

FLOTEK INDUSTRIES INC/CN/

Form 10-Q

May 10, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended March 31, 2007

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

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**FLOTEK INDUSTRIES, INC.**

(Exact name of registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of  
incorporation or organization)

7030 Empire Central Drive, Houston, Texas  
(Address of principal executive offices)

(713) 849-9911

90-0023731  
(I.R.S. Employer  
Identification No.)

77040  
(Zip Code)

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(Registrant's telephone number, including area code)

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See the definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

There were 9,081,657 shares of the issuer's common stock, \$.0001 par value, outstanding as of May 7, 2007.

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We have included or incorporated by reference in this Form 10-Q, and from time to time our management may make, statements that may constitute forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not historical facts but instead represent only our current belief regarding future events, many of which, by their nature, are inherently uncertain and outside our control. The forward-looking statements contained in this Form 10-Q are based on information as of the date of this 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 our business, future operating results and liquidity. We try, whenever possible, to identify these statements by using words such as anticipate, believe, should, estimate, expect, plan, project and similar expressions. We caution you that these statements are only predictions and are not guarantees of future performance. These forward-looking statements and our actual results, developments and business are subject to certain risks and uncertainties that could cause actual results and events to differ materially from those anticipated by these statements. By identifying these statements for you in this manner, we are alerting you to the possibility that our actual results may differ, possibly materially, from the anticipated results indicated in these forward-looking statements. Important factors that could cause actual results to differ from those in the forward-looking statements include, among others, those discussed in our latest Annual Report on Form 10-K under Risk Factors in Part I, Item 1A.

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

(in thousands, except share data)

|  | March 31,<br>2007<br>(Unaudited) | December 31,<br>2006<br>(Audited) |
|--|----------------------------------|-----------------------------------|
| <b>ASSETS</b>  |                                  |                                   |
| Current assets:  |                                  |                                   |
| Cash and cash equivalents  | \$ 684                           | \$ 510                            |
| Accounts receivable, net   | 20,519                           | 19,077                            |
| Inventories, net   | 21,607                           | 17,899                            |
| Other current assets   | 506                              | 578                               |
| <b>Total current assets</b>  | <b>43,316</b>                    | <b>38,064</b>                     |
| Investment in affiliate (See Note 3)   | 6,371                            |                                   |
| Property, plant and equipment, net   | 30,612                           | 19,302                            |
| Goodwill   | 44,055                           | 24,185                            |
| Intangible and other assets, net   | 1,287                            | 1,339                             |
|  | \$ 125,641                       | \$ 82,890                         |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                                  |                                   |
| Current liabilities:   |                                  |                                   |
| Accounts payable   | \$ 7,946                         | \$ 9,941                          |
| Accrued liabilities  | 8,133                            | 7,457                             |
| Current portion of long-term debt  | 6,333                            | 2,589                             |
| Deferred tax liability, current  | 673                              | 675                               |
| <b>Total current liabilities</b>   | <b>23,085</b>                    | <b>20,662</b>                     |
| Long-term debt, less current portion   | 42,775                           | 8,185                             |
| Deferred tax liability, less current portion   | 536                              | 534                               |
| <b>Total liabilities</b>   | <b>66,396</b>                    | <b>29,381</b>                     |
| Stockholders' equity:  |                                  |                                   |
| Common stock, \$.0001 par value; 20,000,000 shares authorized;<br>March 31, 2007 shares issued: 9,079,657; outstanding: 9,015,778;<br>December 31, 2006 shares issued: 8,847,214; outstanding: 8,827,464 | 1                                | 1                                 |
| Additional paid-in capital   | 48,956                           | 46,661                            |
| Accumulated other comprehensive income   | 38                               | 37                                |
| Retained earnings  | 10,440                           | 6,810                             |
| Treasury stock, at cost 35,087 shares  | (190)                            |                                   |
| <b>Total stockholders' equity</b>  | <b>59,245</b>                    | <b>53,509</b>                     |

\$ 125,641      \$ 82,890

See notes to consolidated condensed financial statements.

**Table of Contents****FLOTEK INDUSTRIES, INC.****CONSOLIDATED CONDENSED INCOME STATEMENTS OF INCOME****(UNAUDITED)****(in thousands, except per share data)**

|   | <b>Three Months Ended March 31,</b> |                 |
|---|-------------------------------------|-----------------|
|   | <b>2007</b>                         | <b>2006</b>     |
| Revenue   | \$ 35,079                           | \$ 16,061       |
| Cost of revenue   | 20,032                              | 9,279           |
| <b>Gross profit</b>   | <b>15,047</b>                       | <b>6,782</b>    |
| Expenses:   |                                     |                 |
| Selling, general and administrative   | 6,977                               | 3,187           |
| Depreciation and amortization   | 1,323                               | 598             |
| Research and development  | 170                                 | 155             |
| Total expenses  | 8,470                               | 3,940           |
| <b>Income from operations</b>   | <b>6,577</b>                        | <b>2,842</b>    |
| Other income (expense):   |                                     |                 |
| Interest expense  | (811)                               | (171)           |
| Other, net  | 63                                  | 12              |
| <b>Total other income (expense)</b>   | <b>(748)</b>                        | <b>(159)</b>    |
| Income before income taxes  | 5,829                               | 2,683           |
| Provision for income taxes  | (2,126)                             | (927)           |
| <b>Net income</b>   | <b>\$ 3,703</b>                     | <b>\$ 1,756</b> |
| Other comprehensive income:   |                                     |                 |
| Foreign currency translation adjustment   | 1                                   |                 |
| <b>Comprehensive income</b>   | <b>\$ 3,704</b>                     | <b>\$ 1,756</b> |
| Basic and fully diluted earnings per common share:  |                                     |                 |
| Basic earnings per common share   | \$ 0.42                             | \$ 0.21         |
| Fully diluted earnings per common share   | \$ 0.39                             | \$ 0.19         |
| Weighted average common shares used in computing basic earnings per common share                | 8,915                               | 8,388           |
| Incremental common shares from stock options and warrants                                       | 528                                 | 912             |
| <b>Weighted average common shares used in computing fully diluted earnings per common share</b> | <b>9,443</b>                        | <b>9,300</b>    |

See notes to consolidated condensed financial statements.

