

FLOTEK INDUSTRIES INC/CN/  
Form DEF 14A  
September 16, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**SCHEDULE 14A**

**Proxy Statement Pursuant to Section 14(a)**  
**of the Securities Exchange Act of 1934**

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

- |   |  |
|---|--|
| <input type="checkbox"/> Preliminary Proxy Statement                        | <input type="checkbox"/> Confidential, for use of the Commission only (as permitted by Rule 14a-6(e)(2)) |
| <input checked="" type="checkbox"/> Definitive Proxy Statement              |  |
| <input type="checkbox"/> Definitive Additional Materials                    |  |
| <input type="checkbox"/> Soliciting Material Pursuant to Section 240.14a-12 |  |

**FLOTEK INDUSTRIES, INC.**

(Name of Registrant as Specified In Its Charter)

Payment of Filing Fee (Check the appropriate box):

- No fee required.
- Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

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(2) Aggregate number of securities to which transaction applies:

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- (3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

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- (4) Proposed maximum aggregate value of transaction:

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- (5) Total fee paid:

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.. Fee paid previously with preliminary materials.

.. Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

- (1) Amount Previously Paid:

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- (2) Form, Schedule or Registration Statement No.:

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- (3) Filing Party:

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- (4) Date Filed:

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**FLOTEK INDUSTRIES, INC.**

**2930 W. Sam Houston Pkwy N., Suite 300**

**Houston, Texas 77043**

**NOTICE OF SPECIAL MEETING OF STOCKHOLDERS**

**TO BE HELD ON OCTOBER 29, 2009**

**To the Stockholders of Flotek Industries, Inc.:**

At the direction of the Board of Directors of Flotek Industries, Inc. (the Company), a Delaware corporation, NOTICE IS HEREBY GIVEN that a Special Meeting of Stockholders of the Company will be held at the Flotek Corporate Office, 2930 W. Sam Houston Pkwy. N, Suite 300, Houston, Texas 77043, on Thursday, October 29, 2009 at 9:00 a.m. (local time), for the purpose of considering and voting upon the following matters:

1. The amendment of the Company's Amended and Restated Certificate of Incorporation to increase the number of authorized shares of common stock from 40,000,000 shares to 80,000,000 shares (the Proposed Charter Amendment);
2. The approval of the ability of the Company to pay dividends in the future in respect of its shares of preferred stock by issuing shares of the Company's common stock (the Preferred Stock PIK Dividend Provision);
3. The approval of the anti-dilution price protection provision contained in certain warrants issued by the Company in a private placement in August 2009 (the Exercisable Warrant Anti-dilution Provision);
4. The approval of the contingent warrants issued by the Company in a private placement in August 2009 (the Contingent Warrants); and
5. To consider and take action upon such other matters as may properly come before the Meeting.

By order of the Board of Directors

Casey Doherty  
Corporate Secretary

September 16, 2009

**YOUR VOTE IS IMPORTANT**

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TO ASSURE YOUR REPRESENTATION AT THE MEETING, PLEASE SIGN, DATE AND  
RETURN YOUR PROXY AS PROMPTLY AS POSSIBLE. AN ENVELOPE, WHICH REQUIRES NO  
POSTAGE IF MAILED IN THE UNITED STATES, IS ENCLOSED FOR THIS PURPOSE.

Stockholders with questions about the Special Meeting or who need assistance in voting their shares may call the Company's proxy solicitor, Innisfree M&A Incorporated, toll-free at (888) 750-5834. Banks and brokers may call collect at (212) 750-5833.

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**FLOTEK INDUSTRIES, INC.**

**2930 W. Sam Houston Pkwy N., Suite 300**

**Houston, Texas 77043**

**PROXY STATEMENT**

This Proxy Statement and the accompanying form of proxy are being sent to the stockholders of Flotek Industries, Inc. (the "Company"), a Delaware corporation, in connection with the solicitation by the Board of Directors of the Company (the "Board") of proxies to be voted at a Special Meeting of Stockholders of the Company (the "Meeting") to be held at 9:00 a.m. (local time) on Thursday, October 29, 2009 at the Flotek Corporate Office, 2930 W. Sam Houston Pkwy. N., Suite 300, Houston, Texas 77043 and at any adjournments thereof.

The Notice of Meeting, this Proxy Statement and the accompanying form of proxy are first being mailed to the stockholders on or about September 18, 2009.

**Important Notice Regarding the Availability of Proxy Materials for the Stockholder Meeting to Be Held on October 29, 2009. The Proxy Statement is available at [www.flotekind.com/proxymaterials](http://www.flotekind.com/proxymaterials).**

At the Meeting, stockholders will be asked (i) to consider and vote upon the amendment of the Company's Amended and Restated Certificate of Incorporation to increase the number of authorized shares of common stock, \$0.0001 par value per share ("common stock"), from 40,000,000 shares to 80,000,000 shares (the "Proposed Charter Amendment"); (ii) to consider and vote upon the approval of the ability of the Company to pay dividends in the future in respect of its shares of preferred stock, \$0.0001 par value per share ("preferred stock"), by issuing shares of the Company's common stock (the "Preferred Stock PIK Dividend Provision"); (iii) to consider and vote upon the approval of the anti-dilution price protection provision contained in certain warrants issued by the Company in a private placement in August 2009 (the "Exercisable Warrant Anti-dilution Provision"); (iv) to consider and vote upon the approval of the contingent warrants issued by the Company in a private placement in August 2009 (the "Contingent Warrants"); and (v) to consider and take action upon such other matters as may properly come before the Meeting.

**VOTING SECURITIES**

The Board has fixed the close of business on September 14, 2009, as the record date (the "Record Date") for determination of stockholders entitled to notice of, and to vote at, the Meeting. At the close of business on such date, there were outstanding and entitled to vote 23,437,714 shares of common stock of the Company, which is the Company's only authorized and outstanding class of stock entitled to vote at the Meeting.

Holders of at least one-third of the outstanding shares of common stock are required to be represented at the Meeting, in person or by proxy, to constitute a quorum. Each outstanding share of common stock as of the Record Date is entitled to one vote. There will be no cumulative voting of shares for any matter voted upon at the Meeting.

The affirmative vote of at least a majority of the shares of common stock outstanding is required to approve the Proposed Charter Amendment. In determining whether this proposal has received the requisite number of affirmative votes, abstentions and broker non-votes will have the same effect as votes against the proposal.

The affirmative vote of at least a majority of the shares of common stock represented at the Meeting is required to approve the other matters to be considered at the Meeting. In determining whether each such other proposal has received the requisite number of affirmative votes, abstentions and broker non-votes will have the same effect as votes against such proposal.



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If the enclosed form of proxy is properly executed and returned to the Company prior to or at the Meeting and is not revoked prior to its exercise, all shares of common stock represented thereby will be voted at the Meeting and, where instructions have been given by a stockholder, will be voted in accordance with such instructions.

Any stockholder executing a proxy which is solicited hereby has the power to revoke it prior to its exercise. Revocation may be made by attending the Meeting and voting the shares of common stock in person or by delivering to the Secretary of the Company at the principal executive offices of the Company located at 2930 W. Sam Houston Parkway N., Suite 300, Houston, Texas 77043, prior to exercise of the proxy, a written notice of revocation or a later-dated, properly executed proxy.

The solicitation of proxies will be by mail, but proxies also may be solicited by telephone, telegram or in person by directors, officers and other employees of the Company. The Company will bear all costs of soliciting proxies. In order to solicit proxies, the Company will also request financial institutions, brokerage houses, custodians, nominees and fiduciaries to forward proxy materials to the beneficial owners of shares of common stock as of the Record Date and will reimburse such persons for their reasonable expenses of forwarding the proxy materials in accordance with customary practice. In addition, the Company has engaged Innisfree M&A Incorporated to provide proxy solicitation services for a fee of \$15,000, plus reimbursement of out-of-pocket expenses.



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The following table sets forth the beneficial ownership of our outstanding common stock as of September 1, 2009 by (i) each current director (including each nominee), (ii) each named executive officer of the Company identified in the Summary Compensation Table in our proxy statement for our 2009 annual meeting, and (iii) all current directors and executive officers as a group. There are currently no known beneficial owners of more than 5% of our common stock.

<b>Name of Beneficial Owner</b>	<b>Number of Shares Beneficially Owned</b>	<b>Number of Shares which Individual has the Right to Acquire</b>	<b>Total Number of Shares Beneficially Owned</b>	<b>Percent of Class (1)</b>
Jerry D. Dumas, Sr. (2)	635,450	562,141	1,197,591	4.99%
Jesse E. Neyman	36,258	2,981	39,239	*
Steven A. Reeves	177,328	11,775	189,103	*
Scott D. Stanton	5,556		5,556	*
John W. Chisholm	103,835	25,389	129,224	*
James R. Massey	26,104	1,852	27,956	*
Kevin G. McMahon	22,620	1,852	24,472	*
Barry E. Stewart	71,968	25,057	97,025	*
Richard O. Wilson	93,304	25,057	118,361	*
James A. Jowett (3)	6,395		6,395	*
Lisa G. Meier (4)	40,069		40,069	*
All current directors & executive officers as a group (11)	1,218,887	656,104	1,874,991	7.8%

\* Less than 1%

- (1) Based on 23,437,714 shares of common stock outstanding as of September 1, 2009. For purposes of this table, a person or group of persons is deemed to have beneficial ownership of any shares that such person or group of persons has the right to acquire within 60 days of September 1, 2009.
- (2) Includes 18,096 shares of common stock owned by Saxton River Corporation and 26,000 shares of common stock owned by Dora Tes Foundation both of which is controlled jointly by Mr. and Mrs. Dumas. Number of Shares which Individual has the Right to Acquire do not include shares issuable upon conversion of certain preferred stock or exercise of certain warrants that are not issuable within 60 days hereof as a result of provisions in the governing instruments of such preferred stock and warrants limiting the conversion or exercise thereof if such conversion or exercise would cause the holder to beneficially own more than 4.99% of our common stock.
- (3) Shares owned by Mr. Jowett as of final date of employment.
- (4) Shares owned by Ms. Meier as of final date of employment.

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**PROPOSAL 1: AMENDMENT OF AMENDED AND RESTATED CERTIFICATE OF INCORPORATION**

**TO INCREASE THE AUTHORIZED NUMBER OF SHARES OF COMMON STOCK**

Our Board has unanimously approved and is submitting for stockholder approval an amendment to our Amended and Restated Certificate of Incorporation, also referred to as the Charter, to increase the number of authorized shares of common stock from 40,000,000 shares to 80,000,000 shares. The number of preferred shares (currently 100,000) will be left unchanged.

Of the 40,000,000 currently authorized shares of common stock, as of September 1, 2009, there were 23,697,430 shares issued and 23,437,714 shares outstanding (not including 259,716 shares held as treasury shares). In addition, as of September 1, 2009, 8,907,698 shares were reserved for issuance upon the conversion of outstanding convertible notes, the exercise of outstanding warrants and the exercise of outstanding stock options under our stock-based compensation plans.

If Proposal No. 1 is approved, we will file the certificate of amendment to our Amended and Restated Certificate of Incorporation with the Secretary of State of the State of Delaware, which will become effective either upon filing or at such time as the Board determines the appropriate effective time for the increase in authorized shares, subject to Delaware law. The certificate of amendment would provide that Article FOUR of our Amended and Restated Certificate of Incorporation be amended to read as follows:

FOUR: The aggregate number of shares which the corporation shall have the authority to issue is 80,100,000, consisting of 80,000,000 shares of Common Stock, par value of \$.0001 per share, and 100,000 shares of Preferred Stock, par value of \$.0001 per share.

**Overview of Private Placement Transaction**

On August 12, 2009, we completed a private placement of shares of our preferred stock and warrants to purchase shares of our common stock, yielding aggregate gross proceeds of \$16 million. We undertook this private placement transaction to strengthen our balance sheet and increase our liquidity. In connection with this private placement, we also entered into a amendment to our bank credit facility to waive covenant violations as of June 30, 2009 and relax certain of the financial covenant obligations under our bank credit facility in the future. These actions were necessitated by the current downturn in domestic oil and gas drilling activity, which has adversely impacted our liquidity and results of operations. We used a portion of the net proceeds of this private placement to repay borrowings under our revolving credit facility, and will use the balance of the net proceeds for general corporate purposes, including making scheduled interest payments on our indebtedness.

