

FLOTEK INDUSTRIES INC/CN/  
Form 10-Q  
November 10, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2010

or

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

For the transition period from                      to

Commission File Number 1-13270

**FLOTEK INDUSTRIES, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of

**90-0023731**  
(I.R.S. Employer

incorporation or organization)

Identification No.)

**2930 W. Sam Houston Parkway N. #300**

**Houston, TX**  
(Address of principal executive offices)

**77043**  
(Zip Code)

**(713) 849-9911**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of November 8, 2010, there were 30,810,792 outstanding shares of Flotek Industries, Inc. common stock, \$0.0001 par value.

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****FLOTEK INDUSTRIES, INC.****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

	September 30, 2010	December 31, 2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 7,059	\$ 6,485
Restricted cash		10
Accounts receivable, net of allowance for doubtful accounts of \$284 and \$948 at September 30, 2010 and December 31 2009, respectively	25,101	14,612
Inventories, net	27,183	27,232
Deferred tax assets, net	975	762
Income tax receivable	2,246	6,607
Other current assets	1,216	871
<b>Total current assets</b>	<b>63,780</b>	<b>56,579</b>
Property and equipment, net	53,935	60,251
Goodwill	26,943	26,943
Other intangible assets, net	37,416	35,128
<b>Total assets</b>	<b>\$ 182,074</b>	<b>\$ 178,901</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 9,508	\$ 8,021
Accrued liabilities	9,548	4,941
Interest payable	728	2,672
Current portion of long-term debt	4,364	8,949
<b>Total current liabilities</b>	<b>24,148</b>	<b>24,583</b>
Convertible notes, net of discount	97,309	95,601
Long-term debt, less current portion	31,396	23,589
Warrant liability	7,151	4,729
Deferred tax liabilities, net	3,640	3,203
<b>Total liabilities</b>	<b>163,644</b>	<b>151,705</b>
Commitments and contingencies		
Stockholders' equity:		
Cumulative convertible preferred stock at accreted value, \$0.0001 par value, 100,000 shares authorized; 13,020 and 16,000 shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively; liquidation preference of \$1,000 per share	7,758	6,943

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Common stock, \$0.0001 par value, 80,000,000 shares authorized; shares issued and outstanding: 31,763,792 and 30,810,632, respectively, at September 30, 2010 and 24,168,292 and 23,362,907, respectively, at December 31, 2009

	3	2
Additional paid-in capital	96,574	84,020
Accumulated other comprehensive income	109	118
Accumulated deficit	(85,272)	(63,342)
Treasury stock at cost, 535,811 and 346,270 shares at September 30, 2010 and December 31, 2009, respectively	(742)	(545)
<b>Total stockholders' equity</b>	<b>18,430</b>	<b>27,196</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 182,074</b>	<b>\$ 178,901</b>

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****FLOTEK INDUSTRIES, INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
<b>Revenue</b>	\$ 39,982	\$ 23,818	\$ 99,526	\$ 87,997
<b>Cost of revenue</b>	23,915	17,415	64,097	65,455
Gross margin	16,067	6,403	35,429	22,542
<b>Expenses:</b>				
Selling, general and administrative	8,539	7,307	31,947	26,649
Depreciation and amortization	1,230	1,217	3,604	3,710
Research and development	294	350	1,021	1,175
Impairment of goodwill				18,500
Total expenses	10,063	8,874	36,572	50,034
<b>Income (loss) from operations</b>	6,004	(2,471)	(1,143)	(27,492)
<b>Other income (expense):</b>				
Loss on extinguishment of debt			(995)	
Interest expense	(5,384)	(4,043)	(14,546)	(11,643)
Other financing costs			(816)	
Change in fair value of warrant liability	(1,106)	(789)	(2,422)	(789)
Other income (expense), net	81	(1)	132	(169)
Total other income (expense)	(6,409)	(4,833)	(18,647)	(12,601)
Loss before income taxes	(405)	(7,304)	(19,790)	(40,093)
Income tax (provision) benefit	(758)	(15,871)	2,952	(4,902)
<b>Net loss</b>	(1,163)	(23,175)	(16,838)	(44,995)
Accrued dividends and accretion of discount on preferred stock	(1,191)	(765)	(5,092)	(765)
<b>Net loss attributable to common stockholders</b>	\$ (2,354)	\$ (23,940)	\$ (21,930)	\$ (45,760)
<b>Basic and diluted loss per common share:</b>				
Basic and diluted loss per common share	\$ (0.09)	\$ (1.22)	\$ (0.90)	\$ (2.34)
Weighted average common shares used in computing basic and diluted loss per common share	26,690	19,645	24,458	19,578

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****FLOTEK INDUSTRIES, INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

	<b>Nine Months Ended September 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (16,838)	\$ (44,995)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	10,583	10,543
Amortization of deferred financing costs	2,935	1,148
Accretion of debt discount	3,699	3,554
Impairment of goodwill		18,500
Loss on extinguishment of debt	995	
Change in fair value of warrant liability	2,422	789
Gain on sale of assets	(1,465)	(738)
Stock compensation expense	4,020	1,331
Reduction in tax benefit related to share-based awards	1,716	(8)
Deferred income tax (benefit) provision	(1,492)	10,984
Unrealized loss on interest rate swap		56
Change in current assets and liabilities:		
Restricted cash	10	
Accounts receivable	(10,489)	21,274
Inventories	49	8,821
Income tax receivable	4,361	(5,321)
Other current assets	(345)	(182)
Accounts payable	1,487	(14,804)
Accrued liabilities	2,310	(7,829)
Interest payable	(1,944)	(1,182)
Net cash provided by operating activities	2,014	1,941
<b>Cash flows from investing activities:</b>		
Proceeds from sale of assets	2,639	2,130
Purchase of patents	(2)	
Capital expenditures	(3,128)	(5,567)
Net cash used in investing activities	(491)	(3,437)
<b>Cash flows from financing activities:</b>		
Proceeds from borrowings	40,000	12,604
Repayments of indebtedness	(37,206)	(24,707)
Debt issuance costs	(2,004)	(819)
Reduction in tax benefit related to share-based awards	(1,716)	(24)
Purchase of treasury stock	(86)	
Proceeds from preferred stock offering		16,000
Issuance costs of preferred stock and detachable warrants		(1,199)
Proceeds from exercise of warrants	69	
Proceeds from exercise of stock options	3	30

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Net cash (used in) provided by financing activities	(940)	1,885
Effect of exchange rate changes on cash and cash equivalents	(9)	(6)
<b>Net increase in cash and cash equivalents</b>	574	383
Cash and cash equivalents at the beginning of the period	6,485	193
Cash and cash equivalents at the end of the period	\$ 7,059	\$ 576

See accompanying notes to unaudited condensed consolidated financial statements.



