VENTAS INC
Form 424B4
December 18, 2002
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Filed Pursuant to Rule 424(b)(4)
Registration Nos. 333-101598
333-90756

PROSPECTUS SUPPLEMENT
(To prospectus dated December 16, 2002)

16,477,207 Shares

Ventas, Inc.

Common Stock

We are a healthcare real estate investment trust. As of November 29, 2002, our properties included 44 hospitals, 220 nursing facilities and nine other healthcare and senior housing facilities in 37 states. We also have investments in 25 healthcare and senior housing facilities located in Ohio and Maryland.

We are offering 9,000,000 shares of our common stock, par value $0.25 per share. The selling stockholders are offering 7,477,207 shares of our common stock. Our common stock is listed on the New York Stock Exchange under the symbol VTR. On December 16, 2002, the last reported sale price of our common stock on the New York Stock Exchange was $11.20 per share.

Investing in our common stock involves risks that are described in Risk Factors beginning on page S-9 of this prospectus supplement.

	Per Share	Total
Public Offering Price	$ 11.00	$ 181,249,277
Underwriting discount	$.55	$9,062,464
Proceeds, before expenses, to us	$ 10.45	$94,050,000
Proceeds, before expenses, to selling stockholders	$ 10.45	$78,136,813

The underwriters may also purchase up to 823,860 additional shares of our common stock from the selling stockholders and after such purchase, up to an additional 823,861 shares of our common stock from us at the public offering price, less the underwriting discount, within 30 days from the date of this prospectus supplement to cover over-allotments.

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

The shares of common stock will be ready for delivery on or about December 20, 2002.

Sole Book-Running Manager

Merrill Lynch & Co.

Banc of America Securities LLC

UBS Warburg

Legg Mason Wood Walker
Incorporated

CIBC World Markets

SunTrust Robinson Humphrey

The date of this prospectus supplement is December 16, 2002.

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Prospectus

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This document is in two parts. The first part is the prospectus supplement, which describes the specific terms of this offering and also adds to and updates information contained in the accompanying prospectus and the documents incorporated by reference. The second part is the accompanying prospectus, which gives more general information, some of which may not apply to the offering. This prospectus supplement and the accompanying prospectus are part of two registration statements. The first registration statement is one that we, Ventas Realty, Ventas LLC, and Ventas Capital filed with the Securities and Exchange Commission (the Commission) using a shelf registration process. The second registration statement is one that we have filed with the Commission also using a shelf registration process for the sale by the selling stockholders of our common stock offered hereby.

You should rely only on the information contained in or incorporated by reference into this prospectus supplement and the accompanying prospectus. We have not, and the underwriters have not, authorized anyone to provide you with different information. We are not, and the underwriters are not, making an offer of these securities in any state where the offer is not permitted. You should assume that the information contained in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference is accurate only as of its respective date or on the date which is specified in those documents.

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CAUTIONARY STATEMENTS

Forward-Looking Statements

This prospectus supplement and the accompanying prospectus and the documents incorporated by reference herein and therein include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements regarding our expected future financial position, results of operations, cash flows, funds from operations, dividends and dividend plans, financing plans, business strategy, budgets, projected costs, capital expenditures, competitive positions, growth opportunities, expected lease income, continued qualification as a real estate investment trust, or a REIT, plans and objectives of management for future operations and statements that include words such as anticipate, if, believe, plan, estimate, expect, intend, should, will and other similar expressions are forward-looking statements. Such forward-looking statements are inherently uncertain, and you must recognize that actual results may differ from our expectations. We do not undertake a duty to update such forward-looking statements.

Actual future results and trends for us may differ materially depending on a variety of factors discussed in our filings with the Securities and Exchange Commission, or the Commission. Factors that may affect our plans or results include, without limitation:

- the ability and willingness of Kindred Healthcare, Inc. and certain of its affiliates, which we refer to collectively as Kindred, to continue to meet and/or perform their obligations under their contractual arrangements with us, including without limitation the lease agreements and various agreements entered into by us and Kindred at the time of our spin-off of Kindred on May 1, 1998, as such agreements may have been amended and restated in connection with Kindred s emergence from bankruptcy on April 20, 2001;
- the ability and willingness of Kindred to continue to meet and/or perform its obligation to indemnify and defend us for all litigation and other claims relating to the healthcare operations and other assets and liabilities transferred to Kindred in the 1998 spin off;
- the ability of Kindred and our other operators to maintain the financial strength and liquidity necessary to satisfy their respective obligations and duties under the leases and other agreements with us, and under their existing credit agreements;
- our success in implementing our business strategy;
- the nature and extent of future competition;
- the extent of future healthcare reform and regulation, including cost containment measures and changes in reimbursement policies and procedures;
- increases in the cost of borrowing for us;
- a downgrade in the rating of our debt securities by one or more rating agencies which could have the effect of, among other things, increasing our cost of borrowing;
- the ability of our operators to deliver high quality care and to attract patients;
- the results of litigation affecting us;
- changes in general economic conditions and/or economic conditions in the markets in which we may, from time to time, compete;
- our ability to pay down, refinance, restructure, and/or extend our indebtedness as it becomes due;

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the movement of interest rates and the resulting impact on the value of our interest rate swap agreements and our net worth and our ability to satisfy our obligation to post cash collateral if required to do so under one of these interest rate swap agreements;

the ability and willingness of Atria, Inc. to continue to meet and honor its contractual arrangements with us entered into in connection with our spin-off of our assisted living operations and related assets and liabilities to Atria in August 1996;

our ability and willingness to maintain our qualification as a REIT due to economic, market, legal, tax or other considerations, including without limitation the risk that we may fail to qualify as a REIT due to our ownership of common stock in Kindred;

the outcome of the audit being conducted by the Internal Revenue Service for our tax years ending December 31, 1997 and 1998;

the final determination of our taxable net income for the year ending December 31, 2002;

the ability and willingness of our tenants to renew their leases with us upon expiration of the leases and our ability to relet our properties on the same or better terms in the event such leases expire and are not renewed by the existing tenants;

the impact on the liquidity, financial condition and results of operations of Kindred and our other operators resulting from increased operating costs and uninsured liabilities for professional liability claims, particularly in the state of Florida, and the ability of Kindred and our other operators to accurately estimate the magnitude of such liabilities; and

the value of our common stock in Kindred and the limitations on our ability to sell, transfer or otherwise dispose of our common stock in Kindred arising out of the securities laws and the registration rights agreement we entered into with Kindred and certain of the holders of the common stock in Kindred.

Many of such factors are beyond our control and the control of our management.

We describe some of these risks and uncertainties in greater detail below under the caption Risk Factors. These risks could cause actual results of our industry or our actual results for the year 2002 and beyond to differ materially from those expressed in any forward-looking statement we make. Our future financial performance is dependent upon factors discussed elsewhere in this prospectus supplement and the accompanying prospectus and the documents incorporated by reference herein and therein. Forward-looking statements speak only as of the date on which they are made. For a discussion of factors that could cause actual results to differ, see Risk Factors below and the information contained in our publicly available filings with the Commission. These filings are described below under the captions Where You Can Find More Information and Incorporation by Reference.

Kindred Information

Kindred Healthcare, Inc. is subject to the reporting requirements of the Commission and is required to file with the Commission annual reports containing audited financial information and quarterly reports containing unaudited financial information. The information related to Kindred provided in this prospectus supplement is derived from filings made with the Commission or other publicly available information, or has been provided by Kindred. We have not verified this information either through an independent investigation or by reviewing Kindred s public filings. We have no reason to believe that such information is inaccurate in any material respect, but there can be no assurance that all such information is accurate. We are providing this data for informational purposes only, and the reader of this prospectus is encouraged to obtain Kindred s publicly available filings from the Commission.

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PROSPECTUS SUPPLEMENT SUMMARY

The summary contains basic information about us, our common stock and this offering. Because this is a summary, it does not contain all the information you should consider before investing in our common stock. You should carefully read this summary together with the more detailed information, financial statements and notes to the financial statements contained elsewhere or incorporated by reference into this prospectus supplement or the accompanying prospectus. To fully understand this offering, you should read all of these documents. To the extent there is a conflict between the information contained in this prospectus supplement, on the one hand, and the information contained in the accompanying prospectus, on the other hand, the information in this prospectus supplement shall control. Unless otherwise indicated, all references in this prospectus supplement to Ventas, we, us, our or similar terms refer to Ventas, Inc. together with its subsidiaries. Unless otherwise indicated, the information included in this prospectus supplement assumes no exercise of the underwriter s over-allotment option.

Ventas, Inc.

We are a healthcare real estate investment trust. Our business consists of owning, leasing and financing healthcare facilities. As of November 29, 2002, our properties included 220 skilled nursing facilities in 32 states, 44 hospitals in 20 states and nine other healthcare and senior housing facilities. We also have investments in 25 healthcare and senior housing facilities located in Ohio and Maryland. Our primary tenant, Kindred, is one of the largest providers of long-term healthcare services in the United States. Kindred operates 43 of our hospitals and 210 of our skilled nursing facilities pursuant to five multi-facility master lease agreements. All of the master leases are structured as triple-net leases, under which Kindred is responsible for insurance, taxes, utilities, maintenance and repairs related to our properties.

Our business strategy is comprised of two primary objectives: diversification of our portfolio of properties and further reduction of our indebtedness in relation to our revenue. We intend to diversify our portfolio by operator, facility type and reimbursement source in order to reduce our dependence on Kindred and government reimbursement. We intend to acquire additional healthcare properties, which could include hospitals, nursing centers, assisted or independent living facilities and ancillary healthcare facilities, that are operated by leading providers in their industries. We also intend to further reduce our indebtedness in relation to our revenue.

We conduct substantially all of our business through two wholly owned subsidiaries, Ventas Realty, Limited Partnership and Ventas Finance I, LLC. As of November 29, 2002, Ventas Finance I owned 40 skilled nursing facilities and we and Ventas Realty owned all of our other properties.

Our principal executive offices are located at 4360 Brownsboro Road, Suite 115, Louisville, Kentucky 40207-1642, and our telephone number is (502) 357-9000.

Recent Developments

THI Transaction. On November 5, 2002, we completed a $120 million transaction with Trans Healthcare, Inc., or THI, a privately owned long-term care and hospital company. The transaction was structured as a $53 million sale leaseback transaction and $67 million loan, which is comprised of a first mortgage loan and a mezzanine loan.

Under the sale leaseback, we purchased five properties and are leasing them back to THI under a master lease. The properties subject to the sale leaseback are four skilled nursing facilities and one continuing care retirement community that is comprised of one skilled nursing facility, one rehabilitation hospital, and one

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assisted living facility. Three of the properties are located in Maryland and two are located in Ohio. These properties contain a total of 770 beds. The master lease, which has an initial term of ten years, provides for annual base rent of $5.9 million. The master lease provides that if THI meets specified revenue parameters, the annual base rent will escalate by the greater of (i) three percent or (ii) 50% of the consumer price index.

The loan to THI is divided into two components: a $45 million first mortgage loan and a $22 million mezzanine loan to subsidiaries of THI. The first mortgage loan is secured by 17 skilled nursing facilities and one related assisted living facility. Fourteen of these facilities are located in Ohio and four are located in Maryland. These properties contain a total of 1,402 beds. The first mortgage loan is structured as a collateralized mortgage backed security that we have originated for investment purposes, but may later sell. The first mortgage loan bears interest at LIBOR plus 367 basis points, inclusive of upfront fees (with a LIBOR floor of three percent). The first mortgage loan matures in three years, and THI holds options to exercise two one-year extensions upon satisfaction of certain conditions.

