health and dental plans to our employees. At December 31, 2010 we have an accrual of $35,000 for estimated unpaid health and dental claims related to the run-out of our self-insured plans. Estimated unpaid claims for incurred health and dental services at December 31, 2009 were $310,000.

NOTE 4 FINANCING AGREEMENTS

On May 27, 2010 we entered into a third amended and restated credit and security agreement with Wells Fargo Bank which provides a $12 million line of credit through May 31, 2013 and a real estate note maturing on May 31, 2012. On January 6, 2011, we entered into the first amendment to this agreement which provides a $13.5 million line of credit through May 31, 2013, a new $475,000 equipment term loan tied to equipment purchased in the recent acquisition announced January 3, 2011 and a new term loan of up to $1.0 million for capital expenditures to be made in 2011. Under the new agreement, both the line of credit and real estate term note are subject to variations in the LIBOR rate. Our line of credit bears interest at three-month LIBOR + 4.00% (4.30% at December 31, 2010). The weighted-average interest rate on our line of credit was 4.63% for the year ended December 31, 2010. We had borrowings of $5,615,121 and $5,490,607 outstanding as of December 31, 2010 and 2009, respectively.

The line of credit and other installment debt with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures.

The availability under the line is subject to borrowing base requirements, and advances are at the discretion of the lender. At December 31, 2010, we have net unused availability under our line of credit of approximately $5.2 million. Under the terms of our new agreement, our unused availability increased to $6.5 million on January 6, 2011. The line is secured by substantially all of our assets.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 4 FINANCING AGREEMENTS (Continued)

A summary of long-term debt balances at December 31, 2010 and 2009 is as follows:

Description	2010	2009
Term notes payable Wells Fargo Bank, N.A., one note bears interest at three month LIBOR + 4.50% (approx. 4.8%) and three month LIBOR + 5.00% (approx 5.375%) at December 31, 2010 and 2009, respectively. Two notes bear interest at 4.95%, combined monthly principal payments of approximately $31,000 plus interest, maturities range from June 2011 to May 2012; secured by substantially all assets	$ 1,848,078	$ 3,736,184
Industrial revenue bond payable to the City of Blue Earth, Minnesota which bears interest at 4.07% and has a maturity date of June 1, 2021, with principal of $125,000 payable on June 1, 2011 and $80,000 payable annually on June 1 thereafter	725,000	850,000
Total long-term debt	2,573,078	4,586,184
Current maturities of long-term debt	(841,760)	(1,013,920)
Long-term debt net of current maturities	$ 1,731,318	$ 3,572,264

Future maturity requirements for long-term debt are as follows:

Years Ending December 31,	Amount
2011	$ 841,760
2012	1,211,318
2013	80,000
2014	80,000
2015	80,000
Future	280,000
	$ 2,573,078

On June 28, 2006, we entered into an interest rate swap agreement with a notional amount of $1,440,000 to effectively convert our industrial revenue bond debt from a variable rate to a fixed rate of 4.07% for five years, maturing on June 28, 2011. The amortized notional amount outstanding at December 31, 2010 was approximately $873,000. We do not use this interest rate swap for speculative purposes. The fair value of the swap of $18,140 and $45,912 was recorded in Other Long-Term Liabilities at December 31, 2010 and 2009, respectively. The change in the fair value of ($27,772) and ($18,893) for the years ended December 31, 2010 and 2009, respectively have been recorded as a component of interest expense.

NOTE 5 INCOME TAXES

The income tax expense (benefit) for the years ended December 31, 2010 and 2009 consists of the following:

	2010	2009
Current taxes Federal	$ 128,000	$ (2,500,000)
Current taxes State	(41,000)	(73,000)
Current taxes Foreign	19,000	10,000
Deferred taxes Federal	253,000	324,000
Deferred taxes State	16,000	(148,000)
Income tax expense (benefit)	$ 375,000	$ (2,387,000)

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 5 INCOME TAXES (Continued)

The statutory rate reconciliation for the years ended December 31, 2010 and 2009 is as follows:

	2010	2009
Statutory federal tax provision (benefit)	$ 298,000	$ (2,115,000)
State income taxes (benefit)	34,000	(147,000)
Effect of foreign operations	(5,000)	
Income tax credits	(95,000)	(109,000)
NOL carryback true up	106,000	
Other, including benefit of income taxed at lower rates	37,000	(16,000)
Income tax expense (benefit)	$ 375,000	$ (2,387,000)