**Table of Contents****FLOTEK INDUSTRIES, INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**

(in thousands)

	Common Stock		Preferred Stock		Treasury Stock		Accumulated Other Comprehensive Income			Total
	Shares Issued	Value	Shares	Value	Shares	Cost	Paid-In Capital	(Loss)	Accumulated Deficit	
<b>Balance, December 31, 2009</b>	24,168	\$ 2	16	\$ 6,943	346	\$ (545)	\$ 84,020	\$ 118	\$ (63,342)	\$ 27,196
Net loss									(16,838)	(16,838)
Foreign currency translation adjustment								(9)		(9)
Comprehensive loss										(16,847)
Common stock issued in payment of debt issuance costs	4,042	1					5,094			5,095
Common stock issued in exchange of convertible notes	1,569						1,992			1,992
Accretion of discount on preferred stock				3,795					(3,795)	
Preferred stock dividends, net of forfeitures									(1,297)	(1,297)
Stock warrants exercised	301						69			69
Stock options exercised	140						115			115
Restricted stock granted	248									
Restricted stock forfeited					22					
Treasury stock purchased					168	(197)				(197)
Reduction in tax benefit related to share-based awards							(1,716)			(1,716)
Stock compensation expense							4,020			4,020
Conversion of preferred stock into common stock	1,296		(3)	(2,980)			2,980			
<b>Balance, September 30, 2010</b>	31,764	\$ 3	13	\$ 7,758	536	\$ (742)	\$ 96,574	\$ 109	\$ (85,272)	\$ 18,430

See accompanying notes to unaudited condensed consolidated financial statements.

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**FLOTEK INDUSTRIES, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Organization and Basis of Presentation**

***Organization***

Flotek Industries, Inc. ( Flotek ) is a global developer and supplier of drilling and production related products and services. Flotek 's strategic focus, and that of its wholly-owned subsidiaries (collectively referred to as the Company ), includes oilfield specialty chemicals and logistics, down-hole drilling tools and down-hole production tools used in the energy and mining industries. The Company also manages automated handling, loading and blending facilities for a variety of bulk materials. Flotek 's products and services enable customers to drill wells more efficiently, to increase production from existing wells and to decrease well operating costs. Major customers include leading oilfield service providers, major and independent oil and gas exploration and production companies, and onshore and offshore drilling contractors.

***Basis of Presentation***

The accompanying Unaudited Condensed Consolidated Financial Statements (the Financial Statements ) reflect all adjustments that are, in the opinion of management, necessary for a fair presentation of the financial condition and results of operations for the periods presented. All such adjustments are of a normal recurring nature. The condensed consolidated balance sheet as of December 31, 2009, which has been derived from audited financial statements, and the unaudited interim condensed consolidated financial statements, including selected notes, have been prepared in accordance with the applicable rules and regulations of the Securities and Exchange Commission (the SEC ) regarding interim financial reporting and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America ( GAAP ) for complete financial statements. These interim Financial Statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company 's 2009 Annual Report on Form 10-K/A Amendment No. 2. A copy of Flotek 's 2009 Annual Report on Form 10-K/A Amendment No. 2 may be obtained by visiting [www.sec.gov](http://www.sec.gov) and conducting a search of the Company 's Ticker Symbol: FTK or by visiting the Company 's website, [www.flotekind.com](http://www.flotekind.com). The results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of the results to be expected for the year ending December 31, 2010.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the Financial Statements and accompanying notes. Actual results could differ from these estimates.

**Note 2 Recent Accounting Pronouncements**

***Application of New Accounting Standard***

Effective January 1, 2010, the Company adopted the accounting guidance in Accounting Standards Update ( ASU ) No. 2009-15, *Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing* which amends or adds certain paragraphs to the related Accounting Standards Codification ( ASC or Codification ) Topic 470, *Debt*. This standard addresses the accounting for an entity 's own-share lending arrangement initiated in conjunction with convertible debt or another financing offering and the effect a share-lending arrangement has on earnings per share. The guidance also addresses the accounting and earnings per share implications for probable or actual defaults by the share borrower. The new guidance is required to be applied retrospectively to all periods presented.

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company has applied this guidance to the share lending arrangement (See Note 9). The retrospective effect of the adoption of ASU No. 2009-15 on the Company's consolidated financial statements as of December 31, 2009 and for the three and nine months ended September 30, 2009 is as follows (in thousands, except per share data):

*Balance Sheet Information*

	<b>As of December 31, 2009</b>		
	<b>As Reported</b>	<b>Adjustment</b>	<b>As Adjusted</b>
Other intangible assets (deferred financing costs)	\$ 34,837	\$ 291	\$ 35,128
Total assets	178,610	291	178,901
Additional paid-in capital	\$ 83,555	\$ 465	\$ 84,020
Accumulated deficit	(63,168)	(174)	(63,342)
Total stockholders' equity	26,905	291	27,196
Total liabilities and stockholders' equity	178,610	291	178,901

*Statement of Operations Information*

	<b>Three Months Ended September 30, 2009</b>		
	<b>As Reported</b>	<b>Adjustment</b>	<b>As Adjusted</b>
Interest expense	\$ (4,020)	\$ (23)	\$ (4,043)
Net loss	(23,152)	(23)	(23,175)
Net loss attributable to common stockholders	(23,917)	(23)	(23,940)
Basic and diluted loss per common share	\$ (1.22)		\$ (1.22)
Weighted average common shares used in computing basic and diluted loss per common share	19,645		19,645

	<b>Nine Months Ended September 30, 2009</b>		
	<b>As Reported</b>	<b>Adjustment</b>	<b>As Adjusted</b>
Interest expense	\$ (11,573)	\$ (70)	\$ (11,643)
Net loss	(44,925)	(70)	(44,995)
Net loss attributable to common stockholders	(45,690)	(70)	(45,760)
Basic and diluted loss per common share	\$ (2.33)		\$ (2.34)
Weighted average common shares used in computing basic and diluted loss per common share	19,578		19,578

*New Accounting Requirements and Disclosures*

In January 2010, the FASB issued ASU No. 2010-06, *Improving Disclosures about Fair Value Measurements*, which amends ASC Topic 820-10, *Fair Value Measurements and Disclosures Overall*, to require new disclosures related to the movements in and out of Levels 1, 2, and 3 and clarifies existing disclosures regarding the classification and valuation techniques used to measure fair value. This guidance is effective for

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interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about certain Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010. The Company adopted the guidance regarding disclosure of movements in and out of the fair value measurement levels effective January 1, 2010. Adoption of this standard for these disclosures had no impact on the Company's

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consolidated financial statements. The Company does not expect that adoption, effective January 1, 2011, of the new disclosure requirements regarding Level 3 fair value measurements will have a material impact on the Company's consolidated financial statements.