In the private placement transaction, we issued an aggregate of 16,000 shares of our preferred stock, which are convertible into an aggregate of 6,956,512 shares of our common stock. We also issued currently exercisable warrants (the Exercisable Warrants ) entitling the holders to purchase an aggregate of 2,480,000 shares of our common stock at an exercise price of \$2.31 per share and Contingent Warrants entitling the holders, after stockholder approval of the Contingent Warrants, to purchase an aggregate of 8,000,000 shares of our common stock at an exercise price of \$2.45 per share. We do not currently have a sufficient number of authorized and unissued shares of common stock to permit the exercise of the Contingent Warrants. The terms of the preferred stock also permit us, after obtaining stockholder approval, to pay dividends on the preferred stock by issuing shares of our common stock in lieu of paying cash dividends. We do not currently have a sufficient number of authorized and unissued shares of common stock to permit us to issue shares of our common stock in lieu of paying cash dividends on our preferred stock. In addition, in order to reserve a sufficient number of shares of our common stock for issuance of shares upon conversion of the preferred stock and exercise of the Exercisable Warrants, we were required to utilize approximately 1,251,905 shares of our common stock that had previously been reserved for the issuance of common stock upon future grants of restricted stock or the exercise of future options under our existing stock incentive plans. As a result, we no longer have a sufficient number of authorized and unissued shares of common stock to permit us to make future grants under our current stock incentive plans.

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The purchase agreements we entered into with the investors in the private placement transaction require us to seek stockholder approval of the matters described in this Proxy Statement, including the Proposed Charter Amendment, and provide for certain penalties if we do not obtain stockholder approval of these matters.

### **Why We Are Seeking Stockholder Approval**

Pursuant to the law of our state of incorporation, Delaware, our Board must approve any amendment to our Charter and submit the amendment to stockholders. The affirmative vote of a majority of the outstanding shares of our common stock is required to approve Proposal No. 1. If stockholders approve Proposal No. 1, we will have sufficient authorized shares of our common stock to enable the exercise of the Contingent Warrants and to make future grants of options under our current stock incentive plans. If stockholders do not approve Proposal No. 1, we will be subject to the penalties described below.

### **Consequences of Not Obtaining Stockholder Approval**

Pursuant to the terms of the preferred stock, the dividend rate on the preferred stock will increase from 15% per annum to 17.5% per annum if we have not obtained stockholder approval of the Proposed Charter Amendment, the Preferred Stock PIK Dividend Provision and the Contingent Warrants on or before December 10, 2009, and will further increase to 20% per annum if we have not obtained such stockholder approval by April 9, 2010. Upon any subsequent obtaining of such stockholder approval, the dividend rate on the preferred stock will return to 15% per annum. Thus, failure to obtain stockholder approval of the Proposed Charter Amendment will result in increased dividends under our preferred stock. It is important that you approve the Proposed Charter Amendment so that the dividend rate on the preferred stock does not increase.

Also pursuant to the terms of the preferred stock, if we have not obtained stockholder approval of the Proposed Charter Amendment, the Preferred Stock PIK Dividend Provision and the Contingent Warrants on or before June 30, 2011, we will be required to make an offer to purchase all outstanding shares of our preferred stock at a price equal to 110% of the liquidation preference of the preferred stock plus all accrued and unpaid dividends. We may not have sufficient funds to pay the purchase price for any shares of preferred stock that are tendered to us if we are required to make this offer to purchase. It is therefore important that you approve the Proposed Charter Amendment so that we will not be required to make this offer to purchase the outstanding preferred stock in July 2011.

In addition, we believe that we will be required under generally accepted accounting principles to classify the preferred stock as indebtedness if we have not obtained the required stockholder approvals to eliminate this obligation to make an offer to repurchase the preferred stock. If we are required to classify the preferred stock as indebtedness, we currently would fall below the continued listing requirements of the New York Stock Exchange ( NYSE ) relating to minimum market value and stockholders' equity, which could result in the delisting of our shares of common stock from the NYSE. If our shares of common stock are delisted from the NYSE and we are unable to list our shares of common stock on another U.S. national or regional securities exchange or have our shares of common stock quoted on an established automated over-the-counter trading market in the United States within 30 days, we will be required to make an offer to repurchase all of our outstanding convertible notes at a price of 100% of the principal amount thereof plus accrued and unpaid interest. We may not have sufficient funds to pay the purchase price for any convertible notes that are tendered to us if we are required to make this offer to repurchase. It is therefore important that you approve the Proposed Charter Amendment so that we do not run this risk of our common stock being delisted from the NYSE and the risk of potentially being required to make an offer to repurchase our convertible notes.

Pursuant to the terms of the preferred stock, we can, at our election, automatically convert all outstanding shares of preferred stock into common stock if the closing price of our common stock equals or exceeds 150% of the preferred stock conversion price for at least 15 trading days in any period of 30 consecutive trading days. If we cause the preferred stock to automatically convert into shares of common stock before we have paid eight quarterly dividends on the preferred stock, we will be required to pay an additional amount to the holders of the

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preferred stock in connection with such automatic conversion equal to eight quarterly dividends less all dividends previously paid. This feature of the preferred stock will enable us to eliminate the further accrual of dividends on the preferred stock by converting all of the preferred stock into common stock. However, we cannot cause such automatic conversion unless we have previously obtained stockholder approval of the Proposed Charter Amendment and the Contingent Warrants. It is therefore important that you approve the Proposed Charter Amendment so that we will have the ability to automatically convert the preferred stock into shares of common stock if the price of our common stock reaches the required levels.

If stockholders do not approve the Proposed Charter Amendment at the meeting to which this Proxy Statement relates, the investors in our private placement transaction can require us to call and hold up to three additional meetings of our stockholders to consider and vote on the Proposed Charter Amendment and any of the other proposals set forth in this Proxy Statement that have not previously been approved. Calling such meetings and preparing and distributing proxy materials for such meetings will be expensive and will likely distract management of the Company from the operations of the Company. It is therefore important that you approve the Proposed Charter Amendment so that we are not required to call and hold additional special meetings of our stockholders to consider this and the other proposals again.

## **Other Considerations**

While not the primary purpose for the proposed increase, the additional authorized shares of common stock will also be available from time to time for corporate purposes, including raising additional capital, acquisitions of other companies, products, technologies or businesses, stock dividends, stock splits and other distributions. We do not have any current intention or plan to issue shares of common stock for any purpose except for the issuance of shares (i) upon exercise of the Contingent Warrants (if the Contingent Warrants are approved by stockholders), (ii) in payment of dividends on our preferred stock, if and when declared by our Board and not paid in cash (and if the Preferred Stock PIK Dividend Provision is approved by stockholders), and (iii) upon the exercise of outstanding stock options and future issuances under our existing equity compensation plans to the extent deemed appropriate by the Compensation Committee of our Board.

Authorized but unissued shares of our common stock may be issued from time to time upon authorization by our Board, at such times, to such persons and for such consideration as the Board may determine in its discretion, except as may be required for a particular transaction by applicable law, regulation or the rules of the NYSE. When and if such shares are issued, they would have the same voting and other rights and privileges as the currently issued and outstanding shares of common stock.

The authorization of the additional shares of common stock would not, by itself, have any effect on the rights of stockholders. However, holders of common stock have no preemptive rights to acquire additional shares of common stock, so the issuance of additional shares could have a dilutive effect on earnings per share and the voting power of existing stockholders at the time of the issuance. The issuance of additional shares of common stock, or the perception that additional shares may be issued, may also adversely affect the market price of our common stock.

The Board does not believe an increase in the number of authorized shares of our common stock would significantly affect the ability of a third party to attempt to gain control of us. However, it is possible that an increase in authorized shares of common stock could render such an acquisition more difficult under certain circumstances or discourage an attempt by a third party to obtain control of us by making possible the issuance of shares that would dilute the share ownership of a person attempting to obtain control or otherwise make it difficult to obtain any required stockholder approval for a proposed transaction for control. The Board has no current intention to authorize the issuance of additional shares of common stock for such purposes and is not aware of any present attempt to obtain control of us or otherwise accumulate our common stock.

**THE BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE FOR PROPOSAL NO. 1 TO AMEND OUR AMENDED AND RESTATED CERTIFICATE OF INCORPORATION**

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**PROPOSAL 2: APPROVAL OF THE ABILITY OF THE COMPANY TO PAY DIVIDENDS IN  
RESPECT OF THE PREFERRED STOCK IN SHARES OF COMMON STOCK**

Our Board has unanimously approved and is submitting for stockholder approval this proposal to permit the Company to pay dividends in the future in respect of its shares of preferred stock by issuing shares of the Company's common stock. If stockholders approve this Proposal No. 2, the Company will have the option in the future to pay dividends on its preferred stock in either cash or shares of our common stock or a combination of cash and shares of our common stock.

**Why We Are Seeking Stockholder Approval**

We issued 16,000 shares of our preferred stock on August 12, 2009 in our private placement transaction. Each share of preferred stock has a liquidation preference of \$1,000, and dividends on these shares of preferred stock accrue at 15% per annum, subject to increase in certain circumstances. Dividends on our outstanding shares of preferred stock are payable quarterly in cash or, at our option after stockholder approval of this Proposal No. 2, in shares of common stock based on the volume weighted average trading price of a share of common stock for the 10 trading days prior to the payment date of such dividends, or a combination of cash and shares of common stock. Although we do not currently have a sufficient number of authorized shares of common stock to pay dividends on our preferred stock in shares of our common stock, we will have sufficient authorized shares of common stock if stockholders approve the Proposed Charter Amendment described above in Proposal No. 1.

We believe that the ability to pay dividends on the shares of preferred stock by issuing shares of common stock will give us greater flexibility to retain cash for other uses, such as debt service payments and capital expenditures. In the current economic climate, we believe that it is important for us to have the option to preserve working capital by being able to pay dividends on our preferred stock by issuing shares of common stock in lieu of paying cash dividends.

The purchase agreements we entered into with the investors in the private placement transaction require us to seek stockholder approval of the matters described in this Proxy Statement, including the Preferred Stock PIK Dividend Provision, and provide for certain penalties if we do not obtain stockholder approval of these matters. If stockholders do not approve this Proposal No. 2, we will be subject to the penalties described below.

**Consequences of Not Obtaining Stockholder Approval**

Pursuant to the terms of the preferred stock, the dividend rate on the preferred stock will increase from 15% per annum to 17.5% per annum if we have not obtained stockholder approval of the Proposed Charter Amendment, the Preferred Stock PIK Dividend Provision and the Contingent Warrants on or before December 10, 2009, and will further increase to 20% per annum if we have not obtained such stockholder approval by April 9, 2010. Upon any subsequent obtaining of such stockholder approval, the dividend rate on the preferred stock will return to 15% per annum. Thus, failure to obtain stockholder approval of the Preferred Stock PIK Dividend Provision will result in increased dividends under our preferred stock. It is important that you approve the Preferred Stock PIK Dividend Provision so that the dividend rate on the preferred stock does not increase.

Also pursuant to the terms of the preferred stock, if we have not obtained stockholder approval of the Proposed Charter Amendment, the Preferred Stock PIK Dividend Provision and the Contingent Warrants on or before June 30, 2011, we will be required to make an offer to purchase all outstanding shares of our preferred stock at a price equal to 110% of the liquidation preference of the preferred stock plus all accrued and unpaid dividends. We may not have sufficient funds to pay the purchase price for any shares of preferred stock that are tendered to us if we are required to make this offer to purchase. It is therefore important that you approve the Preferred Stock PIK Dividend Provision so that we will not be required to make this offer to purchase the outstanding preferred stock in July 2011.

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In addition, we believe that we will be required under generally accepted accounting principles to classify the preferred stock as indebtedness if we have not obtained the required stockholder approvals to eliminate this obligation to make an offer to repurchase the preferred stock. If we are required to classify the preferred stock as indebtedness, we currently would fall below the continued listing requirements of the NYSE relating to minimum market value and stockholders' equity, which could result in the delisting of our shares of common stock from the NYSE. If our shares of common stock are delisted from the NYSE and we are unable to list our shares of common stock on another U.S. national or regional securities exchange or have our shares of common stock quoted on an established automated over-the-counter trading market in the United States within 30 days, we will be required to make an offer to repurchase all of our outstanding convertible notes at a price of 100% of the principal amount thereof plus accrued and unpaid interest. We may not have sufficient funds to pay the purchase price for any convertible notes that are tendered to us if we are required to make this offer to repurchase. It is therefore important that you approve the Preferred Stock PIK Dividend Provision so that we do not run this risk of our common stock being delisted from the NYSE and the risk of potentially being required to make an offer to repurchase our convertible notes.

