FLOTEK INDUSTRIES INC/CN/
Form 10-Q
August 06, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended June 30, 2014
or

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

For the transition period from to
Commission File Number 1-13270
FLOTEK INDUSTRIES, INC.
(Exact name of registrant as specified in its charter)

Delaware	90-0023731
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
10603 W. Sam Houston Parkway N., Suite 300 Houston, TX	77064
(Address of principal executive offices)	(Zip Code)

(713) 849-9911
(Registrant’s telephone number, including area code)

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

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

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

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

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

As of July 31, 2014, there were 53,921,233 outstanding shares of Flotek Industries, Inc. common stock, $0.0001 par value.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements
FLOTEK INDUSTRIES, INC.
UNAUDITED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	June 30, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$2,226	$2,730
Accounts receivable, net of allowance for doubtful accounts of $795 and $872 at June 30, 2014 and December 31, 2013, respectively	65,906	65,016
Inventories, net	82,231	63,132
Deferred tax assets, net	2,578	2,522
Other current assets	9,989	4,261
Total current assets	162,930	137,661
Property and equipment, net	82,392	79,114
Goodwill	72,150	66,271
Deferred tax assets, net	15,050	15,012
Other intangible assets, net	75,699	77,523
TOTAL ASSETS	$408,221	$375,581
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$30,775	$19,899
Accrued liabilities	11,690	12,778
Income taxes payable	1,528	3,361
Interest payable	89	111
Current portion of long-term debt	24,939	26,415
Total current liabilities	69,021	62,564
Long-term debt, less current portion	31,970	35,690
Deferred tax liabilities, net	27,223	27,575
Total liabilities	128,214	125,829
Commitments and contingencies		
Stockholders' equity:		
Cumulative convertible preferred stock, $0.0001 par value, 100,000 shares authorized; no shares issued and outstanding	—	—
Common stock, $0.0001 par value, 80,000,000 shares authorized; 60,472,611 shares issued and 53,917,842 shares outstanding at June 30, 2014; 58,265,911 shares issued and 51,804,078 shares outstanding at December 31, 2013	6	6
Additional paid-in capital	280,256	266,122
Accumulated other comprehensive income (loss)	(330)	(359)
Retained earnings (accumulated deficit)	22,217	(841)
Treasury stock, at cost; 5,673,748 and 5,394,178 shares at June 30, 2014 and December 31, 2013, respectively	(22,142)	(15,176)
Total stockholders' equity	280,007	249,752
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$408,221	$375,581

See accompanying Notes to Unaudited Consolidated Financial Statements.

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FLOTEK INDUSTRIES, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Revenue	$105,318	$93,586	$207,893	$171,829
Cost of revenue	63,008	55,992	121,903	101,605
Gross margin	42,310	37,594	85,990	70,224
Expenses:				
Selling, general and administrative	20,854	21,081	42,426	39,098
Depreciation and amortization	2,501	2,003	4,785	3,193
Research and development	1,280	979	2,306	1,854
Total expenses	24,635	24,063	49,517	44,145
Income from operations	17,675	13,531	36,473	26,079
Other income (expense):				
Interest expense	(381)	(531)	(836)	(965)
Other income (expense), net	(272)	170	(218)	58
Total other income (expense)	(653)	(361)	(1,054)	(907)
Income before income taxes	17,022	13,170	35,419	25,172
Income tax expense	(5,981)	(4,730)	(12,361)	(8,967)
Net income	$11,041	$8,440	$23,058	$16,205
Earnings per common share:				
Basic earnings per common share	$0.20	$0.17	$0.42	$0.33
Diluted earnings per common share	$0.20	$0.16	$0.42	$0.31
Weighted average common shares:				
Weighted average common shares used in computing basic earnings per common share	54,645	51,086	54,299	49,841
Weighted average common shares used in computing diluted earnings per common share	55,533	53,713	55,473	52,445

See accompanying Notes to Unaudited Consolidated Financial Statements.

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FLOTEK INDUSTRIES, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net income	$11,041	$8,440	$23,058	$16,205
Other comprehensive income (loss):				
Foreign currency translation adjustment	178	(137)	29	(157)
Unrealized gain on investments available for sale	—	13	—	13
Comprehensive income	$11,219	$8,316	$23,087	$16,061

See accompanying Notes to Unaudited Consolidated Financial Statements.

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FLOTEK INDUSTRIES, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Six months ended June 30,	
	2014	2013
Cash flows from operating activities:		
Net income	$23,058	$16,205
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,814	6,923
Amortization of deferred financing costs	148	12
Accretion of debt discount	—	55
Gain on sale of assets	(1,389)	(2,568)
Stock compensation expense	4,756	5,820
Deferred income tax benefit	(446)	(422)
Excess tax benefit related to share-based awards	(3,373)	(432)
Changes in current assets and liabilities:		
Restricted cash	—	150
Accounts receivable, net	(549)	(2,540)
Inventories	(18,828)	(5,970)
Other current assets	(5,323)	2,045
Accounts payable	10,737	(8,293)
Accrued liabilities	(683)	1,043
Income taxes payable	1,540	(638)
Interest payable	(22)	93
Net cash provided by operating activities	18,440	11,483
Cash flows from investing activities:		
Capital expenditures	(9,245)	(9,119)
Proceeds from sale of assets	1,982	3,026
Payments for acquisition, net of cash acquired	(5,704)	(53,396)
Purchase of patents and other intangible assets	(595)	—
Net cash used in investing activities	(13,562)	(59,489)
Cash flows from financing activities:		
Repayments of indebtedness	(6,720)	(7,649)
Proceeds of borrowings	—	26,190
Borrowings on revolving credit facility	204,750	153,571
Repayments on revolving credit facility	(203,226)	(116,014)
Debt issuance costs	(127)	(991)
Issuance costs of preferred stock and detachable warrants	—	(200)
Excess tax benefit related to share-based awards	3,373	432
Acquisition of treasury stock related to share-based awards	(5,961)	(4,859)
Proceeds from sale of common stock	505	352
Proceeds from exercise of stock options	450	128
Proceeds from exercise of stock warrants	1,545	6
Net cash (used in) provided by financing activities	(5,411)	50,966
Effect of changes in exchange rates on cash and cash equivalents	29	(157)
Net (decrease) increase in cash and cash equivalents	(504)	2,803
Cash and cash equivalents at the beginning of period	2,730	2,700

Cash and cash equivalents at the end of period	$2,226	$5,503

See accompanying Notes to Unaudited Consolidated Financial Statements.