**Note 3 Supplemental Cash Flow Information**

Supplemental cash flow information is as follows (in thousands):

	Nine Months Ended September 30, 2010	2009
Supplemental non-cash investing and financing activities:		
Warrant liability recognized upon issuance of warrants	\$	\$ 5,194
Shares of common stock issued in payment of debt issuance costs	5,095	
Conversion of preferred stock into common stock	2,980	
Debt issuance cost included in accrued liabilities	1,000	
Shares of common stock issued in exchange for convertible notes	1,992	
Reduction of convertible debt upon note exchange	1,996	
Property and equipment acquired through capital leases	427	62
Exercise of stock options through surrender of common stock	111	
Supplemental cash payment information:		
Interest paid	\$ 9,343	\$ 5,174
Income taxes (refunded) paid, net	(6,198)	3,440

**Note 4 Product Revenue**

The Company generates revenue from product sales, equipment rentals and service provider engagements. Revenue and associated cost of revenue related to each of these activities are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenue:				
Product	\$ 25,662	\$ 15,126	\$ 63,075	\$ 56,624
Rental	11,579	6,286	28,785	22,274
Service	2,741	2,406	7,666	9,099
	\$ 39,982	\$ 23,818	\$ 99,526	\$ 87,997
Cost of revenue:				
Product	\$ 14,406	\$ 9,657	\$ 36,204	\$ 39,427
Rental	5,185	3,833	15,595	13,382
Service	1,981	1,579	5,320	5,812
Depreciation	2,343	2,346	6,978	6,834
	\$ 23,915	\$ 17,415	\$ 64,097	\$ 65,455



**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 5 Inventories**

Inventories are as follows (in thousands):

	September 30, 2010	December 31, 2009
Raw materials	\$ 9,789	\$ 9,653
Work-in-process	49	
Finished goods (includes in-transit)	20,099	20,659
Gross inventories	29,937	30,312
Less excess and obsolescence reserve	(2,754)	(3,080)
Inventories, net	\$ 27,183	\$ 27,232

**Note 6 Property and Equipment**

Property and equipment are as follows (in thousands):

	September 30, 2010	December 31, 2009
Land	\$ 1,266	\$ 1,338
Buildings and leasehold improvements	18,614	19,143
Machinery, equipment and rental tools	62,984	62,369
Equipment in progress	189	133
Furniture and fixtures	1,290	1,306
Transportation equipment	3,750	4,252
Computer equipment	1,850	1,750
Property and equipment	89,943	90,291
Accumulated depreciation	(36,008)	(30,040)
Property and equipment, net	\$ 53,935	\$ 60,251

The Company recognized depreciation expense recorded in cost of revenue of \$2.3 million for the three months ended September 30, 2010 and 2009, and \$7.0 million and \$6.8 million for the nine months ended September 30, 2010 and 2009, respectively. The portion of depreciation expense recorded in cost of revenue relates directly to activities that generate revenue (See Note 4).

**Note 7 Goodwill**

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The Company tests goodwill for impairment, on an annual basis, during the fourth fiscal quarter, and more frequently if circumstances indicate a potential impairment. While the Company's external financial reporting and disclosures are based upon three reportable segments (Chemical and Logistics, Drilling Products and Artificial Lift), for goodwill assessment and managerial analysis the Company further refines segment categorization into four divisions (Chemical and Logistics, Drilling Products, Artificial Lift, and Teledrift). Only two of these divisions, Chemical and Logistics and Teledrift, have remaining unamortized goodwill at September 30, 2010. Goodwill was not tested for impairment during the three or nine months ended



**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

September 30, 2010, as the Company was not aware of any changes in market conditions or financial indicators which would require interim period impairment testing.

During the nine months ended September 30, 2009, the Company recognized \$18.5 million of goodwill impairment charges related to its Teledrift reporting unit. Goodwill impairment resulted from a macro-economic decline, in particular, the direct impact the downturn had on the oil and gas industry and affiliated industries, and the Company's forecast related to its Teledrift reporting unit.

**Note 8 Other Intangible Assets**

Other intangible assets are as follows (in thousands):

	September 30, 2010	December 31, 2009
Patents	\$ 6,282	\$ 6,282
Customer lists	28,543	28,543
Non-compete agreements	1,715	1,715
Brand name	6,199	6,199
Supply contract	1,700	1,700
Other	365	428
Other acquired intangible assets	44,804	44,867
Less accumulated amortization	(15,745)	(13,925)
Net other acquired intangible assets	29,059	30,942
Deferred financing costs, net	8,357	4,186
Other intangible assets, net	\$ 37,416	\$ 35,128

Other acquired intangible assets are amortized on a straight-line basis over two to 20 years. The Company recognized amortization expense of \$0.6 million for the three months ended September 30, 2010 and 2009, and \$1.9 million for the nine months ended September 30, 2010 and 2009.

Deferred financing costs are amortized using the effective interest method. The Company recognized amortization expense of \$1.4 million and \$0.4 million for the three months ended September 30, 2010 and 2009, respectively, and \$2.9 million and \$1.1 million for the nine months ended September 30, 2010 and 2009, respectively. During the nine months ended September 30, 2010, the Company capitalized financing costs of \$8.1 million relating to a new term loan and an exchange of convertible notes, and expensed unamortized deferred financing costs related to a senior credit facility with Wells Fargo which was repaid (See Note 9).

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 9 Convertible Notes and Long-Term Debt**

Convertible notes and long-term debt are as follows (in thousands):

	September 30, 2010	December 31, 2009
Convertible notes:		
Convertible senior notes (2008 Notes)	\$ 75,000	\$ 115,000
Convertible senior secured notes (2010 Notes)	36,004	
Less discount on notes	(13,695)	(19,399)
<b>Convertible senior notes, net of discount</b>	<b>\$ 97,309</b>	<b>\$ 95,601</b>
Long-term debt:		
Term loan	\$ 34,887	\$
Senior credit facility:		
Equipment term loans		21,210
Revolving line of credit		9,953
Real estate term loans		717
Capital lease obligations	873	658
<b>Total</b>	<b>35,760</b>	<b>32,538</b>
Less current portion	(4,364)	(8,949)
<b>Long-term debt, less current portion</b>	<b>\$ 31,396</b>	<b>\$ 23,589</b>

**Convertible Notes**

The Company's convertible notes consist of Convertible Senior Notes (the 2008 Notes) and Convertible Senior Secured Notes (the 2010 Notes).

On February 14, 2008, the Company issued the 2008 Notes at par, in the aggregate principal amount of \$115 million. Net proceeds received from issuance of the 2008 Notes were \$111.8 million. The 2008 Notes bear interest at 5.25% and mature on February 15, 2028.

On March 31, 2010, the Company executed an exchange agreement with Whitebox Advisors LLC and a syndicate of lenders (the Exchange Agreement) in order to refinance an existing term loan (described below). The Exchange Agreement permitted each lender to exchange their existing 2008 Notes in proportion to the lender's principal amount of participation in the refinanced term loan, for 2010 Notes and shares of the Company's common stock.