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

|   | <b>Three Months Ended March 31,</b> |                |
|---|-------------------------------------|----------------|
|   | <b>2007</b>                         | <b>2006</b>    |
| <b>Cash flows from operating activities:</b>  |                                     |                |
| Net income  | \$ 3,703                            | \$ 1,756       |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                                     |                |
| Depreciation and amortization   | 1,323                               | 598            |
| Equity income from affiliate  | (59)                                |                |
| Gain on sale of assets  | 36                                  |                |
| Deferred income taxes   | (122)                               | 15             |
| Stock compensation expense  | 13                                  |                |
| Change in assets and liabilities:   |                                     |                |
| Accounts receivable   | 1,989                               | 269            |
| Inventories   | (2,881)                             | 551            |
| Deposits and other  | 309                                 | (64)           |
| Accounts payable  | (3,315)                             | (2,398)        |
| Accrued liabilities   | 261                                 | 1,265          |
| Net cash provided by operating activities   | 1,257                               | 1,992          |
| <b>Cash flows from investing activities:</b>  |                                     |                |
| Acquisitions, net of cash acquired  | (31,122)                            | (6,712)        |
| Investment in affiliate   | (2,932)                             |                |
| Proceeds from sale of assets  | 137                                 |                |
| Other assets  | (54)                                |                |
| Capital expenditures  | (4,029)                             | (2,014)        |
| Net cash used in investing activities   | (38,000)                            | (8,726)        |
| <b>Cash flows from financing activities:</b>  |                                     |                |
| Issuance of stock   | 428                                 | 519            |
| Purchase of treasury stock  | (190)                               |                |
| Proceeds from borrowings  | 54,591                              | 64             |
| Repayments of indebtedness  | (17,912)                            | (632)          |
| Net cash provided by (used in) financing activities   | 36,917                              | (49)           |
| <b>Net increase (decrease) in cash and cash equivalents</b>                                 | <b>174</b>                          | <b>(6,783)</b> |
| Cash and cash equivalents at beginning of period  | 510                                 | 7,377          |
| <b>Cash and cash equivalents at end of period</b>   | <b>\$ 684</b>                       | <b>\$ 594</b>  |
| <b>Supplementary schedule of non-cash investing and financing activities (See Note 3):</b>  |                                     |                |
| Fair value of net assets recorded, including goodwill and other intangible assets           | \$ 37,147                           | \$ 7,275       |
| Less cash acquired  |                                     | (38)           |
| Less equity issued  | (1,855)                             | (525)          |

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|  |    |         |          |
|--|----|---------|----------|
| Less debt issued   |    | (1,545) |          |
| Add elimination of intercompany income                   |    | 307     |          |
| Acquisitions, net of cash acquired                       | \$ | 34,054  | \$ 6,712 |
| <b>Supplemental disclosure of cash flow information:</b> |    |         |          |
| Interest paid  | \$ | 203     | \$ 209   |
| Income taxes paid  | \$ | 300     | \$ 930   |

See notes to consolidated condensed financial statements.



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**FLOTEK INDUSTRIES, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

**Note 1 General**

The information contained in the following notes is condensed from that which would appear in the annual consolidated financial statements; accordingly, the consolidated condensed financial statements included herein should be reviewed in conjunction with the consolidated financial statements for the year ended December 31, 2006 and related notes thereto, included in the Annual Report on Form 10-K filed by Flotek Industries, Inc. ( Flotek ) with the Securities and Exchange Commission. All references to the Company include Flotek and its wholly-owned subsidiaries unless otherwise indicated or the context indicates otherwise.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and certain assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. While management believes current estimates are reasonable and appropriate, actual results could differ from these estimates.

In the opinion of management, the unaudited consolidated condensed financial statements of the Company include all adjustments (consisting solely of normal recurring adjustments) necessary for a fair presentation of its financial position as of March 31, 2007 and its results of operations and cash flows for the three month periods ended March 31, 2007 and 2006. The consolidated condensed statement of financial position as of December 31, 2006 is derived from the December 31, 2006 audited consolidated financial statements. Although management believes the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The results of operations and cash flow for the three month period ended March 31, 2007 are not necessarily indicative of the results to be expected for the full year.

**Note 2 Recent Accounting Pronouncements**

In February 2007, the FASB issued Statement No. 159 ( FAS No. 159 ), The Fair Value Option for Financial Assets and Financial Liabilities . FAS No. 159 allows entities to voluntarily choose, at specified election dates, to measure many financial assets and financial liabilities at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, FAS No. 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. The provisions of FAS No. 159 are effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact that FAS No. 159 will have on our results of operations and financial position.

In September 2006, the Financial Accounting Standards Board ( FASB ) issued its Statement of Financial Accounting Standards No. 157 ( FAS No. 157 ), Fair Value Measurements. FAS No. 157 establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently evaluating the impact that FAS No. 157 will have on our results of operations and financial position.

In June 2006, the FASB issued FASB Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes . FIN 48 is an interpretation of FASB Statement No. 109 Accounting for Income Taxes and was adopted by the Company effective January 1, 2007. FIN 48 prescribes a recognition threshold and measurement attribute, as well as criteria for subsequently recognizing, derecognizing and measuring tax positions for financial statement purposes and requires companies to make disclosures about uncertain income tax positions, including a detailed rollforward of tax benefits taken that do not qualify for financial statement recognition.

**Note 3 Acquisitions**

On January 4, 2007, the Company acquired substantially all the assets of Triumph Drilling Tools, Inc. ( Triumph ) for \$31 million in cash. Triumph is a leading regional provider of down-hole rental equipment to the oil and gas industry. Triumph maintains an extensive inventory of drilling tools for lease or sublease to customers in Texas, New Mexico, Louisiana, Oklahoma and Arkansas. Triumph s rental products include stabilizers, drill collars, drilling jars, roller reamers and other specialized drilling tools. Triumph also provides bottom hole assembly design, inspection services and other related technical services. Triumph services numerous drilling contractors, directional drilling companies and major and independent operators. Results of operations for Triumph are included in the Company s consolidated condensed statement of income

as of January 1, 2007.

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

The purchase price of the Triumph acquisition was allocated to the assets acquired and liabilities assumed based on estimated fair values, following the completion of an independent appraisal. In accordance with SFAS No. 141, *Accounting for Business Combinations*, the excess of the purchase price over the net fair value of the assets acquired was allocated to goodwill. The table below details the recorded investment in Triumph (in thousands):

|                               | <b>Recorded<br/>Investment</b> |
|-------------------------------|--------------------------------|
| Accounts receivables          | \$ 3,429                       |
| Other current assets          | 243                            |
| Inventories                   | 827                            |
| Property, plant and equipment | 8,612                          |
| Goodwill                      | 19,924                         |
| Accounts payable              | (1,321)                        |
| Accrued liabilities           | (483)                          |
| Notes payable                 | (109)                          |
| <b>Total purchase price</b>   | <b>\$ 31,122</b>               |

The Company is continuing to evaluate the initial purchase price allocation and will adjust the allocations as additional information relative to the fair market values of the assets and liabilities of the business becomes known. The Company will also adjust the purchase price allocation of the acquired business as additional information is received supporting the fair market value of the acquired assets and liabilities for up to one year from the acquisition date.