The mezzanine loan bears interest, inclusive of upfront fees, of 18% per annum and is secured by a pledge of the ownership interests in the entities that own the 18 facilities that also collateralize the first mortgage loan, liens on four additional healthcare/senior housing properties and interests in three additional properties operated by THI.

The THI transaction covers a total of 32 facilities: 18 skilled nursing facilities, four assisted living facilities, and one rehabilitation hospital containing 1,546 beds in Ohio; and nine skilled nursing facilities containing 1,206 beds in Maryland.

Kindred s Increased Professional Liability Expense in Florida. On October 10, 2002, Kindred announced that it will record a substantial increase in costs related to professional liability claims, primarily claims related to skilled nursing facility operations conducted in Florida. Kindred leases 15 skilled nursing facilities in Florida from us. The cash rent from the 15 Florida skilled nursing facilities we lease to Kindred is approximately $8.5 million annually, which constitutes approximately 4.5% of the total $187 million in annualized rent payable to us by Kindred. We believe that under the terms of our leases with Kindred, Kindred is not entitled to abandon the leased properties, reduce the rent, or receive other concessions based on the increases in professional liability costs.

On December 11, 2002, Kindred publicly announced that it had entered into a non-binding letter of intent with Senior Health Management, LLC to transfer the operations of Kindred s 18 skilled nursing facilities in Florida, including the 15 skilled nursing facilities in Florida that Kindred leases from us, and to sublease our 15 facilities to Senior Health Management or its designee. The announcement indicated that consummation of the proposed transaction is subject to a number of material closing conditions, including approval from Kindred s lenders and regulatory and governmental approvals. Kindred stated that the lease payments under the proposed subleases would be equal to the lease payments under the primary leases and that Kindred will remain a primary guarantor under the lease with us.

Based on the information available to us, we believe our consent is required for the proposed sublease of the 15 skilled nursing facilities by Kindred. However, in its December 11, 2002 announcement, Kindred stated, among other things, that it has the ability to sublease 12 of the skilled nursing facilities in Florida without our consent and that our consent cannot be unreasonably withheld on the remaining 3 skilled nursing facilities in Florida. Kindred further stated that if we improperly interfere with the completion of the proposed transaction, it will seek appropriate legal remedies against us as well as damages for the continuing losses it is sustaining with respect to these facilities. We believe that we have the right to consent to the proposed sublease of the 15 skilled nursing facilities in Florida held by Kindred, and intend to defend any legal actions arising out of our withholding of such consent vigorously. However, there can be no assurance as to what the outcome of any such action on the part of Kindred might be or the ultimate effects it might have on our financial condition, results of operations, or the share price of our common stock.

We have been discussing strategic alternatives regarding the skilled nursing facilities in Florida with Kindred, and are currently considering Kindred s proposed transfer of its Florida skilled nursing operations to Senior Health Management and the proposed sublease of the facilities to a designee of Senior Health Management. We currently intend to work with Kindred to permit it to exit the Florida skilled nursing facility market on terms acceptable to us. However, there can be no assurance as to the outcome of our discussions with Kindred or when or if any exit by Kindred from the Florida skilled nursery facility market will occur.

As a result of Kindred s October 10, 2002 announcement of its increased costs in Florida and other events, the market value of the Kindred common stock we own has declined substantially from $34.1 million as of September 30, 2002 to approximately $17.5 million as of December 13, 2002. Our investment in Kindred common stock is classified as available for sale in accordance with SFAS No. 115 Accounting for Certain Investments in Debt and Equity Securities. Accordingly, the Kindred common stock is measured and reported on our balance sheet at fair value. Our unrealized gains and losses on our Kindred common stock are reported as a component of Accumulated Other Comprehensive Income on our balance sheet.

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The Offering

For a description of our common stock, see Description of Common Stock and Description of Outstanding Capital Stock in the accompanying prospectus. For a description of stockholder rights attached to our shares of common stock, see Note 13 to our Consolidated Financial Statements for the year ended December 31, 2001, which is incorporated by reference in this prospectus supplement and the accompanying prospectus.

Securities offered:

By us	9,000,000 shares of common stock, plus up to an additional 823,861 shares if the underwriters exercise their over-allotment option in full.
By the selling stockholders	7,477,207 shares of common stock, plus up to an additional 823,860 shares if the underwriters exercise their over-allotment option.
Shares to be outstanding after this offering	78,849,055, assuming no exercise of the underwriters over-allotment option.
Use of proceeds	We estimate that our net proceeds from this offering without exercise of the over-allotment option will be approximately $93.1 million. We intend to use these net proceeds to reduce certain of our outstanding indebtedness. We will not receive any of the proceeds from the sale of shares by the selling stockholders. See Use of Proceeds.
Restrictions on ownership and transfer	Our certificate of incorporation contains restrictions on ownership and transfer of our common stock intended to assist us in maintaining our status as a REIT for federal and/or state income tax purposes. For example, our certificate of incorporation generally restricts any person from acquiring beneficial ownership of more than 9% of our outstanding shares of common stock, as more fully described in the section entitled Description of Outstanding Capital Stock in the accompanying prospectus.
Risk factors	See Risk Factors and other information included in this prospectus supplement and the accompanying prospectus for a discussion of factors you should carefully consider before deciding to invest in the common stock.
New York Stock Exchange symbol	VTR

Our Board of Directors has declared a regular quarterly dividend of $0.2375 per share of common stock, payable in cash on January 3, 2003 to stockholders of record of our common stock on December 17, 2002. Purchasers of shares of common stock in this offering will not receive the January 3, 2003 dividend on shares purchased in this offering. The number of shares to be outstanding after this offering as shown above is based on the shares of our common stock outstanding as of November 26, 2002.

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SUMMARY SELECTED FINANCIAL DATA

The selected consolidated financial data as of December 31, 1999, 2000 and 2001 and for the years then ended presented below is derived from our audited financial statements and accompanying notes. The selected financial data presented below as of and for the nine months ended September 30, 2001 and 2002 has been derived from our unaudited financial statements. In the opinion of management, the unaudited financial statements have been prepared on the same basis as the audited financial statements and include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the financial position and results of operation as of such dates and for such periods. The data presented below should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations, our Consolidated Financial Statements as of December 31, 2000 and 2001 and for the years ended December 31, 1999, 2000 and 2001 and accompanying notes, and our unaudited Condensed Consolidated Financial Statements for the nine months ended September 30, 2001 and 2002 and as of September 30, 2002 incorporated by reference in this prospectus supplement. The results for the interim period do not necessarily indicate the results to be expected for the full fiscal year.

	(dollars in thousands, except per share data)				
	Year Ended December 31,			Nine Months Ended September 30,	
	1999	2000	2001	2001	2002
				(unaudited)	
Operating Data:					
Rental income	$ 224,405	$ 228,569	$ 183,329	$ 137,242	$ 140,903
Loss on uncollectible amounts due from tenants	33,829	47,394			
Gain on sale of Kindred common stock			15,425		5,014
General and administrative expenses	21,566	20,781	14,902	11,335	9,723
United States Settlement (1)		96,493			
Interest expense	87,124	93,570	86,175	64,540	57,661
Net loss on swap breakage					5,407
Interest on United States Settlement			4,592	3,053	4,204
Discontinued operations (including gain on sale of assets)	1,673	1,283	681	954	23,831
Net income (loss) before extraordinary charge	42,535	(61,245)	51,888	27,841	63,181
Net income (loss)	42,535	(65,452)	50,566	27,841	56,262
Other Data:					
Net cash provided by operating activities	103,580	85,338	79,893	61,324	96,687
Net cash provided by (used in) investing activities	371	5,359	2,760	283	34,783
Net cash provided by (used in) financing activities	35,305	(142,890)	(151,458)	(125,181)	(145,945)
FFO (2)	85,023	76,479	93,502	58,978	70,915
Normalized FFO, excluding gain on Kindred common stock (3)	85,023	76,479	78,077	58,978	71,308
Net income per common share (basic)	0.63	(0.96)	0.74	0.41	0.82
Net income per common share (diluted)	0.63	(0.96)	0.73	0.40	0.80
Dividends declared per common share (4) (5)	0.39	0.91	0.92	0.66	0.7125
Basic weighted average number of common shares outstanding	67,754	68,010	68,409	68,375	68,895
Diluted weighted average number of common shares outstanding	67,989	68,131	69,363	69,255	69,978

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	(dollars in thousands)		
	December 31,		September 30, 2002
	2000	2001	
			(unaudited)
Balance Sheet Data:			
Real estate investments, net	$ 848,545	$ 806,336	$ 769,981
Cash and cash equivalents	87,401	18,596	4,121
Kindred common stock		55,118	34,098
Total assets	981,145	941,859	857,243
Notes payable and other debt	886,385	848,368	785,924
United States Settlement (1)	96,493	54,747	46,789
Stockholders equity (deficit) (6)	(117,514)	(91,074)	(125,625)

(1) The United States Settlement is a comprehensive settlement of various claims and investigations by the United States Department of Justice involving operations at our healthcare facilities prior to our spinoff of Kindred in 1998. See Note 9 and Note 12 to our Consolidated Financial Statements for the year ended December 31, 2001, which are incorporated by reference in this prospectus supplement and the accompanying prospectus.

(2) We consider funds from operations, or FFO, an appropriate measure of performance of an equity REIT and we use the National Association of Real Estate Investment Trust s, or NAREIT, definition of FFO. NAREIT defines FFO as net income (computed in accordance with GAAP), excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. FFO presented herein is not necessarily comparable to FFO presented by other real estate companies due to the fact that not all real estate companies use the same definition. FFO should not be considered as an alternative to net income (determined in accordance with GAAP) as an indicator of our financial performance or as an alternative to cash flow from operating activities (determined in accordance with GAAP) as a measure of our liquidity, nor is FFO indicative of sufficient cash flow to fund all of our needs. FFO in 2000 excludes the effect of the United States Settlement.

(3) Normalized FFO excludes the gain on sale of Kindred common stock and net loss on swap breakage for the respective periods:

	Year Ended December 31, 2001	Nine Months Ended September 30, 2002
FFO	$ 93,502	$ 70,915
Gain on Sale of Kindred Common Stock	(15,425)	(5,014)
Net Loss on swap breakage		5,407
	$ 78,077	$ 71,308

(4) Our Board of Directors has declared a regular quarterly dividend of $0.2375 per share of common stock payable in cash on January 3, 2003 to stockholders of record on December 17, 2002. Purchasers of shares of common stock in this offering will not receive the January 3, 2003 dividend on shares purchased in this offering.

(5) Our fourth quarter 2001 distribution of $0.26 per share was paid in a combination of cash and shares of Kindred common stock. For every 200 shares of our common stock, stockholders received one share of Kindred common stock and $0.98 in cash. For purposes of this distribution, the Kindred common stock was valued on December 31, 2001 at $51.02 per share.

(6) Total stockholders equity at December 31, 2001 includes $17.5 million cumulative increase from a change in accounting for derivatives.

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RISK FACTORS

Our business, operations and financial condition are subject to various risks. Some of these risks are described below, and you should take these risks into account in evaluating an investment in our common stock. This section does not describe all risks applicable to us, our industry or our business, and it is intended only as a summary of certain material factors. If any of the following risks actually occur, we could be materially and adversely affected. In such case, you may lose all or part of your investment in our common stock.

We have grouped these risk factors into three general categories:

- Risks arising from our business;
- Risks arising from our capital structure; and
- Risks arising from our status as a REIT.

Risks Arising from Our Business

We are dependent on Kindred; Kindred s inability or unwillingness to satisfy its obligations under its agreements with us could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders as required to continue to qualify as a REIT or otherwise.