If stockholders do not approve the Preferred Stock PIK Dividend Provision at the meeting to which this Proxy Statement relates, the investors in our private placement transaction can require us to call and hold up to three additional meetings of our stockholders to consider and vote on the Preferred Stock PIK Dividend Provision and any of the other proposals set forth in this Proxy Statement that have not previously been approved. Calling such meetings and preparing and distributing proxy materials for such meetings will be expensive and will likely distract management of the Company from the operations of the Company. It is therefore important that you approve the Preferred Stock PIK Dividend Provision so that we are not required to call and hold additional special meetings of our stockholders to consider this and the other proposals again.

## **Other Considerations**

The issuance of additional shares of common stock in payment of dividends on our shares of preferred stock could have a dilutive effect on earnings per share and the voting power of existing stockholders at the time of the issuance. The issuance of additional shares of common stock, or the perception that additional shares may be issued, may also adversely affect the market price of our common stock.

**THE BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE FOR PROPOSAL NO. 2 TO APPROVE THE PREFERRED STOCK PIK DIVIDEND PROVISION.**

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**PROPOSAL 3: APPROVAL OF THE EXERCISABLE WARRANT ANTI-DILUTION PROVISION**

Our Board has unanimously approved and is submitting for stockholder approval this proposal to approve the anti-dilution provision of certain warrants we issued in our private placement transaction on August 12, 2009. If stockholders approve this Proposal No. 3, the exercise price of such warrants will be subject to adjustment in certain circumstances.

**Why We Are Seeking Stockholder Approval**

In the private placement transaction that we completed on August 12, 2009, we issued shares of preferred stock and warrants to purchase shares of our common stock. Of those warrants, warrants to purchase an aggregate of 2,480,000 shares of common stock are currently exercisable, and warrants to purchase 8,000,000 shares of common stock are contingent on stockholder approval (as described below in Proposal No. 4). The Exercisable Warrants contain a provision that provides that if, prior to the exercise or termination of the Exercisable Warrants, we issue shares of common stock or securities convertible into or exercisable for shares of common stock at a consideration per share less than the exercise price of the Exercisable Warrants (currently \$2.31 per share), subject to certain exceptions, the exercise price of the Exercisable Warrants will be reduced to be equal to the aggregate consideration per share of common stock received by the Company in such issuance. In accordance with NYSE rules, this provision only applies after we have obtained stockholder approval of such anti-dilution price protection provision. The Exercisable Warrants will expire if not exercised on or before August 11, 2014. The anti-dilution provision of the Exercisable Warrants and related definitions are attached to this Proxy Statement as Exhibit A.

The purchase agreements we entered into with the investors in the private placement transaction require us to seek stockholder approval of the matters described in this Proxy Statement, including the Exercisable Warrant Anti-dilution Provision, and provide for certain penalties if we do not obtain stockholder approval of these matters. If stockholders do not approve this Proposal No. 3, we will be subject to the penalties described below.

**Consequences of Not Obtaining Stockholder Approval**

If stockholders do not approve the Exercisable Warrant Anti-dilution Provision at the meeting to which this Proxy Statement relates, the investors in our private placement transaction can require us to call and hold up to three additional meetings of our stockholders to consider and vote on the Exercisable Warrant Anti-dilution Provision and any of the other proposals set forth in this Proxy Statement that have not previously been approved. Calling such meetings and preparing and distributing proxy materials for such meetings will be expensive and will likely distract management of the Company from the operations of the Company. It is therefore important that you approve the Exercisable Warrant Anti-dilution Provision so that we are not required to call and hold additional special meetings of our stockholders to consider this and the other proposals again.

**Other Considerations**

Any reduction in the exercise price of the Exercisable Warrants will result in the receipt by the Company of less consideration upon the exercise of the Exercisable Warrants, which may have a dilutive effect on the book value per share of our common stock. However, the Exercisable Warrant Anti-dilution Provision will not increase the number of shares of common stock issuable upon exercise of the Exercisable Warrants.

**THE BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE FOR PROPOSAL NO. 3 TO APPROVE THE EXERCISABLE WARRANT ANTI-DILUTION PROVISION.**

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**PROPOSAL 4: APPROVAL OF THE CONTINGENT WARRANTS**

Our Board has unanimously approved and is submitting for stockholder approval this proposal to approve the Contingent Warrants we issued in our private placement transaction on August 12, 2009. If stockholders approve this Proposal No. 4, the Contingent Warrants will be exercisable on the terms described below.

**Why We Are Seeking Stockholder Approval**

In the private placement transaction that we completed on August 12, 2009, we issued shares of preferred stock and warrants to purchase shares of our common stock. Of those warrants, warrants to purchase 8,000,000 shares of common stock are contingent on stockholder approval as set forth in this Proposal No. 4. In accordance with NYSE rules, the Contingent Warrants are not exercisable until we have obtained stockholder approval of the Contingent Warrants.

The purchase agreements we entered into with the investors in the private placement transaction require us to seek stockholder approval of the matters described in this Proxy Statement, including the Contingent Warrants, and provide for certain penalties if we do not obtain stockholder approval of these matters. If stockholders do not approve this Proposal No. 4, we will be subject to the penalties described below.

**Summary of the Contingent Warrants**

The terms of the Contingent Warrants are governed by the warrant certificates issued to the investors in the private placement transaction, and the following summary is qualified in its entirety by the terms set forth in such warrant certificates. A form of the warrant certificate governing the Contingent Warrants is attached to this Proxy Statement as Exhibit B.

The Contingent Warrants will be exercisable at any time on or after the first business day following approval by the stockholders of the Contingent Warrants and the Proposed Charter Amendment and on or before 5:00 p.m., New York time, on the earlier of (1) the sixty-month anniversary of the day following approval by the stockholders of the Contingent Warrants and the Proposed Charter Amendment or (2) the ninety-eight-month anniversary of August 12, 2009.

The Contingent Warrants will be exercisable, at the option of each holder, in whole or in part by properly delivering a notice of exercise to the Company, accompanied by payment in full for the number of shares of the common stock purchased upon such exercise (except in the event of a proper cashless exercise as described below).

The holder will not have the right to exercise any portion of the Contingent Warrants to the extent the holder would beneficially own in excess of 4.99% (or, if elected by a holder of the warrant upon not less than 61 days advance written notice, up to 9.99%) of the number of shares of common stock outstanding immediately after the exercise.

If we are in breach of our obligations under the purchase agreements that we entered into in connection with the private placement transaction to provide an effective registration statement for the resale of the shares of common stock issuable upon exercise of the Contingent Warrants, then the Contingent Warrants may be exercised, if otherwise exercisable and only during the continuation of such breach, on a cashless basis. If any Contingent Warrants are so exercisable on a cashless basis, such Contingent Warrants will be exercisable, in whole or in part by properly delivering a notice of exercise to the Company, by canceling a portion of the warrant in payment of the purchase price payable in respect of the number of shares of common stock purchased upon such exercise.

The exercise price per share of common stock underlying the Contingent Warrants is \$2.45. This exercise price is subject to appropriate adjustment in the event of stock splits, certain dividends and distributions, reorganizations and similar events affecting the Company's common stock.



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If prior to the exercise or termination of the Contingent Warrants we issue shares of common stock or securities convertible into or exercisable for shares of common stock at a consideration per share less than the exercise price of the Contingent Warrants, subject to certain exceptions, the exercise price of the Contingent Warrants will be reduced to be equal to the aggregate consideration per share of common stock received by us in such issuance.

It shall be a condition to our entry into a Fundamental Transaction that the successor entity assumes in writing (or remains bound by) all of our obligations under the Contingent Warrants pursuant to written agreements, including (if necessary) agreements to deliver to each holder of Contingent Warrants in exchange for such Contingent Warrants a written instrument issued by the successor entity substantially similar in form and substance to the Contingent Warrants exercisable for the consideration that would have been issuable in the Fundamental Transaction in respect of the shares issuable upon exercise of the Contingent Warrants had the Contingent Warrants been exercised immediately prior to the consummation of the Fundamental Transaction. In the event of certain Fundamental Transactions, we will be required to make an offer to purchase the Contingent Warrants from the holders after such Fundamental Transaction at the Black Scholes value of such Contingent Warrants.

Fundamental Transaction means one or more related transactions in which, (i) the Company, directly or indirectly, effects any merger or consolidation with or into another person, (ii) the Company, directly or indirectly, effects any sale, lease, license, assignment, transfer, conveyance or other disposition of all or substantially all of its assets, (iii) any, direct or indirect, purchase offer, tender offer or exchange offer (whether by the Company or another person) is completed pursuant to which holders of the Company's common stock are permitted to sell, tender or exchange their shares for other securities, cash or property and has been accepted by the holders of 50% or more of the Company's outstanding common stock, (iv) the Company, directly or indirectly, effects any reclassification, reorganization or recapitalization of its common stock or any compulsory share exchange pursuant to which the Company's common stock is effectively converted into or exchanged for other securities, cash or property, or (v) the Company, directly or indirectly, consummates a stock or share purchase agreement or other business combination (including, without limitation, a reorganization, recapitalization, spin-off or scheme of arrangement) with another person whereby such other person acquires more than 50% of the outstanding shares of the Company's common stock (not including any shares of common stock held by the other person or other persons making or party to, or associated or affiliated with the other persons making or party to, such stock or share purchase agreement or other business combination).

The Contingent Warrants and all associated rights are transferable, in whole or in part, at the option of the holder, upon surrender to us of the Contingent Warrant together with a written assignment of the Contingent Warrant duly executed by the holder of such Contingent Warrant, payment to us of funds sufficient to pay any transfer taxes payable upon the making of such transfer, and delivery by the holder and transferee to us of any factual representations reasonably required to establish exemptions from the registration requirements of applicable securities laws relating to such transfer. The Contingent Warrants are restricted securities under Rule 144, and may not be transferred except pursuant to an effective registration statement or an exemption from the registration requirements of the Securities Act. We have no obligation to file a registration statement to register the resale of the Contingent Warrants.

### **Consequences of Not Obtaining Stockholder Approval**

Pursuant to the terms of the preferred stock, the dividend rate on the preferred stock will increase from 15% per annum to 17.5% per annum if we have not obtained stockholder approval of the Proposed Charter Amendment, the Preferred Stock PIK Dividend Provision and the Contingent Warrants on or before December 10, 2009, and will further increase to 20% per annum if we have not obtained such stockholder approval by April 9, 2010. Upon any subsequent obtaining of such stockholder approval, the dividend rate on the preferred stock will return to 15% per annum. Thus, failure to obtain stockholder approval of the Contingent Warrants will result in increased dividends under our preferred stock. It is important that you approve the Contingent Warrants so that the dividend rate on the preferred stock does not increase.

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Also pursuant to the terms of the preferred stock, if we have not obtained stockholder approval of the Proposed Charter Amendment, the Preferred Stock PIK Dividend Provision and the Contingent Warrants on or before June 30, 2011, we will be required to make an offer to purchase all outstanding shares of our preferred stock at a price equal to 110% of the liquidation preference of the preferred stock plus all accrued and unpaid dividends. We may not have sufficient funds to pay the purchase price for any shares of preferred stock that are tendered to us if we are required to make this offer to purchase. It is therefore important that you approve the Contingent Warrants so that we will not be required to make this offer to purchase the outstanding preferred stock in July 2011.

In addition, we believe that we will be required under generally accepted accounting principles to classify the preferred stock as indebtedness if we have not obtained the required stockholder approvals to eliminate this obligation to make an offer to repurchase the preferred stock. If we are required to classify the preferred stock as indebtedness, we currently would fall below the continued listing requirements of the NYSE relating to minimum market value and stockholders' equity, which could result in the delisting of our shares of common stock from the NYSE. If our shares of common stock are delisted from the NYSE and we are unable to list our shares of common stock on another U.S. national or regional securities exchange or have our shares of common stock quoted on an established automated over-the-counter trading market in the United States within 30 days, we will be required to make an offer to repurchase all of our outstanding convertible notes at a price of 100% of the principal amount thereof plus accrued and unpaid interest. We may not have sufficient funds to pay the purchase price for any convertible notes that are tendered to us if we are required to make this offer to repurchase. It is therefore important that you approve the Contingent Warrants so that we do not run this risk of our common stock being delisted from the NYSE and the risk of potentially being required to make an offer to repurchase our convertible notes.