The following table presents information related to the Triumph acquisition and assumes the acquisition had been completed as of January 1, 2006:

|                            | <b>Three Months Ended</b>                |                           |
|----------------------------|--|---------------------------|
|                            | <b>March 31,</b>                         |                           |
|                            | <b>2007</b>                              | <b>Pro Forma<br/>2006</b> |
|                            | <b>(in thousands, except share data)</b> |                           |
| Revenue                    | \$ 35,079                                | \$ 19,759                 |
| Income before income taxes | \$ 5,829                                 | \$ 3,273                  |
| Net income                 | \$ 3,703                                 | \$ 2,134                  |
| Basic earnings per share   | \$ 0.42                                  | \$ 0.25                   |

On January 31, 2006 the Company acquired a 50% partnership interest in CAVO Drilling Motors Ltd Co. (CAVO) for approximately \$2.5 million in cash, 71,717 shares of our common stock and a \$1.5 million promissory note to the seller. CAVO is a complete downhole motor solutions provider specializing in the rental, servicing and sale of high-performance mud motors for a variety of drilling applications. CAVO serves both the domestic and international drilling markets with a customer base extending throughout North America, South America, Russia and West Africa. The partnership interest will be reported using the equity method of accounting.

**Note 4 Inventories**

The components of inventories as of March 31, 2007 and December 31, 2006 were as follows:

|  | March 31,<br>2007 | December 31,<br>2006 |
|--|-------------------|----------------------|
|  | (in thousands)    |                      |
| Raw materials                              | \$ 6,762          | \$ 4,415             |
| Work-in-process                            | 1,316             | 700                  |
| Finished goods (includes in-transit)       | 15,115            | 13,646               |
| Gross inventories                          | 23,193            | 18,761               |
| Less: Slow-moving and obsolescence reserve | (1,586)           | (862)                |
| Inventories, net                           | \$ 21,607         | \$ 17,899            |

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS****Note 5 Property, Plant and Equipment**

As of March 31, 2007 and December 31, 2006, property, plant and equipment were comprised of the following:

|                                       | March 31,<br>2007 | December 31,<br>2006 |
|---------------------------------------|-------------------|----------------------|
|                                       | (in thousands)    |                      |
| Land                                  | \$ 609            | \$ 609               |
| Buildings and leasehold improvements  | 3,791             | 3,665                |
| Machinery, equipment and rental tools | 24,707            | 13,941               |
| Equipment in progress                 | 5,073             | 3,856                |
| Furniture and fixtures                | 350               | 318                  |
| Transportation equipment              | 2,695             | 2,144                |
| Computer equipment                    | 497               | 491                  |
| Gross property, plant and equipment   | 37,722            | 25,024               |
| Less: Accumulated depreciation        | (7,110)           | (5,722)              |
| Property, plant and equipment, net    | \$ 30,612         | \$ 19,302            |

Net property, plant and equipment of approximately \$8.6 million associated with the Triumph acquisition was recorded January 1, 2007 (See Note 3).

**Note 6 Goodwill**

The Company evaluates the carrying value of goodwill during the fourth quarter of each year and on an interim basis, if events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount. Such circumstances could include, but are not limited to: (i) a significant adverse change in legal factors or in business climate, (ii) unanticipated competition, or (iii) an adverse action or assessment by a regulator. When evaluating whether goodwill is impaired, the Company compares the fair value of the reporting unit to which the goodwill is assigned to the reporting unit's carrying amount, including goodwill. The fair value of the reporting unit is estimated using a combination of the income, or discounted cash flows approach and the market approach, which utilizes comparable companies data. If the carrying amount of a reporting unit exceeds its fair value, then the amount of the impairment loss must be measured. The impairment loss would be calculated by comparing the implied fair value of reporting unit goodwill to its carrying amount. In calculating the implied fair value of reporting unit's goodwill, the fair value of the reporting unit is allocated to all of the other assets and liabilities of that unit based on their fair values. The excess of the fair value of a reporting unit over the amount assigned to its other assets and liabilities is the implied fair value of goodwill. An impairment loss would be recognized when the carrying amount of goodwill exceeds its implied fair value. The Company's evaluation of goodwill completed during 2006 resulted in no impairment losses.

Additional goodwill of approximately \$19.9 million associated with the Triumph acquisition was recorded January 1, 2007 (See Note 3).

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS****Note 7 Long-Term Debt**

Long-term debt for the period ended March 31, 2007 and December 31, 2006 consisted of the following:

|   | March 31,<br>2007 | December 31,<br>2006 |
|---|-------------------|----------------------|
|   | (in thousands)    |                      |
| Senior Credit Facility  |                   |                      |
| Equipment term loans  | \$ 34,167         | \$ 5,482             |
| Real estate term loans  | 915               | 933                  |
| Revolving line of credit  | 11,261            | 2,911                |
| Promissory notes to stockholders of acquired businesses, maturing February 2008 | 378               | 740                  |
| Promissory note to stockholders of acquired businesses, maturing December 2009  | 1,545             |                      |
| Other   | 842               | 708                  |
| Total   | 49,108            | 10,774               |
| Less current maturities   | (6,333)           | (2,589)              |
| Long-term debt, less current portion  | \$ 42,775         | \$ 8,185             |

In August 2006 we amended the Senior Credit Facility with Wells Fargo. The amendment to the Senior Credit Facility increased the maximum amount outstanding on the revolving line of credit from the lesser of (a) \$10.0 million or (b) the sum of 80% of eligible domestic trade accounts receivable and 50% of eligible inventory, as defined. The terms are interest-only, maturing in August 2009.

In January 2007, we amended the Senior Credit Facility in conjunction with the acquisition of Triumph. The amendment to the Senior Credit Facility increased the maximum amount outstanding on the revolving line of credit from the lesser of (a) \$20.0 million or (b) the sum of 80% of eligible domestic trade accounts receivable and 50% of eligible inventory, as defined. The terms of the revolving loan agreement were modified to provide for borrowings that bear interest at LIBOR rate plus 175 basis points maturing in August 2009. The equipment term loan was amended to provide for borrowings of \$35.0 million bearing interest at LIBOR rate plus 175 basis points payable over 84 months. The amendment modified many of our principal covenants including our leverage ratio, fixed charge coverage ratio and net capital expenditures. The real estate term loans remained unchanged. Our bank borrowings are collateralized by substantially all of our assets. Based on the amended maturity date, the current revolving line of credit is classified as long-term debt.