We are dependent on Kindred in a number of ways:

- We lease substantially all of our properties to Kindred under five master leases, and therefore:
  - Kindred is the primary source of our rental income, accounting for approximately 98.8% of our rental income in 2001; and
  - since our master leases with Kindred are triple-net leases, we depend on Kindred to pay for insurance, taxes, utilities and maintenance and repair expenses required in connection with the leased properties.
- In connection with our spin off of Kindred in 1998, Kindred assumed, and agreed to indemnify us for, the following:
  - all obligations under third-party leases and third-party contracts, except for those contracts relating to our ownership of our properties;
  - all losses, including costs and expenses, resulting from future claims and all liabilities that may arise out of the ownership or operation of the healthcare operations either before or after the date of the spin off; and
  - any claims that were pending at the time of the spin off and that arose out of the ownership or operation of the healthcare operations or were asserted after the spin off and that arise out of the ownership and operation of the healthcare operations or any of the assets or liabilities transferred to Kindred in connection with the spin off.
- The failure of Kindred to make three consecutive payments of rent under any of our master leases with them constitutes an event of default under our credit agreement.
- We own 920,814 shares of Kindred common stock, which we intend to use to satisfy certain of our obligations.

Although Kindred emerged from bankruptcy on April 20, 2001, there can be no assurance that Kindred will have sufficient assets, income and access to financing and insurance coverage to enable it to satisfy its obligations under its agreements with us. In addition, any failure by Kindred to effectively conduct its operations could have a material adverse effect on its business reputation or on its ability to enlist and maintain patients in its facilities. Any inability or unwillingness on the part of Kindred to satisfy its obligations under its agreements

with us, decrease in the price of Kindred common stock, or failure of Kindred to keep the shelf registration statement effective with respect to the shares of Kindred common stock held by us could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT.

We may be unable to find another lessee or operator for our properties if we have to replace Kindred or our other operators.

We may have to find another lessee/operator for the properties covered by one or more of our master leases with Kindred or our other operators upon the expiration of the terms of the master leases or upon a default by Kindred or our other operators. During any period that we are attempting to locate one or more lessee/operators there could be a decrease or cessation of rental payments by Kindred or our other operators. There can be no assurance that we will be able to locate another suitable lessee/operator or, if we are successful in locating such an operator, that the rental payments from the new operator would not be significantly less than the existing rental payments. Our ability to locate another suitable lessee/operator may be significantly delayed or limited by various state licensing, receivership, certificate-of-need or other laws, as well as by Medicare and Medicaid change-of-ownership rules.

We may encounter certain risks when implementing our business strategy to pursue investments in, and/or acquisitions or development of, healthcare-related or other properties.

We intend to pursue investments in, and/or acquisitions or development of, additional healthcare-related or other properties, subject to the contractual restrictions contained in our indentures and our credit facility, assuming that Kindred s financial condition remains stabilized and we have the financial flexibility at that time to do so. However, we may still encounter certain risks. Acquisitions of and investments in healthcare-related properties entail general investment risks associated with any real estate investments, including risks that investments will fail to perform in accordance with expectations, the estimates of the cost of improvements necessary for acquired properties will prove inaccurate, and the inability of the lessee/operator to meet performance expectations. We do not presently contemplate any development projects, although if we were to pursue new development projects, such projects would be subject to numerous risks, including risks of construction delays or cost overruns that may increase project costs, new project commencement risks such as receipt of zoning, occupancy and other required governmental approvals and permits and the incurrence of development costs in connection with projects that are not pursued to completion. In addition, we may borrow to finance any investments in, and/or acquisition or development of, healthcare-related or other properties, which would increase our leverage.

We may compete for acquisition or investment opportunities with entities that have substantially greater financial resources than we have. Our ability to compete successfully for such opportunities is affected by many factors, including our cost of obtaining debt and equity capital at rates comparable to or better than our competitors. Competition generally may reduce the number of suitable acquisition or investment opportunities available to us and increase the bargaining power of property owners seeking to sell, thereby impeding our acquisitions, investment or development activities.

Even if we are successful at identifying and competing for acquisition or investment opportunities, such opportunities involve a number of risks, including diversion of management s attention, the risk that the value of the properties we acquire or invest in could decrease substantially after such acquisition or investment and the risk that we will not be able to accurately assess the value of properties that are not of the type we currently own, some or all of which could have a material adverse effect on our business, financial condition, results of operation and liquidity, on our ability to service our indebtedness and our obligations under our settlement with the United States Department of Justice.

Additionally, if we are successful in implementing our business strategy to pursue investments in, and/or acquisitions or development of, healthcare-related properties, we may have numerous operators of our

properties. Historically, substantially all of our properties have been operated by a single operator, Kindred. There can be no assurance that we would have the capabilities to successfully monitor and manage a portfolio of properties with multiple operators.

We are subject to the risks associated with investment in a single industry: the heavily regulated healthcare industry.

All of our investments are in properties used in the healthcare industry; therefore we are exposed to risks associated with the healthcare industry in particular. The healthcare industry is highly regulated and changes in government regulation have in the past had material adverse consequences on the industry in general, which may not even have been contemplated by lawmakers and regulators. There can be no assurance that future changes in government regulation of healthcare will not have a material adverse effect on the healthcare industry, including our lessees. Moreover, our ability to invest in non-healthcare related properties may be restricted by the terms of our credit facility.

Our tenants, including Kindred, may be adversely affected by increasing healthcare regulation and enforcement.

We believe that the regulatory environment surrounding the long-term care industry has intensified both in the amount and type of regulations and in the efforts to enforce those regulations. This is particularly true for large for-profit, multi-facility providers like Kindred.

The extensive federal, state and local laws and regulations affecting the healthcare industry include, but are not limited to, laws and regulations relating to licensure, conduct of operations, ownership of facilities, addition of facilities and equipment, allowable costs, services, prices for services, quality of care, patient rights, fraudulent or abusive behavior, and financial and other arrangements which may be entered into by healthcare providers. Federal and state governments have intensified enforcement policies, resulting in a significant increase in the number of inspections, citations of regulatory deficiencies and other regulatory sanctions, including terminations from the Medicare and Medicaid programs, bars on Medicare and Medicaid payments for new admissions, civil monetary penalties and even criminal penalties. If Kindred and our other tenants and operators fail to comply with the extensive laws, regulations and other requirements applicable to their businesses, they could become ineligible to receive reimbursement from governmental and private third-party payor programs, suffer civil or criminal penalties or be required to make significant changes to their operations. Kindred and our other tenants also could be forced to expend considerable resources responding to an investigation or other enforcement action under applicable laws or regulations. In addition, as part of the settlement agreement Kindred entered into with the federal government, it agreed to comply with the terms of a corporate integrity agreement. Kindred s failure to comply with the corporate integrity agreement could have a material adverse effect on Kindred s results of operations, financial condition and its ability to make rental payments to us, which, in turn, could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT.

We are unable to predict the future course of federal, state and local regulation or legislation, including the Medicare and Medicaid statutes and regulations. Changes in the regulatory framework could have a material adverse effect on Kindred and our other operators, which, in turn, could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT.

Changes in the reimbursement rates or methods of payment from third-party payors, including the Medicare and Medicaid programs, could have a material adverse effect on our tenants.

Kindred and our other tenants and operators rely on reimbursement from third-party payors, including the Medicare and Medicaid programs, for substantially all of their revenues. Reductions in those reimbursement

rates could have a material adverse effect on Kindred and our other operators, which, in turn, could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT.

In an effort to reduce federal spending on healthcare, in 1997 the Federal government enacted the Balanced Budget Act, which contained extensive changes to the Medicare and Medicaid programs intended to reduce the projected amount of increase in payments under such programs between 1998 and 2002, and eased impediments on the states ability to reduce their Medicaid reimbursement levels. As a result, substantially all of the large nursing home chains in the country were forced into bankruptcy protection. Although there has been some relief from the effects of the Balanced Budget Act, certain temporary relief provisions implemented after the Balanced Budget Act s enactment expired on September 30, 2002. In addition, long-term acute care hospitals, or LTACs, are now subject to a prospective payment system pursuant to a final rule published by the Centers for Medicare and Medicaid Services on August 30, 2002. Under the LTAC prospective payment system, LTACs are no longer reimbursed through a methodology that reflects the costs incurred by the LTACs. Instead, the LTAC prospective payment system provides a predetermined, per-patient amount to each LTAC upon each patient s discharge. LTACs that have filed cost reports before October 1, 2002 may choose to undergo a gradual 5-year transition to 100% federal prospective payment. Alternatively, such LTACs may exercise a one-time opportunity to transition fully and permanently to the LTAC prospective payment system rate at the beginning of any cost reporting period during the 5-year transition period. During the 5-year transition period, LTACs are paid blended rates combining the old cost-based system and the new LTAC prospective payment system. During a LTAC s 5-year transition period, the percentage representing the LTAC prospective payment system s portion of the blended reimbursement rates progressively increases by 20% each year while the percentage representing the old system s portion of the blended reimbursement rates progressively decreases by 20% each year such that by the fifth year the LTAC is receiving 100% federal prospective payment under the LTAC prospective payment system. The 5-year transition period does not apply to LTACs that have their first cost reporting period beginning on or after October 1, 2002. We cannot predict the impact of the LTAC prospective payment system on our tenants and operators.

There also continue to be state legislative proposals that would impose more limitations on government and private payments to providers of healthcare services such as Kindred. Many states have enacted or are considering enacting measures that are designed to reduce their Medicaid expenditures and to make certain changes to private healthcare insurance. Some states also are considering regulatory changes that include a moratorium on the designation of additional LTACs. There are a number of legislative proposals currently under consideration, including cost caps and the establishment of Medicaid prospective payment systems for nursing centers.

There continue to be various federal and state legislative and regulatory proposals to implement cost-containment measures that limit payments to healthcare providers. In addition, private third-party payors have continued their efforts to control healthcare costs. There can be no assurance that adequate reimbursement levels will be available for services to be provided by Kindred and other tenants which are currently being reimbursed by Medicare, Medicaid or private payors. Significant limits by governmental and private third-party payors on the scope of services reimbursed and on reimbursement rates and fees could have a material adverse effect on the liquidity, financial condition and results of operations of Kindred and our other operators and other tenants, which, in turn, could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT.

Significant legal actions, particularly in the State of Florida, could subject Kindred and our other operators to increased operating costs and substantial uninsured liabilities, which could materially and adversely affect Kindred s and our other operators liquidity, financial condition and results of operation.

Kindred and our other operators have experienced substantial increases in both the number and size of patient care liability claims in recent years. In addition to large compensatory claims, plaintiffs attorneys increasingly are seeking significant punitive damages and attorneys fees. In the State of Florida, where Kindred

operates 15 of our skilled nursing facilities and six of our hospitals, general liability and professional liability costs for nursing centers have increased substantially and become increasingly difficult to estimate.

Kindred s and our other operators insurance coverage might not cover all claims against them or continue to be available to them at a reasonable cost. If Kindred or our other operators are unable to maintain adequate insurance coverage or are required to pay punitive damages, they may be exposed to substantial liabilities.

Kindred insures its professional liability risks in part through a wholly-owned, limited purpose insurance company. The limited purpose insurance company insures initial losses up to specified coverage levels per occurrence and in the aggregate. Coverage for losses in excess of those levels is maintained through unaffiliated commercial insurance carriers; however, the limited purpose insurance company insures all claims arising in Florida up to a per occurrence limit without the benefit of any aggregate coverage limit through unaffiliated commercial insurance carriers. Kindred maintains general liability insurance and professional malpractice liability insurance in amounts and with deductibles which Kindred management has indicated that it believes are sufficient for its operations.