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FLOTEK INDUSTRIES, INC.
UNAUDITED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock		Treasury Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings(Accumulated Deficit)	Total
	Shares Issued	Par Value	Shares	Cost				
Balance, December 31, 2013	58,266	$6	5,394	$(15,176)	$266,122	$(359)	$ (841)	$249,752
Net income	—	—	—	—	—	—	23,058	23,058
Other comprehensive income	—	—	—	—	—	29	—	29
Common stock issued under employee stock purchase plan	—	—	(17)	—	505	—	—	505
Common stock issued in payment of accrued liability	27	—	—	—	600	—	—	600
Stock warrants exercised	1,277	—	—	—	1,545	—	—	1,545
Stock options exercised	289	—	—	—	1,455	—	—	1,455
Stock surrendered for exercise of stock options	—	—	39	(1,005)	—	—	—	(1,005)
Restricted stock granted	515	—	—	—	—	—	—	—
Restricted stock forfeited	—	—	28	—	—	—	—	—
Treasury stock acquired related to tax withholding for share-based awards	—	—	230	(5,961)	—	—	—	(5,961)
Excess tax benefit related to share-based awards	—	—	—	—	3,373	—	—	3,373
Stock compensation expense	—	—	—	—	4,756	—	—	4,756
Stock issued in EOGA acquisition	94	—	—	—	1,750	—	—	1,750
Stock issued in SiteLark acquisition	5	—	—	—	150	—	—	150
Balance, June 30, 2014	60,473	$6	5,674	$(22,142)	$280,256	$(330)	$ 22,217	$280,007

See accompanying Notes to Unaudited Consolidated Financial Statements.

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FLOTEK INDUSTRIES, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Organization and Significant Accounting Policies

Organization and Nature of Operations

Flotek Industries, Inc. (“Flotek” or the “Company”) is a technology-driven supplier of energy chemicals and consumer and industrial chemicals and is a global developer and supplier of drilling, completion and production technologies and related services.

Flotek's strategic focus, and that of its diversified wholly-owned subsidiaries (collectively referred to as the “Company”), includes energy-related chemical technologies, drilling technologies, production technologies (previously referred to as artificial lift technologies), and consumer and industrial chemical technologies. Within energy technologies, the Company provides oilfield specialty chemicals and logistics, down-hole drilling tools and production-related tools used in the energy and mining industries. Flotek's products and services enable customers to drill wells more efficiently, to realize increased production from both new and existing wells and to decrease future well operating costs. Major customers include leading oilfield service providers, pressure-pumping service companies, onshore and offshore drilling contractors, and major and independent oil and gas exploration and production companies. Within consumer and industrial chemical technologies, the Company provides products for the flavor and fragrance industry and the industrial chemical industry. Major customers include food and beverage companies, fragrance companies, and companies providing household and industrial cleaning products.

The Company is headquartered in Houston, Texas, with operating locations in Florida, Louisiana, New Mexico, North Dakota, Oklahoma, Pennsylvania, Texas, Utah, Wyoming, the Netherlands, and the Middle East. Flotek’s products are marketed both domestically and internationally, with international presence and/or representation in over 20 countries.

Basis of Presentation

The accompanying Unaudited Consolidated Financial Statements and accompanying footnotes (collectively the “Financial Statements”) reflect all adjustments, in the opinion of management, necessary for fair presentation of the financial condition and results of operations for the periods presented. All such adjustments are normal and recurring in nature. The Financial Statements, including selected notes, have been prepared in accordance with applicable rules and regulations of the Securities and Exchange Commission (the “SEC”) regarding interim financial reporting and do not include all information and disclosures required by accounting principles generally accepted in the United States of America (“GAAP”) for comprehensive financial statement reporting. These interim Financial Statements should be read in conjunction with the audited consolidated financial statements and notes included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013 (the “Annual Report”). A copy of the Annual Report is available on the SEC’s website, www.sec.gov, under the Company’s ticker symbol (“FTK”) or on Flotek’s website, www.flotekind.com. The results of operations for the three and six months ended June 30, 2014 are not necessarily indicative of the results to be expected for the year ending December 31, 2014.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and reported amounts of revenue and expenses. Actual results could differ from these estimates.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation. The reclassifications did not impact net income.

Note 2 — Recent Accounting Pronouncements

(a) Application of New Accounting Standards

Effective January 1, 2014, the Company adopted the accounting guidance in Accounting Standards Update ("ASU") No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," which provides guidance for reporting unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. The guidance requires an unrecognized tax benefit to be presented as a decrease in a deferred tax asset where a net

operating loss, a similar tax loss, or a tax credit carryforward exists and certain criteria are met. Implementation of this standard did not have a material effect on the consolidated financial statements.