If stockholders do not approve the Contingent Warrants at the meeting to which this Proxy Statement relates, the investors in our private placement transaction can require us to call and hold up to three additional meetings of our stockholders to consider and vote on the Contingent Warrants and any of the other proposals set forth in this Proxy Statement that have not previously been approved. Calling such meetings and preparing and distributing proxy materials for such meetings will be expensive and will likely distract management of the Company from the operations of the Company. It is therefore important that you approve the Contingent Warrants so that we are not required to call and hold additional special meetings of our stockholders to consider this and the other proposals again.

## **Other Considerations**

The issuance of additional shares of common stock upon exercise of the Contingent Warrants could have a dilutive effect on earnings per share and the voting power of existing stockholders at the time of the issuance. The issuance of additional shares of common stock, or the perception that additional shares may be issued, may also adversely affect the market price of our common stock.

**THE BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE FOR PROPOSAL NO. 4 TO APPROVE THE CONTINGENT WARRANTS.**

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**OTHER MATTERS**

The Board is not aware of any other matters that may come before the Meeting. However, the proxies may be voted with discretionary authority with respect to any other matters that may properly come before the Meeting.

**STOCKHOLDER COMMUNICATIONS**

Stockholder proposals for inclusion in the Proxy Statement for the 2010 Annual Meeting of Stockholders must be received by the Company at its principal executive offices by January 6, 2010 to be considered for inclusion in the Proxy Statement and form of proxy relation to the 2010 Annual Meeting of Stockholders. Such stockholder proposals, together with any supporting statements, should be directed to the Secretary of the Company.

Stockholders and interested parties who wish to communicate with the Board, or with any individual director, may do so by (1) calling Lighthouse Services Inc., a third party call center, at (800) 785-1003 or (2) correspondence addressed to the Board, or to an individual director, at the principal executive offices of the Company. All communications received from stockholders are sent directly to Board members.

Stockholders who have questions about the Special Meeting or who need assistance in voting their shares may call the Company's proxy solicitor, Innisfree M&A Incorporated, toll-free at (888) 750-5834. Banks and brokers may call collect at (212) 750-5833.

**Table of Contents****EXHIBIT A****Anti Dilution Provision of Exercisable Warrants and Related Definitions**

Subject to stockholder approval of this section, if at any time on or after the Initial Exercise Date the Company issues or sells, or in accordance with this is deemed to have issued or sold, any shares of Common Stock (including the issuance or sale of shares of Common Stock owned or held by or for the account of the Company, but excluding Excluded Securities) for a consideration per share (the New Issuance Price ) less than a price (the Applicable Price ) equal to the Exercise Price in effect immediately prior to such issue or sale or deemed issuance or sale (the foregoing, a Dilutive Issuance ), then immediately after such Dilutive Issuance the Exercise Price then in effect shall be reduced to an amount equal to the New Issuance Price. For purposes of determining the adjusted Exercise Price under this section, the following shall be applicable:

(a) **Issuance of Options.** If the Company in any manner grants any Options and the lowest price per share for which one share of Common Stock is issuable upon the exercise of any such Option or upon conversion, exercise or exchange of any Convertible Securities issuable upon exercise of any such Option is less than the Applicable Price, then such share of Common Stock shall be deemed to be outstanding and to have been issued and sold by the Company at the time of the granting or sale of such Option for such price per share. For purposes of this section, the lowest price per share for which one share of Common Stock is issuable upon exercise of such Options or upon conversion, exercise or exchange of such Convertible Securities shall be equal to the sum of the lowest amounts of consideration (if any) received or receivable by the Company with respect to any one share of Common Stock upon the granting or sale of the Option, upon exercise of the Option and upon conversion, exercise or exchange of any Convertible Security issuable upon exercise of such Option. No further adjustment of the Exercise Price shall be made upon the actual issuance of such Common Stock or of such Convertible Securities upon the exercise of such Options or upon the actual issuance of such Common Stock upon conversion, exercise or exchange of such Convertible Securities.

(b) **Issuance of Convertible Securities.** If the Company in any manner issues or sells any Convertible Securities and the lowest price per share for which one share of Common Stock is issuable upon the conversion, exercise or exchange thereof is less than the Applicable Price, then such share of Common Stock shall be deemed to be outstanding and to have been issued and sold by the Company at the time of the issuance or sale of such Convertible Securities for such price per share. For the purposes of this section, the lowest price per share for which one share of Common Stock is issuable upon the conversion, exercise or exchange shall be equal to the sum of the lowest amounts of consideration (if any) received or receivable by the Company with respect to one share of Common Stock upon the issuance or sale of the Convertible Security and upon conversion, exercise or exchange of such Convertible Security. No further adjustment of the Exercise Price shall be made upon the actual issuance of such Common Stock upon conversion, exercise or exchange of such Convertible Securities, and if any such issue or sale of such Convertible Securities is made upon exercise of any Options for which adjustment of this exercisable warrant has been or is to be made pursuant to other provisions of this section, no further adjustment of the Exercise Price shall be made by reason of such issue or sale.

(c) **Change in Option Price or Rate of Conversion.** If the purchase price provided for in any Options, the additional consideration, if any, payable upon the issue, conversion, exercise or exchange of any Convertible Securities, or the rate at which any Convertible Securities are convertible into or exercisable or exchangeable for Common Stock increases or decreases at any time, the Exercise Price in effect at the time of such increase or decrease shall be adjusted to the Exercise Price which would have been in effect at such time had such Options or Convertible Securities provided for such increased or decreased purchase price, additional consideration or increased or decreased conversion rate, as the case may be, at the time initially granted, issued or sold. For purposes of this section, if the terms of any Option or Convertible Security that was outstanding as of the date of issuance of this exercisable warrant are increased or decreased in the manner described in the immediately preceding sentence, then such Option or Convertible Security and the

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Common Stock deemed issuable upon exercise, conversion or exchange thereof shall be deemed to have been issued as of the date of such increase or decrease. No adjustment pursuant to this section shall be made if such adjustment would result in an increase of the Exercise Price then in effect.

(d) Calculation of Consideration Received. In case any Option is issued in connection with the issue or sale of other securities of the Company, together comprising one integrated transaction in which no specific consideration is allocated to such Options by the parties thereto, the Options will be deemed to have been issued for a consideration of \$0.0001. If any Common Stock, Options or Convertible Securities are issued or sold or deemed to have been issued or sold for cash, the consideration received therefor will be deemed to be the net amount received by the Company therefor. If any Common Stock, Options or Convertible Securities are issued or sold for a consideration other than cash, the amount of such consideration received by the Company will be the fair value of such consideration, except where such consideration consists of securities, in which case the amount of consideration received by the Company will be the Closing Sale Price of such security on the date of receipt. If any Common Stock, Options or Convertible Securities are issued to the owners of the non-surviving entity in connection with any merger in which the Company is the surviving entity, the amount of consideration therefor will be deemed to be the fair value of such portion of the net assets and business of the non-surviving entity as is attributable to such Common Stock, Options or Convertible Securities, as the case may be. The fair value of any consideration other than cash or securities will be determined in good faith by the board of directors of the Company.

(e) Record Date. If the Company takes a record of the holders of Common Stock for the purpose of entitling them (A) to receive a dividend or other distribution payable in Options or in Convertible Securities or (B) to subscribe for or purchase Common Stock, Options or Convertible Securities, then such record date will be deemed to be the date of the issue or sale of the shares of Common Stock deemed to have been issued or sold upon the declaration of such dividend or the making of such other distribution or the date of the granting of such right of subscription or purchase, as the case may be.

***Certain Defined Terms***

**Closing Sale Price** means, for any security as of any date, the last closing trade price for such security on the Principal Market, as reported by Bloomberg, L.P. ( "Bloomberg" ), or, if the Principal Market begins to operate on an extended hours basis and does not designate the closing trade price, then the last trade price of such security prior to 4:00 p.m., New York Time, as reported by Bloomberg, or, if the Principal Market is not the principal securities exchange or trading market for such security, the last trade price of such security on the principal securities exchange or Trading Market where such security is listed or traded as reported by Bloomberg, or if the foregoing do not apply, the last trade price of such security in the over-the-counter market on the electronic bulletin board for such security as reported by Bloomberg, or, if no last trade price is reported for such security by Bloomberg, the average of the bid prices, or the ask prices, respectively, of any market makers for such security as reported in the "pink sheets" by Pink Sheets LLC (formerly the National Quotation Bureau, Inc.).

**Common Stock** means the common stock, par value \$0.0001 per share, of the Company.

**Convertible Securities** means any stock or securities (other than Options) directly or indirectly convertible into or exercisable or exchangeable for Common Stock.

**Excluded Securities** means any Common Stock issued or issuable: (i) in connection with any stock plan of the Company; (ii) upon exercise of the exercisable warrants; (iii) pursuant to a bona fide firm commitment underwritten public offering with a nationally recognized underwriter that generates gross proceeds to the Company in excess of \$25,000,000 (other than an "at-the-market offering" as defined in Rule 415(a)(4) under the Securities Act and "equity lines" ); (iv) upon conversion of any Options or Convertible Securities that are outstanding on the day immediately preceding the Initial Exercise Date, provided that the terms of such Options or Convertible Securities are not amended, modified or changed on or after the Initial Exercise Date; (v) in

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connection with any acquisition, merger, joint venture or strategic investment that has been approved by the board of directors of the Company; (vi) securities issued to commercial banks or financial institutions, the primary business of which is not making equity-related loans; (vii) securities issued to lessors in connection with commercial credit arrangements, equipment financings or similar transactions or to independent contractors or vendors of the Company in connection with bona fide business transactions; or (vii) upon conversion of the preferred stock issued in connection with the exercisable warrants.

Exercise Price means \$2.31 per share of Common Stock under the exercisable warrant, subject to adjustment.

Initial Exercise Date means August 11, 2009.

Options means any right, warrants or options to subscribe for or purchase Common Stock or Convertible Securities.

Principal Market means the New York Stock Exchange.

Trading Market means any of the following markets or exchanges on which the Common Stock is listed or quoted for trading on the date in question: the NYSE Alternext, the Nasdaq Capital Market, the Nasdaq Global Market, the Nasdaq Global Select Market or the New York Stock Exchange (or any successors to any of the foregoing).

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**EXHIBIT B**

NEITHER THE WARRANTS REPRESENTED BY THIS WARRANT CERTIFICATE NOR THE SECURITIES ISSUABLE UPON EXERCISE HEREOF HAVE BEEN REGISTERED OR QUALIFIED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE SECURITIES ACT ), OR THE SECURITIES LAWS OF ANY STATE OR OTHER JURISDICTION. SUCH SECURITIES MAY NOT BE OFFERED, SOLD, PLEDGED OR OTHERWISE TRANSFERRED EXCEPT (1) PURSUANT TO AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OR (2) PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT, IN EACH CASE IN ACCORDANCE WITH ALL APPLICABLE STATE SECURITIES LAWS AND THE SECURITIES LAWS OF OTHER JURISDICTIONS, AND IN THE CASE OF A TRANSACTION EXEMPT FROM REGISTRATION, UNLESS THE COMPANY HAS RECEIVED AN OPINION OF COUNSEL REASONABLY SATISFACTORY TO IT THAT SUCH TRANSACTION DOES NOT REQUIRE REGISTRATION UNDER THE SECURITIES ACT AND SUCH OTHER APPLICABLE LAWS OR THE COMPANY HAS RECEIVED FROM THE HOLDER REASONABLE ASSURANCE THAT THE SECURITIES CAN BE SOLD, ASSIGNED OR TRANSFERRED PURSUANT TO RULE 144 UNDER THE SECURITIES ACT. NOTWITHSTANDING THE FOREGOING, THE SECURITIES MAY BE PLEDGED IN CONNECTION WITH A BONA FIDE MARGIN ACCOUNT OR OTHER LOAN OR FINANCING ARRANGEMENT SECURED BY THE SECURITIES.

FLOTEK INDUSTRIES, INC.

**WARRANT TO PURCHASE COMMON STOCK**

Warrant Shares: \_\_\_\_\_

Issue Date: August 11, 2009

THIS WARRANT TO PURCHASE COMMON STOCK (the Warrant ) certifies that, for value received, \_\_\_\_\_ (the Holder ) is entitled, upon the terms and subject to the limitations on exercise and the conditions hereinafter set forth, at any time on or after the date Flotek Industries, Inc., a Delaware corporation (the Company ) obtains the Stockholder Approval described in Section 5 hereof (the Initial Exercise Date ) and on or prior to the earlier of (i) 5:00 p.m. Eastern time on the 60-month anniversary of the date the Company obtains the Stockholder Approval, or (ii) 5:00 p.m. Eastern time on the 98-month anniversary of the date hereof (the Termination Date ) but not thereafter, to subscribe for and purchase from the Company \_\_\_\_\_ fully paid nonassessable shares of Common Stock of the Company (the Warrant Shares ). The purchase price of one share of Common Stock under this Warrant shall be equal to the Exercise Price, as defined in Section 2(b).