Income (loss) from operations before income taxes was derived from the following sources:

	2010	2009
Domestic	$ 820,000	$ (6,251,000)
Foreign	62,000	29,000
Total	$ 882,000	$ (6,222,000)

Deferred tax assets (liabilities) at December 31, 2010 and 2009, consist of the following:

	2010	2009
Allowance for uncollectable accounts	$ 31,000	$ 50,000
Inventories reserve	383,000	400,000
Accrued vacation	308,000	262,000
Health insurance reserve	13,000	113,000
Non-compete amortization	397,000	400,000
Stock-based compensation	59,000	47,000
Other	425,000	607,000
Deferred tax assets	1,616,000	1,879,000
Prepaid expenses	(211,000)	(188,000)
Property and equipment	(592,000)	(590,000)
Deferred tax liabilities	(803,000)	(778,000)
Net deferred tax assets	$ 813,000	$ 1,101,000
Net current deferred tax assets	$ 594,000	$ 753,000
Net non-current deferred tax assets	219,000	348,000
Net deferred tax assets	$ 813,000	$ 1,101,000

We have determined that it is more likely than not that our deferred tax assets will be realized, principally through anticipated taxable income in future tax years. As a result, we have determined that establishing a valuation allowance on our deferred tax assets is not necessary.

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 5 INCOME TAXES (Continued)

The tax effects from an uncertain tax position can be recognized in our consolidated financial statements, only if the position is more likely than not to be sustained on audit, based on the technical merits of the position. We recognize the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more likely than not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. The following table sets forth changes in our total gross unrecognized tax benefit liabilities, excluding accrued interest, for the year ended December 31, 2010:

Balance as of December 31, 2009	$	115,000
Tax positions related to current year:		
Additions		27,000
Reductions		(28,000)
Balance as of December 31, 2010	$	114,000

The $114,000 of unrecognized tax benefits as of December 31, 2010 includes amounts which, if ultimately recognized, will reduce our annual effective tax rate.

Our policy is to accrue interest related to potential underpayment of income taxes within the provision for income taxes. The liability for accrued interest as of December 31, 2010 was not significant. Interest is computed on the difference between our uncertain tax benefit positions and the amount deducted or expected to be deducted in our tax returns.

Due to statute expiration, an approximate $35,000 decrease could occur with respect to our reserve in the next twelve months. This reserve, including associated interest, relates to federal research tax credits and section 199 deductions.

We are subject to income taxes in the U.S. federal jurisdiction and various state jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply.

With few exceptions, we are no longer subject to U.S. federal, state or local income tax examinations by tax authorities for the years before 2007. We are currently under audit by the IRS related primarily to the 2009 NOL carry back claim. We are not aware of any significant items as a result of the IRS audit that should either be incorporated into the FIN 48 analysis or tax projections for the year ended December 31, 2010.

NOTE 6 COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes income or losses resulting from foreign currency translations. The details of comprehensive income (loss) are as follows:

	Year Ended December 31 2010		Year Ended December 31 2009	
Net income (loss), as reported	$	506,766	$	(3,835,041)
Other comprehensive income		10,973		15,689
Comprehensive income (loss)	$	517,739	$	(3,819,352)

NOTE 7 401(K) RETIREMENT PLAN

We have a 401(k) profit sharing plan (the "Plan") for our employees. The Plan is a defined contribution plan covering all of our employees except for employees covered by a collective bargaining agreement and non-resident aliens earning non-U.S. source income. Employees are eligible to participate in the Plan after completing three months of service and attaining the age of 18. Employees are allowed to contribute up to 60% of

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 7 401(K) RETIREMENT PLAN (Continued)

their wages to the Plan. Historically we have matched 25% of the employees' contribution up to 6% of covered compensation. We suspended this benefit from the second quarter of 2009 thru June 2010. We made contributions of approximately $79,000 and $84,000 during the years ended December 31, 2010 and 2009, respectively.