As of March 31, 2007, we had \$11.3 million outstanding under the revolving line of credit of the amended Senior Credit Facility. Availability under the revolving line of credit as of March 31, 2007 is approximately \$4.7 million. Bank borrowings are subject to certain covenants and a material adverse change subjective acceleration clause. Affirmative covenants include compliance with laws, various reporting requirements, visitation rights, maintenance of insurance, maintenance of properties, keeping of records and books of account, preservation of existence of assets, notification of adverse events, ERISA compliance, joinder agreement with new subsidiaries, borrowing base audits, and use of treasury management services. Negative covenants include limitations associated with liens, indebtedness, change in nature of business, transactions with affiliates, investments, distributions, subordinate debt, leverage ratio, fixed charge coverage ratio, consolidated net income, prohibition of fundamental changes, asset sales and capital expenditures. As of March 31, 2007 we were in compliance with all covenants. As of March 31, 2007 the Company had approximately \$0.8 million in vehicle loans and capitalized vehicle leases.

In conjunction with the acquisition of a 50% interest in CAVO in January 2007, the Company issued a note to the seller in the amount of \$1.5 million. The note bears interest at 6% and is payable evenly over the next 3 years.

The Company believes the fair value of its long-term debt approximates the recorded value as of March 31, 2007, as the majority of the long-term debt carries a floating interest rate.



**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS****Note 8 Common Stock**

The amount of common shares issued and outstanding is summarized as follows:

|   |           |
|---|-----------|
| Issued and outstanding as of December 31, 2006                              | 8,847,214 |
| Shares issued for CAVO acquisition (See Note 3)                             | 71,717    |
| Stock options exercised through March 31, 2007                              | 160,726   |
| Shares issued as of March 31, 2007  | 9,079,657 |
| Shares restricted as of March 31, 2007 (See below)                          | (28,792)  |
| Shares repurchased during the three months ended March 31, 2007 (See below) | (35,087)  |
| Shares outstanding as of March 31, 2007                                     | 9,015,778 |

During the quarter, the Company repurchased shares of its common stock issued in conjunction with the acquisition of Spidle Sales and Services, Inc. The repurchase of these shares was optional by the parties involved in the acquisition agreement. The Company accounts for treasury stock using the cost method and includes treasury stock as a component of stockholders' equity. The Company currently does not have or intend to initiate a share repurchase program.

On December 22, 2005, the Compensation Committee, on behalf of the Board of Directors approved the acceleration of the vesting of all previously unvested stock options granted under Flotek Industries, Inc.'s 2003 and 2005 Long Term Incentive Plans. The vesting acceleration imposed selling restrictions equal to the original option vesting requirements. Shares that are restricted as of March 31, 2007 related to exercise of stock options with selling restrictions are excluded in the weighted average calculation of basic and diluted earnings per share.

**Note 9 Earnings Per Share ( EPS )**

Basic EPS excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Fully diluted EPS is based on the weighted average number of shares outstanding during each period and the assumed exercise of dilutive instruments (stock options and warrants) less the number of treasury shares assumed to be purchased with the exercise proceeds using the average market price of the Company's common stock for each of the periods presented.

The following table presents information necessary to calculate earnings per share for the periods presented.

|   | For the Three Months Ended<br>March 31, |          |
|---|---|----------|
|   | 2007                                    | 2006     |
|   | (in thousands)                          |          |
| Net income  | \$ 3,703                                | \$ 1,756 |
| Basic weighted-average common shares outstanding                    | 8,915                                   | 8,388    |
| Basic earnings per common share                                     | \$ 0.42                                 | \$ 0.21  |
| Fully diluted earnings per common share                             | \$ 0.39                                 | \$ 0.19  |
| Basic weighted-average common shares outstanding                    | 8,915                                   | 8,388    |
| Effect of dilutive securities                                       | 528                                     | 912      |
| Fully diluted weighted-average common equivalent shares outstanding | 9,443                                   | 9,300    |

**Note 10 Stock-Based Compensation**



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The Company adopted SFAS 123R effective as of January 1, 2006. SFAS 123R requires all stock-based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on their fair values. The Company follows the modified prospective method of adoption of SFAS 123R whereby earnings for prior periods will not be restated as though stock-based compensation had been expensed.

Under SFAS 123R, the Company's compensation costs based on the fair value at the grant date for its stock options, net income and EPS would have been reduced.

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

In the first quarter of 2007, the Company issued stock options and restricted stock to certain current officers and employees as equity based compensation. Options to purchase 70,602 shares of our common stock were granted with an exercise price of \$27.61 per share and 28,868 shares of restricted stock were granted. These options and restricted shares vest evenly over four years. Approximately \$13,000 of stock based compensation expense was recognized during the three months ended March 31, 2007 related to prior stock option grants.

**Note 11 Income Taxes**

FIN 48 clarifies the criteria that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in a company's financial statements. FIN 48 prescribes a recognition threshold of more-likely-than-not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those tax positions to be recognized in the financial statements. Effective January 1, 2007, the Company has adopted the provisions of FIN 48. As a result the cumulative effect related to adopting FIN 48 was \$72,000. In addition, certain amounts have been reclassified in the statement of financial position in order to comply with the requirements of the statement.

As of January 1, 2007, the Company has no unrecognized tax benefits. The Company does not expect that the amounts of unrecognized tax benefits will change significantly within the next 12 months.

The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending December 31, 2003 through 2006. The Company and its subsidiaries' state income tax returns are open to audit under the statute of limitations for the years ending December 31, 2002 through 2006.

As of January 1, 2007, the Company has accrued \$200,000 of interest and penalties related to uncertain tax positions. Beginning January 1, 2007 the Company accounts for interest and penalties related to uncertain tax positions as part of its provision for income taxes. Prior to 2007 the Company recorded interest related to uncertain tax positions in interest expense and did not include it as part of its provision for income taxes.