On October 10, 2002, Kindred announced that it will record a substantial increase in costs related to professional liability claims, primarily claims related to skilled nursing facility operations conducted in Florida. Kindred leases 15 skilled nursing facilities in Florida from us. We believe that under the terms of our leases with Kindred, Kindred is not entitled to abandon the leased properties, reduce the rent, or receive other concessions based on the increases in professional liability costs.

On December 11, 2002, Kindred publicly announced that it had entered into a non-binding letter of intent with Senior Health Management, LLC to transfer the operations of Kindred s 18 skilled nursing facilities in Florida, including the 15 skilled nursing facilities in Florida that Kindred leases from us, and to sublease our 15 facilities to Senior Health Management or its designee. The announcement indicated that consummation of the proposed transaction is subject to a number of material closing conditions, including approval from Kindred s lenders and regulatory and governmental approvals. Kindred stated that the lease payments under the proposed subleases would be equal to the lease payments under the primary leases and that Kindred will remain a primary guarantor under the lease with us.

Based on the information available to us, we believe our consent is required for the proposed sublease of the 15 skilled nursing facilities by Kindred. However, in its December 11, 2002 announcement, Kindred stated, among other things, that it has the ability to sublease 12 of the skilled nursing facilities in Florida without our consent and that our consent cannot be unreasonably withheld on the remaining 3 skilled nursing facilities in Florida. Kindred further stated that if we improperly interfere with the completion of the proposed transaction, it will seek appropriate legal remedies against us as well as damages for the continuing losses it is sustaining with respect to these facilities. We believe that we have the right to consent to the proposed sublease of the 15 skilled nursing facilities in Florida held by Kindred, and intend to defend any legal actions arising out of our withholding of such consent vigorously. However, there can be no assurance as to what the outcome of any such action on the part of Kindred might be or the ultimate effects it might have on our financial condition, results of operations, or the share price of our common stock.

We have been discussing strategic alternatives regarding the skilled nursing facilities in Florida with Kindred, and are currently considering Kindred s proposed transfer of its Florida skilled nursing operations to Senior Health Management and the proposed sublease of the facilities to a designee of Senior Health Management. We currently intend to work with Kindred to permit it to exit the Florida skilled nursing facility market on terms acceptable to us. However, there can be no assurance as to the outcome of our discussions with Kindred or when or if any exit by Kindred from the Florida skilled nursery facility market will occur.

A downgrade of our credit ratings may have a material adverse effect.

We currently have a Ba3 senior debt rating from Moody s Investors Service and a BB- corporate credit rating from Standard & Poor s Rating Services, a division of The McGraw-Hill Companies, Inc. In October 2002, Moody s placed our credit ratings, including those of Ventas Realty,

Limited Partnership and our other rated subsidiaries under review for possible downgrade. Factors that may influence a rating agency s determination of our credit rating include, but are not limited to, our success in raising sufficient equity capital, our capital structure, our level of indebtedness and pending or future changes in the regulatory framework applicable to our tenants or our industry. Any downgrade of our credit ratings could make it more difficult or more expensive for us to incur additional indebtedness and adversely affect the value of our common stock. There can be no assurance that our credit ratings will not be downgraded in the future.

Kindred and our other operators may be sued under a federal whistleblower statute.

Kindred and our other operators may be sued under a federal whistleblower statute designed to combat fraud and abuse in the healthcare industry. These lawsuits can involve significant monetary damages and award bounties to private plaintiffs who successfully bring these suits. If any such lawsuits were to be brought against Kindred and our other operators, such suits combined with increased operating costs and substantial uninsured liabilities could have a material adverse effect on the liquidity, financial condition and results of operation of Kindred and our other operators and their ability to make rental payments to us, which, in turn, could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT.

Even though Atria, Inc. has assumed and agreed to repay indebtedness evidenced by bonds that we issued under the spin off of our assisted living operations, we may still be liable for the indebtedness if Atria cannot or does not honor its obligations.

We have issued bonds to residents of an assisted living facility that we own and lease to (and is operated by) Atria, Inc. Proceeds from the bonds are paid to and utilized by Atria. The obligation to repay the bonds is secured by a mortgage and trust indenture that encumbers (among other properties) the assisted living facility. Currently, based solely upon information obtained from Atria, the bonds evidence an aggregate principal amount of indebtedness of approximately $29.4 million. In connection with our spin off of our assisted living operations and related assets and liabilities to Atria in 1996, Atria assumed and agreed to repay the indebtedness and to indemnify and hold us harmless from and against all amounts we may be obligated to pay under the mortgage and trust indenture, including the obligation to repay the bonds. We may remain the primary obligor under the bonds and the mortgage and trust indenture. If Atria is unable to or does not satisfy these obligations, we may be liable for these obligations. There can be no assurance that Atria will have sufficient means to enable it to satisfy its obligations or will continue to honor those obligations under the mortgage and trust indenture and the bonds. However, we believe that Atria s failure to satisfy its obligations would, subject to any applicable defenses available to Atria, allow us to terminate the lease between us and Atria, repossesses the property, and exercise all other available remedies under the lease between us and Atria. Our payment or performance of these obligations could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT. We are currently engaged in efforts to have ourselves released from liability under the bonds and the mortgage and trust indenture. There can be no assurance that we will be successful in our attempts to be released from this potential liability. A lawsuit is pending against us wherein Atria is seeking, among other things, a declaration that Atria s indemnity obligation in favor of us relative to the bonds is void and unenforceable.

If any of our properties are found to be contaminated, or if we become involved in any environmental disputes, we could incur substantial liabilities and costs.

Under federal and state environmental laws and regulations, a current or former owner of real property may be liable for costs related to the investigation, removal and remediation of hazardous or toxic substances or

petroleum that are released from or are present at or under, or that are disposed of in connection with such property. Owners of real property may also face other environmental liabilities, including government fines and penalties imposed by regulatory authorities and damages for injuries to persons, property or natural resources. Environmental laws and regulations often impose liability without regard to whether the owner was aware of, or was responsible for, the presence, release or disposal of hazardous or toxic substances or petroleum. In certain circumstances, environmental liability may result from the activities of a current or former operator of the property. While we are generally indemnified by the current operators of our properties for contamination caused by such operators, such indemnities may not adequately cover all environmental costs.

Risks Arising from Our Capital Structure

We are highly leveraged.

As of November 29, 2002, we had approximately $897 million of indebtedness, approximately an additional $47 million of obligations under a settlement we entered into with the United States Department of Justice, and approximately $31 million in additional borrowings available under our credit facility. Our indentures permit us to incur substantial additional debt, and we may borrow additional funds, which may include secured borrowings. A high level of indebtedness may have the following consequences:

- the requirement that a substantial portion of our cash flow from operations must be dedicated to the payment of debt service, thus reducing the funds available for our business strategy and for distributions to stockholders;
- potential limits on our ability to adjust rapidly to changing market conditions and vulnerability in the event of a downturn in general economic conditions or in the real estate and/or healthcare sectors;
- a potential impairment of our ability to obtain additional financing for our business strategy; and
- a downgrade in the rating of our debt securities by one or more rating agencies which could have the effect of, among other things, increasing the cost of our borrowing.

After this offering, we may be unable to raise additional capital necessary to implement our business plan and to meet our debt payments and our obligations under the settlement we entered into with the United States Department of Justice.

In order to implement our business plan and to meet our debt payments and our obligations under the settlement we entered into with the United States Department of Justice, we may need to raise additional capital after this offering is consummated. Our ability to incur additional indebtedness is restricted by the terms of our indentures and our credit facility. In addition, adverse economic conditions could cause the terms on which we can obtain additional borrowings to become unfavorable. In such circumstances, we may be required to raise additional equity in the capital markets or liquidate one or more investments in properties at times that may not permit realization of the maximum return on the investments and that could result in adverse tax consequences to us. In addition, certain healthcare regulations may constrain our ability to sell assets. There can be no assurance that we will be able to meet our debt service obligations or our obligations under the settlement we entered into with the United States Department of Justice and the failure to do so could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT.

One of our interest rate swap agreements may obligate us to post collateral which could negatively impact our liquidity and access to financing.

The terms of our interest rate swap agreement entered into at the time of our spin off of Kindred in 1998, or the 1998 Swap, require that we make a cash payment or otherwise post collateral to the other party to the 1998 Swap if the fair value loss to us exceeds specified threshold levels. Under the 1998 Swap, if collateral must be posted, the amount of that collateral must equal the difference between the fair value unrealized loss of the 1998 Swap at the time of such determination and the threshold amount. The posting of collateral under the 1998 Swap could negatively impact our liquidity and access to financing. There can be no assurance that we will

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have sufficient assets, income and access to financing to enable us to post collateral if required to do so under the 1998 Swap. Failure to post collateral under the terms of the 1998 Swap could significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT.

The 1998 Swap is scheduled to terminate on June 30, 2003. We have entered into a second interest rate swap agreement to hedge our existing floating-rate debt for the period between July 1, 2003 and June 30, 2008 that does not require us to post collateral. However, there can be no assurance that any other swap agreements we may enter into, including swap agreements to hedge any additional floating-rate debt we may assume prior to or after June 30, 2008, will not require us to post collateral.

We hedge floating-rate debt with interest rate swaps and may record charges associated with the termination or change in value of these interest-swaps.

We have interest rate swaps that hedge interest payment obligations on floating-rate debt. We periodically assess our interest rate swaps in relation to our outstanding balances of floating-rate debt, and based on such assessments may terminate portions of our swaps or enter into additional swaps. Termination of swaps with accrued losses, or changes in the value of swaps as a result of falling interest rates, would result in changes to our earnings and net worth, which could be significant.

Risks Arising from our Status as a REIT

Loss of our status as a REIT would have significant adverse consequences to us and the value of our common stock.

If we lose our status as a REIT, we will face serious tax consequences that will substantially reduce the funds available for distribution to our stockholders for each of the years involved because:

- we would not be allowed a deduction for distributions to stockholders in computing our taxable income and would be subject to federal income tax at regular corporate rates;
- we also could be subject to the federal alternative minimum tax and possibly increased state and local taxes; and
- unless we are entitled to relief under statutory provisions, we could not elect to be subject to tax as a REIT for four taxable years following the year during which we were disqualified.

In addition, if we fail to qualify as a REIT, all distributions to stockholders would be subject to tax as ordinary income (but corporate distributees may be eligible for the dividends received deduction) to the extent of our current and accumulated earnings and profits, we will not be required to make distributions to stockholders.

As a result of all these factors, our failure to qualify as a REIT also could impair our ability to implement our business strategy and would adversely affect the value of our common stock.

Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which there are only limited judicial and administrative interpretations. The determination of various factual matters and circumstances not entirely within our control may affect our ability to remain qualified as a REIT. In addition, new legislation, regulations, administrative interpretations or court decisions may adversely affect our investors or our ability to remain qualified as a REIT for tax purposes. Although we believe that we qualify as a REIT, there can be no assurance that we will continue to qualify or remain qualified as a REIT for tax purposes.

The 90% distribution requirement will decrease our liquidity and may limit our ability to engage in otherwise beneficial transactions.

To comply with the 90% distribution requirement applicable to REITs and to avoid the nondeductible excise tax, we must make distributions to our stockholders. The terms of our indentures permit us to make annual

distributions to our stockholders in an amount equal to the minimum amount necessary to maintain our REIT status so long as our ratio of Debt to Adjusted Total Assets does not exceed 60% and to make additional distributions if we pass certain other financial tests.