NOTE 8 INCENTIVE PLANS

Employee Profit Sharing

During 1993, we adopted an employee profit sharing plan (the "Plan"). The purpose of the Plan is to provide a bonus for increased output, improved quality and productivity and reduced costs. We have authorized 50,000 common shares to be available under this Plan. In accordance with the terms of the Plan, employees could acquire newly issued shares of common stock for 90% of the current market value. During 2009, 37 common shares were issued in connection with this plan and zero were issued in 2010. Through December 31, 2010, 22,118 common shares had been issued under this Plan.

Stock Options

In 1992, we approved the adoption of a fixed stock based compensation plan. In February 2003, we reached the maximum options allowed to be granted under that plan.

During 2003, our shareholders approved the adoption of the Nortech Systems Incorporated 2003 Stock Option Plan (the "2003 Plan"). On May 3, 2005, the shareholders approved the 2005 Incentive Compensation Plan (the "2005 Plan") and eliminated the remaining 172,500 option shares available for grant under the 2003 Plan effective February 23, 2005. The total number of shares of common stock that may be granted under the 2005 Plan is 200,000, of which 23,750 remain available for grant at December 31, 2010. The 2005 Plan provides that option shares granted come from our authorized but unissued common stock. The price of the option shares granted under the plan will not be less than 100% of the fair market value of the common shares on the date of grant. Options are generally exercisable after one or more years and expire no later than 10 years from the date of grant.

During 2007, the Board of Directors approved the adoption of the FOCUS Incentive Plan (the "2007 Plan"). The purpose of the 2007 Plan was to provide incentives to our employees to increase our return on sales "ROS" performance measurement. The FOCUS plan is unique from the preceding Plans in that vesting of options is conditional upon our achievement of established performance measurements as follows:

- If we achieve 1.95% ROS for any of the three years ending 2007, 2008, or 2009, one-third of the options will vest.

- If we achieve 3% ROS for either of the two calendar years 2008 or 2009, an additional one-third of the options will vest.

- If we achieve 4% ROS for the calendar year 2009, the remaining one-third of the options will vest.

As these performance measures were not met, no options granted through December 31, 2010 from the 2007 Plan will ever vest.

We estimate the fair value of share-based awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense in the consolidated statement of operations over the requisite service periods. Because share-based compensation expense is based on awards that are ultimately expected to vest, share-based compensation expense will be reduced to account for estimated forfeitures. We estimate forfeitures at the time of grant and revise the estimate, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

We used the Black-Scholes option-pricing model to calculate the fair value of option-based awards. Our determination of fair value of option-based awards on the date of grant using the Black-Scholes model is affected by our stock price as well as assumptions regarding a number of subjective variables as noted in the following table. These variables include, but are not limited to, our expected stock price volatility over the term of the awards, risk-free interest rate, and the expected life of the options. The risk-free interest rate is based on a treasury

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 8 INCENTIVE PLANS (Continued)

instrument whose term is consistent with the expected life of our stock options. The expected volatility and holding period are based on our historical experience. For all grants, the amount of compensation expense recognized has been adjusted for an estimated forfeiture rate, which is based on historical data. The variables used for the grants for the year ended December 31, 2009 are below. There were no grants during the year ended December 31, 2010.

	2009
Expected volatility	49.0%
Expected dividends	None
Expected term (in years)	7
Risk-free rate	2.6 - 2.7%

Stock Options with Time-Based Vesting

Total compensation expense related to stock options with time-based vesting for the years ended December 31, 2010 and 2009 was $31,728 and $128,047, respectively. As of December 31, 2010 there was approximately $27,000 of unrecognized compensation expense related to unvested option awards that we expect to recognize over a weighted-average period of 0.85 years.

Stock Options with Performance-Based Vesting

As mentioned previously, the vesting of options granted under the 2007 Plan was conditional upon the Company meeting established performance measurements. At December 31, 2009, the performance measures were not met and the measurement period expired. Therefore, no options granted to date from the 2007 Plan will ever vest, although the options will remain outstanding until the earlier of the option expiration date or the termination of the employee. No compensation expense has been recorded for the years ended December 31, 2010 and 2009 and no expense is expected to be recorded in the future related to these option grants.

A summary of option activity under all plans as of December 31, 2010, and changes during the year then ended is presented below.

	Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding January 1, 2010	736,750	$ 7.20		
Granted				
Exercised	(4,000)	3.13		
Forfeited	(69,600)	6.21		
Outstanding December 31, 2010	663,150	$ 7.32	5.54	$ 4,627
Exercisable on December 31, 2010	303,250	$ 7.30	4.31	$

The weighted-average grant-date fair value of options granted during 2009 was $1.92. There were no grants during the year ended December 31, 2010. The weighted-average fair value of options vested during the years ended December 31, 2010 and 2009 were $3.69 and $3.70, respectively. The total intrinsic value of options exercised during the year ended December 31, 2010 was $20. There were no options exercised during the year ended December 31, 2009. Cash received from option exercise under all share-based payment arrangements for the year ended December 31, 2010 was $12,500. We recognize the tax benefit from the exercise of options in the statement of cash flows as a cash inflow from financing activities.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 8 INCENTIVE PLANS (Continued)

Equity Appreciation Rights Plan

In November 2010, the Board of Directors approved the adoption of the Nortech Systems Incorporated Equity Appreciation Rights Plan (the "2010 Plan"). The total number of Equity Appreciation Right Units (Units) the Plan can issue shall not exceed an aggregate of 750,000 Units, of which 100,000 Units were issued during the year. The 2010 Plan provides that Units issued shall fully vest three years from the grant date unless terminated earlier. Units give the holder a right to receive a cash payment equal to the appreciation in book value per share of common stock from the base date, as defined, to the redemption date. Unit redemption payments under this plan shall be paid in cash within 90 days after we determine the book value of the Units as of the calendar year immediately preceding the redemption date. The Units issued during the year ended December 31, 2010 have a book value per Unit of $6.84 and have a weighted average life remaining of two years at December 31, 2010. Total compensation expense related to these Units based on the estimated appreciation over their remaining term for the year ended December 31, 2010 was $5,096.

NOTE 9 COMMITMENTS AND CONTINGENCIES

Operating Leases

We have various operating leases for production and office equipment, office space, and buildings under non-cancelable lease agreements expiring on various dates through 2017.

In connection with the restructuring activities during 2009, the Garner, Iowa facility was sub-leased through the remaining term of the lease which expires on June 30, 2011. At December 31, 2010 future minimum lease payments, net of sublease income, was $0.

Rent expense for the years ended December 31, 2010 and 2009 amounted to approximately $914,000 and $875,000 respectively.

Approximate future minimum lease payments under non-cancelable leases are as follows:

Years Ending December 31,	Amount
2011	$ 303,000
2012	461,000
2013	461,000
2014	458,000
2015	398,000
Thereafter	328,000
Total	$ 2,409,000

Litigation

We are subject to various legal proceedings and claims that arise in the ordinary course of business. In our opinion, the amount of any ultimate liability with respect to these actions will not materially affect our consolidated financial statements or results of operations.

Executive Life Insurance Plan

During 2002, we set up an Executive Bonus Life Insurance Plan (the "Plan") for our key employees ("participants"). Pursuant to the Plan, we will pay a bonus to officer participants of 15% and a bonus to all other participants of 10% of the participants' base annual salary, as well as an additional bonus to cover federal and state taxes incurred by the participants. The participants are required to purchase life insurance and retain ownership of the life insurance policy once it is purchased. The Plan provides a five-year graded vesting schedule in which the participants vest at a rate of 20% each year. Should a participant terminate employment prior to the fifth year of vesting, that participant may be required to reimburse us for any unvested amounts, under certain circumstances. Expenses under the Plan were $338,000 and $44,000 for the years ended December 31, 2010 and 2009, respectively. Due to the economic downturn and cost reduction efforts this benefit was reduced in 2009 and reinstated in its entirety in 2010.

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 9 COMMITMENTS AND CONTINGENCIES (Continued)

Change of Control Agreements

During 2002, we entered into Change of Control Agreements (the "Agreement(s)") with certain key executives ("the Executive(s)"). The Agreements provide an inducement for each Executive to remain as an employee in the event of any proposed or anticipated change of control in the organization, including facilitating an orderly transition, and to provide economic security for the Executive after a change in control has occurred.