Section 1. Definitions. As used herein, the following terms shall have the following respective meanings:

- a) Affiliate means any Person that, directly or indirectly through one or more intermediaries, controls or is controlled by or is under common control with a Person, as such terms are used in and construed under Rule 405 under the Securities Act.
- b) Board of Directors means the board of directors of the Company.
- c) Business Day means any day except any Saturday, any Sunday, any day which is a federal legal holiday in the United States or any day on which banking institutions in the State of New York are authorized or required by law or other governmental action to close.
- d) Certificate of Designations means the Certificate of Designations of the Company establishing the Preferred Stock.

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- e) Certificate of Incorporation means the Amended and Restated Certificate of Incorporation of the Company, as such may be amended, modified or restated from time to time.
  
- f) Closing Sale Price means, for any security as of any date, the last closing trade price for such security on the Principal Market, as reported by Bloomberg, L.P. (Bloomberg ), or, if the Principal Market begins to operate on an extended hours basis and does not designate the closing trade price, then the last trade price of such security prior to 4:00 p.m., New York Time, as reported by Bloomberg, or, if the Principal Market is not the principal securities exchange or trading market for such security, the last trade price of such security on the principal securities exchange or Trading Market where such security is listed or traded as reported by Bloomberg, or if the foregoing do not apply, the last trade price of such security in the over-the-counter market on the electronic bulletin board for such security as reported by Bloomberg, or, if no last trade price is reported for such security by Bloomberg, the average of the bid prices, or the ask prices, respectively, of any market makers for such security as reported in the pink sheets by Pink Sheets LLC (formerly the National Quotation Bureau, Inc.).
  
- g) Commission means the United States Securities and Exchange Commission.
  
- h) Common Stock means the common stock, par value \$0.0001 per share, of the Company.
  
- i) Convertible Securities means any stock or securities (other than Options) directly or indirectly convertible into or exercisable or exchangeable for Common Stock.
  
- j) Exchange Act means the Securities Exchange Act of 1934, as amended, and the rules and regulations promulgated thereunder.
  
- k) Excluded Securities means any Common Stock issued or issuable: (i) in connection with any stock plan of the Company; (ii) upon exercise of the Warrants; (iii) pursuant to a bona fide firm commitment underwritten public offering with a nationally recognized underwriter that generates gross proceeds to the Company in excess of \$25,000,000 (other than an at-the-market offering as defined in Rule 415(a)(4) under the Securities Act and equity lines ); (iv) upon conversion of any Options or Convertible Securities that are outstanding on the day immediately preceding the Initial Exercise Date, provided that the terms of such Options or Convertible Securities are not amended, modified or changed on or after the Initial Exercise Date; (v) in connection with any acquisition, merger, joint venture or strategic investment that has been approved by the Board of Directors of the Company; (vi) securities issued to commercial banks or financial institutions, the primary business of which is not making equity-related loans; (vii) securities issued to lessors in connection with commercial credit arrangements, equipment financings or similar transactions or to independent contractors or vendors of the Company in connection with bona fide business transactions; or (viii) in connection with the conversion of the Preferred Stock or exercise of the warrants issued in connection with the Warrants (including warrants issued after the date hereof to the placement agent pursuant to the agreement between the Company and the placement agent entered into in connection with the issuance of Warrants, not to exceed 175,000 shares at an exercise price of not less than \$2.31 per share).
  
- l) Options means any right, warrants or options to subscribe for or purchase Common Stock or Convertible Securities.
  
- m) &m">

20,795

Short-term investments - Available for Sale

2,478

2,430

2,443

Short-term investments - Held-To-Maturity

4,015

-

-



Accounts receivable, net

24,220

19,039

24,577

Inventories

50,209

45,954

51,482

Other current assets

2,263

1,675

2,894

Total current assets

98,924

83,008

102,191

Property, plant and equipment, net

52,530

45,537

51,651

Goodwill

11,462

11,462

11,462

Deferred income taxes

491

581

419

Long-term investments - Held-To-Maturity

26,853

31,050

30,945

Long-term investments - Rabbi Trust

6,921

4,994

5,466

Investment in unconsolidated joint venture

1,522

-

1,106

Other assets

2,340

2,495

2,394

Total assets

\$

201,043

179,127

205,634

Current liabilities:

Accounts payable-trade

\$

24,600

20,183

29,101

Accounts payable - capital expenditures

3,209

3,000

4,767

Accrued expenses

7,364

8,878

11,947

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Income taxes payable - current

692

513

287

Total current liabilities

35,865

32,574

46,102

Accounts payable - capital expenditures

-

-

1,322

Income taxes payable - long-term

487

3,734

467

Deferred income taxes

4,641

1,699

3,593

Deferred compensation

6,970

5,171

5,520

Total liabilities

47,963

43,178

57,004

Commitments and Contingencies (Note 15)

Shareholders' equity

Preferred stock, \$0.05 par value, authorized

10,000,000

-

-

-

Common stock, \$0.05 par value, authorized

40,000,000 shares, issued and outstanding

12,435,276 at October 29, 2017; 12,311,756

at October 30, 2016; and 12,356,631 at

April 30, 2017

622

615

618

Capital contributed in excess of par value

47,441

45,349

47,415

Accumulated earnings

104,957

90,029

100,601

Accumulated other comprehensive income (loss)

60

(44

)

(4

)

Total shareholders' equity

153,080

135,949

148,630

Total liabilities and shareholders' equity

\$

201,043

179,127

205,634

\* Derived from audited financial statements.

See accompanying notes to consolidated financial statements.

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CULP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE SIX MONTHS ENDED OCTOBER 29, 2017 AND OCTOBER 30, 2016  
UNAUDITED  
(Amounts in Thousands)

	SIX MONTHS ENDED	
	October 29, 2017	October 30, 2016
Cash flows from operating activities:		
Net income	\$8,959	9,789
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	3,713	3,511
Amortization of other assets	166	80
Stock-based compensation	1,558	1,657
Deferred income taxes	976	2,121
Realized loss on sale of short-term investments (Available for Sale)	-	12
Loss on sale of equipment	-	9
Loss from investment in unconsolidated joint venture	193	-
Foreign currency exchange loss (gain)	42	(53 )
Changes in assets and liabilities:		
Accounts receivable	561	4,142
Inventories	1,597	219
Other current assets	723	751
Other assets	(35 )	-
Accounts payable - trade	(5,074 )	(3,274 )
Accrued expenses and deferred compensation	(3,607 )	(2,469 )
Income taxes	406	554
Net cash provided by operating activities	10,178	17,049
Cash flows from investing activities:		
Capital expenditures	(4,978 )	(6,308 )
Investment in unconsolidated joint venture	(609 )	-
Proceeds from the sale of equipment	6	-
Proceeds from the sale of short-term investments (Available for Sale)	-	2,000
Purchase of short-term investments (Available for Sale)	(24 )	(23 )
Purchase of long-term investments (Held-To-Maturity)	-	(31,050)
Proceeds from the sale of long-term investments (Rabbi Trust)	54	-
Purchase of long-term investments (Rabbi Trust)	(1,457 )	(929 )
Net cash used in investing activities	(7,008 )	(36,310)
Cash flows from financing activities:		
Proceeds from line of credit	10,000	7,000
Payments on line of credit	(10,000)	(7,000 )
Payments on vendor-financed capital expenditures	(2,500 )	-
Dividends paid	(4,603 )	(4,307 )
Common stock surrendered for withholding taxes payable	(1,147 )	(280 )
Payments on debt issuance costs	-	(2 )
Proceeds from common stock issued	5	11
Net cash used in financing activities	(8,245 )	(4,578 )
Effect of exchange rate changes on cash and cash equivalents	19	(38 )
Decrease in cash and cash equivalents	(5,056 )	(23,877)
Cash and cash equivalents at beginning of period	20,795	37,787

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Cash and cash equivalents at end of period	\$ 15,739	13,910
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See accompanying notes to consolidated financial statements.

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CULP, INC.  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
UNAUDITED  
(Dollars in thousands, except share data)

	Common Stock		Capital Contributed in Excess of Par	Accumulated Earnings	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
	Shares	Amount	Value			
Balance, May 1, 2016	12,265,489	\$ 614	43,795	84,547	(144 )	\$ 128,812
Net income	-	-	-	22,334	-	22,334
Stock-based compensation	-	-	3,358	-	-	3,358
Unrealized gain on investments	-	-	-	-	140	140
Excess tax benefit related to stock based compensation	-	-	657	-	-	657
Common stock issued in connection with vesting of performance based restricted stock units	49,192	2	(2 )	-	-	-
Fully vested common stock award	4,800	-	-	-	-	-
Common stock issued in connection with exercise of stock options	68,000	3	585	-	-	588
Common stock surrendered for the cost of stock option exercises and withholding taxes payable	(30,850 )	(1 )	(978 )	-	-	(979 )
Dividends paid	-	-	-	(6,280 )	-	(6,280 )
Balance, April 30, 2017 *	12,356,631	618	47,415	100,601	(4 )	148,630
Net income	-	-	-	8,959	-	8,959
Stock-based compensation	-	-	1,558	-	-	1,558
Unrealized gain on investments	-	-	-	-	64	64
Common stock issued in connection with vesting of performance based restricted stock units	118,845	6	(6 )	-	-	-
Fully vested common stock award	4,800	-	-	-	-	-
Common stock issued in connection with vesting of time-based restricted stock unit	1,200	-	-	-	-	-
Common stock issued in connection with exercise of stock options	600	-	5	-	-	5
Common stock surrendered for withholding taxes payable	(46,800 )	(2 )	(1,531 )	-	-	(1,533 )
Dividends paid	-	-	-	(4,603 )	-	(4,603 )
Balance, October 29, 2017	12,435,276	\$ 622	47,441	104,957	60	\$ 153,080

\* Derived from audited financial statements.

See accompanying notes to consolidated financial statements.



Culp, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Culp, Inc. and subsidiaries (the “company”) include all adjustments, which are, in the opinion of management, necessary for fair presentation of the results of operations and financial position. All of these adjustments are of a normal recurring nature. Results of operations for interim periods may not be indicative of future results. The unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements, which are included in the company’s annual report on Form 10-K filed with the Securities and Exchange Commission on July 14, 2017, for the fiscal year ended April 30, 2017.

The company’s six months ended October 29, 2017, and October 30, 2016, represent 26 week periods, respectively.

2. Significant Accounting Policies

As of October 29, 2017, there were no changes in the nature of our significant accounting policies or the application of those policies from those reported in our annual report on Form 10-K for the year then ended April 30, 2017.

Recently Adopted Accounting Pronouncements

Measurement of Inventory

In July 2015, the FASB issued ASU No. 2015-11, “Simplifying the Measurement of Inventory”, which changed the measurement principle for inventory from the lower of cost or market to lower of cost and net realizable value. ASU No. 2015-11 was effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2016. As a result, we adopted ASU No. 2015-11 in the first quarter of fiscal 2018 and the adoption of this guidance did not have a significant impact on our consolidated financial statements.

Stock-Based Compensation

In March 2016, the FASB issued ASU No. 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting". ASU No. 2016-09 was effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2016. Accordingly, we adopted this guidance during the first quarter of fiscal 2018. ASU No. 2016-09 aims to simplify several aspects of accounting and financial reporting for share-based payment transactions. One provision within this pronouncement requires that excess income tax benefits and deficiencies related to share-based payments be recognized within income tax expense as a discrete event in the period in which they occur, rather than within additional paid-in capital on our consolidated balance sheet on a prospective basis. The impact to our results of operations related to this provision through the second quarter of fiscal 2018 was a reduction to income tax expense of \$556,000. The impact of this provision on our future results of operations will depend in part on the market prices for the shares of our common stock on the dates there are taxable events related to the share-based awards, and therefore, the impact is difficult to predict. In connection with another provision within ASU No. 2016-09, we have elected to account for forfeitures of share-based awards as an estimate of the number of awards that are expected to vest, which is consistent with our accounting policy prior to adoption.

Culp, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Also, we adopted the provisions of ASU No. 2016-09 related to changes on the Consolidated Statements of Cash Flows on a retrospective basis. As a result, we no longer classify excess income tax benefits as a financing activity, which increased net cash provided by operating activities and reduced net cash provided by financing activities by \$167,000 for the six months ended October 30, 2016. Additionally, we no longer classify payments for employee taxes when common stock shares are withheld to satisfy the employer's statutory income tax withholding obligation as an operating activity, which increased net cash provided by operating activities and reduced net cash provided by financing activities by \$280,000 for the six months ended October 30, 2016.