Although we anticipate that we generally will have sufficient cash or liquid assets to enable us to satisfy the REIT distribution requirement, it is possible that from time to time we may not have sufficient cash or other liquid assets to meet the 90% distribution requirement or to distribute such greater amount as may be necessary to avoid income and excise taxation. This may be due to the timing differences between the actual receipt of income and actual payment of deductible expenses on the one hand and the inclusion of that income and deduction of those expenses in arriving at our taxable income. In addition, nondeductible expenses such as principal amortization or repayments or capital expenditures in excess of noncash deductions may also cause us to fail to have sufficient cash or liquid assets to enable us to satisfy the 90% distribution requirement.

These distributions may limit our ability to rely upon rental payments from our properties or subsequently acquired properties to finance investments, acquisitions or new developments.

In the event that timing differences or other cash needs occur, we may find it necessary to borrow funds, issue additional equity securities (although there can be no assurance that we will be able to do so), pay taxable stock dividends, if possible, distribute other property or securities (including Kindred common stock) or engage in a transaction intended to enable us to meet the REIT distribution requirements. This may require us to raise additional capital to meet our obligations; however, see Risk Factors Risks Arising from our Capital Structure We may be unable to raise additional capital necessary to implement our business plan and to meet our debt payments and our obligations under the settlement we entered into with the United States Department of Justice. The terms of our indentures and our credit facility restrict our ability to engage in some of these transactions.

We may still be subject to corporate level taxes.

Following our REIT election, we are considered to be a former C corporation for income tax purposes. Therefore, potentially, we remain subject to corporate level taxes for any asset dispositions occurring between January 1, 1999 and December 31, 2008. The Internal Revenue Service is currently reviewing our federal tax returns for tax years ended December 31, 1997 and 1998 and may also review our federal tax returns for subsequent years. On September 25, 2002, we agreed to the IRS Revenue Agent s report quantifying the examination findings in connection with the 1997 and 1998 income tax periods. This report concludes that pending final review by the Joint Committee of Taxation, we do not owe any additional taxes, and are entitled to an additional refund of $1.2 million, for the period in question, which $1.2 million would be deposited into a joint tax escrow account between us and Kindred. Until the review of the Joint Committee of Taxation is final, however, there can be no assurance as to the ultimate outcome of these matters or whether that outcome will significantly harm us and our ability to service our indebtedness and other obligations and to make distributions to our stockholders, as required to continue to qualify as a REIT.

However, if there are any resulting tax liabilities for the tax years ended December 31, 1997 and 1998, we intend to use the net operating loss, or NOL, carryforwards, if any (including the NOL carryforwards that were utilized to offset our federal income tax liability for 1999 and 2000), to satisfy those tax liabilities. If the tax liabilities exceed the amount of NOL carryforwards, then we will use the escrowed amounts under the tax refund escrow agreement we entered into when Kindred emerged from bankruptcy to satisfy the remaining tax liabilities. As of November 29, 2002, $29 million was escrowed under the tax liability escrow agreement. To the extent that NOL carryforwards and escrowed amounts are not sufficient to satisfy the tax liabilities, Kindred has indemnified us for specific tax liabilities and Kindred has assumed these obligations under the tax refund escrow agreement. There can be no assurance that the NOL carryforwards and the escrowed amounts will be sufficient to satisfy these liabilities, that Kindred has any obligation to indemnify us for particular tax liabilities, that Kindred will have sufficient financial means to enable it to satisfy its indemnity obligations under such tax refund escrow agreement or that Kindred will continue to honor its indemnification obligations.

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We may jeopardize our REIT status if we violate the 10% securities test or the 5% asset test because of the value of the Kindred common stock.

We lease substantially all of our properties to Kindred and Kindred is the primary source of our rental income. Under Kindred s plan of reorganization, we received 1,498,500 shares of Kindred common stock on April 20, 2001 as future rent. We sold 83,300 of those shares of Kindred common stock on November 14, 2001 through an underwritten offering, and distributed 334,886 shares of Kindred common stock as part of the 2001 dividend. During the nine months ended September 30, 2002, we disposed of a total of 159,500 shares of Kindred common stock. Consequently, as of November 29, 2002 we owned 920,814 shares of Kindred common stock. If we violated or violate the 10% securities test described below under the heading Material United States Federal Income Taxation Considerations, Kindred would be a related party tenant and consequently, the rents from Kindred would not qualify as rents from real property under the tax code. As a result, we would lose our REIT status because we likely would not be able to satisfy either the 75% or the 95% gross income test also described below under the heading Material United States Federal Income Taxation Considerations.

In addition, if our shares of Kindred common stock exceed 10% of the voting power or value of Kindred s outstanding stock or if the value of our shares of Kindred common stock exceeds 5% of the value of our total assets at the end of the quarter in which we received the Kindred common stock or at the end of any subsequent quarter (except where such excess in subsequent quarters is caused by value fluctuations of our various investments and not by the acquisition or disposition of assets), we would violate the 10% securities test or the 5% asset test. Consequently, we would lose our REIT status unless we cured the violation in a timely manner under the applicable provisions of the Code. There can be no assurance that relief for such a violation would be available. See Material United States Federal Income Taxation Considerations.

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USE OF PROCEEDS

We estimate that we will receive approximately $99.0 million in gross proceeds from this offering ($93.1 million in net proceeds, after deducting approximately $5.9 million in underwriting discount and our estimated net expenses), based upon a public offering price of $11.00 per share.

We intend to use the net proceeds from this offering to reduce the amounts outstanding under the revolving line of credit portion of our credit facility and/or retire a portion of our long-term indebtedness. We may invest the proceeds of the offering in short-term investments pending such application of the net proceeds.

Our credit facility is secured by liens on certain of our properties and consists of a $60 million term loan and a $290 million revolving line of credit. Borrowings under the revolving line of credit currently bear interest at a spread of 2.75% over LIBOR per annum, although the credit facility offers us other interest rate options, and must be repaid in full by April 17, 2005. As of November 29, 2002, our revolving line of credit had an outstanding balance of $214 million with an effective interest rate of 4.42% per annum, excluding the effect of the related interest rate swap agreement.

Our senior notes consist of $175 million in aggregate principal amount of unsecured senior notes due May 1, 2009 bearing interest at 8¾% per annum and $225 million in aggregate principal amount of unsecured senior notes due May 1, 2012 bearing interest at 9% per annum.

We entered into our current credit facility on April 17, 2002 and concurrently completed the offering of our senior notes. We used borrowings under our current credit facility and the net proceeds of the senior note offering to repay all outstanding indebtedness under our prior credit facility and to pay breakage costs for the partial termination of the associated interest rate swap agreement.

The estimated proceeds shown above do not reflect the underwriters exercise of their over-allotment option. If the underwriters exercise their over-allotment option in full, we will receive additional estimated net proceeds of approximately $8.6 million based on a public offering price $11.00 per share.

We will not receive any of the proceeds from the sale of common stock by the selling stockholders.

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CAPITALIZATION

The following table shows our capitalization:

on an actual basis:

on an as adjusted basis to give effect to our transaction with THI described under Prospectus Supplement Summary Recent Developments, as if that transaction had been completed on September 30, 2002; and

on an as adjusted basis to give effect to our transaction with THI and the sale of the common stock offered by this prospectus supplement based upon a public offering price of $11.00 per share and underwriting discount and estimated net offering expenses of approximately $5.9 million and the use of $93.1 million of estimated net proceeds for the purposes described under Use of Proceeds above, as if these transactions had been completed on September 30, 2002.

You should read this table in conjunction with our historical consolidated financial statements and the other financial and statistical information that are included or incorporated by reference in this prospectus supplement and the accompanying prospectus.

	As of September 30, 2002		
	Actual	As Adjusted for THI Transaction(1)	As Adjusted for THI Transaction(1) and this Offering
	(dollars in thousands)		(unaudited)
Cash and Cash Equivalents	$ 4,121	$ 4,121	$ 4,121
Debt			
Term loan	$ 59,850	$ 59,850	$ 59,850
CMBS loan	223,274	223,274	223,274
Other long-term debt (2)	502,800	620,700	527,640
Total debt	785,924	903,824	810,764
Stockholders Equity			
Preferred stock, 10,000,000 shares authorized, no shares issued and outstanding			
Common stock and paid in capital, $.25 par value per share, 180,000,000 shares authorized, 69,668,026, 69,668,026 and 78,668,026 shares issued and outstanding	123,717	123,717	216,777
Accumulated other comprehensive income (loss)	(10,232)	(10,232)	(10,232)
Retained earnings (deficit)	(127,126)	(127,126)	(127,126)
Other	(1,155)	(1,155)	(1,155)
Treasury stock	(110,829)	(110,829)	(110,829)
Total stockholders equity (deficit)	(125,625)	(125,625)	(32,565)
Total Capitalization	$ 660,299	$ 778,199	$ 778,199

(1) On November 5, 2002, we completed the THI transaction. The THI transaction was funded through additional borrowings under the revolving line of credit portion of our credit facility. The net amount funded is computed as follows:

Gross Transaction	$ 120,000
Origination Fees Collected	(2,100)
Net Amount Funded	$ 117,900

(2) Includes the revolving line of credit portion of our credit facility and our senior notes.

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PRICE RANGE OF OUR COMMON STOCK AND DISTRIBUTIONS

Our common stock is listed and traded on the New York Stock Exchange under the symbol VTR. The following table sets forth the high and low sale prices for the indicated periods, as reported by the New York Stock Exchange and distributions declared per share of our common stock.

	Price Per Share		Distributions Declared Per Share
	High	Low	
2000			
First Quarter	$ 4.25	$ 2.6875	$
Second Quarter	$ 4.25	$ 3.125	$
Third Quarter	$ 5.8125	$ 3.25	$ 0.62
Fourth Quarter	$ 5.75	$ 4.3125	$ 0.29
2001			
First Quarter	$ 8.62	$ 5.5625	$ 0.22
Second Quarter	$ 11.02	$ 8.50	$ 0.22
Third Quarter	$ 12.85	$ 10.14	$ 0.22
Fourth Quarter	$ 12.80	$ 10.75	$ 0.26(1)
2002			
First Quarter			

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)
(UNAUDITED)

The following is a schedule of future maturities of long-term debt:

For the Month Ending June 30, 2003	
2004	$ 1,170,675
2005	$ 875,979
2006	$ 884,126
2007	$ 907,014
2008	$ 164,192
Thereafter	$ 71,016

The revolving lines of credit and bank notes payable are owed to the Company s primary lending bank and are secured by substantially all of the assets of the Company. They have also been personally guaranteed by an officer of the Company.

(1) On February 24, 2003, the Company entered into a forbearance agreement with two shareholders of acquired businesses extending $100,000 each of the principal payments due, under the original promissory note, on January 22, 2003 until June 30, 2003 and September 30, 2003. Interest at 9% under the terms of the original note continues to be payable quarterly. In the event that principal payments are not made when due, a penalty of 5.25% of the outstanding unpaid principal will be assessed and, in addition, interest will default to a rate of 12% per annum until past due amounts are paid. See Note 15 of the Notes to Consolidated Financial Statements.

(2) As of June 30, 2003, the Company was in arrears in interest payments in the amount of $12,742.

(3) As of June 30, 2003, the Company was in arrears in interest payments in the amount of $1,320.

(4) As of June 30, 2003, the Company was in arrears in interest payments in the amount of $4,217.

Note 11 Related Party Transactions

On January 30, 2003, CESI Chemical (CESI), a Flotek Industries, Inc. company, entered into an agreement with Stimulation Chemicals, LLC (SCL) for the purchase of various raw materials from CESI Chemical suppliers under deferred payment terms. SCL will procure the raw materials as ordered by CESI granting CESI 120 day payment terms for a percent markup on established supplier prices up to a purchase value of $500,000. SCL invoices not paid by CESI within 120 days will bear interest at 1% per month. SCL is owed $480,056 as of June 30, 2003. SCL is owned jointly by Dr. Penny and Mr. Beall, whom are both directors of Flotek Industries, Inc. Dr. Penny is also an employee of the Company.