In the event of an involuntarily termination, each Executive would receive their base salary, annual bonus at time of termination, and continued participation in health, disability and life insurance plans for a period of three years for officers and two years for all other participants. Participants would also receive professional outplacement services up to $10,000, if applicable. Each Agreement remains in full force until the Executive terminates employment or we terminate the employment of the Executive.

NOTE 10 NET INCOME (LOSS) PER COMMON SHARE

The following is a reconciliation of the numerators and the denominators of the diluted net income per common share computations.

	2010	2009
Diluted Net Income (Loss) Per Common Share		
Net Income (Loss)	$ 506,766	$ (3,835,041)
Weighted average common shares outstanding	2,742,389	2,738,982
Stock options		
Weighted average common shares for diluted net income (loss) per common share	2,742,389	2,738,982
Diluted net income (loss) per common share*	$ 0.18	$ (1.40)

For the year ended December 31, 2010 and 2009, the effect of all stock options is antidilutive either due to net loss incurred in 2009 or because to include them would be antidilutive in 2010. Therefore, no outstanding options were included in the computation of per-share amounts.

NOTE 11 RESTRUCTURING AND IMPAIRMENT CHARGES

To better align our cost structure with changes in customer demand, our Board of Directors approved a restructuring plan in the second quarter of fiscal year 2009. This restructuring resulted in the closing of our Garner, Iowa facility at the end of August 2009 with production moving to Merrifield, Minnesota and closing our Fairmont Aerospace assembly production facilities and moving these activities to Blue Earth, Minnesota. One building in Fairmont was sold and another was held for sale at December 31, 2009 and was reclassified to Other Assets on the balance sheet. As a result of these moves, we recognized approximately $968,000 of restructuring and impairment charges for the year ended December 31, 2009, in Income (Loss) from Operations.

The restructuring and impairment costs included $502,000 of non-cash property and equipment charges and $466,000 in cash charges related to employee benefits, contract termination costs, and other expenses incurred to relocate production. The property and equipment impairment charges were for certain assets identified that are no longer being used in our operations as a result of the restructuring.

In 2010, we abandoned a second building in Fairmont and recognized an impairment charge of $56,000 based on a real estate appraisal completed. At December 31, 2010 the two remaining buildings are classified as held for sale and included in Other Assets on the balance sheet.

NOTE 12 BUSINESS ACQUISITION

On May 4, 2010, we acquired all of the intellectual property and assets, excluding cash and receivables, of Trivirix Corporation, Milaca, MN for cash of $403,000. The fair value of assets acquired included $303,000 in inventory and $100,000 in property and equipment. This operation specializes in design, manufacturing and post-production services of complex electronic and electromechanical medical devices for diagnostic,

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 12 BUSINESS ACQUISITION (Continued)

analytical and other life-science applications. This acquisition expands our capabilities and expertise serving medical electronics manufacturers. The acquisition has been accounted for as a business combination and results of operations for Milaca since the date of acquisition are included in the consolidated financial statements.

NOTE 13 SUBSEQUENT EVENT (UNAUDITED)

On November 15, 2010, the Company entered into an Asset Purchase Agreement with Winland Electronics, Inc. (Winland) to acquire substantially all of Winland's EMS assets and assume certain liabilities relating to their EMS operations located in Mankato, MN. The purchase was completed on January 1, 2011. Winland is a designer and manufacturer of custom electronic control products and systems. This purchase will provide needed manufacturing capacity, particularly for supporting medical and industrial customers with printed circuit board assemblies and higher-level builds.

We paid $1,042,389 in cash at closing and will make deferred payments of $250,000 on each July 1, 2011 and October 1, 2011. We also agreed to purchase a minimum of $2,200,000 of inventory as consumed over the next 24 months.

In connection with the acquisition, Nortech also entered into an agreement to manufacture certain products related to the production of Winland's remaining proprietary monitoring devices business unit and Nortech also agreed to a six year agreement to lease office and manufacturing space at 1950 Excel Drive, Mankato, Minnesota, 56001, and sublease 1,000 square feet back to Winland for one year.

The following table presents the allocation of the acquisition cost to the assets acquired and liabilities assumed, based on their estimated fair values at the time of the acquisition:

Accounts receivable	$	1,914,723
Property, plant and equipment		2,451,000
Accounts payable assumed		(1,772,334)
Lease payoff		(259,385)
Net assets acquired	$	2,334,004
Cash Paid at Closing		1,042,389
Due to Winland		500,000
Purchase price		1,542,389
Bargain purchase gain		791,615
Net assets acquired	$	2,334,004

We will recognize a $791,615 bargain purchase gain related to the excess fair value over the purchase price for the assets acquired.