A reconciliation of the effective income tax rate to the statutory income tax rate is as follows:

|  | <b>For the Three Months Ended</b> |             |
|--|-----------------------------------|-------------|
|  | <b>March 31,</b>                  |             |
|  | <b>2007</b>                       | <b>2006</b> |
| Income tax (benefit) at statutory rate | 35.0%                             | 34.0%       |
| State taxes, net of federal benefit    | 2.8                               | 2.6         |
| Deductible items                       | (1.1)                             | (0.3)       |
| Other                                  | (0.2)                             | (1.8)       |
| Provision for income taxes             | 36.5%                             | 34.5%       |

Our effective income tax rate in 2007 and 2006 differs from the federal statutory rate primarily due to state income taxes and domestic production deductions. As of March 31, 2007, we had estimated U.S. net operating loss carryforwards of approximately \$1.8 million, expiring in various amounts in 2017 through 2025.

Our current corporate organization structure requires us to file two separate consolidated U.S. Federal income tax returns. As a result, taxable income of one group can not be offset by tax attributes, including net operating losses, of the other group.

**Table of Contents****FLOTEK INDUSTRIES, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

Our current corporate organization structure requires us to file two separate consolidated U.S. Federal income tax returns. As a result, taxable income of one group can not be offset by tax attributes, including net operating losses, of the other group. Accordingly, the effective tax rate in future periods may differ significantly from the expected statutory rates depending on the level of taxable income or loss for each group.

**Note 12 Commitments and Contingencies**

The Company is involved, on occasion, in routine litigation incidental to our business.

**Note 13 Segment Information**

The Company has three operating segments.

The Chemicals and Logistics segment is made up of two business units. The specialty chemical business unit designs, develops, manufactures, packages and sells chemicals used by oilfield service companies in oil and gas well drilling, cementing, stimulation and production. The logistics business unit manages automated bulk material handling, loading facilities, and blending capabilities for oilfield service companies.

The Drilling Products segment rents, inspects, manufactures and markets downhole drilling equipment for the energy, mining, water well and industrial drilling sectors.

The Artificial Lift segment manufactures and markets artificial lift equipment which includes the Petrovalve line of beam pump components, electric submersible pumps, gas separators, valves and services to support coal bed methane production.

The Company evaluates performance based on several factors, of which the primary financial measure is business segment income before taxes. The accounting policies of the business segments are the same as those described in Note 2: Summary of Significant Accounting Policies. Inter-segment sales are accounted for at fair value as if sales were to third parties and are eliminated in the consolidated financial statements.

Summarized financial information concerning the segments for the three months ending March 31, 2007 and 2006 is shown in the following tables (in thousands):

|  | Chemicals<br>and<br>Logistics |           |          |            | Drilling<br>Products | Artificial<br>Lift | Corporate<br>and Other | Total |
|--|-------------------------------|-----------|----------|------------|----------------------|--------------------|------------------------|-------|
| <b>Three months ended March 31, 2007</b> |                               |           |          |            |                      |                    |                        |       |
| Net revenue to external customers        | \$ 16,875                     | \$ 14,644 | \$ 3,560 | \$         | \$ 35,079            |                    |                        |       |
| Income (loss) from operations            | \$ 6,270                      | \$ 1,824  | \$ 290   | \$ (1,807) | \$ 6,577             |                    |                        |       |
| <b>Three months ended March 31, 2006</b> |                               |           |          |            |                      |                    |                        |       |
| Net revenue to external customers        | \$ 7,876                      | \$ 8,092  | \$ 93    | \$         | \$ 16,061            |                    |                        |       |
| Income (loss) from operations            | \$ 1,911                      | \$ 1,781  | \$ (100) | \$ (750)   | \$ 2,842             |                    |                        |       |

Total assets by reportable segment were as follows:

March 31,

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|                         | 2007           | December 31,<br>2006 |
|-------------------------|----------------|----------------------|
|                         | (in thousands) |                      |
| Chemicals and Logistics | \$ 25,352      | \$ 25,459            |
| Drilling Products       | 82,067         | 39,748               |
| Artificial Lift         | 17,787         | 16,860               |
| Corporate and Other     | 435            | 823                  |
| Total assets            | \$ 125,641     | \$ 82,890            |

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with Item 1. Financial Statements contained herein.

#### **Business Overview**

We are a global provider of oilfield services and equipment. We focus on serving the drilling-related needs of oil and gas companies primarily through our Chemicals and Logistics and our Drilling Products segments, and the production-related needs of oil and gas companies through our Artificial Lift and Chemicals and Logistics segments.

We were incorporated in 1985 and currently trade on the American Stock Exchange under the stock ticker symbol FTK. Our headquarters are in Houston, Texas. We have expanded geographically so that we now have a growing presence in select domestic and international market areas in Oklahoma, Arkansas, New Mexico, the Gulf Coast, the Rocky Mountains, Canada, Mexico, Central America, South America, Europe and Asia. We market our products domestically and internationally in over 20 countries.

We operate as a diversified oilfield service company through our three business segments. We believe that our product and service offerings and geographical presence through our three business segments provide us with diverse sources of cash flow. Each segment has its own technical expertise and a common commitment to provide its customers with competitively priced quality equipment and services.

The Chemicals and Logistics segment is made up of two business units. The specialty chemical business unit develops, manufactures and markets specialty chemicals used by oilfield service companies in oil and gas well cementing, stimulation, drilling and production. Our research laboratories support the specific drilling and production needs of our customers. The logistics division designs and manages automated bulk material handling, loading facilities, and blending capabilities for oilfield service companies.

The Drilling Products segment rents, inspects, manufactures and markets downhole drilling equipment for the energy, mining, water well and industrial drilling sectors.

The Artificial Lift segment manufactures and markets artificial lift equipment which includes the Petrovalve line of beam pump components, electric submersible pumps, gas separators, valves and services to support coal bed methane production. The customers for our products and services include the major integrated oil and natural gas companies, independent oil and natural gas companies, pressure pumping service companies and state-owned national oil companies. Our ability to compete in the oilfield services market is dependent on our ability to differentiate our products and services, provide superior quality and service, and maintain a competitive cost structure. Activity levels in our three segments are driven primarily by current and expected commodity prices, drilling rig count, oil and gas production levels, and customer capital spending allocated for drilling and production.