As of June 30, 2003, the Company was in arrears in interest payments to SCL in the amount of $1,087.

On February 11, 2003, Mr. Dumas, Chairman of the Board and Chief Executive Officer, made a short-term loan to the Company for $135,000 to cover operating cash flow requirements. This note bears interest at 6% annually. As of June 30, 2003, the current balance of the note payable to Mr. Dumas was $115,000. Additional amounts owed to Mr. Dumas as of June 30, 2003 total $141,158 for various operational loans bearing interest of 10% annually.

Note 12 Stock-Based Compensation

The Company recognizes compensation expense associated with stock-based awards under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations. The difference between the quoted market price as of the date of the grant and the contractual purchase price of shares is charged to operations over the vesting period. No compensation cost has been recognized for stock options with fixed exercise prices equal to the market price of the stock on the dates of grant. Pro forma net loss and loss per share disclosures as if the Company recorded compensation expense based on the fair value for stock-based awards have been presented in accordance with the provisions of Statement of Financial Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No.

148, "Accounting for Stock-Based Compensation Transition and Disclosure", and are as follows:

	Three Months Ended June 30, 2003	Three Months Ended June 30, 2002	Six Months Ended June 30, 2003	Six Months Ended June 30, 2003
Net loss from continuing operations:				
As reported	$ (291,087)	$ (427,837)	$ (213,738)	$ (384,786)
Stock-based employee compensation expense determined under fair value-based method	57,078	--	57,078	--
Pro forma	$ (348,165)	$ (427,837)	$ (270,816)	$ (384,786)
Basic and diluted loss per share of common stock:				
As reported	(0.05)	(0.09)	(0.04)	(0.08)
Pro forma net loss	(0.06)	(0.09)	(0.05)	(0.08)

The fair value of each option is estimated at the date of grant using the Black-Scholes option pricing model, as determined with the assistance of a third-party appraiser, with the following assumptions for 2003: expected volatility of 50%; risk-free interest rate of 4.04%; and expected lives of 10 years. The fair value as determined on the date of the grant (April 3, 2003) was $.39 per common share.

On April 3, 2003, a stock grant of 125,000 shares was awarded to Mr. Jerry D. Dumas, Sr., Chairman and CEO of the Company. This award resulted in $75,000 of compensation expense.

Note 13 Net Income (Loss) Per Common Share

Net income (loss) per common share is calculated by dividing net income (loss) attributable to common stockholders by the weighted average number of common shares outstanding. Diluted income (loss) per share is calculated by dividing net income (loss) attributable to common stockholders by the weighted average number of common shares and dilutive potential common shares outstanding. The dilutive effect of stock-based compensation and stock options is computed using the treasury stock method. The number of potentially dilutive securities for the three and six months ended June 30, 2003 was 144,136 shares. The potentially dilutive securities for the three and six months ended June 30, 2003 were not included in the computation of diluted earnings per share, since to do so would have been antidilutive due to our net loss position.

FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)
(UNAUDITED)

Note 14 Segment Information

The Company s product lines are divided into three segments within the oilfield service industry:

The Specialty Chemicals segment develops, manufactures, packages and sells chemicals used by other oilfield service companies in oil and gas well cementing, stimulation and production.

The Equipment Manufacturing segment designs, constructs and manages automated bulk material handling and loading facilities for other oilfield service companies.

The Downhole Equipment segment manufactures and markets the Petrovalve line of downhole pump components and the Turbeco line of casing centralizers.

The Company s reportable segments are strategic business units that offer different products and services. Each business segment requires different technology and marketing strategies and is managed independently. The accounting policies used in each of the segments are the same as those described in the significant accounting policies disclosed in Form 10-KSB for the year ending December 31, 2002. The Company evaluates the performance of its operating segments based on operating income excluding unusual charges. Intersegment sales and transfers are not material.

The following table presents the revenues and operating income by business segment and on a comparable basis:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2003
Revenues:				
Specialty Chemicals	$ 2,610,234	$ 1,597,409	$ 4,677,420	$ 2,900,339
Equipment Manufacturing	436,857	593,761	1,067,017	1,076,001
Downhole Equipment	570,778	686,570	1,201,877	1,933,055
Consolidated	$ 3,617,869	$ 2,877,740	$ 6,946,314	$ 5,909,395
Income (loss) from operations:				
Specialty Chemicals	$ 432,224	$ 148,698	$ 726,826	$ 260,732
Equipment Manufacturing	(26,430)	18,501	112,037	88,490
Downhole Equipment	(6,585)	(57,840)	85,845	396,669

	Three Months Ended June 30,		Six Months Ended June 30,	
Corporate and Other	(520,345)	(381,426)	(839,316)	(902,102)
Consolidated	$ (121,136)	$ (272,067)	$ 85,392	$ (156,211)

FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) (UNAUDITED)

Note 15 Subsequent Events

On July 28, 2003, the February 24, 2003 forbearance agreements with two shareholder s of acquired businesses were modified to defer the payments due on June 30, 2003 and September 30, 2003, respectively, to not later than December 31, 2003 and January 22, 2004, respectively with no interest penalty. All other due dates for payments set forth are extended one (1) year from the original due date specified in these notes.

On August 1, 2003, the primary bank lender revolving lines of credit totaling $3,023,151 became due. Except for a borrowing base deficiency of approximately $258,000 these loans are performing as all interest payments are current as of this filing. The primary lender has not indicated, as of this filing, that they will not renew these lines of credit.

On August 6, 2003, the Company was in default on a $500,000 promissory note to Oklahoma Facilities LLC (Facilities). This note is secured by an account receivable from the Company s major customer in Venezuela which has not been paid by that customer. The note was due on the earlier of collection of the pledged accounts receivable or August 1, 2003. Interest and principal payments totaling $48,270, as of June 30, 2003 have not been paid on this obligation. An officer of the Company has a minority interest in and is an officer of Facilities. The Company is in negotiations with Facilities to remedy the default.

As of August 12, 2003, the Company had received, subsequent to June 30, 2003, $175,000 from accredited investors for purchase of common stock. These proceeds were used for operating cash flow.

As of July 31, 2003 an employment agreement with a former shareholder of MTI and employee of the Company was terminated. This negates any further obligation for additional shares of common stock of the Company as mentioned in Note 2 of the Notes to Consolidated Financial Statements.

On August 12, 2003 an asset purchase agreement was signed with Special Equipment Manufacturing, Inc. (SEM) for the purchase of certain Equipment Specialties Division (ES) equipment and assets used in the discontinued business. Operations of the business were assumed

by SEM on August 1, 2003. The initial sale proceeds from this transaction total approximately $225,000. Dr. Penny, an employee and director of Flotek Industries, Inc., is a majority owner and director of SEM.

Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

Business Overview

Flotek was established in 1985 and is currently traded on the OTC Bulletin Board market. On October 31, 2001, the Company completed a Merger with Chemical & Equipment Specialties, Inc. (CESI). The Merger has been accounted for as a reverse acquisition using the purchase method of accounting. In the Merger, the shareholders of the acquired company, CESI, received the majority of the voting interests in the surviving consolidated company. Accordingly, CESI was deemed to be the acquiring company for financial reporting purposes and the historical financial statements of the Company are the historical financial statements of CESI. All of the assets and liabilities of Flotek were recorded at fair value on October 31, 2001, the date of the Merger, and the operations of Flotek have been reflected in the operations of the combined company only for periods subsequent to the date of the Merger.

CESI was incorporated on June 27, 2000 to acquire businesses in the specialty chemical and equipment manufacturing segments of the oilfield service industry. It had no revenues or operations prior to the acquisitions of Esses, Inc., Plainsman Technology, Inc., Neal s Technology, Inc., and Padko International, Inc. in January 2001. It subsequently acquired Material Translogistics, Inc. in June 2001. These five companies are referred to collectively as the CESI Acquired Businesses .

The Company s product lines are divided into three segments within the oilfield service industry:

The Specialty Chemicals segment develops, manufactures, packages and sells chemicals used by other oilfield service companies in oil and gas well cementing, stimulation and production.

The Equipment Manufacturing segment designs, constructs and manages automated bulk material handling and loading facilities for other oilfield service companies.

The Downhole Equipment segment manufactures and markets the Petrovalve line of downhole pump components and the Turbeco line of casing centralizers.

All of the Company s businesses serve the oil and gas industry and are affected by changes in the worldwide demand for and price of oil and natural gas. The majority of our products are dependent on the level of

exploration and development activity and the completion phase of oil and gas well drilling. Other products and services, such as our Petrovalve downhole pump products and a small number of our specialty chemicals are more closely tied to the production of oil and gas and are less dependent on drilling activity.

The oil and gas industry has continued to improve in 2003. Oil and gas commodity prices have remained strong and the U.S. rig count, as measured by Baker Hughes Incorporated, has continued to strengthen throughout the year. Having begun the year at 837 rigs, the count increased to 962 active rigs at the beginning of the second quarter and is currently at 1,097 rigs. This activity has been underpinned by demand for natural gas required to refill storage, which is still 20% below 2002 levels despite near record levels of injections. Natural gas and crude oil prices have remained strong through the second quarter. The current 12-month strip for natural gas is $4.85/MCF, up from $4.10 in 2002. Although crude prices have softened somewhat since the start of the Iraq war, wellhead and futures prices are still strong with the 12-month strip at $28.61. Our business will continue to benefit from these oil and gas commodity prices and the increase in drilling activity as we have seen in the second quarter.

On June 27, 2003, the Company announced its intentions to divest its Equipment Specialties Division located in Duncan Oklahoma. Company expects to finalize the sale of this division during the third quarter of 2003. The estimated proceeds from the sale are approximately $255,000 and the estimated loss on disposal is approximately $1,158.0 thousand. The loss on disposal is recorded separately on the Consolidated Statement of Operations. Adjustments to the estimated loss, if any, will continue to be recorded through the date on which the transaction closes.

The Equipment Specialties Division is accounted for as a discontinued operation and therefore, the results of operations have been removed from the company s results of continuing operations for all periods presented in this document.

Results of Operations

	Six Months Ended June 30,	
	2003	2002
Revenues	$ 6,946,314	$ 5,909,395
Cost of revenues	4,295,554	3,487,013
Gross margin	2,650,760	2,422,382
Gross margin %	38.2%	41.0%
Selling, general and administrative	2,220,977	2,284,293
Depreciation and amortization	303,704	228,872
Research and development	40,687	65,428
Total expenses	2,565,368	2,578,593

	Six Months Ended June 30,	
Operating income (loss)	85,392	(156,211)
Operating income (loss) %	1.2%	(2.6)%
Interest expense	(300,906)	(228,745)
Other income, net	1,776	170
Other expense, net	(299,130)	(228,575)
Loss from continuing operations	$ (213,738)	$ (384,786)

Total revenues increased by $1,036,919 or 17.5% in the first six months of 2003 compared to the same period in 2002. As discussed in the segment analysis that follows, the Specialty Chemicals segment produced this increase in revenues in 2003 compared to 2002. The Equipment Manufacturing segment, which now excludes the discontinued operating results for Equipment Specialties, please refer to Note 3 of the Notes to Consolidated Financial Statements, was essentially flat between periods, while the Downhole Equipment segment had significantly lower revenues in the first half of 2003 compared to the same period in 2002 due to the Petrovalve line of downhole pump components.