On March 31, 2010, in accordance with the terms of the Exchange Agreement, investors received, for each \$1,000 principal amount of 2008 Notes exchanged, (a) \$900 principal amount of 2010 Notes and (b) \$50 in shares of the Company's common stock (based on the greater of 95% of (1) the volume-weighted average price of the common stock for the preceding ten trading days or (2) the closing price of the common stock on the day before the closing). The 2010 Notes carry the same maturity date, interest rate, conversion rights, conversion rate, Company

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redemption rights and guarantees as the 2008 Notes. The only modification in terms, as compared to the 2008 Notes is that the 2010 Notes are secured by a second priority lien on substantially all of the Company's assets, while the 2008 Notes remain unsecured.

The Company exchanged \$40 million of 2008 Notes for aggregate consideration of \$36 million of 2010 Notes and \$2.0 million worth of shares of the Company's common stock. On March 31, 2010, the Company issued 1,568,867 shares of common stock to satisfy the common stock component of the exchange. The transaction was

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**FLOTEK INDUSTRIES, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

accounted for as an exchange of debt in accordance with ASC 470-50, Debt Modifications and Extinguishments. Appropriately, no gain or loss was recognized and the difference between the debt exchanged and the net carrying amount of the debt was recorded as a reduction of the previously recognized debt discount. The resulting net discount continues to be amortized over the period the convertible debt is expected to remain outstanding. The Company capitalized commitment fees related to the Exchange Agreement which are being amortized using the effective interest method over the period the convertible debt is expected to remain outstanding. Third-party transaction costs of \$0.8 million incurred as a result of the Exchange Agreement were expensed as incurred.

The 2008 and 2010 Notes are guaranteed by substantially all of the Company's wholly-owned subsidiaries. The Company is a holding company and has no independent assets or operations. The guarantees, provided by the Company's subsidiaries, are full and unconditional and joint and several. Any subsidiaries of the Company that are not guarantors are deemed to be minor subsidiaries in accordance with SEC Regulation S-X, Rule 3-10, Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered. The agreements governing the Company's long-term indebtedness do not contain any significant restrictions on the ability of the Company, or any guarantor, to obtain funds from subsidiaries by dividend or loan.

Interest on the 2008 and 2010 Notes is accrued at 5.25% per annum, and is payable semiannually in arrears on February 15 and August 15 of each year. The Company is also required to pay contingent interest to holders of the 2008 and 2010 Notes during any six-month period from an interest payment date to, but excluding, the following interest payment date, commencing with the six-month period beginning on February 15, 2013, if the trading price of a note for each of the five trading days ending on the third trading day immediately preceding the first day of the relevant six-month period equals 120% or more of the principal amount of the note. Contingent interest payable per note, with respect to any such period, will be equal to 0.5% per annum of the average trading price of such note for the five trading days referenced above.

The 2008 and 2010 Notes mature on February 15, 2028. On or after February 15, 2013, the Company may redeem, for cash, all or a portion of the 2008 and 2010 Notes at a redemption price equal to 100% of the principal note amount to be redeemed plus associated accrued and unpaid interest (including any contingent interest). Holders of either 2008 or 2010 Notes may require the Company to purchase all, or a portion, of the holder's outstanding notes on each of February 15, 2013, February 15, 2018, and February 15, 2023. In addition, if the Company experiences specific types of corporate transactions, noteholders can require the Company to purchase all or a portion of the holder's outstanding notes. Any repurchase of notes pursuant to these provisions are to be for a cash price equal to 100% of the principal amount of the notes to be purchased plus associated accrued and unpaid interest (including any contingent interest).

The 2008 and 2010 Notes are convertible into shares of the Company's common stock at the option of the note holder, subject to various contractual conditions. The conversion rate is 43.9560 shares per \$1,000 principal note amount (equal to a conversion price of approximately \$22.75 per share), subject to adjustment, as defined. Upon conversion, the Company will deliver, at the Company's option, cash or shares of common stock or a combination of cash and shares of common stock.

As the 2008 Notes may be settled in cash upon conversion, the Company has accounted for the liability and equity components of the 2008 Notes using the Company's nonconvertible debt borrowing rate. The Company assumed an 11.5% nonconvertible debt interest rate and a five year expected term to determine the debt discount. The expected five year term represents the time period from inception until contractual call/put options, contained within the 2008 Notes, are able to be exercised (February 2013). The effective tax rate assumed was 38.0%. At the date of issuance, the discount on the 2008 Notes was \$27.8 million, with a related deferred tax liability of \$10.6 million. The resulting discount is being accreted over the period the convertible debt is expected

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

to be outstanding as additional non-cash interest expense. At March 31, 2010, the unamortized discount related to the pro-rata portion of the 2008 Notes exchanged was allocated to the 2010 Notes and continues to be accreted over the same period, at an assumed rate of 9.9%, using the effective interest method. The Company recorded non-cash interest expense related to accretion of the discount of \$1.2 million for the three months ended September 30, 2010 and 2009, and \$3.7 million and \$3.6 million for the nine months ended September 30, 2010 and 2009, respectively.

***Term Loan Senior Credit Facility***

On March 31, 2010, the Company executed an Amended and Restated Credit Agreement with Whitebox Advisors LLC, as administrative agent for a syndicate of lenders, for a \$40 million term loan. This term loan was used to repay the Company's existing senior credit facility at Wells Fargo Bank and provided net proceeds of \$6.1 million to be used for general corporate purposes.

The term loan indebtedness matures November 1, 2012 and has scheduled cash principal payments of \$750,000 in 2010, \$3,750,000 in 2011, and \$3,000,000 in 2012 with the remaining unpaid principal balance due at maturity. Interest is payable quarterly. The Company has the option to fully pay the interest due in cash or to pay a portion of the interest due in cash and capitalize the remaining unpaid interest due. Any capitalization of interest results in an increase in the principal amount due under the senior credit facility. The annualized cash interest rate is 12.5% when the principal balance exceeds \$30 million, 11.5% when the principal balance is \$20 million or more but not in excess of \$30 million, and 10.5% when the principal balance is less than \$20 million. If the Company elects to capitalize a portion of the interest, the annualized cash interest rate is 8% and additional interest is capitalized and added to the principal amount of the new senior credit facility at a annualized rate of 6% when the principal balance exceeds \$30 million, 4.5% when the principal balance is \$20 million or more but not in excess of \$30 million, and 3.5% when the principal balance is less than \$20 million.

The Amended and Restated Credit Agreement requires additional mandatory principal payments of (a) 50% of EBITDA (earnings before interest, taxes, depreciation and amortization) in excess of \$4.5 million in any fiscal quarter, (b) 50% of cash proceeds in excess of \$5 million and up to \$15 million from certain asset disposals, plus 75% of cash proceeds in excess of \$15 million from certain asset disposals, (c) 75% of any Federal income tax refunds, and (d) upon election by the lenders, up to \$1 million of additional principal on quarterly payment dates, when the volume-weighted average price of the Company's stock price is equal to or greater than \$1.3419 per share, payable by issuing common stock (based on 95% of the volume-weighted average price of the common stock for the preceding ten trading days).