The Mankato operations results are not included in the consolidated financial statements since the date of acquisition was after December 31, 2010; however the table below reflects our unaudited pro forma combined results of operations as if the acquisition had taken place as of January 1, 2010:

	Pro Forma For the Year Ended December 31, 2010 (unaudited)
Net Sales	$ 114,473,000
Net Loss	$ (291,000)
Basic Loss per Common Share	$ (0.11)

Combined results for the two companies for the year ended December 31, 2010 were adjusted for the following in order to create the unaudited proforma results in the table above:

Additional rent expense of approximately $178,000 for the lease of the facility from Winland,

Additional depreciation expense of approximately $158,000 resulting from the adjustment of property and equipment to their fair values,

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2010 AND 2009

NOTE 13 SUBSEQUENT EVENT (UNAUDITED) (Continued)

Elimination of inventory obsolescence charges of approximately $297,000 as we did not acquire Winland's inventory as part of the acquisition,

Tax benefit of approximately $489,000 using an effective tax rate of 38 percent,

The impact of these adjustments on outstanding shares of 2,742,389 was to decrease proforma loss per share by $0.29.

The pro forma unaudited results do not purport to be indicative of the results which would have been obtained had the acquisition been completed as of the beginning of the earliest period presented. In addition they do not include any benefits that may result from the acquisition due to synergies that may be derived from the elimination of any duplicative costs.

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Report of Independent Registered Public Accounting Firm on Supplementary Information

To the Board of Directors and Shareholders
Nortech Systems Incorporated and Subsidiary

Our audits of the consolidated financial statements referred to in our report dated March 11, 2011, (included elsewhere in this Annual Report on Form 10-K) also included the consolidated financial statement schedule of Nortech Systems Incorporated and Subsidiary, listed in Item 15(a) of this Form 10-K. This schedule is the responsibility of Nortech Systems Incorporated and Subsidiary's management. Our responsibility is to express an opinion based on our audits of the consolidated financial statements.

In our opinion, the consolidated financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ MCGLADREY & PULLEN, LLP

Minneapolis, Minnesota
March 11, 2011

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

SCHEDULE II Valuation and Qualifying Accounts

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

Classification	Balance at Beginning of Year	Additions Charged to Costs and Expenses	Deductions	Balance at End of Year
Year Ended December 31, 2010:				
Allowance for Uncollectible Accounts	$ 138,000	$ 58,000	$ (110,000)	$ 86,000
Inventory Reserves	1,095,000	1,243,000	(1,296,000)	1,042,000
Self-insurance Accrual	310,000	3,110,000	(3,385,000)	35,000
Year Ended December 31, 2009:				
Allowance for Uncollectible Accounts	$ 492,000	$ 226,000	$ (580,000)	$ 138,000
Inventory Reserves	1,340,000	966,000	(1,211,000)	1,095,000
Self-insurance Accrual	446,000	4,663,000	(4,799,000)	310,000

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures.* In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), as of the end of the period covered by this Annual Report on Form 10-K, the Company's management evaluated, with the participation of the Company's President and Chief Executive Officer and the Chief Financial Officer, the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the President and Chief Executive Officer and the Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of the date of such evaluation in ensuring that information required to be disclosed in the Company's Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to management, including the Company's President and Chief Executive Officer and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

(b) *Changes in internal control.* There was no change in the Company's internal control over financial reporting that occurred during the period covered by this Annual Report on Form 10-K that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Management's Annual Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to management and the board of directors regarding the effectiveness of our internal control processes over the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

We have assessed the effectiveness of our internal controls over financial reporting as of December 31, 2010. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework. Based on our assessment, we believe that, as of December 31, 2010, our internal control over financial reporting is effective based on those criteria.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's independent registered public accounting firm pursuant to the rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT AND CORPORATE GOVERNANCE

Information regarding the directors and executive officers of the Registrant will be included in the Registrant's 2010 proxy statement to be filed with the Securities and Exchange Commission within 120 days after December 31, 2010, the end of our fiscal year, and said portions of the proxy statement are incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

Information regarding executive compensation of the Registrant will be included in the Registrant's 2010 proxy statements to be filed with the Securities and Exchange Commission within 120 days after December 31, 2010, the end of our fiscal year, and said portions of the proxy statement are incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information regarding security ownership of certain beneficial owners and management of the Registrant will be included in the Registrant's 2010 proxy statements to be filed with the Securities and Exchange Commission within 120 days after December 31, 2010, the end of our fiscal year, and said portions of the proxy statements are incorporated herein by reference.