On an aggregate basis, the gross margin as a percentage of revenues decreased from 41.0% in 2002 to 38.2% in 2003. The gross margin is best analyzed on a segment by segment basis, discussed below, as the margin varies significantly between operating segments and can vary significantly from period to period in certain of our operating segments. Gross margin for 2003 and 2002 also includes approximately $686,526 and $209,071; respectively, of selling, general and administrative (SG&A) costs that are considered direct overhead expenditures of providing sales and service. These reclassified costs reduced gross margin as a percentage of revenue for 2003 and 2002 by 10% and 4%; respectively.

SG&A represents the costs of selling and general and administrative expenses not directly attributable to products sold or services rendered. The revenues from services are less than 10% of consolidated revenues and the direct costs of providing these services are included in the cost of revenues. SG&A amounted to 32.0% of revenues in 2003, which is 6.7% lower than 2002, which was 38.7% of revenues. Significant emphasis and effort has been placed on reducing SG&A costs and these costs have decreased between comparable first half year periods for 2003 and 2002 from $2,284,293 for the first six months of 2002 to $2,220,977 for the first six months of 2003. Further reduction of SG&A is possible with respect to legal fees, once the patent litigation suit as described in Part II Item 1 is settled.

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Depreciation and amortization expense increased $74,832 or 32.7% in the first half of 2003 compared to the same period in 2002. All of this increase is due to depreciation associated with the approximate $1.1 million capital investment at the MTI transload facility in Raceland, Louisiana.

Interest expense increased $72,161 or 32.7% in the first half of 2003 compared to the same period in 2002. The average amount of outstanding debt under the Company s credit agreements and related party debt was significantly higher in 2003 as a result of the financing of capital expenditures and increased working capital needs between periods. The majority of the Company s indebtedness carries a variable interest rate tied to the prime rate and is adjusted on a quarterly basis. This variable rate has been falling for the last several quarters.

Loss from discontinued operations decreased $575,617 or 54% in the first six months of 2003 as compared to the same period in 2002. The net loss reflected in 2002 contains approximately $700,000 worth of warranty work provided during that time.

Results by Segment

Specialty Chemicals

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2003
Revenues	$ 2,610,234	$ 1,597,409	$ 4,677,420	$ 2,900,339
Gross margin	$ 839,183	$ 555,037	$ 1,468,945	$ 929,361
Gross margin percentage	32.1%	34.7%	31.4%	32.0%
Operating income	$ 432,224	$ 148,698	$ 726,826	$ 260,732
Operating margin percentage	16.6%	9.3%	15.5%	9.0%

Specialty Chemical revenues increased $1,777,081 or 61.3%, in the first six months of 2003 compared to the same period in 2002. Sales in this segment are heavily dependent on drilling activity and this increase is attributable to a 28% increase in drilling activity in the second quarter of 2003 compared to 2002, as well as market penetration in the US, Canada and Mexico and the addition of environmentally friendly chemicals to the product offering.

The gross margin in this segment slightly decreased from 32% for the first six months of 2002 to 31.4% for the same comparable period in 2003. The majority of this margin reduction is due to increased product costs on select products that we have not been able to pass on to the customer. Approximately one half of this increased cost occurred in the second quarter of 2003 and is directly related to the reduced margins of 2.6%, from 34.7% for the second quarter of 2002 to 32.1% for the second quarter of 2003. We expect margins in this segment to be somewhat lower than last year until we are able to curtail or stop the added product costs associated with a related party procurement arrangement. Reference Note 11 of the Notes to Consolidated Financial Statements. Gross margin for 2003 and 2002 also includes approximately $346,511 and $105,242, respectively, of reclassified overhead costs that are considered direct costs of providing sales and service.

Operating income increased $466,094 or 178.8%, in the first six months of 2003 compared to the same period in 2002, primarily as a result of increased revenues and gross margins between periods. This segment has very good operating leverage from revenue growth as evidenced by the $466,094 increase in operating income yielding 26% of the $1,777,081 revenue increase between periods. SG&A and other costs of operations were kept in line with increased levels of activity.

Operating results for the second quarter of 2003 compared to the same period in 2002, were higher for much of the same reasons mentioned above regarding the first six months of 2003.

Equipment Manufacturing

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2003
Revenues	$ 436,857	$ 593,761	$ 1,067,017	$ 1,076,001
Gross margin	$ 158,931	$ 216,047	$ 456,128	$ 404,472
Gross margin percentage	36.4%	44.0%	42.7%	37.6%
Operating income (loss)	$ (26,430)	$ 18,501	$ 112,037	$ 88,490
Operating margin percentage	(6.1)%	3.1%	10.5%	8.2%

As discussed in Note 3 of the Notes to Consolidated Financial Statements, the Equipment Specialties reporting unit, which designed, manufactured and rebuilt specialized cementing and stimulation equipment, including heavy vehicles used for pressure pumping, blending and bulk material transport, is being discontinued with assets held for sale. The remaining operations in this segment consist of the MTI reporting unit which designs, constructs and manages automated bulk material handling and loading facilities for other oilfield service companies. The Equipment Manufacturing segment comparative financial information above relates only to the MTI reporting unit.

Equipment Manufacturing revenues were essentially flat between the first six months of 2003 compared to the same period for 2002. Increased revenues from opening the bulk material transload facility at Raceland, Louisiana essentially offset reduced revenues from the design and construction of bulk material handling facilities. Contract awards for bulk material handling facilities have declined significantly over the past twelve months due to a lack of customer capital spending and working capital limitations at Flotek Industries, Inc. which limited some customer projects to project management versus lump sum.

Gross margin percentage increased from 37.6% in the first six months of 2002 to 42.7% in the same comparable period for 2003 or 5.1%. This improvement was essentially due to product mix. Gross margin contributed by the bulk material transload facility at Raceland, Louisiana was 8.7% higher than margins contributed by the bulk material facility design and construction portion of this segment. Gross margin, as a percent of revenue, for the bulk material design and construction portion was essentially flat between the first six months of 2003 compared to the first six months of 2002. For 2003 and 2002, gross margin also includes approximately $339,985 and $103,829; respectively, of reclassified overhead costs that are considered direct overhead costs of providing sales and service.

Operating income increased $23,547 or 26.6% in the first six months of 2003 compared to the same period in 2002. This modest improvement is due to the higher margins contributed by the bulk material transload facility and a reduction of SG&A costs between reporting periods for this segment.

Operating results for the second quarter of 2003 compared to the same period in 2002 were lower due to a significant decrease in revenue and

gross profit from bulk material facility design and construction projects. There will not be a significant emphasis on growing this business in the second half of 2003 due to working capital constraints and the higher risk of managing these projects.

Downhole Equipment

	Three Months Ended June 30, 2003	Three Months Ended June 30, 2002	Six Months Ended June 30, 2003	Six Months Ended June 30, 2003
Revenues	$ 570,778	$ 686,570	$ 1,201,877	$ 1,933,055
Gross margin	$ 336,620	$ 325,117	$ 725,687	$ 1,088,549
Gross margin percentage	59.0%	47.4%	60.4%	56.3%
Operating income (loss)	$ (6,585)	$ (57,840)	$ 85,845	$ 396,669
Operating margin percentage	(1.2)%	(8.4)%	7.1%	20.5%

Downhole Equipment revenues decreased $731,178 or 37.8% in the first six months of 2003 compared to the same period in 2002. This significant decrease is due to reduced sales for the Petrovalve line of downhole pump components as the Turbeco line of casing centralizers has increased 129.5% between years. Petrovalve sales in the first six months of 2002 totaled $1,442,104 and were almost exclusively to one customer in Venezuela. As more fully discussed in Note 4 of the Notes to Consolidated Financial Statements and the Capital Resources and Liquidity section that follows, this customer has not paid for these goods within the customary payment terms. Sales to the Venezuela customer stopped after April 2002 due to political unrest in that country. In addition, oil and gas production workers went on strike in Venezuela in December 2002 further limiting use of tools previously sold. The strike has ended and production is approaching and/or exceeding pre-strike levels. We are optimistic that the customer will begin using our products previously sold but we do not foresee additional large sales to this country in 2003.

Gross margin percentage increased 4.1% from 56.3% in 2002 to 60.4% in 2003. This increase is due to the Turbeco line of casing centralizers. This reporting unit has contributed 92.4% of the gross margin for this reporting segment in the first six months of 2003 compared to the same period in 2002 at significantly improved margins over 2002. The Petrovalve line of downhole pump components did not contribute significantly to the operating results for this segment in the first six months of 2003 due to a lack of significant sales to international customers.

Operating income decreased $310,824 or 78.4% in the first six months of 2003 compared to the same period in 2002. This was due to the significant decline in revenue and gross profit for Petrovalve sales to international customers. SG&A expenses were lower for this segment, between periods, by approximately $60,000 but were not reduced further as we expect improved operating results for this segment in 2003. The Turbeco line of casing centralizers has shown significant improvement over the last several quarters and is now a significant profit contributor to this segment. We expect this reporting unit to continue to grow and produce positive operating results as drilling activity for 2003 continues to improve.

Operating results for the second quarter of 2003 compared to the same period in 2002 improved from an operating loss of ($57,840) in the first six months of 2002 to a reduced loss of ($6,585) in the same comparable period for 2003. This improvement is entirely due to the improved operating results of the Turbeco line of casing centralizers.

Capital Resources and Liquidity

In the first six months of 2003, the Company produced a loss from continuing operations of $213,738 and had positive cash flow from continuing operations of $209,099. The loss is the result of lower operating results for the Equipment Manufacturing segment, and higher SG&A and interest costs in the second quarter of 2003 compared to the first quarter of 2003. The positive cash flow from continuing operations is a result of minimal working capital requirements to grow operations in the first half of 2003 primarily for the Specialty Chemical segment and the Turbeco reporting unit which is part of the Downhole Equipment segment.

As of June 30, 2003, net working capital was a negative $4,660,141, resulting in a current ratio of .55 to 1. Accounts receivable have increased due to higher levels of activity for the Specialty Chemical segment and the Turbeco reporting unit which is part of the Downhole Equipment segment during the first six months of 2003. In addition, amounts due to related parties has increased $655,322 during the first six months of 2003 primarily due to an agreement between CESI Chemical (CESI), a Flotek Industries, Inc. company, and Stimulation Chemicals, LLC (SCL), owned by two directors of the Company, for the purchase of various raw materials from CESI chemical suppliers under deferred payment terms. See Note 11 of the Notes to Consolidated Financial Statements.

Cash and cash equivalents are $0.00 at June 30, 2003. As discussed in Notes 9, 10 and 11 of the Notes to Consolidated Financial Statements, several short-term financing arrangements have been made to help the Company s working capital requirements until operating cash flows improve. Overall, the level of business activity is increasing and cash flow from operations is improving, but cash flow is still tenuous.

As discussed in Note 4 of the Notes to Consolidated Financial Statements, at June 30, 2003, the Company had approximately $1,227.0 thousand of accounts receivable from a customer in Venezuela, all of which arose from goods shipped in the first half of 2002. As a result of political instability and work disruptions in the country, these amounts have not been paid within the customary payment terms for this customer. The ultimate customer for these goods is PDVSA, the national oil company of Venezuela. Our customer holds a contract to deliver over $5 million of our proprietary products to PDVSA during the next three years. However, PDVSA has delayed acceptance of the majority of the goods shipped due to the recent political unrest and oil and gas industry work curtailment in Venezuela. The $1,227.0 thousand has not been shipped to the end customer (PDVSA). Our contacts within PDVSA inform us that our product will be needed as they begin to ramp up oil production. We believe the product will eventually be shipped to PDVSA but we cannot predict when. Thus, we have established a reserve for doubtful

accounts for $878.0 thousand, the portion that we believe to be unrealizable if the product is not ultimately delivered to PDVSA. We fully expect, once PDVSA accepts the product, that they will pay, as they have in 2002, within their customary payment terms. The delay in collecting this accounts receivable has had a significant adverse effect on the cash flow of the Company.