The Amended and Restated Credit Agreement provides for a commitment fee of \$7,300,000, payable as follows: (a) \$925,975 cash payment at closing, (b) \$4,374,025 through issuance of 3,431,133 shares of common stock at closing (based on 95% of the volume-weighted average price of the Company's common stock for the preceding ten trading days), (c) \$1,000,000 payable in September 2010 in either cash, common stock or a combination of both cash and common stock (based on \$1.2077 per share), and (d) \$1,000,000 payable in March 2011 in cash, common stock or a combination of both cash or common stock (based on \$1.1406 per share). At September 30, 2010, the unpaid commitment fee of \$1.0 million is recorded in accrued liabilities. The election as to whether the commitment fee for (c) and (d) is payable in cash, common stock or combination of both cash and common stock is decided by the Company if the volume-weighted average price of the common stock is \$1.00 or more per share and by the lenders if such average is less than \$1.00 per share at the payment date. One half of the commitment fee has been allocated to the term loan and one half of the commitment fee has been allocated to the Exchange Agreement (See above). Commitment fees are capitalized as deferred financing costs (See Note 8) and are being amortized over the periods the term loan and the convertible debt are expected to remain outstanding.

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**FLOTEK INDUSTRIES, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Amended and Restated Credit Agreement does not contain a revolving line of credit facility nor require quarterly or annual financial covenants; however, the credit agreement does restrict the payment of dividends on the Company's common stock without the prior written consent of the lenders.

***Share Lending Agreement***

Concurrent with the offering of the 2008 Notes, the Company entered into a share lending agreement (the *Share Lending Agreement*) with Bear, Stearns International Limited (the *Borrower*). In May 2008, the Borrower became an indirect, wholly-owned subsidiary of JPMorgan Chase & Company. Under the Share Lending Agreement, the Company agreed to loan 3,800,000 shares of common stock (the *Borrowed Shares*) to the Borrower during a period commencing February 11, 2008 and ending on February 15, 2028. The Company may terminate the Share Lending Agreement earlier, upon written notice to the Borrower, if the entire principal balance of the 2008 Notes is no longer outstanding or upon agreement with the Borrower. The Borrower is permitted to use the Borrowed Shares only for the purpose of directly or indirectly facilitating the sale of the 2008 Notes and for the establishment of hedge positions by holders of the 2008 Notes. The Company did not require collateral in support of the Share Lending Agreement.

In February 2008, the Borrower borrowed all 3,800,000 shares available under the Share Lending Agreement. The number of shares is subject to adjustments for stock dividends, stock splits or reverse stock splits which change the number of shares of common stock outstanding. The Company did not receive any proceeds for the Borrowed Shares but did receive a nominal loan fee of \$0.0001 for each share loaned to the Borrower. The Borrower receives all proceeds from any sale of Borrowed Shares pursuant to the Share Lending Agreement. Upon conversion, the number of Borrowed Shares proportionate to the conversion rate for such notes must be returned to the Company. Any borrowed shares returned to the Company cannot be re-borrowed.

The Borrowed Shares are issued and outstanding for corporate law purposes; accordingly, the holders of the Borrowed Shares have all of the rights of a holder of the Company's outstanding shares, including the right to vote the shares on all matters submitted to a vote of shareholders, as well as the right to receive any dividends or other distributions that the Company may declare or pay on its outstanding shares of common stock. Under the Share Lending Agreement, the Borrower has agreed to pay to the Company, within one business day after the payment date, an amount equal to any cash dividends that the Company paid on the Borrowed Shares, and to pay or deliver to the Company, upon termination of the loan of Borrowed Shares, any other distribution, in liquidation or otherwise, that the Company made on the Borrowed Shares.

To the extent the Borrowed Shares lent under the Share Lending Agreement are not sold or returned to the Company, the Borrower has agreed to not vote any borrowed shares of which Borrower is the record owner. The Borrower has also agreed, under the Share Lending Agreement, to not transfer or dispose of any borrowed shares, other than to Borrower's affiliates, unless such transfer or disposition is pursuant to a registration statement that is effective under the Securities Act. Investors that purchase shares from the Borrower, and all subsequent transferees of such purchasers, will be entitled to the same voting rights, with respect to those shares, as any other holder of common stock.

Contractual undertakings of the Borrower have the effect of substantially eliminating the economic dilution that otherwise would result from the issuance of the borrowed shares; accordingly, and all shares outstanding under the Share Lending Agreement are required to be returned to the Company at a future date. As a result, the shares of the Company's stock loaned under the Share Lending Agreement are not considered to be outstanding for the purpose of computing and reporting earnings per share.

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At inception, the fair value of the Share Lending Agreement was \$0.5 million, which has been capitalized as an issuance cost and is being amortized as interest expense, using the effective interest method, for an expected term of five years. At September 30, 2010, unamortized issuance costs remaining were \$0.2 million.

***Capital Lease Obligations***

The Company leases certain equipment and vehicles under capital leases. At September 30, 2010 and December 31, 2009, the Company's capital lease obligations were \$0.9 million and \$0.7 million, respectively.

**Note 10 Fair Value of Financial Instruments**

The Company's liabilities measured at fair value on a recurring basis, including identification of the fair value hierarchy of the valuation techniques used by the Company to determine these fair values, are as follows (in thousands):

	Fair Value Measurements Using			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>At September 30, 2010:</b>				
Common stock warrants (1)	\$	\$	\$ 7,151	\$ 7,151
<b>At December 31, 2009:</b>				
Common stock warrants (1)	\$	\$	\$ 4,729	\$ 4,729
Interest rate swap (2)	\$	\$ 334	\$	\$ 334

(1) The fair value of the warrants was estimated using a Black-Scholes option-pricing model.

(2) The interest rate swap valuation was obtained from bank estimates utilizing pricing models with market-based inputs.

Changes in Level 3 liabilities measured at fair value on a recurring basis for the nine months ended September 30, 2010 are as follow (in thousands):

	<b>Warrant Liability</b>
Balance at December 31, 2009	\$ 4,729
Fair value adjustments, net	2,422
Net transfers in/(out)	

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Balance at September 30, 2010

\$ 7,151



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The carrying value and estimated fair value of the Company's other financial instruments are as follows (in thousands):

	September 30, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Convertible senior notes (2008 Notes) (1)	\$ 64,947	\$ 45,188	\$ 95,601	\$ 60,375
Convertible senior secured notes (2010 Notes) (1)	32,362	22,831		
Term loan	34,887	35,331		
Senior credit facility			31,880	31,880
Capital lease obligations	873	828	658	628

(1) The convertible senior notes carrying value is representative of the bifurcated debt component only, while the fair value is based on quoted market prices for the convertible senior notes, which includes the convertible equity features.