Recently Issued Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, which amends ASC Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are intended to enhance the comparability of revenue recognition practices and will be applied to all contracts with customers. Improved disclosures related to the nature, amount, timing, and uncertainty of revenue that is recognized are requirements under the amended guidance. In April 2015, the FASB issued ASU 2015-24, Revenue from Contracts with Customers: Deferral of the Effective Date which proposed a deferral of the effective date by one year, and on July 7, 2015, the FASB decided to delay the effective date by one year. The deferral results in the new revenue standard being effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. We are therefore required to apply the new revenue guidance in our fiscal 2019 interim and annual financial statements. This ASU can be adopted either retrospectively or as a cumulative-effect adjustment as of the date of adoption. We are currently assessing the impact that this guidance will have on our consolidated financial statements but we expect this guidance to have a material impact on our disclosures in our notes to the consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which increases transparency and comparability among companies accounting for lease transactions. The most significant change of this update will require the recognition of lease assets and liabilities on the balance sheet for operating lease arrangements with lease terms greater than twelve months for lessees. This update will require a modified retrospective application which includes a number of optional practical expedients related to the identification and classification of leases commenced before the effective date. This ASU is effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2018. We are therefore required to apply this guidance in our fiscal 2020 interim and annual financial statements. We are currently assessing the impact that this guidance will have on our consolidated financial statements but we expect this guidance to have a material impact on our financial position as a result of the requirement to recognize right-of-use assets and lease liabilities on our consolidated balance sheets.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, to address the diversity in how certain cash receipts and cash payments are presented in the statement of cash flows. This new guidance provides clarity around the cash flow classification for eight specific issues in an effort to reduce the current and potential future diversity in practice. This standard, which is to be applied retrospectively, will be effective for the first interim period within annual reporting periods beginning after December 15, 2017, and early adoption is permitted. We are therefore required to apply this new guidance in our fiscal 2019 interim and annual financial statements. We are currently assessing the impact that this guidance will have on our consolidated financial statements.

Culp, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory, to reduce the diversity in practice and complexity associated with accounting for the income tax consequences of intra-entity transfers of assets other than inventory. Current GAAP prohibits recognition of deferred income taxes for an intra-entity transfer until the asset has been sold to an outside party. The new pronouncement stipulates that an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. This new guidance will be effective for annual reporting periods beginning after December 15, 2017, including interim periods within those annual reporting periods, with early adoption permitted in the first interim period only. We are therefore required to apply this new guidance in our fiscal 2019 interim and annual financial statements. The amendments are to be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. We are currently assessing the impact that this guidance will have on our consolidated financial statements.

There are no other new accounting pronouncements that are expected to have a significant impact on our consolidated financial statements.

### 3. Stock-Based Compensation

#### Equity Incentive Plan Description

On September 16, 2015, our shareholders approved an equity incentive plan entitled the Culp, Inc. 2015 Equity Incentive Plan (the "2015 Plan"). The 2015 Plan updated and replaced our 2007 Equity Incentive Plan (the "2007 Plan") as the vehicle for granting new equity based awards substantially similar to those authorized under the 2007 Plan. In general, the 2015 Plan authorizes the grant of stock options intended to qualify as incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, performance units, and other equity and cash related awards as determined by our Compensation Committee. An aggregate of 1,200,000 shares of common stock were authorized for issuance under the 2015 Plan, with certain sub-limits that would apply with respect to specific types of awards that may be issued as defined in the 2015 Plan. In connection with the approval of the 2015 Plan, no further awards will be granted under the 2007 Plan, but outstanding awards under the 2007 Plan will be settled in accordance with their terms.

At October 29, 2017, there were 902,556 shares available for future equity based grants under our 2015 plan.

#### Incentive Stock Option Awards

We did not grant any incentive stock option awards through the through the second quarter of fiscal 2018.

At October 29, 2017, options to purchase 15,000 shares of common stock were outstanding and exercisable, had a weighted average exercise price of \$7.08 per share, and a weighted average contractual term of 0.6 years. At October 29, 2017, the aggregate intrinsic value for options outstanding and exercisable was \$373,000.

The aggregate intrinsic value for options exercised for the six months ending October 29, 2017 and October 30, 2016, was \$14,000 and \$43,000, respectively.

Culp, Inc.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

At October 29, 2017, there were no unvested incentive stock option awards. Therefore, there was no unrecognized compensation cost related to incentive stock option awards at October 29, 2017.

No compensation expense was recorded for incentive stock options for the six months ended October 29, 2017 and October 30, 2016, respectively.

Performance Based Restricted Stock Units

Executive Management

On July 13, 2017, we granted performance-based restricted stock units to members of executive management (NEOs) which could earn up to a certain number of shares of common stock if certain performance targets are met over a three-fiscal year performance period as defined in the related restricted stock unit agreements. The number of shares of common stock that are earned based on the performance targets that have been achieved will be adjusted based on a market-based total shareholder return component as defined in the related restricted stock unit agreements. Compensation cost is measured based on the fair market value on the date of grant (July 13, 2017). The fair market value per share was determined using the Monte Carlo simulation model for the market-based total shareholder return component and the closing price of our common stock for the performance-based components.

The following table provides assumptions used to determine the fair market value of the market-based total shareholder return component using the Monte Carlo simulation model on the date of grant:

Closing price of our common stock	\$32.50
Expected volatility of our common stock	31.0 %
Expected volatility of peer companies	16.5 %
Risk-free interest rate	1.56 %
Dividend yield	1.66 %
Correlation coefficient of peer companies	0.46

On July 14, 2016 and July 15, 2015, we granted performance-based restricted stock units to NEOs which could earn up to a certain number of shares of common stock if certain performance targets are met over a three-fiscal year performance period as defined in the related restricted stock unit agreements. These awards were measured based on the fair market value (closing price of our common stock) on the date of grant. No market-based total shareholder return component was included in these awards.

Key Employees and a Non-Employee

We granted performance-based restricted stock units which could earn up to a certain number of shares of common stock if certain performance targets are met over a three-fiscal year performance period as defined in the related restricted stock unit agreements. Our performance based restricted stock units granted to key employees were measured based on the fair market value (the closing price of our common stock) on the date of grant. Our performance based restricted stock units granted to a non-employee were measured based on the fair market value (the closing price of our common stock) at the earlier date of when the performance criteria are met or the end of the reporting period. No market-based total shareholder return component was included in these awards.

Culp, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The following table summarizes information related to our grants of performance based restricted stock units associated with NEOs and key employees that are currently invested:

Date of Grant	(3) Restricted		
	Stock Units	Price Per Share	Vesting Period
July 13, 2017 (1)	78,195	\$31.85 (4)	3 years
July 13, 2017 (2)	44,000	\$32.50 (5)	3 years
July 14, 2016 (1) (2)	107,880	\$28.00 (5)	3 years
July 15, 2015 (1) (2)	107,554	\$32.23 (5)	3 years

(1) Performance-based restricted stock units awarded to NEOs.

(2) Performance-based restricted stock units awarded to key employees.

(3) Amounts represent the maximum number of common stock shares that could be earned if certain performance targets are met as defined in the related restricted stock unit agreements.

(4) Price per share represents the fair market value per share (\$0.98 per \$1 or a reduction of \$0.65 to the closing price of the our common stock) determined using the Monte Carlo simulation model for the market-based total shareholder return component and the closing price of our common stock (\$32.50) for the performance-based components of the performance-based restricted stock units granted to our NEOs on July 13, 2017.

(5) Price per share represents the closing price of our common stock on the date of grant.

The following table summarizes information related to our grants of performance-based restricted stock units associated with a non-employee that are currently invested:

Date of Grant	(1) Restricted		
	Stock Units	Price Per Share	Vesting Period
July 13, 2017	10,200	\$31.95 (2)	3 years
July 14, 2016	11,549	\$31.95 (2)	3 years
July 15, 2015	10,364	\$31.95 (2)	3 years

(1) Amounts represent the maximum number of common stock shares that could be earned if certain performance targets are met as defined in the related restricted stock unit agreements.

(2) The respective grant was invested at the end of our reporting period. Accordingly, the price per share represents the closing price of our common stock on October 29, 2017, the end of our reporting period.

Culp, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The following table summarizes information related to our performance based restricted stock units that vested during the six month periods ending October 29, 2017 and October 30, 2016:

Fiscal Year	Common Stock Shares Vested	(3) Weighted Average Price	
		Fair Value	Per Share
Fiscal 2018 (1)	102,845	\$1,820	\$17.70(4)
Fiscal 2018 (2)	16,000	\$520	\$32.50(5)
Fiscal 2017 (1)	37,192	\$637	\$17.12(4)
Fiscal 2017 (2)	12,000	\$345	\$28.77(5)

(1) NEOs and key employees.

(2) Non-employee

(3) Dollar amounts are in thousands.

(4) Price per share represents closing price of our common stock on the date of grant.

(5) The respective grant vested during the first quarter of fiscal 2018 or 2017, respectively. Accordingly, the price per share represents the closing price of our common stock on the date the award vested.

Overall

We recorded compensation expense of \$1.4 million and \$1.5 million within selling, general, and administrative expense associated with our performance based restricted stock units for the six month periods ending October 29, 2017 and October 30, 2016, respectively. Compensation cost is recorded based on an assessment each reporting period of the probability that certain performance goals will be met during the vesting period. If performance goals are not probable of occurrence, no compensation cost will be recognized and any recognized compensation cost would be reversed.

At October 29, 2017, the remaining unrecognized compensation cost related to the performance based restricted stock units was \$4.3 million, which is expected to be recognized over a weighted average vesting period of 1.9 years.

Common Stock Awards

We granted a total of 4,800 shares of common stock to our outside directors on October 2, 2017, and October 3, 2016, respectively. These shares of common stock vested immediately and were valued based on the fair market value on the date of grant. The fair value of these awards were \$33.20 and \$29.80 per share, on October 2, 2017, and October 3, 2016, which represents the closing price of our common stock on the date of grant.

We recorded \$159,000 and \$143,000 of compensation expense within selling, general, and administrative expense for these common stock awards for the six month periods ending October 29, 2017 and October 30, 2016, respectively.

Culp, Inc.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

Time Vested Restricted Stock Units

Fiscal 2018 Grant

On July 13, 2017, an employee was granted 1,200 shares of time vested restricted stock units which vested over the requisite service period of 11 months. This award was measured at its fair market value, which was \$32.50 per share, and represented the closing price of our common stock on the date of grant.

Fiscal 2017 Grant

On July 14, 2016, an employee was granted 1,200 shares of time vested restricted stock units which vested over the requisite service period of 11 months. This award was measured at its fair market value, which was \$28 per share, and represented the closing price of our common stock on the date of grant.

During the first quarter of fiscal 2018, 1,200 shares of common stock associated with this grant vested and had a weighted average fair value of \$34,000 or \$28 per share.

Overall

We recorded compensation expense of \$17,000 and \$11,000 within selling, general, and administrative expense associated with our time vested restricted stock unit awards for the six month periods ending October 29, 2017 and October 30, 2016, respectively.

At October 29, 2017, the remaining unrecognized compensation cost related to unvested time vested restricted stock awards was \$27,000, which is expected to be recognized over the next 7.5 months.

4. Accounts Receivable

A summary of accounts receivable follows:

(dollars in thousands)	October 29, 2017	October 30, 2016	April 30, 2017
Customers	\$25,593	\$20,580	\$26,211
Allowance for doubtful accounts	(374 )	(420 )	(414 )
Reserve for returns and allowances and discounts	(999 )	(1,121 )	(1,220 )
	\$24,220	\$19,039	\$24,577

A summary of the activity in the allowance for doubtful accounts follows:

(dollars in thousands)	Six months ended October	
	29, 2017	October 30, 2016
Beginning balance	\$(414)	\$(1,088)
Provision for bad debts	40	216
Net write-offs, net of recoveries	-	452
Ending balance	\$(374)	\$(420 )

Culp, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

A summary of the activity in the allowance for returns and allowances and discounts accounts follows:

(dollars in thousands)	Six months ended	
	October 29, 2017	October 30, 2016
Beginning balance	\$(1,220)	\$(962 )
Provision for returns, allowances and discounts	(1,330)	(1,620)
Credits issued	1,551	1,461
Ending balance	\$(999 )	\$(1,121)

#### 5. Inventories

Inventories are carried at the lower of cost or market. Cost is determined using the FIFO (first-in, first-out) method.