Accounts payable and accrued expenses increased $679,711 during the first six months of 2003. This increase is primarily due to increased litigation payables and Equipment Specialties Division payables retained by the Company on jobs completed or in process that were not held for sale.

On February 28, 2002, the Company sold its rights and obligation to purchase the land and buildings covered by a capital lease obligation, together with capital improvements to the property totaling approximately $750,000 to Oklahoma Facilities, LLC (Facilities). An officer of the Company has a minority investment interest in and is an officer of Facilities. This transaction resulted in net cash proceeds to the Company of $761,000. The Company simultaneously entered into an agreement to lease back the facility over ten years. As of June 30, 2003, lease payments totaling $74,500 have not been paid on this indebtedness due to cash flow constraints. This transaction has been recorded as a capital lease as discussed in Note 8 of the Notes to Consolidated Financial Statements and is also included in Liabilities Discontinued Operations as referenced in Note 3 of the Notes to Consolidated Financial Statements.

Compensation expense of $75,000 was recorded as a result of a 125,000 stock grant awarded to Mr. Jerry D. Dumas, Sr., Chairman and CEO of the Company.

In May 2003, the Company issued 166,666 shares of its common stock in a private offering to accredited investors in exchange for $100,000 of subscription proceeds, which was paid by the tender to the Company of $100,000 in cash. These proceeds were used for operating cash flow. See Note 15 of the Notes to Consolidated Financial Statements.

The Company has borrowed $319,993 in the first six months on 2003 under its line of credit arrangements, including an approximate $200.0 thousand refinance of the construction loan for the Material Translogistics transload facility in Raceland, Louisiana. In addition, as discussed in Note 10 of the Notes to Consolidated Financial Statements, on February 24, 2003, the Company entered into a forbearance agreement with two shareholders of acquired businesses extending $100,000 each of principal payments due, under the original promissory notes, on January 22, 2003 until June 30, 2003 and September 30, 2003. Interest at 9% under the terms of the original note continues to be payable quarterly. In the event that principal payments are not made when due, a penalty of 5.25% of the outstanding unpaid principal will be assessed and in addition, interest will default to a rate of 12% per annum, until past due amounts are paid.

On July 28, 2003, the February 24, 2003 forbearance agreement was modified to defer the $50,000 payment due June 30, 2003 to on or before December 31, 2003 and the $50,000 payment due September

30, 2003 to January 22, 2004, with no interest penalty. All other due dates for payments set forth in the Promissory Notes are extended one (1) year from the original due date specified in the Promissory Notes.

As of August 12, 2003, the revolving lines of credit, totaling $3,023,151 and secured by accounts receivable and inventory due August 1, 2003 have not been renewed by the lender. The Company has borrowings which have exceeded its eligible asset base by $258,299 at June 30, 2003. The Company is current as of August 14, 2003 on all interest payments associated with this revolving line of credit. We expect these lines to be renewed by the bank during August 2003 business. See Note 9 of the Notes to Consolidated Financial Statements.

On August 6, 2003, the Company was in default on a $500,000 promissory note to Oklahoma Facilities LLC (Facilities). As discussed in Note 9 of the Notes to Consolidated Financial Statements, this note is secured by an account receivable from the Company s major customer in Venezuela which has not been paid by that customer. The note was due on the earlier of collection of the pledged accounts receivable or August 1, 2003. Interest and principal payments totaling $48,270 as of June 30, 2003, have not been made on this obligation. An officer of the Company has a minority investment in and is an officer of Facilities. The Company is in negotiations with Facilities to remedy the default.

The Company made debt service payments of $225,602 during the first six months of 2003. The company has estimated minimum debt service payments in 2003 of $1.6 million. This includes minimum principal and interest payments on Related Party indebtedness, Notes Payable, and Long-Term Debt as discussed in Notes 9, 10 and 11 of the Notes to Consolidated Financial Statements.

Capital expenditures in the first six months of 2003 totaled $296,259. These expenditures were primarily for additional improvements at the MTI transload facility in Raceland, Louisiana, and the purchase of a new financial software package and related hardware. The Company has an approved capital budget pool of $515,000 and anticipates using the majority of this pool during 2003 if business conditions continue to improve during the year.

The Company believes its operations are capable of generating sufficient cash flow to meet its debt service obligations if we successfully collect amounts due from our Venezuelan customer. However, the collection of these amounts, and certain other factors involved in executing our business strategy, are beyond our control. While the market we serve continues to steadily improve we believe the Company will need to raise additional capital through the sale of its debt or equity securities to provide the necessary cash flow to grow the business. There can be no assurance that the Company will be able to secure such financing on acceptable terms or raise the required equity.

Forward Looking Statements

Except for the historical information contained herein, the discussion in this Form 10-QSB includes forward-looking statements within the

meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. The words anticipate, believe, expect, plan, intend, project, forecast, could and similar expressions are intended to identify forward-looking statements. All statements other than statements of historical facts included in this Form 10-QSB regarding the Company s financial position, business strategy, budgets and plans and objectives of management for future operations are forward-looking statements. Forward-looking information involves risks and uncertainties and reflects our best judgment based on current information. Our results of operations can be affected by inaccurate assumptions we make or by known or unknown risks and uncertainties. In addition, other factors may affect the accuracy of our forward-looking information. As a result, no forward-looking information can be guaranteed. Actual events and the results of operations may vary materially.

While it is not possible to identify all factors, we continue to face many risks and uncertainties that could cause actual results to differ from our forward-looking statements including:

The Company is dependent on the oil and gas industry, and activity levels in the industry are volatile.

Oil and gas prices are volatile and have a direct impact on the spending levels of our customers.

Severe weather conditions, for example, hurricanes, can have a direct impact on activity levels in the affected areas, and oil and gas prices.

The oilfield service industry is highly competitive and we must compete with many companies possessing greater financial resources and better established market positions.

The introduction of new products and technologies by competitors may adversely affect the demand for our products and services.

The Company s debt service obligations may limit our ability to fund operations and capital spending or provide for future growth.

Changes in political conditions, governmental regulations, economic and financial market conditions, unexpected litigation and other uncertainties may have an adverse effect on our operations.

Item 4 Controls and Procedures

The Company s Chief Executive Officer and Chief Financial Officer (collectively, the Certifying Officers) are responsible for establishing and maintaining disclosure controls and procedures for the Company. Such officers have concluded (based upon their evaluation of these controls and procedures as of a date within 90 days of the filing of this report) that the Company s disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in this report is accumulated and communicated to the Company s management, including its principal executive officers as

appropriate, to allow timely decisions regarding required disclosure.

The Certifying Officers also have indicated that there were no significant changes in the Company s internal controls or other factors that could significantly affect such controls subsequent to the date of their evaluation.

Within the 90 days prior to the date of this Quarterly Report, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Primary Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rules 13a 14(c) and 15d 14 (c) under the Securities Exchange Act of 1934). Based upon the evaluation, the Chief Executive Officer and Primary Financial Officer concluded that the Company s disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There were no significant changes in the Company s internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. Previously noted weaknesses have been corrected.

PART II OTHER INFORMATION

Item 1 Legal Proceedings

Milam Tool Company and the Estate of Jack J. Milam vs. Flotek Industries, Inc., Turbeco, Inc. and Jerry D. Dumas, Sr., individually, C.A. No. H-02-1647 (Jury Demanded), in the United States District Court, Southern District of Texas, Houston Division.

On May 1, 2002, Milam Tool Company and the Estate of Jack J. Milam filed a complaint against Flotek Industries, Inc., Turbeco, Inc. and Jerry D. Dumas, Sr., individually, in the United States District Court for the Southern District of Texas, Houston Division. The complaint asserts that the sale of TURBO-LOK turbulators, which are part of the Company s Downhole Equipment segment, violates an agreement among the parties and infringes a United States patent controlled by the Plaintiffs. Plaintiffs seek injunctive relief and

unspecified damages. The Company has answered the complaint. The Company strongly denies the assertions in the complaint and intends to vigorously contest this matter.

Item 4 Submission of Matters to a Vote of Security Holders

On May 22, 2003, Flotek Industries, Inc. held an annual stockholder s meeting for purposes of considering and voting upon upon the following matters:

Election of Directors. The election of seven directors to serve until the next annual meeting of stockholders of the Company. Directors elected and votes cast were as follows:

Name	Votes For	Votes Against	Votes Withheld
Jerry D. Dumas, Sr.	3,934,809	-	1,586,861
Gary M. Pittman	3,951,839	-	1,569,831
Robert S. Beall	3,951,839	-	1,569,831
Barry E. Stewart	3,951,839	-	1,569,831
John W. Chisholm	3,950,925	-	1,570,745
Glenn S. Penny	3,951,839	-	1,569,831
William R. Ziegler	3,951,839	-	1,569,831

The above represents all directors of Flotek Industries, Inc.

2003 Long-Term Incentive Plan. This plan is intended to provide employees, directors, consultants and other individuals rendering services to or on behalf of Flotek Industries, Inc. (the Corporation) and /or one or more of its subsidiaries an opportunity to acquire an equity interest in the Corporation. The Corporation intends to use the Plan to link the long-term interests of the stockholders of the Corporation and Plan Participants, attract and retain Participants services, motivate Participants to increase the Corporation s value, and create flexibility in compensating Participants. The plan was approved as follows:

	Votes For	Votes Against	Votes Withheld
2003 Long-Term Incentive Plan	3,554,721	16,864	1,950,085

Item 6 Exhibits and Reports on Form 8-K

(a) Exhibits:

Index to Exhibits

Exhibit Number	Description of Exhibit

Exhibit Number		Description of Exhibit
10.1		Asset Purchase Agreement dated August 12, 2003 for equipment sale between Flotek Industries, Inc. and Special Equipment Manufacturing, Inc.
10.2	*	The revolving line of credit, totaling $1,609,115.31 due August 1, 2003. Reference Note 9 of the Notes to Consolidated Financial Statements. (This exhibit is incorporated by reference to the Company's Form 10-QSB filed with the Commission on August 14, 2002.)
10.3	*	The revolving line of credit, totaling $1,414,085.31 due August 1, 2003. Reference Note 9 of the Notes to Consolidated Financial Statements. (This exhibit is incorporated by reference to the Company's Form 10-KSB filed with the Commission on April 15, 2002).
10.4	*	Forbearance Agreement dated July 28, 2003 between John Todd Sanner and Flotek Industries, Inc., successor in interest of Chemical & Equipment Specialties, Inc. (This exhibit is incorporated by reference to the Company's Form 10-KSB filed with the Commission on April 15, 2002).
10.5	*	Forbearance Agreement dated July 28, 2003 between Earl E. Schott and Flotek Industries, Inc., successor in interest of Chemical & Equipment

Exhibit Number	Description of Exhibit
	Specialties, Inc. (This exhibit is incorporated by reference to the Company's Form 10-KSB filed with the Commission on April 15, 2002).
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	Certification of Periodic Report by Chief Executive Officer and Chief Financial Officer.

(b) Reports on Form 8-K

During the quarter ended June 30, 2003, the Company filed the following Current Reports on Form 8-K:

Exhibit Number		Description of Exhibit
(i)	*	Current Report on Form 8-K dated July 3, 2003 reporting under Item 5 - Other events, announcement of the Company's intention to divest its Equipment Specialties Division located in Duncan Oklahoma. (This exhibit is incorporated by reference to the Company's Form 8-K filed with the Commission on July 3, 2003).

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SIGNATURES

In accordance with the requirements of the Exchange Act, the Registrant caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 19, 2003

/s/ Mark D. Kehnemund

Mark D. Kehnemund
Chief Operating Officer & Chief Financial Officer