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FLOTEK INDUSTRIES, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(b) New Accounting Requirements and Disclosures
In June 2014, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." The ASU requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. The ASU is effective for annual reporting periods beginning after December 15, 2015, with early adoption permitted. The Company is evaluating the potential impacts of the new standard on its existing stock-based compensation plans.
In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers." The ASU will supersede most of the existing revenue recognition requirements in U.S. GAAP and will require entities to recognize revenue at an amount that reflects the consideration to which the Company expects to be entitled in exchange for transferring goods or services to a customer. The new standard also requires significantly expanded disclosures regarding the qualitative and quantitative information of an entity's nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The pronouncement is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period and is to be applied retrospectively, with early application not permitted. The Company is currently evaluating the impact the pronouncement will have on the consolidated financial statements and related disclosures.
In April 2014, the FASB issued ASU No. 2014-08, "Presentation of Financial Statements and Property, Plant, and Equipment - Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity," which amends the definition of a discontinued operation by raising the threshold for a disposal to qualify as discontinued operations. The ASU will also require entities to provide additional disclosures about discontinued operations as well as disposal transactions that do not meet the discontinued operations criteria. The pronouncement is effective prospectively for all disposals (except disposals classified as held for sale before the adoption date) of components initially classified as held for sale in periods beginning on or after December 15, 2014. Early adoption is permitted. The Company is currently evaluating this guidance and does not expect that adoption will have a material effect on the consolidated financial statements.
Note 3 — Acquisitions
On January 1, 2014, the Company acquired 100% of the membership interests in Eclipse IOR Services, LLC ("EOGA"), a leading Enhanced Oil Recovery ("EOR") design and injection firm, for $6.4 million in cash consideration and 94,354 shares of the Company's Common Stock. EOGA’s enhanced oil recovery processes and its use of polymers to improve the performance of EOR projects has been combined with the Company’s existing EOR products and services.
On April 1, 2014, the Company acquired 100% of the membership interests in SiteLark, LLC ("SiteLark") for $0.4 million and 5,327 shares of the Company's common stock. SiteLark provides reservoir engineering and modeling services for a variety of hydrocarbon applications. Its services include proprietary software which assists engineers with reservoir simulation, reservoir engineering and waterflood optimization.
As discussed in more detail in the Company's Annual Report, the Company acquired Florida Chemical Company, Inc. ("Florida Chemical") on May 10, 2013 for a total purchase price of $106.4 million. Florida Chemical is one of the world's largest processors of citrus oils and a pioneer in solvent, chemical synthesis, and flavor and fragrance applications from citrus oils. Florida Chemical has been an innovator in creating high performance, bio-based products for a variety of industries, including applications in the oil and gas industry. This acquisition brings a portfolio of high performance renewable and sustainable chemistries that perform well in the oil and gas industry as well as non-energy related markets. This acquisition expands the Company's business into consumer and industrial chemical technologies which provide products for the flavor and fragrance industry and the specialty chemical industry. These technologies are used by food and beverage companies, fragrance companies, and companies providing household and industrial cleaning products.

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FLOTEK INDUSTRIES, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Note 4 — Supplemental Cash Flow Information

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

	Six months ended June 30,	
	2014	2013
Supplemental non-cash investing and financing activities:		
Value of common stock issued in acquisitions	$1,900	$52,711
Value of common stock issued in payment of accrued liability	600	—
Equipment acquired through capital leases	—	691
Exercise of stock options by common stock surrender	1,005	2,418
Supplemental cash payment information:		
Interest paid	$710	$780
Income taxes paid	13,884	10,157

Note 5 — Revenue

The Company differentiates revenue and cost of revenue based on whether the source of revenue is attributable to products, rentals or services. Revenue and cost of revenue by source are as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Revenue:				
Products	$82,302	$71,523	$164,707	$127,853
Rentals	15,065	15,679	28,989	31,419
Services	7,951	6,384	14,197	12,557
	$105,318	$93,586	$207,893	$171,829
Cost of revenue:				
Products	$49,995	$46,992	$97,731	$81,508
Rentals	7,654	4,281	14,165	10,798
Services	3,265	2,832	5,978	5,569
Depreciation	2,094	1,887	4,029	3,730
	$63,008	$55,992	$121,903	$101,605

Note 6 — Inventories

Inventories are as follows (in thousands):

	June 30, 2014	December 31, 2013
Raw materials	$35,733	$13,953
Work-in-process	2,942	1,904
Finished goods	45,764	50,019
Inventories	84,439	65,876
Less reserve for excess and obsolete inventory	(2,208)	(2,744)
Inventories, net	$82,231	$63,132

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FLOTEK INDUSTRIES, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Note 7 — Property and Equipment
Property and equipment are as follows (in thousands):

	June 30, 2014	December 31, 2013
Land	$5,833	$5,088
Buildings and leasehold improvements	32,607	32,269
Machinery, equipment and rental tools	76,704	71,073
Equipment in progress	6,222	4,601
Furniture and fixtures	2,376	2,400
Transportation equipment	6,599	6,340
Computer equipment and software	7,468	7,617
Property and equipment	137,809	129,388
Less accumulated depreciation	(55,417)	(50,274)
Property and equipment, net	$82,392	$79,114

Depreciation expense, including expense recorded in cost of revenue, totaled $3.4 million and $2.9 million for the three months ended June 30, 2014 and 2013, respectively, and $6.4 million and $5.4 million for the six months ended June 30, 2014 and 2013, respectively.
Note 8 — Goodwill and Other Intangible Assets
During the six months ended June 30, 2014, the Company recognized $5.9 million of goodwill within the Energy Chemical Technologies reporting unit in connection with the acquisitions of EOGA and SiteLark. There were no impairments of goodwill recognized during the three and six months ended June 30, 2014 and 2013.
Changes in the carrying value of goodwill for each reporting unit are as follows (in thousands):

	Energy Chemical Technologies	Consumer and Industrial Chemical Technologies	Teledrift™	Total
Balance at December 31, 2013	$30,296	$20,642	$15,333	$66,271
Addition upon acquisition of EOGA	5,312	—	—	5,312
Addition upon acquisition of SiteLark	567	—	—	567
Balance at June 30, 2014	$36,175	$20,642	$15,333	$72,150