The Company determined the estimated fair value of the convertible senior notes based on the quoted market price of the notes. The estimated fair value of the term loan was determined based on current rates available for instruments with similar risks and maturities. The carrying value of the Wells Fargo senior credit facility approximated fair value as interest rates were variable, and accordingly, the carrying value approximated the current market value for instruments with similar risks and maturities. The fair value of the capital leases was determined based on recent lease rates adjusted for a risk premium.

The Company's non-financial assets, including goodwill, other intangible assets and property and equipment are measured at fair value on a nonrecurring basis and are subject to fair value adjustments in certain circumstances (e.g., evidence of impairment). The Company had no cash equivalents at September 30, 2010 or December 31, 2009. The fair value of all other assets and liabilities approximate carrying value as a result of the short-term nature of these accounts.

**Note 11 Loss Per Share**

Basic loss per common share is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding for the period. Diluted loss per common share is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding and potentially dilutive common equivalent shares outstanding, if the effect is dilutive. As a result of the net losses recognized during the three and nine months ended September 30, 2010 and 2009, potentially dilutive securities have been excluded from the calculation of diluted earnings per share, as inclusion would have an anti-dilutive effect on net loss per share.

In connection with the sale of the 2008 Notes, the Company entered into a share lending agreement (See Note 9) for 3,800,000 shares of its common stock. Contractual undertakings of the Borrower have the effect of substantially eliminating the economic dilution that would otherwise result from the issuance of borrowed shares. Further, all shares outstanding under the share lending agreement are required to be returned to the Company at a future date. As a result, the 3,800,000 shares of the Company's stock loaned under the share lending agreement are not considered to be outstanding for the purpose of computing and reporting loss per share.

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The computational components of basic and diluted loss per common share are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Weighted average common shares used in computing basic and diluted loss per common share	26,690	19,645	24,458	19,578

Securities convertible into shares of common stock at the dates indicated, not used in the computation of diluted loss per common share because the effect would be anti-dilutive, are as follows (in thousands):

	September 30,	
	2010	2009
Stock options under long-term incentive plans	1,231	1,223
Stock warrants	9,476	10,480
Convertible senior notes (if-converted)	4,879	5,055
Convertible preferred stock (if-converted)	5,661	6,957
	21,247	23,715

**Note 12 Income Taxes**

The Company has two U.S. tax filing groups which file separate U.S. Federal income tax returns (Flotek Industries, Inc. and subsidiaries and Petrovalve, Inc and subsidiaries). As a result, taxable income of one return cannot be offset by tax attributes, including net operating losses, of the other return.

The effective income tax rate for the three months ended September 30, 2010 and 2009 was (187.2)% and (217.3)%, respectively. The Company's effective tax rate in 2010 differs from the U.S. federal statutory rate primarily due to the change in the valuation allowance on deferred tax assets, the non-deductibility of the change in the warrant liability, and state income taxes. Additional tax expense was recorded in the three months ended September 30, 2010 due to a reduction in the Company's forecasted 2010 tax benefit as the result of a shift in the forecasted loss between the Company's two U.S. tax filing groups.

The Company has recorded a federal income tax receivable of approximately \$2.2 million at September 30, 2010 related to the anticipated carryback of net operating losses incurred in the first nine months of 2010. The Company received a federal income tax refund of approximately \$7.2 million during the three months ended September 30, 2010 related to the carryback of 2009 net operating losses.

**Note 13 Convertible Preferred Stock and Stock Warrants**

On August 12, 2009, the Company sold 16,000 units (the Units), consisting of Series A cumulative convertible preferred stock and warrants, for \$1,000 per Unit, yielding aggregate gross proceeds of \$16.0 million. Net proceeds from issuance of the Units were \$14.8 million. The Company used the net proceeds from the sale of Units to reduce borrowings under the Company's bank credit facility, thereby increasing the availability of credit, and for general corporate purposes.

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Each Unit was comprised of one share of cumulative convertible preferred stock ( Convertible Preferred Stock ), warrants to purchase up to 155 shares of the Company s common stock at an exercise price of \$2.31 per share ( Exercisable Warrants ) and contingent warrants to purchase up to 500 shares of the Company s common stock at an exercise price of \$2.45 per share ( Contingent Warrants ).

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**FLOTEK INDUSTRIES, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Each share of Convertible Preferred Stock is convertible at the holder's option, at any time, into 434.782 shares of the Company's common stock. This conversion rate is equivalent to a conversion price of approximately \$2.30 per share of common stock. The conversion rate is subject to adjustment in the event of stock splits, stock dividends and distributions, reorganizations and similar events affecting the common stock.

Each share of Convertible Preferred Stock has a liquidation preference of \$1,000. Dividends accrue at the rate of 15% of the liquidation preference per year and accumulate if not paid quarterly. The Company may pay dividends, at its option, in cash, common stock (based on the market value of the common stock) or a combination thereof. The Company has not declared or paid dividends on the Convertible Preferred Stock since its issuance. If the Company does not declare or pay dividends or if dividends are in arrears for an aggregate number of days equal to six calendar quarters, the holders of the Convertible Preferred Stock will be entitled to elect two new directors to the Company's board at the next annual meeting of stockholders, and at each subsequent meeting until all accumulated and unpaid dividends on the Convertible Preferred Stock have been fully paid or set aside for payment.

The Company may, at its option after February 11, 2010, automatically convert the preferred shares into common shares if the closing price of the common stock is equal to or greater than 150% of the then current conversion price for any 15 trading days during any 30 consecutive trading day period. If the Convertible Preferred Stock automatically converts and the Company has not previously paid holders amounts equal to at least eight quarterly dividends on the Convertible Preferred Stock, the Company will also pay to the holders, in connection with any automatic conversion, an amount, in cash or shares of common stock, equal to eight quarterly dividends less any dividends previously paid to holders of the Convertible Preferred Stock.

The Company may redeem any of the Convertible Preferred Stock beginning on August 12, 2012. The initial redemption price will be 105% of the liquidation preference, declining to 102.5% on August 12, 2013, and to 100% on or after August 12, 2014, in each case plus accrued and unpaid dividends to the redemption date.

The Exercisable Warrants are immediately exercisable and will expire if not exercised by August 12, 2014. The Contingent Warrants became exercisable on November 9, 2009 and will expire if not exercised by November 9, 2014. Both the Exercisable Warrants and Contingent Warrants contain anti-dilution price protection in the event the Company issues shares of common stock or securities exercisable for or convertible into common stock at a price per share less than their exercise price. Due to the anti-dilution price adjustment provision in the warrant agreements, the warrants were not considered equity and were recorded at fair value as warrant liabilities when issued. The warrant liabilities are adjusted to fair value with changes in the fair value recognized in the statement of operations at the end of each reporting period over the life of the warrants.