A summary of inventories follows:

(dollars in thousands)	October 29, 2017	October 30, 2016	April 30, 2017
Raw materials	\$6,617	\$6,128	\$6,456
Work-in-process	2,686	2,518	3,095
Finished goods	40,906	37,308	41,931
	\$50,209	\$45,954	\$51,482

#### 6. Other Assets

A summary of other assets follows:

(dollars in thousands)	October 29, 2017	October 30, 2016	April 30, 2017
Cash surrender value – life insurance	\$376	\$358	\$376
Non-compete agreement, net	790	866	828
Customer relationships, net	638	689	664
Other	536	582	526
	\$2,340	\$2,495	\$2,394

#### Non-Compete Agreement

We recorded our non-compete agreement at its fair value based on a discounted cash flow valuation model. Our non-compete agreement is amortized on a straight-line basis over the fifteen year life of the respective agreement.

The gross carrying amount of our non-compete agreement was \$2.0 million at October 29, 2017, October 30, 2016 and April 30, 2017, respectively. Accumulated amortization for our non-compete agreement was \$1.2 million at October 29, 2017, October 30, 2016, and April 30, 2017, respectively.

Amortization expense for our non-compete agreement was \$38,000 for the six month periods ending October 29, 2017 and October 30, 2016. The remaining amortization expense for the next five fiscal years and thereafter follows: FY 2018 - \$37,000; FY 2019 - \$75,000; FY 2020 - \$75,000; FY 2021 - \$75,000; FY 2022 - \$75,000 and Thereafter - \$453,000.



Culp, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The weighted average amortization period for our non-compete agreement is 10.5 years as of October 29, 2017.

#### Customer Relationships

We recorded our customer relationships at their fair value based on a multi-period excess earnings valuation model. Our customer relationships are amortized on a straight-line basis over its seventeen year useful life.

The gross carrying amount of our customer relationships was \$868,000 at October 29, 2017, October 30, 2016, and April 30, 2017, respectively. Accumulated amortization for our customer relationships was \$230,000, \$179,000, and \$204,000 at October 29, 2017, October 30, 2016, and April 30, 2017, respectively.

Amortization expense for our customer relationships was \$26,000 for the six months ended October 29, 2017 and October 30, 2016. The remaining amortization expense for the next five fiscal years and thereafter follows: FY 2018 - \$25,000; FY 2019 - \$51,000; FY 2020 - \$51,000; FY 2021 - \$51,000; FY 2022 - \$51,000; and Thereafter - \$409,000.

The weighted average amortization period for our customer relationships is 12.5 years as of October 29, 2017.

#### Cash Surrender Value – Life Insurance

At October 29, 2017, October 30, 2016, and April 30, 2017, we had one life insurance contract with a death benefit of \$1.4 million.

Our cash surrender value – life insurance balances totaling \$376,000, \$358,000 and \$376,000 at October 29, 2017, October 30, 2016, and April 30, 2017, respectively, are collectible upon death of the respective insured.

#### 7. Accrued Expenses

A summary of accrued expenses follows:

	October 29, 2017	October 30, 2016	April 30, 2017
(dollars in thousands)			
Compensation, commissions and related benefits	\$5,399	\$7,111	\$10,188
Advertising rebates	650	734	468
Interest	18	5	51
Other accrued expenses	1,297	1,028	1,240
	\$7,364	\$8,878	\$11,947

#### 8. Lines of Credit

##### Revolving Credit Agreement – United States

Our Credit Agreement with Wells Fargo Bank, N.A. (“Wells Fargo”) provides a revolving loan commitment of \$30 million. Interest was charged at a rate (applicable interest rate of 2.69%, 1.98%, and 2.45% at October 29, 2017, October 30, 2016, and April 30, 2017) as a variable spread over LIBOR based on our ratio of debt to EBITDA. The Credit Agreement contains certain financial and other covenants as defined in the agreement and is set to expire on August 15, 2018.

Culp, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The purposes of our revolving credit line is to support potential short term cash needs in different jurisdictions within our global operations, mitigate our risk associated with foreign currency exchange rate fluctuations, and ultimately repatriate earnings and profits from our foreign subsidiaries to the U.S. for various strategic purposes.

Outstanding borrowings are secured by a pledge of 65% of the common stock of Culp International Holdings Ltd. (our subsidiary located in the Cayman Islands), as required by the Credit Agreement. There were no borrowings outstanding under the Credit Agreement at October 29, 2017, October 30, 2016, and April 30, 2017.

At October 29, 2017, October 30, 2016, and April 30, 2017, there were \$250,000 in outstanding letters of credit (all of which related to workers compensation) provided by the Credit Agreement.

Effective August 1, 2016, we entered into a Third Amendment to our Credit Agreement that allows us to issue letters of credit not to exceed \$7.5 million. On August 3, 2016, we issued a \$5.0 million letter of credit (\$3.75 million is currently outstanding in addition to the \$250,000 letter of credit noted above) for the construction of a new building associated with our mattress fabrics segment (see Note 15 for further details). The \$3.75 million outstanding letter of credit will be automatically reduced in increments of \$1.25 million on November 1, 2017, February 1, 2018, and May 15, 2018, respectively.

#### Revolving Credit Agreement – China

We have an unsecured credit agreement associated with our operations in China that provides for a line of credit of up to 40 million Chinese Yuan Renminbi (approximately \$6.0 million USD at October 29, 2017), that expires February 15, 2018. This agreement has an interest rate determined by the Chinese government and there were no borrowings outstanding as of October 29, 2017, October 30, 2016, and April 30, 2017.

#### Overall

Our loan agreements require, among other things, that we maintain compliance with certain financial covenants. At October 29, 2017, the company was in compliance with these financial covenants.

#### 9. Fair Value of Financial Instruments

ASC Topic 820 establishes a fair value hierarchy that distinguishes between assumptions based on market data (observable inputs) and the company's assumptions (unobservable inputs). Determining where an asset or liability falls within that hierarchy depends on the lowest level input that is significant to the fair value measurement as a whole. An adjustment to the pricing method used within either level 1 or level 2 inputs could generate a fair value measurement that effectively falls in a lower level in the hierarchy. The hierarchy consists of three broad levels as follows:

Level 1 – Quoted market prices in active markets for identical assets or liabilities;

Level 2 – Inputs other than level 1 inputs that are either directly or indirectly observable, and

Level 3 – Unobservable inputs developed using the company's estimates and assumptions, which reflect those that market participants would use.

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Culp, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Recurring Basis

The following table presents information about assets measured at fair value on a recurring basis:

(amounts in thousands)	Fair value measurements at October 29, 2017 using:			Total
	Quoted prices in active markets for identical assets Level	Significant other observable inputs Level 2	Significant unobservable inputs Level 3	
Assets:				
U.S. Corporate Bonds	\$-	\$ 30,773	\$ -	\$30,773
Premier Money Market Fund	6,153	N/A	N/A	6,153
Low Duration Bond Fund	1,087	N/A	N/A	1,087
Intermediate Term Bond Fund	765	N/A	N/A	765
Strategic Income Fund	626	N/A	N/A	626
Large Blend Fund	393	N/A	N/A	393
Growth Allocation Fund	153	N/A	N/A	153
Moderate Allocation Fund	107	N/A	N/A	107
Other	115	N/A	N/A	115

(amounts in thousands)	Fair value measurements at October 30, 2016 using:			Total
	Quoted prices in active markets for identical assets Level 1	Significant other observable inputs Level 2	Significant unobservable inputs Level 3	
Assets:				
Cash and Cash Equivalents	\$23,940	N/A	N/A	\$23,940
U.S. Corporate Bonds	-	7,110	N/A	7,110
Premier Money Market Fund	4,421	N/A	N/A	4,421
Low Duration Bond Fund	1,075	N/A	N/A	1,075
Intermediate Term Bond Fund	750	N/A	N/A	750
Strategic Income Fund	605	N/A	N/A	605
Large Blend Fund	319	N/A	N/A	319

Growth Allocation Fund	102	N/A	N/A	102
Other	152	N/A	N/A	152

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(amounts in thousands)	Fair value measurements at April 30, 2017 using:			Total
	Quoted prices in active markets for identical assets Level	Significant other observable inputs Level 2	Significant unobservable inputs Level 3	
Assets:				
U.S. Corporate Bonds	\$-	\$ 30,831	\$ -	\$30,831
Premier Money Market Fund	4,811	N/A	N/A	4,811
Low Duration Bond Fund	1,081	N/A	N/A	1,081
Intermediate Term Bond Fund	751	N/A	N/A	751
Strategic Income Fund	611	N/A	N/A	611
Large Blend Fund	365	N/A	N/A	365
Growth Allocation Fund	126	N/A	N/A	126
Moderate Allocation Fund	88	N/A	N/A	88
Other	76	N/A	N/A	76

Our U.S. corporate bonds were classified as level 2 as they are traded over the counter within a broker network and not on an active market. The fair value of our U.S. corporate bonds is determined based on a published source that provides an average bid price. The average bid price is based on various broker prices that are determined based on market conditions, interest rates, and the rating of the respective U.S. corporate bond.

The determination of where an asset or liability falls in the hierarchy requires significant judgment. We evaluate our hierarchy disclosures each quarter based on various factors and it is possible that an asset or liability may be classified differently from quarter to quarter. However, we expect that changes in classifications between different levels will be rare.

#### Short-Term Investments – Available for Sale

At October 29, 2017, October 30, 2016, and April 30, 2017, our short-term investments classified as available for sale totaled \$2.5 million, \$2.4 million, and \$2.4 million, respectively, and consisted of short-term bond funds. Since these short-term bond funds are classified as available for sale, these investments are recorded at their fair market value and their unrealized gains or losses are included in other comprehensive income (loss). Our short-term bond investments had an accumulated unrealized loss totaling \$36,000, \$45,000, and \$47,000 at October 29, 2017, October 30, 2016, and April 30, 2017, respectively. At October 29, 2017, October 30, 2016, and April 30, 2017, the fair value of our short-term bond funds approximated its cost basis.

#### Short-Term and Long-Term Investments - Held-To-Maturity

During the second quarter of fiscal 2017, management decided to invest approximately \$31.0 million in investment grade U.S. Corporate bonds with maturities that ranged from 2 to 2.5 years. The purpose of this investment was to earn a higher rate of return on our excess cash located in the Cayman Islands. These investments are classified as held-to-maturity as we have the positive intent and ability to hold these investments until maturity. Our held-to-maturity investments will be recorded as either current or noncurrent on our Consolidated Balance Sheets, based on contractual maturity date as of a respective reporting period and stated at amortized cost.

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At October 29, 2017 and April 30, 2017, our held-to-maturity investments totaled \$30.9 million and consisted of U.S. Corporate bonds. At October 30, 2016, our held-to-maturity investments totaled \$31.0 million and consisted of invested cash and cash equivalents of \$23.9 million and U.S. Corporate bonds of \$7.1 million. The \$23.9 million in invested cash and cash equivalents were used to purchase U.S. Corporate bonds during our third quarter of fiscal 2017. The fair value of our held-to-maturity investments at October 29, 2017, October 30, 2016, and April 30, 2017 totaled \$30.8 million, \$31.0 million, and \$30.8 million, respectively.

#### Long-Term Investments - Rabbi Trust

We have a Rabbi Trust to set aside funds for participants of our deferred compensation plan (the "Plan") and enable the participants to credit their contributions to various investment options of the Plan. The investments associated with the Rabbi Trust consist of a money market fund and various mutual funds that are classified as available for sale.

These long-term investments are recorded at their fair values of \$6.9 million, \$5.0 million, and \$5.5 million at October 29, 2017, October 30, 2016, and April 30, 2017, respectively. Our long-term investments had an accumulated unrealized gain of \$96,000, \$1,000 and \$43,000 at October 29, 2017, October 30, 2016, and April 30, 2017, respectively. The fair value of our long-term investments associated with our Rabbi Trust approximates its cost basis.

#### Other

The carrying amount of our cash and cash equivalents, accounts receivable, other current assets, accounts payable, accrued expenses, and line of credit approximates fair value because of the short maturity of these financial instruments.

### 10. Cash Flow Information

Interest and income taxes paid are as follows:

	Six months ended	
	October 29,	October 30,
(dollars in thousands)	2017	2016
Interest	\$146	\$45
Income taxes	2,599	3,238

Interest costs charged to operations were \$137,000 and \$45,000 for the six months ended October 29, 2017 and October 30, 2016, respectively.