Finite lived intangible assets acquired are amortized on a straight-line basis over two to 20 years. Amortization of finite lived intangible assets acquired totaled $1.2 million and $1.0 million for the three months ended June 30, 2014 and 2013, respectively, and $2.4 million and $1.5 million for the six months ended June 30, 2014 and 2013, respectively.
Amortization of deferred financing costs was not significant for the three months ended June 30, 2014 and 2013 and the six months ended June 30, 2013. Amortization of deferred financing costs was $0.1 million for the six months ended June 30, 2014.
Note 9 — Long-Term Debt and Credit Facility
Long-term debt is as follows (in thousands):

	June 30, 2014	December 31, 2013
Long-term debt:		
Term loan	$39,113	$45,833
Borrowings under revolving credit facility	17,796	16,272
Total long-term debt	56,909	62,105
Less current portion of long-term debt	(24,939)	(26,415)
Long-term debt, less current portion	$31,970	$35,690

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FLOTEK INDUSTRIES, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Credit Facility

On May 10, 2013, the Company and certain of its subsidiaries (the “Borrowers”) entered into an Amended and Restated Revolving Credit, Term Loan and Security Agreement (the “Credit Facility”) with PNC Bank, National Association (“PNC Bank”). The Company may borrow under the Credit Facility for working capital, permitted acquisitions, capital expenditures and other corporate purposes. Under terms of the Credit Facility, as amended on December 31, 2013, the Company (a) may borrow up to $75 million under a revolving credit facility and (b) has borrowed $50 million under a term loan.

The Credit Facility is secured by substantially all of the Company's domestic real and personal property, including accounts receivable, inventory, land, buildings, equipment and other intangible assets. The Credit Facility contains customary representations, warranties, and both affirmative and negative covenants, including a financial covenant to maintain a consolidated earnings before interest, taxes, depreciation and amortization (“EBITDA”) to debt ratio of 1.10 to 1.00, a financial covenant to maintain a ratio of funded debt to adjusted EBITDA of not greater than 4.0 to 1.0, and an annual limit on capital expenditures of approximately $36 million. The Credit Facility restricts the payment of cash dividends on common stock. In the event of default, PNC Bank may accelerate the maturity date of any outstanding amounts borrowed under the Credit Facility.

The Credit Facility includes a provision that 25% of EBITDA minus cash paid for taxes, dividends, debt payments and unfunded capital expenditures, not to exceed $3.0 million for any year, be paid within 60 days of the fiscal year end. For the year ended December 31, 2013, the excess cash flow exceeded $3.0 million. Consequently, the Company paid $3.0 million on its term loan balance to PNC Bank on March 3, 2014. This amount is classified as current debt at December 31, 2013.

Each of the Company’s domestic subsidiaries is fully obligated for Credit Facility indebtedness as a Borrower or as a guarantor.

(a) Revolving Credit Facility

Under the revolving credit facility, the Company may borrow up to $75 million through May 10, 2018. This includes a sublimit of $10 million that may be used for letters of credit. The revolving credit facility is secured by substantially all the Company's domestic accounts receivable and inventory.

At June 30, 2014, eligible accounts receivable and inventory securing the revolving credit facility provided availability of approximately $74.8 million under the revolving credit facility. Available borrowing capacity, net of outstanding borrowings, was $57.0 million at June 30, 2014.

The interest rate on advances under the revolving credit facility varies based on the level of borrowing. Rates range (a) between PNC Bank's base lending rate plus 0.5% to 1.0% or (b) between the London Interbank Offered Rate (LIBOR) plus 1.5% to 2.0%. PNC Bank's base lending rate was 3.25% at June 30, 2014. The Company is required to pay a monthly facility fee of 0.25% on any unused amount under the commitment based on daily averages. At June 30, 2014, $17.8 million was outstanding under the revolving credit facility, with $1.8 million borrowed as base rate loans at an interest rate of 3.75% and $16.0 million borrowed as LIBOR loans at an interest rate of 1.65%.

Borrowing under the revolving credit agreement is classified as current debt as a result of the required lockbox arrangement and subjective acceleration clause.

(b) Term Loan

The Company increased borrowing to $50 million under the term loan on May 10, 2013. Monthly principal payments of $0.6 million are required. The unpaid balance of the term loan is due May 10, 2018. Prepayments are permitted, and may be required in certain circumstances. Amounts repaid under the term loan may not be reborrowed. The term loan is secured by substantially all of the Company's domestic land, buildings, equipment and other intangible assets.

The interest rate on the term loan varies based on the level of borrowing under the revolving credit facility. Rates range (a) between PNC Bank's base lending rate plus 1.25% to 1.75% or (b) between LIBOR plus 2.25% to 2.75%. At June 30, 2014, $39.1 million was outstanding under the term loan, with $0.1 million borrowed as base rate loans at an interest rate of 4.50% and $39.0 million borrowed as LIBOR loans at an interest rate of 2.41%.

Convertible Notes

The Company’s convertible notes have consisted of Convertible Senior Unsecured Notes (“2008 Notes”) and Convertible Senior Secured Notes (“2010 Notes”). On February 15, 2013, the Company repurchased the remaining $5.2 million of outstanding 2008 Notes for cash equal to the original principal amount, plus accrued and unpaid interest. These 2008 Notes were either tendered

by the holder pursuant to the Company's tender offer or were redeemed by the Company pursuant to provisions of the indenture for the 2008 Notes. Following this repurchase, the Company no longer has any outstanding convertible senior notes.

Share Lending Agreement

Concurrent with the offering of the 2008 Notes, the Company entered into a share lending agreement (the “Share Lending Agreement”) with Bear, Stearns International Limited which was subsequently acquired and became an indirect, wholly owned subsidiary of JPMorgan Chase & Company (the “Borrower”). In accordance with the Share Lending Agreement, the Company loaned 3.8 million shares of its common stock (the “Borrowed Shares”) to the Borrower for a period commencing February 11, 2008 and ending on the earlier of February 15, 2028 or the date the 2008 Notes were paid. The Borrower was permitted to use the Borrowed Shares only for the purpose of directly or indirectly facilitating the sale of the 2008 Notes and for the establishment of hedge positions by holders of the 2008 Notes. The Company did not require collateral to mitigate any inherent or associated risk of the Share Lending Agreement.