The gross proceeds from the issuance of the Units were allocated at the date of the transaction based on the relative fair values of the preferred stock and the warrants. In order to calculate the relative fair values, the Company obtained third-party valuations to assist with establishing the fair value of the debt and equity components of the Units. The fair value of the warrants was determined using the Black-Scholes option-pricing model assuming a five-year term, volatility of 54.0%, a risk-free rate of 2.7% and an assumed dividend rate of zero. The fair value of the preferred stock component was determined via separate valuations of the conversion rights and the host contract. The fair value of the conversion rights were determined based on a Monte Carlo simulation of the Company's possible future stock prices, which generated potential conversion outcomes. Due to a lack of comparable transactions by companies with similar credit ratings, the value of the host contract was determined by applying a risk-adjusted rate of return to the annual dividend. At the date of the transaction, the Company recorded approximately 68% of the proceeds or \$10.8 million (net of the discount resulting from the allocation of the proceeds to the warrants) as preferred stock in stockholders' equity and the detachable warrants with a fair value of \$5.2 million were recorded as a warrant liability.

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company determined that the embedded conversion option within the preferred stock was beneficial (had intrinsic value) to the holders of the preferred stock. The intrinsic value of the conversion option was determined to be \$5.2 million and was recognized as a beneficial conversion discount with offset to additional paid-in capital at the date of the transaction.

The conversion period for the preferred stock was estimated to be 36 months based on an evaluation of the conversion options. The accretion of the discount on the preferred stock was \$0.7 million and \$0.5 million for the three months ended September 30, 2010 and 2009, respectively, and \$3.8 million and \$0.5 million for the nine months ended September 30, 2010 and 2009, respectively, including the effect of the conversions which occurred during the first six months of 2010 (described in *Conversions of Preferred Stock* below).

The fair value of the warrants has been calculated for each reporting period end using the Black-Scholes option-pricing model. At September 30, 2010, inputs for the fair value calculation included the remaining term of the warrants, volatility of 67.9%, a risk-free rate of 0.9%, and an assumed dividend rate of zero.

***Conversions of Preferred Stock***

During the nine months ended September 30, 2010, holders of 2,980 shares of preferred stock elected conversion into 1,295,648 shares of the Company's common stock. The Company did not receive any proceeds from the conversions. The holders of the preferred stock were not entitled to accumulated and unpaid dividends on the converted shares; therefore, \$0.3 million of accrued and unpaid dividends were forfeited and are reported as a reduction of accrued dividends during the nine months ended September 30, 2010. At September 30, 2010, the Company had accrued and unpaid dividends on its preferred stock of \$2.2 million (\$168.75 per share).

Upon conversion of the preferred stock, the Company recognized the unamortized discount remaining on the converted preferred shares as additional accretion of discount on preferred stock.

***Re-pricing and Exercises of Stock Warrants***

Both the Exercisable Warrants and the Contingent Warrants contain anti-dilution price protection. In accordance with the anti-dilution price adjustment provisions of the warrants, they were re-priced following payment of a portion of the commitment fee with common stock on March 31, 2010 and again following payment of a portion of the deferred commitment fee with common stock on September 30, 2010 (See Note 9). At September 30, 2010, there are outstanding warrants to purchase up to 9,475,750 shares of the Company's common stock at an exercise price of \$1.21 per share. No warrants were exercised during the three months ended September 30, 2010. During the nine months ended September 30, 2010, warrants were exercised to purchase 300,454 shares of the Company's common stock.

**Note 14 Common Stock**

A reconciliation of the change in issued shares of the Company's common stock during the nine months ended September 30, 2010 is as follows:

Shares issued at December 31, 2009	24,168,292
Issued upon conversion of preferred stock	1,295,648
Issued in exchange of convertible notes	1,568,867
Issued in payment of debt issuance costs	4,042,241
Issued upon exercise of warrants	300,454
Issued as restricted stock award grants	248,004
Issued upon exercise of stock options	140,286

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Shares issued at September 30, 2010

31,763,792

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**Note 15 Commitments and Contingencies**

***Class Action Litigation***

A class action suit was commenced in August 2009 in the United States District Court for the Southern District of Texas on behalf of purchasers of the Company's common stock between May 2007 and January 2008, seeking to pursue remedies under the Securities Exchange Act of 1934. The complaint alleged that, throughout the time period indicated, the Company made misrepresentations and failed to disclose material adverse facts about its true financial condition, business and prospects. On September 29, 2010, the United States District Court dismissed this class action suit, finding that the plaintiffs failed to allege sufficient facts to state a claim under applicable federal securities laws. The plaintiffs did not file an appeal within the time period required, and absent a showing of good cause by the plaintiffs for failure to file this appeal, the time period for appeal of this dismissal has expired.

On September 17, 2010, an individual claiming to be a shareholder of the Company filed a purported shareholder derivative petition in State District Court in Harris County, Texas. The petition names the Company as a nominal defendant and certain of the Company's current and former officers, certain of the Company's former directors and four of the Company's current directors as defendants. The suit asserts claims for breach of fiduciary duty and other violations of law, and seeks contribution and indemnification against the individual defendants. The factual allegations in the derivative petition are similar to the factual allegations in the class action suit that was dismissed by the Federal Court on September 29, 2010, and include allegations regarding the company's internal controls. On November 5, 2010, the plaintiff filed a motion with the Court asking that the case be dismissed without prejudice. The Company believes that it is likely that the motion to dismiss the case will be granted by the Court. If dismissed pursuant to this motion, there would be no legal bar to the case being refiled at a later time.

***Other Litigation***

The Company is subject to routine litigation and other claims that arise in the normal course of business. Management is not aware of any pending or threatened lawsuits or proceedings which would have a material effect on the Company's financial position, results of operations or liquidity.

***Common Stock Listing on the New York Stock Exchange***

The Company's common stock is listed on the New York Stock Exchange (NYSE). Under the NYSE's continued listing standards, a company is considered to be below compliance standards if, among other things, both its average global market capitalization is less than \$50 million over a 30 trading-day period and its stockholders' equity is less than \$50 million. The Company failed to comply with this compliance standard during the fourth quarter of 2009 and was notified of such by the NYSE. At such time the NYSE required the Company to file a plan addressing the compliance breach and the Company's proposed remedy. The Company remains non-compliant as of September 30, 2010.

In March 2010, the NYSE accepted the Company's plan to regain compliance with the continued listing standards during an 18-month cure period, which continues through June 2011. During implementation and execution of the Company's plan, the Company's common stock will continue to be listed on the NYSE, subject to compliance with other NYSE continued listing requirements.