Over the last year we have grown our sales internally and through acquisitions. During 2006 and 2007, we entered into the following acquisitions that were outside the ordinary course of our business:

acquired the assets of Can-Ok Oil Field Services, Inc. and Stabilizer Technology, Inc. ( Can-Ok ), a drilling tool sales and rental provider in Oklahoma, Louisiana and Arkansas, on January 2, 2006;

acquired the assets of TWS, which manufactures, markets and services electric submersible pumps and downhole gas/water separators primarily to coal bed methane gas producers, on April 3, 2006;

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acquired the assets of LifTech, which manufactures, markets and services electric submersible pumps and downhole gas/water separators primarily to coal bed methane gas producers, on June 6, 2006;

acquired the assets of Triumph Drilling Tools, Inc. ( Triumph ), a drilling tool sales and rental provider in Texas, New Mexico, Louisiana, Oklahoma and Arkansas, on January 4, 2007; and

acquired a 50% membership interest in CAVO Drilling Motors, Ltd. Co. ( CAVO ), which specializes in the rental, service and sale of high performance mud motors, on January 31, 2007.

We continue to actively seek profitable acquisition or merger candidates in our core businesses to either decrease costs of providing products or add new products and customer base to diversify our market.

**Table of Contents****Results of Operations**

|                                     | <b>Three Months Ended March 31,</b> |                 |
|-------------------------------------|-------------------------------------|-----------------|
|                                     | <b>2007</b>                         | <b>2006</b>     |
|                                     | <b>(in thousands)</b>               |                 |
| Revenue                             | \$ 35,079                           | \$ 16,061       |
| Cost of revenue                     | 20,032                              | 9,279           |
| <b>Gross profit</b>                 | <b>15,047</b>                       | <b>6,782</b>    |
| Gross profit %                      | 42.9%                               | 42.2%           |
| Expenses:                           |                                     |                 |
| Selling, general and administrative | 6,977                               | 3,187           |
| Depreciation and amortization       | 1,323                               | 598             |
| Research and development            | 170                                 | 155             |
| <b>Total expenses</b>               | <b>8,470</b>                        | <b>3,940</b>    |
| Income from operations              | 6,577                               | 2,842           |
| Income from operations %            | 18.7%                               | 17.7%           |
| Other income (expense):             |                                     |                 |
| Interest expense                    | (811)                               | (171)           |
| Other, net                          | 63                                  | 12              |
| <b>Total other income (expense)</b> | <b>(748)</b>                        | <b>(159)</b>    |
| Income before income taxes          | 5,829                               | 2,683           |
| Provision for income taxes          | (2,126)                             | (927)           |
| <b>Net income</b>                   | <b>\$ 3,703</b>                     | <b>\$ 1,756</b> |

*Consolidated Comparison of Three Months Ended March 31, 2007 and 2006*

Revenue for the three months ended March 31, 2007 were \$35.1 million, an increase of 118.4%, compared to \$16.1 million for 2006. Revenue increased in all of our business segments due to increased acceptance of our products, acquisitions completed in 2006 and 2007, incremental rental revenue from expansion of our drilling tool inventory, and improved pricing. Revenue increased most significantly due to organic growth of our Chemicals and Logistics segment, the Drilling Products segment acquisition of Triumph in January 2007 and two Artificial Lift segment acquisitions in April and June 2006. These acquisitions accounted for \$7.8 million of the increase in revenue. Severe weather in the Mid-Continent and Rocky Mountains adversely affected activity levels and resulted in the delay of approximately \$2.0 million of specialty chemical and artificial lift revenues.

Gross profit for the three months ended March 31, 2007 increased 121.9% to \$15.0 million, or 42.9% of revenue, compared to \$6.8 million, or 42.2% of revenue, for 2006. The increase in gross profit is due to the increase in revenue in all of our business segments, with specialty chemical sales contributing most significantly. The increase in gross profit as a percentage of revenue is primarily due to the organic growth of our Chemicals and Logistics segment, partially offset by lower margins of the two artificial lift acquisitions in 2006 which typically have lower margins than our existing businesses.

As the Company matures, and with the addition of new products and services from acquisitions, margins within the segments have shifted. Organically, management's focus has been placed on expanding sales of our higher margin products and services. This has been offset by the addition of several new products that generate lower margins but complement the existing businesses and allow the Company to cross sell products and services in new markets, and spread corporate costs over a larger base of operations.

Selling, general and administrative costs are not directly attributable to products sold or services rendered. Selling, general and administrative costs were \$7.0 million for the three months ended March 31, 2007 versus \$3.2 million in 2006. The increase was primarily due to increased sales and field support costs in the Drilling Products and Artificial Lift segments.

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Depreciation and amortization increased from \$0.6 million for the three months ended March 31, 2006 to \$1.3 million in 2007. The increase is due to additional depreciable assets resulting from acquisitions and capital expenditures.



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Research and development ( R&D ) costs were virtually unchanged at \$0.2 million for the three months ended March 31, 2007 compared to the same period in 2006. We plan to expand significantly our research efforts in 2007. R&D expenditures are charged to expense as incurred.

Interest expense was \$0.8 million for the three months ended March 31, 2007 versus \$0.2 million in 2006. The increase was a result of the increase in our overall debt level associated with the Triumph acquisition. We amended our credit facility in January 2007 in conjunction with the Triumph acquisition. Borrowing capacity on the line of credit was increased and we added two equipment term loans while paying off two of our smaller equipment term loans.

A provision for income taxes of \$2.1 million was recorded for the three months ended March 31, 2007. An effective tax rate of 36.5% was applied in 2007 versus 34.5% in 2006.

**Results by Segment****Chemicals and Logistics**

|                          | <b>Three Months Ended March 31,</b> |             |
|--------------------------|-------------------------------------|-------------|
|                          | <b>2007</b>                         | <b>2006</b> |
|                          | <b>(in thousands)</b>               |             |
| Revenue                  | \$ 16,875                           | \$ 7,876    |
| Gross profit             | 8,094                               | 2,984       |
| Gross profit %           | 48.0%                               | 37.9%       |
| Income from operations   | 6,270                               | 1,911       |
| Income from operations % | 37.2%                               | 24.3%       |

*Chemicals and Logistics Comparison of Three Months Ended March 31, 2007 and 2006*

Chemicals and Logistics revenue increased \$9.0 million, or 114.3%, for the three months ended March 31, 2007 compared to 2006. The increase in revenue is a result of an increase in volume coupled with higher prices, particularly of our proprietary specialty chemicals. The most significant revenue growth occurred in the Rocky Mountains, Mid-Continent and Permian Basin regions and the East Coast. Sales of our proprietary, biodegradable, environmentally benign green chemicals grew 257.9% from \$3.0 million in the first quarter of 2006 to \$10.8 million in the first quarter of 2007. Margins continue to increase as we focus on shifting more of our sales mix to higher margin patented and proprietary products. Inclement weather in the first quarter of 2007 negatively impacted sales by approximately \$1.5 million.