The Company did not receive any proceeds for the Borrowed Shares, but did receive a nominal loan fee of $0.0001 for each share loaned. The Borrower retained all proceeds from sales of Borrowed Shares pursuant to the Share Lending Agreement. Upon conversion or replacement of the 2008 Notes, the number of Borrowed Shares proportionate to the converted or repaid notes were to be returned to the Company. The Borrowed Shares were issued and outstanding for corporate law purposes. Accordingly, holders of Borrowed Shares possessed all of the rights of a holder of the Company’s outstanding shares, including the right to vote the shares on all matters submitted to a vote of stockholders and the right to receive any dividends or other distributions declared or paid on outstanding shares of common stock. Under the Share Lending Agreement, the Borrower agreed to pay to the Company, within one business day after a payment date, an amount equal to any cash dividends that the Company paid on the Borrowed Shares, and to pay or deliver to the Company, upon termination of the loan of Borrowed Shares, any other distribution, in liquidation or otherwise, that the Company made on the Borrowed Shares.

To the extent the Borrowed Shares loaned under the Share Lending Agreement were not sold or returned to the Company, the Borrower agreed to not vote any borrowed shares of which the Borrower was the owner of record. The Borrower also agreed, under the Share Lending Agreement, to not transfer or dispose of any borrowed shares unless such transfer or disposition was pursuant to a registration statement that was effective under the Securities Act of 1933, as amended. Investors that purchased shares from the Borrower, and all subsequent transferees of such purchasers, were entitled to the same voting rights, with respect to owned shares, as any other holder of common stock.

During 2011 and 2012, the Borrower returned 1,360,442 shares of the Company’s borrowed common stock. On January 22, 2013, the remaining 2,439,558 shares of the Company's common stock held by J.P. Morgan Markets Limited were returned to the Company. No consideration was paid by the Company for the return of the Borrowed Shares. The Share Lending Agreement has been terminated.

Shares that had been loaned under the Share Lending Agreement were not considered outstanding for the purpose of computing and reporting earnings per share.

Note 10 — Earnings Per Share

Basic earnings per common share is calculated by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings per common share is calculated by dividing net income, adjusted for the effect of assumed conversion of convertible notes, by the weighted average number of common shares outstanding combined with dilutive common share equivalents outstanding, if the effect is dilutive.

In connection with the sale of the 2008 Notes, the Company entered into a Share Lending Agreement for 3.8 million shares of the Company’s common stock (see Note 9). Contractual undertakings of the Borrower had the effect of substantially eliminating the economic dilution that otherwise would result from the issuance of the Borrowed Shares, and all shares outstanding under the Share Lending Agreement were contractually obligated to be returned to the Company. As a result, shares loaned under the Share Lending Agreement were not considered outstanding for the

purpose of computing and reporting earnings per share. The Share Lending Agreement was terminated on January 22, 2013 upon the return of all Borrowed Shares to the Company.

On February 15, 2013, the Company repurchased the remaining $5.2 million of outstanding 2008 Notes for cash. Following this repurchase, the Company no longer has any outstanding convertible senior notes. For the six months ended June 30, 2013, the Company's convertible notes were excluded from the calculation of diluted earnings per common share, as inclusion was anti-dilutive. In addition, for the three and six months ended June 30, 2013, approximately 0.1 million stock options with an exercise price in excess of the average market price of the Company's common stock were excluded from the calculation of diluted earnings per common share.

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Basic and diluted earnings per common share are as follows (in thousands, except per share data):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net income - Basic and Diluted	$11,041	$8,440	$23,058	$16,205
Weighted average common shares outstanding - Basic	54,645	51,086	54,299	49,841
Assumed conversions:				
Incremental common shares from warrants	—	1,429	243	1,421
Incremental common shares from stock options	878	1,174	916	1,167
Incremental common shares from restricted stock units	10	24	15	16
Weighted average common shares outstanding - Diluted	55,533	53,713	55,473	52,445
Basic earnings per common share	$0.20	$0.17	$0.42	$0.33
Diluted earnings per common share	$0.20	$0.16	$0.42	$0.31

Note 11 — Fair Value Measurements

Fair value is defined as the amount that would be received for selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company categorizes financial assets and liabilities into the three levels of the fair value hierarchy. The hierarchy prioritizes the inputs to valuation techniques used to measure fair value and bases categorization within the hierarchy on the lowest level of input that is available and significant to the fair value measurement.

- Level 1 — Quoted prices in active markets for identical assets or liabilities;
- Level 2 — Observable inputs other than Level 1, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and
- Level 3 — Significant unobservable inputs that are supported by little or no market activity or that are based on the reporting entity’s assumptions about the inputs.

Fair Value of Other Financial Instruments

The carrying amounts of certain financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, approximate fair value due to the short-term nature of these accounts. The Company had no cash equivalents at June 30, 2014 or December 31, 2013.

The carrying value and estimated fair value of the Company’s long-term debt are as follows (in thousands):

	June 30, 2014		December 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Term loan	$39,113	$39,113	$45,833	$45,833
Borrowings under revolving credit facility	17,796	17,796	16,272	16,272

The carrying value of the term loan and borrowings under the revolving credit facility approximate their fair value because the interest rates are variable.

Assets Measured at Fair Value on a Nonrecurring Basis

The Company's non-financial assets, including property and equipment, goodwill and other intangible assets are measured at fair value on a non-recurring basis and are subject to fair value adjustment in certain circumstances. No impairment of any of these assets was recognized during the six months ended June 30, 2014 and 2013.