**Note 16 Segment Information**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and in assessing performance.

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company is comprised of three reportable segments (Chemical and Logistics, Drilling Products, and Artificial Lift):

The Chemical and Logistics segment consists of two business divisions: 1) Specialty Chemicals and 2) Logistics. The Specialty Chemicals division designs, develops, manufactures, packages and sells chemicals used by oilfield service companies in oil and gas well drilling, cementing, stimulation and production activities. The Logistics division manages automated bulk material handling, loading facilities, and blending capabilities of bulk materials for oilfield service companies.

The Drilling Products segment rents, inspects, manufactures and markets down-hole drilling equipment used in energy, mining, water well and industrial drilling activities.

The Artificial Lift segment manufactures and markets artificial lift equipment, including the Petrovalve line of beam pump components, electric submersible pumps, gas separators, valves and services that support coal bed methane production activities. The Company evaluates performance based on several factors, of which the primary financial measure is business segment income before taxes. Various functions, including certain sales and marketing activities and corporate general and administrative activities, are provided centrally from the corporate office. Costs associated with these functions, various other income and expense items and estimated income tax provisions (benefits), are not allocated to the segments. Intersegment sales are accounted for at fair value as if sales were to third parties. Intersegment revenue is not considered material.

Summarized financial information concerning the segments as of and for the three and nine months ended September 30, 2010 and 2009 is as follows (in thousands):

	<b>Chemical and Logistics</b>	<b>Drilling Products</b>	<b>Artificial Lift</b>	<b>Corporate and Other</b>	<b>Total</b>
<b><u>Three Months Ended September 30, 2010</u></b>					
Net revenue from external customers	\$ 18,203	\$ 17,185	\$ 4,594	\$	\$ 39,982
Gross margin	8,160	6,381	1,526		16,067
Income (loss) from operations	5,956	2,340	1,161	(3,453)	6,004
Depreciation and amortization	426	2,961	54	131	3,572
Total assets	41,345	114,176	8,772	18,006	182,299
Capital expenditures	106	840	3	119	1,068
<b><u>Three Months Ended September 30, 2009</u></b>					
Net revenue from external customers	\$ 10,976	\$ 10,258	\$ 2,584	\$	\$ 23,818
Gross margin	5,220	688	495		6,403
Income (loss) from operations	3,494	(3,174)	117	(2,908)	(2,471)
Depreciation and amortization	439	2,988	64	71	3,562
Total assets	34,700	124,223	7,340	10,463	176,726
Capital expenditures	239	364	32		635



**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>Chemical and Logistics</b>	<b>Drilling Products</b>	<b>Artificial Lift</b>	<b>Corporate and Other</b>	<b>Total</b>
<b>Nine Months Ended September 30, 2010</b>					
Net revenue from external customers	\$ 45,332	\$ 44,957	\$ 9,237	\$	\$ 99,526
Gross margin	20,375	12,114	2,940		35,429
Income (loss) from operations	13,636	(1,061)	1,795	(15,513)	(1,143)
Depreciation and amortization	1,290	8,836	165	292	10,583
Total assets	41,345	114,176	8,772	18,006	182,299
Capital expenditures	172	2,800	32	124	3,128
<b>Nine Months Ended September 30, 2009</b>					
Net revenue from external customers	\$ 37,661	\$ 40,143	\$ 10,193	\$	\$ 87,997
Gross margin	15,986	4,340	2,216		22,542
Income (loss) from operations	9,547	(27,283)	870	(10,626)	(27,492)
Depreciation and amortization	1,358	8,806	226	153	10,543
Total assets	34,700	124,223	7,340	10,463	176,726
Capital expenditures	362	5,173	32		5,567

One customer, inclusive of affiliates, accounted for \$4.1 million and \$4.2 million of consolidated revenue for the three months ended September 30, 2010 and 2009, respectively, and for \$11.0 million and \$15.3 million of consolidated revenue for the nine months ended September 30, 2010 and 2009, respectively. Approximately 97% of this revenue was generated by Chemical and Logistics sales for the three and nine months periods ended September 30, 2010 and approximately 93% for the corresponding periods in 2009.

Revenue by country is determined based upon the physical location of services provided and the products sold. Revenue by geographic location is as follows (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
United States	\$ 34,672	\$ 20,356	\$ 85,639	\$ 76,244
Other countries	5,310	3,462	13,887	11,753
<b>Total</b>	<b>\$ 39,982</b>	<b>\$ 23,818</b>	<b>\$ 99,526</b>	<b>\$ 87,997</b>

Long-lived assets held in countries other than the United States are not material.

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**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
***Special Note About Forward-Looking Statements***

Certain statements in *Management's Discussion and Analysis of Financial Condition and Results of Operations* other than purely historical information, including estimates, projections and statements relating to the Company's business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are to be considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not historical facts but instead represent only current assumptions and beliefs regarding future events, many of which, by their nature, are inherently uncertain and outside the Company's control. The forward-looking statements contained in this Quarterly Report are based on information available as of the date of this Quarterly Report. Many of these forward looking statements relate to future industry trends, actions, future performance or results of current and anticipated initiatives and the outcome of contingencies and other uncertainties that may have a significant impact on the Company's business, future operating results and liquidity. These forward-looking statements generally are identified by words such as anticipate, believe, estimate, continue, intend, expect, plan, forecast, project and similar expressions, or future-tense or conditional constructions such as will, may, should, could, etc. The Company cautions that these statements are only predictions and are not to be considered guarantees of future performance. Forward-looking statements are based upon current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially from the forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section entitled *Risk Factors* in the Company's Annual Report on Form 10-K/A Amendment No. 2 for the fiscal year ended December 31, 2009, the Quarterly Report on Form 10-Q for the period ended March 31, 2010, June 30, 2010 and in this Quarterly Report on Form 10-Q. The Company undertakes no obligation to update or revise publicly any forward-looking statements, whether as a result of new information or future events, except as required by law.

***Executive Summary***

Flotek is a global technology-driven growth company that provides oilfield products, services and equipment to the oil, gas, and mining industries. Operations are based in both domestic (Gulf Coast, Southwest, Rocky Mountain, Northeastern and Mid-Continental regions of the United States) and international (Canada, Mexico, Central America, South America, Europe, Africa and Asia) markets. Products and services are actively marketed in over 20 countries worldwide. Customers include major integrated oil and natural gas companies, independent oil and natural gas companies, pressure pumping service companies and state-owned national oil companies.

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Success within the oilfield services industry is dependent upon the Company's ability to differentiate its products and services, to provide superior quality products and services, and to maintain a competitive cost structure. North American operations are highly correlated with natural gas exploration and production activity and, to a lesser extent, oil well drilling activity. Aforementioned drilling activity is significantly influenced by current natural gas prices, natural gas price volatility, forward natural gas/crude oil price forecasts and availability of capital. In addition, the Company's gross margins are directly affected by the inherent variable pricing of products and services within the oilfield services industry. Variable pricing is reactive to level of customer activity, availability of equipment/resources, technological advantage and competitive pressures. Historical market conditions are reflected in the following table.