Information regarding executive compensation plans (including individual compensation arrangements) as of the end of the last fiscal year, on two categories of equity compensation plans (that is, plans that have been approved by security holders and plans that have not been approved by security holders) will be included in the Registrant's 2010 proxy statements to be filed with the Securities and Exchange Commission within 120 days after December 31, 2010, the end of our fiscal year, and said portions of the proxy statements are incorporated herein by reference.

The following table provides information about our equity compensation plans (including individual compensation arrangements) as of December 31, 2010.

Plan category	Number of securities to be issued upon the exercise of outstanding options, warrants and rights(1)	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column)(2)
Equity compensation plans approved by security holders	663,150	$ 7.32	167,950
Equity compensation plans not approved by security holders	0	0	0
Total	663,150	$ 7.32	167,950

(1) Represents common shares issuable upon the exercise of outstanding options granted under our 1992 Employee Stock Incentive Plan (the "1992 Plan"), the 2003 Stock Option Plan (the "2003 Plan"), the 2005 Incentive Compensation Plan (the "2005 Plan") and the 2007 FOCUS Incentive Compensation Plan (the "2007 Plan").

(2) Represents common shares remaining available for issuance under the 2005 and 2007 Plans.

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ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item will be included in the Registrant's 2010 proxy statements to be filed with the Securities and Exchange Commission within 120 days after December 31, 2010, the end of our fiscal year, and said portions of the proxy statements are incorporated herin by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item will be included in the Registrant's 2010 proxy statements to be filed with the Securities and Exchange Commission within 120 days after December 31, 2010, the end of our fiscal year, and said portions of the proxy statement are incorporated herin by reference.

PART IV

ITEM 15. EXHIBITS, CONSOLIDATED FINANCIAL STATEMENTS SCHEDULES

(a)1. Consolidated Financial Statements Consolidated Financial Statements and related Notes are included in Part II, Item 8, and are identified in the Index on Page 23.

(a)2. Consolidated Financial Statement Schedule The following financial statement schedule and the Auditors' report thereon is included in this Annual Report on Form 10-K:

All other schedules are omitted because the required information is inapplicable or the information is presented in the consolidated financial statements or related notes.

(a)3. The following exhibits are incorporated herein by reference:

10.7 First Amendment to Third Amended and Restated Credit and Security Agreement between the Company and Wells Fargo Bank, National Association

10.8 Winland Asset Purchase Agreement

23.1 Consent of McGladrey & Pullen, LLP.

31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.

31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.

32.1 Certification of the Chief Executive Officer and Chief Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

NORTECH SYSTEMS INCORPORATED

March 11, 2011	/s/ *RICHARD G. WASIELEWSKI*
	Richard G. Wasielewski *Chief Financial Officer and Principal Accounting Officer*
March 11, 2011	/s/ *MICHAEL J. DEGEN*
	Michael J. Degen *President, Chief Executive Officer and Director*

Pursuant to the requirements of the Securities Exchange Act of 1934, the following persons on behalf of the registrant and in the capacities and on the dates indicated have signed this report.

March 11, 2011	/s/ *MICHAEL J. DEGEN*
	Michael J. Degen *President, Chief Executive Officer and Director*
March 11, 2011	/s/ *MYRON KUNIN*
	Myron Kunin *Chairman and Director*
March 11, 2011	/s/ *RICHARD W. PERKINS*
	Richard W. Perkins, *Director*
March 11, 2011	/s/ *C. TRENT RILEY*
	C. Trent Riley, *Director*
March 11, 2011	/s/ *KEN LARSON*
	Ken Larson, *Director*

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INDEX TO EXHIBITS

DESCRIPTIONS OF EXHIBITS

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