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Liabilities Measured at Fair Value on a Recurring Basis

At June 30, 2014 and December 31, 2013, no liabilities were required to be measured at fair value on a recurring basis. There were no transfers in or out of either Level 1 or Level 2 fair value measurements during the six months ended June 30, 2014 and 2013 and the year ended December 31, 2013. During the six months ended June 30, 2014 and 2013 and the year ended December 31, 2013, there were no transfers in or out of the Level 3 hierarchy.

Note 12 — Income Taxes

The Company’s corporate organizational structure requires the filing of two separate consolidated U.S. Federal income tax returns. Taxable income of one group cannot be offset by tax attributes, including net operating losses, of the other group.

A reconciliation of the effective tax rate to the U.S. federal statutory tax rate is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Federal statutory tax rate	35.0 %	35.0 %	35.0 %	35.0 %
State income taxes, net of federal benefit	2.2	3.3	2.2	2.9
Change in valuation allowance	—	(0.3)	—	(0.2)
Domestic production activities deduction	(2.7)	(2.4)	(2.7)	(2.4)
Other	0.6	0.3	0.4	0.3
Effective income tax rate	35.1 %	35.9 %	34.9 %	35.6 %

Fluctuations in effective tax rates were historically impacted by permanent tax differences with no associated income tax impact and existing deferred tax asset valuation allowances.

Deferred taxes are presented in the balance sheets as follows (in thousands):

	June 30, 2014	December 31, 2013
Current deferred tax assets	$2,578	$2,522
Non-current deferred tax assets	15,050	15,012
Non-current deferred tax liabilities	(27,223)	(27,575)
Net deferred tax assets (liabilities)	$(9,595)	$(10,041)

Note 13 — Convertible Preferred Stock and Stock Warrants

In August 2009, the Company sold 16,000 units (the “Units”), consisting of preferred stock and warrants for $1,000 per Unit. Each Unit consisted of one share of Series A cumulative convertible preferred stock (“Convertible Preferred Stock”), detachable warrants to purchase up to 155 shares of the Company's common stock at an exercise price of $2.31 per share (“Exercisable Warrants”) and detachable contingent warrants to purchase up to 500 shares of the Company's common stock at an exercise price of $2.45 per share (“Contingent Warrants”).

Preferred Stock

Each share of Convertible Preferred Stock was convertible at any time, at the holder’s option, into 434.782 shares of the Company’s common stock. The conversion rate represented an equivalent conversion price of approximately $2.30 per share of common stock.

Each share of Convertible Preferred Stock had a liquidation preference of $1,000. Dividends accrued at a rate of 15% of the liquidation preference per year and accumulated, if not paid quarterly. Subsequent to February 11, 2010, the Company had the ability to convert the preferred shares into common shares if the closing price of the common stock met certain price criteria. In the event any Convertible Preferred Stock was converted, the Company was obligated to pay an amount, in cash or common stock, equal to eight quarterly dividend payments less any dividends previously paid.

In February 2011, the Company exercised its contractual right to mandatorily convert all outstanding shares of Convertible Preferred Stock into shares of common stock at the prevailing conversion rate of 434.782 shares of common stock for each share of preferred stock. Currently, the Company has no issued or outstanding shares of preferred stock.

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Stock Warrants

Exercisable Warrants were exercisable upon issuance and expire August 12, 2014, if not exercised. Contingent Warrants became exercisable on November 9, 2009, and expire November 9, 2014, if not exercised. Prior to June 14, 2012, the warrants contained anti-dilution price protection in the event the Company issued shares of common stock or securities exercisable for, or convertible into, common stock at a price per share less than the warrants' exercise price. In accordance with these contractual anti-dilution price adjustment provisions, the warrants were re-priced as a result of a payment of a portion of the initial and deferred commitment fees related to the Company's term loan with common stock on March 31, 2010 and September 30, 2010.

Due to the anti-dilution price adjustment provisions established at the issuance date, the warrants were deemed to be a liability and were recorded at fair value at the date of issuance. The warrant liability was adjusted to fair value at the end of each reporting period through the statement of operations during the period the anti-dilution price adjustment provisions were in effect. On June 14, 2012, contractual provisions within the Company's Exercisable and Contingent Warrant agreements were modified to eliminate the anti-dilution price adjustment provisions of the warrants and remove the cash settlement provisions in the event of a change of control. The amended warrants then qualified to be classified as equity. Accordingly, the Company revalued the warrants as of June 14, 2012, the date of contractual amendment. The change in fair value of the warrant liability compared to the fair value on December 31, 2011, $2.6 million, was recognized in income during 2012. The revalued warrant liability of $14.0 million was reclassified to additional-paid-in-capital on June 14, 2012. There were no longer fair value adjustments because the warrants continued to meet the criteria for equity classification.

The Company used the Black-Scholes option-pricing model to estimate the fair value of the warrant liability for each reporting period. On June 14, 2012, the date the warrants were amended, inputs into the fair value calculation included the actual remaining term of the warrants, a volatility rate of 58.1%, a risk-free rate of return of 0.36%, and an assumed dividend rate of zero.

On February 7, 2014, warrants were exercised to purchase 1,277,250 shares of the Company's common stock at $1.21 per share. The Company received cash proceeds of $1.5 million in connection with the warrants exercised. Following the exercise, the Company no longer had any outstanding warrants from its sale of preferred stock and warrants in August 2009.

Note 14 — Business Segment, Geographic and Major Customer Information

Segment Information

Operating segments are defined as components of an enterprise for which separate financial information is available that is regularly evaluated by chief operating decision-makers in deciding how to allocate resources and assess performance. The operations of the Company are categorized into four reportable segments: Energy Chemical Technologies, Consumer and Industrial Chemical Technologies, Drilling Technologies and Production Technologies.