Gross profit as a percentage of revenue increased from 37.9% for the three months ended March 31, 2006 to 48.0% in 2007. The increase in gross profit is due to price increases and a reduction in cost of goods as a percentage of total revenue. Margins continue to increase as the sales mix shifts to higher margin patented and proprietary products. As of March 31, 2007, construction of a 30,000 square foot expansion to our production facilities was substantially completed. This facility triples production capabilities and allows the division to manage larger volumes of inputs to take further advantage of volume pricing discounts.

Income from operations increased from \$1.9 million for the three months ended March 31, 2006 to \$6.3 million for the same period in 2007, with income from operations as a percentage of revenue increasing from 24.3% to 37.2%, respectively.

**Drilling Products**

|                          | <b>Three Months Ended March 31,</b> |             |
|--------------------------|-------------------------------------|-------------|
|                          | <b>2007</b>                         | <b>2006</b> |
|                          | <b>(in thousands)</b>               |             |
| Revenue                  | \$ 14,644                           | \$ 8,092    |
| Gross profit             | 6,138                               | 3,779       |
| Gross profit %           | 41.9%                               | 46.7%       |
| Income from operations   | 1,824                               | 1,781       |
| Income from operations % | 12.5%                               | 22.0%       |



**Table of Contents***Drilling Products Comparison of Three Months Ended March 31, 2007 and 2006*

During 2007 we continued expanding our drilling products sales through acquisition, allowing us to expand geographically and to grow our line of products and services. In January 2007 we acquired the assets of Triumph, a drilling tool sales and rental provider in Texas, New Mexico, Louisiana, Oklahoma and Arkansas. Additionally, in January 2007 we acquired a 50% interest in CAVO, which specializes in the rental, service and sale of high performance mud motors. These acquisitions expanded machining, repair, tool rental and inspection service capability within our drilling products group.

Drilling Products revenue increased \$6.6 million, or 81.0%, for the three months ended March 31, 2007 compared to the same period in 2006. The drilling tool acquisitions completed in January 2007 increased downhole mud motor rentals, and higher centralizer sales contributed to the increase in overall sales.

Gross profit increased \$2.4 million, or 62.4%, for the three months ended March 31, 2007 compared to the same period in 2006. Gross profit as a percentage of revenue decreased from 46.7% in the first quarter of 2006 to 41.9% in the first quarter of 2007. The decrease in gross profit as a percentage of revenue relates to high level of subrentals and bit sales in the Rocky Mountains which generate lower margins.

Income from operations as a percentage of revenue decreased to 12.5% for the three months ended March 31, 2007 compared to 22.0% in 2006. Costs related to increased headcount and additional depreciation associated with acquired assets contributed to the decrease.

**Artificial Lift**

|                               | <b>Three Months Ended March 31,</b> |             |
|-------------------------------|-------------------------------------|-------------|
|                               | <b>2007</b>                         | <b>2006</b> |
|                               | <b>(in thousands)</b>               |             |
| Revenue                       | \$ 3,560                            | \$ 93       |
| Gross profit                  | 815                                 | 19          |
| Gross profit %                | 22.9%                               | 20.6%       |
| Income (loss) from operations | 290                                 | (100)       |
| Income from operations %      | 8.1%                                | (107.1)%    |

*Artificial Lift Comparison of Three Months Ended March 31, 2007 and 2006*

In the second quarter of 2006 we acquired two coal bed methane service companies to expand our production driven revenue base. The combined companies provide a broad spectrum of electric submersible pumps, gas separators, valves and services to support the coal bed methane producers in the Powder River Basin region and beyond.

Revenue was \$3.6 million for the three months ended March 31, 2007 versus \$0.1 million in 2006, with the acquisitions accounting for the increase. Inclement weather in the first quarter of 2007 negatively impacted sales by approximately \$0.5 million.

Gross profit increased \$0.8 million primarily due to the increased revenue base. The gross profit as a percentage of revenue increased from 20.6% for the three months ended March 31, 2006 to 22.9% in 2007. The increase in gross margin as a percentage of revenue reflects our efforts to improve supply chain management and product mix.

Income from operations increased to \$0.3 million for the three months ended March 31, 2007 from a loss from operations of \$0.1 million in 2006.

**Capital Resources and Liquidity**

Cash and cash equivalents increased \$0.2 million during the first quarter of 2007. Cash flows from operations decreased from \$2.0 million in 2006 to \$1.3 million in 2007 due to increased working capital needs. Increased working capital requirements decreased operating cash flow by \$3.6 million in the first quarter of 2007 versus a decrease in operating



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cash flow of \$0.4 million for the same period in 2006. The net increase in working capital was the result of a \$3.1 million decrease in accounts payable and accrued liabilities primarily related to our chemical suppliers and a \$2.9 million increase in inventory as we ramped up feedstock supplies for anticipated increased levels of chemical production, offset by a \$2.0 million decrease in accounts receivable and a \$0.3 million decrease in deposits and other.

Capital expenditures for the three months ended March 31, 2007 totaled approximately \$4.0 million. The most significant expenditures related to the expansion of our mud motor fleet, addition of rental tools to expand our rental tool base and the purchase of manufacturing and repair equipment. Based on the success of the motors, Flotek acquired a 50% interest in CAVO in January 2007. CAVO is a complete downhole motor solutions provider specializing in the rental, servicing and sale of high performance mud motors for a variety of drilling applications. Looking forward in 2007, we anticipate significant capital expenditures associated with the construction of our liquids blending facility in Louisiana and continued expansion of our mud motor fleet.

In January 2007, we amended our Senior Credit Facility with Wells Fargo in conjunction with the acquisition of Triumph. The amendment to the Senior Credit Facility increased the maximum amount outstanding on the revolving line of credit from the lesser of (a) \$20.0 million or (b) the sum of 80% of eligible domestic trade accounts receivable and 50% of eligible inventory, as defined. The terms of the revolving loan agreement were modified to provide for borrowings that bear interest at LIBOR plus 175 basis points maturing in August 2009. The equipment term loan was amended to provide for borrowings of \$35.0 million bearing interest at LIBOR plus 175 basis points payable over 84 months. The amendment modified many of our principal covenants including our leverage ratio, fixed charge coverage ratio and net capital expenditures. The real estate term loans remained unchanged. Our bank borrowings are collateralized by substantially all of our assets. Based on the amended maturity date, the current revolving line of credit is classified as long-term debt.