- Energy Chemical Technologies designs, develops, manufactures, packages and markets specialty chemicals, some of which hold patent protection, used in oil and gas well cementing, stimulation, acidizing, drilling and production. Activities in this segment also include construction and management of automated material handling facilities and management of loading facilities and blending operations for oilfield services companies.
- Consumer and Industrial Chemical Technologies ("CICT") designs, develops and manufactures products that are sold to companies in the flavor and fragrance industry and the specialty chemical industry. These technologies are used by beverage and food companies, fragrance companies, and companies providing household and industrial cleaning products.
- Drilling Technologies rents, sells, inspects, manufactures and markets down-hole drilling equipment used in energy, mining, water well and industrial drilling activities.
- Production Technologies assembles and markets production-related equipment, including the Petrovalve product line of rod pump components, electric submersible pumps, gas separators, valves and services that support natural gas, oil and coal bed methane production activities.

The Company evaluates performance based upon a variety of criteria. The primary financial measure is segment operating income. Various functions, including certain sales and marketing activities and general and administrative activities, are provided centrally by the corporate office. Costs associated with corporate office functions, other corporate income and expense items, and income taxes, are not allocated to reportable segments.

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Summarized financial information of the reportable segments is as follows (in thousands):

As of and for the three months ended June 30,	Energy Chemical Technologies	Consumer and Industrial Chemical Technologies	Drilling Technologies	Production Technologies	Corporate and Other	Total
2014						
Net revenue from external customers	$ 62,589	$ 12,607	$ 27,241	$ 2,881	$—	$105,318
Gross margin	27,432	2,893	10,762	1,223	—	42,310
Income (loss) from operations	19,162	972	4,200	421	(7,080)	17,675
Depreciation and amortization	1,095	549	2,493	92	366	4,595
Total assets	140,028	97,935	139,095	15,922	15,241	408,221
Capital expenditures	1,418	17	2,025	50	747	4,257
2013						
Net revenue from external customers	$ 47,709	$ 12,675	$ 29,785	$ 3,417	$—	$93,586
Gross margin	20,586	3,693	12,455	860	—	37,594
Income (loss) from operations	14,729	2,347	5,782	330	(9,657)	13,531
Depreciation and amortization	809	252	2,415	60	354	3,890
Total assets	119,137	104,201	118,722	13,296	27,754	383,110
Capital expenditures	1,933	35	2,141	70	557	4,736

As of and for the six months ended June 30,	Energy Chemical Technologies	Consumer and Industrial Chemical Technologies	Drilling Technologies	Production Technologies	Corporate and Other	Total
2014						
Net revenue from external customers	$ 124,966	$ 25,638	$ 52,142	$ 5,147	$—	$207,893
Gross margin	56,650	6,927	20,550	1,863	—	85,990
Income (loss) from operations	40,785	3,307	7,517	343	(15,479)	36,473
Depreciation and amortization	2,162	982	4,930	163	577	8,814
Total assets	140,028	97,935	139,095	15,922	15,241	408,221
Capital expenditures	2,804	30	5,321	110	980	9,245
2013						
Net revenue from external customers	$ 92,359	$ 12,675	$ 58,699	$ 8,096	$—	$171,829
Gross margin	39,699	3,693	23,801	3,031	—	70,224
Income (loss) from operations	29,053	2,347	11,201	1,943	(18,465)	26,079
Depreciation and amortization	1,269	252	4,777	121	504	6,923
Total assets	119,137	104,201	118,722	13,296	27,754	383,110
Capital expenditures	2,958	35	3,002	1,067	2,057	9,119

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FLOTEK INDUSTRIES, INC.
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Geographic Information
Revenue by country is based on the location where services are provided and products are sold. No individual country other than the United States ("U.S.") accounted for more than 10% of revenue. Revenue by geographic location is as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
U.S.	$91,691	$83,488	$179,022	$149,510
Other countries	13,627	10,098	28,871	22,319
Total	$105,318	$93,586	$207,893	$171,829

Long-lived assets held in countries other than the U.S. are not considered material to the consolidated financial statements.
Major Customers
One customer accounted for 17.7% and 16.9% of consolidated revenue for the three months ended June 30, 2014 and 2013, respectively, and 19.2% and 17.2% for the six months ended June 30, 2014 and 2013, respectively. Over 94% of the revenue from this customer was in the Energy Chemical Technologies segment.
Note 15 — Commitments and Contingencies
Litigation
The Company is subject to routine litigation and other claims that arise in the normal course of business. Management is not aware of any pending or threatened lawsuits or proceedings that are expected to have a material effect on the Company's financial position, results of operations or liquidity.
Representation Agreements
In February 2011, the Company entered into two separate representation agreements with Basin Supply Corporation ("Basin Supply"), a multinational, energy industry-focused supply chain management company, to market certain of the Company's specialty chemicals and down-hole drilling products and services within various international markets, including the Middle East, Africa, Latin America and the former Soviet Union. Both agreements are effective through December 31, 2015. Under each agreement, Basin Supply is eligible to receive warrants to purchase Flotek common stock (at an exercise price of 125% of the price of Flotek's common stock on the grant date) upon exceeding contractually defined annual base and "stretch" sales targets. The number of warrants that could be issued under the terms of each of the agreements is 100,000 during 2014.
Concentrations and Credit Risk
The majority of the Company's revenue is derived from the oil and gas industry. Customers include major oilfield services companies, major integrated oil and natural gas companies, independent oil and natural gas companies, pressure pumping service companies and state-owned national oil companies. This concentration of customers in one industry increases credit and business risks.
The Company is subject to concentrations of credit risk within trade accounts receivable as the Company does not generally require collateral as support for trade receivables. In addition, the majority of the Company's cash is maintained at one major financial institution and balances often exceed insurable amounts.

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q (the "Quarterly Report"), and in particular, Part I, Item 2 - "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains "forward-looking statements" within the meaning of the safe harbor provisions, 15 U.S.C. § 78u-5, of the Private Securities Litigation Reform Act of 1995 (the "Reform Act"). Forward-looking statements are not historical facts, but instead represent the Company's current assumptions and beliefs regarding future events, many of which, by their nature, are inherently uncertain and outside the Company's control. Such statements include estimates, projections, and statements related to Flotek Industries, Inc.'s ("Flotek" or the "Company") business plan, objectives, expected operating results and assumptions upon which those statements are based. The forward-looking statements contained in this Quarterly Report are based on information available as of the date of this Quarterly Report.

The forward-looking statements relate to future industry trends and economic conditions, forecast performance or results of current and future initiatives and the outcome of contingencies and other uncertainties that may have a significant impact on the Company's business, future operating results and liquidity. These forward-looking statements generally are identified by words including, but not limited to, "anticipate," "believe," "estimate," "continue," "intend," "expec "plan," "forecast," "project" and similar expressions, or future-tense or conditional constructions such as "will," "may," "shoul "could," etc. The Company cautions that these statements are merely predictions, and are not to be considered guarantees of future performance. Forward-looking statements are based upon current expectations and assumptions that are subject to risks and uncertainties that can cause actual results to differ materially from those projected, anticipated or implied.

A detailed discussion of potential risks and uncertainties that could cause actual results and events to differ materially from forward-looking statements is included in Part I, Item 1A - "Risk Factors" of the Annual Report on Form 10-K for the year ended December 31, 2013 (the "Annual Report") and periodically in subsequent reports filed with the Securities and Exchange Commission (the "SEC"). The Company has no obligation to publicly update or revise any forward-looking statements, whether as a result of new information or future events, except as required by law.

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with the unaudited consolidated financial statements and the related notes thereto, as well as the Annual Report. Phrases such as "Company," "we," "our" and "us" refer to Flotek Industries, Inc. and its subsidiaries.

Executive Summary

Flotek is a global diversified, technology-driven company that develops and supplies oilfield products, services and equipment to the oil, gas and mining industries, and high value compounds to companies that make cleaning products, cosmetics, food and beverages, and other products that are sold in the consumer and industrial markets.

The Company's oilfield businesses include specialty chemicals and logistics, down-hole drilling tools and production-related tools. Flotek's technologies enable customers to drill wells more efficiently, increase well production and decrease well operating costs. The Company also provides automated bulk material handling, loading facilities and blending capabilities. The Company sources citrus oil domestically and internationally and is one of the largest processors of citrus oil in the world. Products produced from processed citrus oil include (1) high value compounds used as additives by companies in the flavors and fragrances markets and (2) environmentally friendly chemicals for use in numerous industries around the world, specifically the oil and gas ("O&G") industry.

Flotek operates in over 20 domestic and international markets, including the Gulf Coast, Southwest, Rocky Mountains, Northeastern and Mid-Continental regions of the United States (the "U.S."), Canada, Mexico, Central America, South America, Europe, Africa, Middle East, Australia and Asia-Pacific. Customers include major integrated O&G companies, oilfield services companies, independent O&G companies, pressure-pumping service companies, national and state-owned oil companies, and international supply chain management companies. The Company's customers also include non-energy-related citrus oil users, including household and commercial cleaning product companies, fragrance and cosmetic companies, and food manufacturing companies through the CICT segment.

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The operations of the Company are categorized into four reportable segments: Energy Chemical Technologies, Consumer and Industrial Chemical Technologies, Drilling Technologies and Production Technologies (previously referred to as Artificial Lift Technologies).

- Energy Chemical Technologies designs, develops, manufactures, packages and markets specialty chemicals used in O&G well drilling, cementing, completion, stimulation and production. Activities in this segment also include construction and management of automated material handling facilities and management of loading facilities and blending operations for oilfield services companies.

- Consumer and Industrial Chemical Technologies designs, develops and manufactures products that are sold to companies in the flavor and fragrance industries and specialty chemical industry. These technologies are used by beverage and food companies, fragrance companies, and companies providing household and industrial cleaning products.

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

- Production Technologies assembles and markets production-related equipment, including the Petrovalve product line of rod pump components, electric submersible pumps, gas separators, valves and services that support natural gas, oil and coal bed methane production activities.

Market Conditions

The Company's success is sensitive to a number of factors, which include, but are not limited to, drilling activity, customer demand for its advanced technology products, market prices for raw materials and governmental actions. Drilling activity levels are influenced by a number of factors, including the number of rigs in operation, the geographical areas of rig activity, and drill rig efficiency (rig days required per well). Additional factors that influence the level of drilling activity include:

- Historical, current, and anticipated future O&G prices,
- Federal, State and local governmental actions that may encourage or discourage drilling activity,
- Customers' strategies relative to capital funds allocations,
- Weather conditions, and
- Technological changes to drilling methods and economics.

Historical North American drilling activity is reflected in "TABLE A" below:

Customers' demand for advanced technology products and services provided by the Company are dependent on their recognition of the value of:

- Chemistries that improve the economics of their O&G operations,
- Drilling products that improve drilling operations and efficiencies, and
- Chemistries that are economically viable, socially responsible and ecologically sound.

Market prices for citrus oils can be influenced by:

- Historical, current, and anticipated future production levels of the global citrus (primarily orange) crop,
- Weather related risks, and
- Health and condition of citrus trees (e.g., disease and pests).

Governmental actions may restrict the future use of hazardous chemicals, including but not limited to, the following industrial applications:

- O&G drilling and completion operations,
- O&G production operations, and

- Non-O&G industrial solvents.

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TABLE A

	Three months ended June 30,			Six months ended June 30,		
	2014	2013	% Change	2014	2013	% Change
North American Average Active Drilling Rigs						
U.S.	1,852	1,761	5.2 %	1,816	1,759	3.2 %
Canada	199	152	30.9 %	362	342	5.8 %
Total Average North American Drilling Rigs	2,051	1,913	7.2 %	2,178	2,101	3.7 %
U.S. Average Active Drilling Rigs by Type						
Vertical	395	455	(13.2)%	391		