As of March 31, 2007, we had \$11.3 million outstanding under the revolving line of credit of the amended Senior Credit Facility. Availability under the revolving line of credit as of March 31, 2007 is approximately \$4.7 million. Bank borrowings are subject to certain covenants and a material adverse change subjective acceleration clause. Affirmative covenants include compliance with laws, various reporting requirements, visitation rights, maintenance of insurance, maintenance of properties, keeping of records and books of account, preservation of existence of assets, notification of adverse events, ERISA compliance, joinder agreement with new subsidiaries, borrowing base audits, and use of treasury management services. Negative covenants include limitations associated with liens, indebtedness, change in nature of business, transactions with affiliates, investments, distributions, subordinate debt, leverage ratio, fixed charge coverage ratio, consolidated net income, prohibition of fundamental changes, asset sales and capital expenditures. As of March 31, 2007 we were in compliance with all covenants.

As of March 31, 2007 the Company had approximately \$0.8 million in vehicle loans and capitalized vehicle leases.

We have funded our capital requirements with operating cash flows, debt borrowings, and by issuing shares of our common stock. Common stock issued during the three months ended March 31, 2007 is described below:

In the acquisition of the 50% membership interest in CAVO in January 2006, we issued 71,717 shares of common stock.

Stock options to purchase 160,726 shares (10,000 shares are restricted) were exercised by officers, directors and employees, with proceeds of approximately \$0.4 million paid to the Company.

*Impact of Recently Issued Accounting Standards*

In February 2007, the FASB issued Statement No. 159 ( FAS No. 159 ), The Fair Value Option for Financial Assets and Financial Liabilities . FAS No. 159 allows entities to voluntarily choose, at specified election dates, to measure many financial assets and financial liabilities at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, FAS No. 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. The provisions of FAS No. 159 are effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact that FAS No. 159 will have on our results of operations and financial position.

In September 2006, the Financial Accounting Standards Board ( FASB ) issued its Statement of Financial Accounting Standards No. 157 (FAS No. 157), Fair Value Measurements. FAS No. 157 establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently evaluating the impact that FAS No. 157 will have on our results of operations and financial position.



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### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Certain financial instruments we have used to obtain capital are subject to market risks from fluctuations in market interest rates. As of March 31, 2007, we have \$46.3 million of variable rate indebtedness within our credit facility. As a result, a fluctuation in market interest rates of one percentage point over the next twelve months would impact our interest expense by approximately \$0.5 million.

### **Item 4. Controls and Procedures**

The Company's management has evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures, as of the end of the period covered by this report, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Company's Chief Executive Officer, along with the Company's Chief Financial Officer, concluded that the Company's disclosure controls and procedures were not effective as a result of material weaknesses in internal controls as of March 31, 2007. Our management is responsible for establishing and maintaining internal control over financial reporting (ICFR). Our internal control system was designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation and fair presentation of published financial statements. All internal control systems, no matter how well designed, have inherent limitations, and therefore can only provide reasonable assurance with respect to financial statement preparation and presentation.

Our management's assessment is that the Company did not maintain effective ICFR as of December 31, 2006 within the context of the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our ICFR as designed, documented and tested, we identified two material weaknesses. The material weaknesses in our internal controls related to inadequate staffing within our accounting department and not having adequate monitoring controls in place during the year. As a result of these material weaknesses, the Company recorded adjustments to the financial statements for the year ended December 31, 2006, prior to their issuance that affected several financial statement line items.

The status of management's initiative for correcting the material weaknesses disclosed at year-end December 31, 2006 follows:

- 1) As a corrective measure for internal control weakness related to inadequate staffing within the accounting department, management hired additional accounting and IT personnel and has engaged several outside consulting firms to assist with taxes and the design and evaluation of our internal controls framework. We are actively interviewing candidates for senior accounting positions including a director of internal controls, controller and director of acquisition accounting. We expect that by adding these personnel, we will be better able to address technical accounting issues on a timely basis. In addition, we will reevaluate all other finance and accounting needs and personnel and change and enhance, as necessary.
- 2) A training seminar for Rental Tool Management Software (RTMS), which will be used to better monitor our drilling tool rental activities, was attended by several accounting and operational staff in the first quarter of 2007. Implementation of RTMS began in one of our drilling tools locations in South Texas during the first quarter of 2007. Management's plan is to stage implementation throughout all the drilling tools locations over the remainder of 2007.

The Company believes that the above measures will address all matters identified as a material weakness by management and the independent registered public accounting firm. The Company will continue to monitor the effectiveness of its internal controls and procedures on an ongoing basis and will take further actions, as appropriate.

### **Changes in Internal Control Over Financial Reporting**

Except as otherwise discussed herein, there have been no significant changes in the Company's internal control over financial reporting during the most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. However, the Company made changes to the design and operation of internal control over financial reporting during the fourth quarter in order to increase the design and operating effectiveness of internal controls in connection with implementing Section 404 of the Sarbanes-Oxley Act of 2002. In addition, the Company is currently implementing enhancements to the Company's internal control over financing reporting to address the material weaknesses described above.

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**PART II OTHER INFORMATION**

**Item 1A. Risk Factors.**

There have been no material changes during the period ended March 31, 2007 in our Risk Factors as discussed in our Form 10-K for the fiscal year ended December 31, 2006.

**Item 6. Exhibits.**

| <b>Exhibit No.</b> | <b>Description of Exhibit</b>   |
|--------------------|---|
| 31.1               | Rule 13a-15(e) and 15d-15(e) Certification of Chief Executive Officer                   |
| 31.2               | Rule 13a-15(e) and 15d-15(e) Certification of Chief Financial Officer                   |
| 32.1               | Certification of Periodic Report by Chief Executive Officer and Chief Financial Officer |

**SIGNATURES**

Pursuant to the requirements 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.

FLOTEK INDUSTRIES, INC.  
(Registrant)

FLOTEK INDUSTRIES, INC.

By: /s/ Jerry D. Dumas Sr.

Jerry D. Dumas, Sr.  
Chairman, Chief Executive Officer and President

By: /s/ Lisa G. Meier

Lisa G. Meier  
Chief Financial Officer and Vice President

May 10, 2007



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**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description of Exhibit</b>   |
|--------------------|---|
| 31.1               | Rule 13a-15(e) and 15d-15(e) Certification of Chief Executive Officer                   |
| 31.2               | Rule 13a-15(e) and 15d-15(e) Certification of Chief Financial Officer                   |
| 32.1               | Certification of Periodic Report by Chief Executive Officer and Chief Financial Officer |