Interest costs of \$100,000 and \$45,000 for the construction of qualifying fixed assets were capitalized and will be amortized over the related assets' useful lives for the six months ended October 29, 2017 and October 30, 2016, respectively.

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11. Net Income Per Share

Basic net income per share is computed using the weighted-average number of shares outstanding during the period. Diluted net income per share uses the weighted-average number of shares outstanding during the period plus the dilutive effect of stock-based compensation calculated using the treasury stock method. Weighted average shares used in the computation of basic and diluted net income per share follows:

(amounts in thousands)	Three months ended	
	October 29, 2017	October 30, 2016
Weighted average common shares outstanding, basic	12,440	12,308
Dilutive effect of stock-based compensation	140	199
Weighted average common shares outstanding, diluted	12,580	12,507

All options to purchase shares of common stock were included in the computation of diluted net income for the three months ended October 29, 2017 and October 30, 2016, as the exercise price of the options was less than the average market price of the common shares.

(amounts in thousands)	Six months ended	
	October 29, 2017	October 30, 2016
Weighted average common shares outstanding, basic	12,420	12,297
Dilutive effect of stock-based compensation	193	198
Weighted average common shares outstanding, diluted	12,613	12,495

All options to purchase shares of common stock were included in the computation of diluted net income for the six months ended October 29, 2017 and October 30, 2016, as the exercise price of the options was less than the average market price of the common shares.

12. Segment Information

Our operations are classified into two business segments: mattress fabrics and upholstery fabrics. The mattress fabrics segment manufactures, sources, and sells fabrics and mattress covers to bedding manufacturers. The upholstery fabrics segment manufactures, sources, develops, and sells fabrics primarily to residential and commercial furniture manufacturers.

We evaluate the operating performance of our segments based upon income from operations before certain unallocated corporate expenses and other non-recurring items. Cost of sales in both segments include costs to manufacture, develop, or source our products, including costs such as raw material and finished goods purchases, direct and indirect labor, overhead and incoming freight charges. Unallocated corporate expenses primarily represent compensation and benefits for certain executive officers, all costs related to being a public company, and other miscellaneous expenses. Segment assets include assets used in the operations of each segment and primarily consist of accounts receivable, inventories, and property, plant and equipment. The mattress fabrics segment also includes in segment assets, goodwill, investment in an unconsolidated joint venture, a non-compete agreement, and customer relationships associated with an acquisition.





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Financial information for the company's operating segments follows:

	Three months ended	
	October 29, 2017	October 30, 2016
Net sales:		
Mattress Fabrics	\$48,601	\$45,527
Upholstery Fabrics	32,097	29,816
	\$80,698	\$75,343
Gross profit:		
Mattress Fabrics	\$9,730	\$10,756
Upholstery Fabrics	6,074	6,145
	\$15,804	\$16,901
Mattress Fabrics	\$3,168	\$3,296
Upholstery Fabrics	3,700	3,652
Total segment selling, general, and administrative expenses	6,868	6,948
Unallocated corporate expenses	2,547	2,654
	\$9,415	\$9,602
Income from operations:		
Mattress Fabrics	\$6,562	\$7,460
Upholstery Fabrics	2,374	2,493
Total segment income from operations	8,936	9,953
Unallocated corporate expenses	(2,547 )	(2,654 )
Total income from operations	6,389	7,299
Interest expense	(37 )	-
Interest income	128	15
Other expense	(321 )	(155 )
Income before income taxes	\$6,159	\$7,159
	Six months ended	
	October 29, 2017	October 30, 2016
(dollars in thousands)		
Net sales:		
Mattress Fabrics	\$97,030	\$96,057
Upholstery Fabrics	63,200	59,969
	\$160,230	\$156,026
Gross profit:		
Mattress Fabrics	\$19,495	\$22,657
Upholstery Fabrics	12,773	12,664
	\$32,268	\$35,321
Selling, general, and administrative expenses:		

Mattress Fabrics	\$6,559	\$6,795
Upholstery Fabrics	7,511	7,185
Total segment selling, general, and administrative expenses	14,070	13,980
Unallocated corporate expenses	4,846	5,368
	\$18,916	\$19,348
Income from operations:		
Mattress Fabrics	\$12,936	\$15,862
Upholstery Fabrics	5,262	5,479
Total segment income from operations	18,198	21,341
Unallocated corporate expenses	(4,846 )	(5,368 )
Total income from operations	13,352	15,973
Interest expense	(37 )	-
Interest income	259	40
Other expense	(674 )	(307 )
Income before income taxes	\$12,900	\$15,706

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Balance sheet information for the company's operating segments follows:

(dollars in thousands)	October 29, 2017	October 30, 2016	April 30, 2017
Segment assets:			
Mattress Fabrics			
Current assets (1)	\$42,728	\$38,062	\$47,038
Non-compete agreement	790	866	828
Customer relationships	638	689	664
Investment in unconsolidated joint venture	1,522	-	1,106
Goodwill	11,462	11,462	11,462
Property, plant and equipment (2)	49,965	43,228	48,916
Total mattress fabrics assets	107,105	94,307	110,014
Upholstery Fabrics			
Current assets (1)	31,701	26,931	29,021
Property, plant and equipment (3)	2,063	1,480	1,879
Total upholstery fabrics assets	33,764	28,411	30,900
Total segment assets	140,869	122,718	140,914
Non-segment assets:			
Cash and cash equivalents	15,739	13,910	20,795
Short-term investments (Available for Sale)	2,478	2,430	2,443
Short-term investments (Held-to-Maturity)	4,015	-	-
Deferred income taxes	491	581	419
Other current assets	2,263	1,675	2,894
Property, plant and equipment (4)	502	829	856
Long-term investments (Held-to-Maturity)	26,853	31,050	30,945
Long-term investments (Rabbi Trust)	6,921	4,994	5,466
Other assets	912	940	902
Total assets	\$201,043	\$179,127	\$205,634

(dollars in thousands)	Six months ended	
	October 29, 2017	October 30, 2016
Capital expenditures (5):		
Mattress Fabrics	\$4,364	\$8,857
Upholstery Fabrics	203	165
Unallocated Corporate	30	62
Total capital expenditures	\$4,597	\$9,084
Depreciation expense:		
Mattress Fabrics	\$3,310	\$3,101
Upholstery Fabrics	403	410

Total depreciation expense \$3,713 \$3,511

(1) Current assets represent accounts receivable and inventory for the respective segment.

The \$50.0 million at October 29, 2017, represents property, plant, and equipment of \$35.8 million and \$14.2 million located in the U.S. and Canada, respectively. The \$43.2 million at October 30, 2016, represents property, (2) plant, and equipment of \$28.5 million and \$14.7 million located in the U.S. and Canada, respectively. The \$48.9 million at April 30, 2017, represents property, plant, and equipment of \$34.0 million and \$14.9 million located in the U.S. and Canada, respectively.

The \$2.1 million at October 29, 2017, represents property, plant, and equipment of \$1.4 million and \$722 located (3) in the U.S. and China, respectively. The \$1.5 million at October 30, 2016, represents property, plant, and equipment of \$890 and \$590 located in the U.S. and China, respectively. The \$1.9 million at April 30, 2017, represents property, plant, and equipment of \$1.2 million and \$655 located in the U.S. and China, respectively.

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- (4) The \$502, \$829, and \$856 at October 29, 2017, October 30, 2016 and April 30, 2017, respectively, represent property, plant, and equipment associated with unallocated corporate departments and corporate departments shared by both the mattress and upholstery fabric segments. Property, plant, and equipment associated with corporate are located in the U.S.
- (5) Capital expenditure amounts are stated on the accrual basis. See Consolidated Statements of Cash Flows for capital expenditure amounts on a cash basis.

## 13. Income Taxes

## Effective Income Tax Rate

We recorded income tax expense of \$3.7 million, or 29.1% of income before income taxes, for the six month period ended October 29, 2017, compared to income tax expense of \$5.9 million, or 37.7% of income before income taxes, for the six month period ended October 30, 2016. Our effective income tax rates for the six month periods ended October 29, 2017, and October 30, 2016, were based upon the estimated effective income tax rate applicable for the full year after giving effect to any significant items related specifically to interim periods. The effective income tax rate can be affected over the fiscal year by the mix and timing of actual earnings from our U.S. operations and foreign sources versus annual projections and changes in foreign currency exchange rates in relation to the U.S. dollar.

The following schedule summarizes the factors that contribute to the difference between income tax expense at the federal income tax rate and the effective income tax rate reflected in the consolidated financial statements:

	2018	2017
Federal income tax rate	34.0%	34.0%
Excess income tax benefits related to stock-based compensation	(4.3)	-
Tax effects of Chinese foreign exchange (losses) gains	(1.5)	1.6
U.S. state income tax expense	0.4	0.6
Other	0.5	1.5
	29.1%	37.7%

## Deferred Income Taxes

Valuation Allowance

In accordance with ASC Topic 740, we evaluate our deferred income taxes to determine if a valuation allowance is required. ASC Topic 740 requires that companies assess whether a valuation allowance should be established based on the consideration of all available evidence using a “more-likely-than-not” standard, with significant weight being given to evidence that can be objectively verified. Since the company operates in multiple jurisdictions, we assess the need for a valuation allowance on a jurisdiction-by-jurisdiction basis, taking into account the effects of local tax law. Based on our assessment at October 29, 2017, we recorded a partial valuation allowance of \$632,000, of which \$554,000 pertained to certain U.S. state net operating loss carryforwards and credits and \$78,000 pertained to loss carryforwards associated with our Culp Europe operation located in Poland. Based on our assessment at October 30, 2016, we recorded a partial valuation allowance of \$603,000, of which \$519,000 pertained to certain U.S. state net operating loss carryforwards and credits and \$84,000 pertained to loss carryforwards associated with our Culp Europe operation located in Poland. Based on our assessment at April 30, 2017, we recorded a partial valuation allowance of \$536,000, of which \$464,000 pertained to certain U.S. state net operating loss carryforwards and credits and \$72,000

pertained to loss carryforwards associated with our Culp Europe operation located in Poland.

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No valuation allowance was recorded against our net deferred income tax assets associated with our operations located in China and Canada at October 29, 2017, October 30, 2016, and April 30, 2017, respectively.

The recorded valuation allowance of \$632,000 at October 29, 2017, has no effect on our operations, loan covenant compliance, or the possible realization of certain U.S. state net operating loss carryforwards and credits and our loss carryforwards associated with our Culp Europe operation located in Poland. If it is determined that it is more-likely-than-not that we will realize any of these deferred income tax assets, an income tax benefit will be recognized at that time.

Undistributed Earnings

In accordance with ASC Topic 740, we assess whether the undistributed earnings from our foreign subsidiaries will be reinvested indefinitely or eventually distributed to our U.S. parent company. ASC Topic 740 requires that a deferred tax liability should be recorded for undistributed earnings from foreign subsidiaries that will not be reinvested indefinitely. Based on our assessment as of October 29, 2017, it is our intention not to permanently invest our undistributed earnings from our foreign subsidiaries, with the exception of \$1.8 million that has been reinvested indefinitely since the fourth quarter of fiscal 2017 in our unconsolidated joint venture located in Haiti. Also, we assess the recognition of U.S. foreign income tax credits associated with foreign withholding and income tax payments and whether it is more-likely-than-not that our foreign income tax credits will not be realized. If it is determined that any foreign income tax credits need to be recognized or it is more-likely-than-not our foreign income tax credits will not be realized, an adjustment to our provision for income taxes will be recognized at that time.

At October 29, 2017, we had accumulated earnings and profits from our foreign subsidiaries totaling \$145.3 million. At the same date, the deferred tax liability associated with our undistributed earnings from our foreign subsidiaries totaled \$322,000, which included U.S. income and foreign withholding taxes totaling \$42.4 million, offset by U.S. foreign income tax credits of \$42.1 million.

At October 30, 2016, we had accumulated earnings and profits from our foreign subsidiaries totaling \$138.9 million. At the same date, the deferred tax liability associated with our undistributed earnings from our foreign subsidiaries totaled \$657,000, which included U.S. income and foreign withholding taxes totaling \$41.4 million, offset by U.S. foreign income tax credits of \$40.7 million.

At April 30, 2017, we had accumulated earnings and profits from our foreign subsidiaries totaling \$146.9 million. At the same date, the deferred tax liability associated with our undistributed earnings from our foreign subsidiaries totaled \$497,000, which included U.S. income and foreign withholding taxes totaling \$44.0 million, offset by U.S. foreign income tax credits of \$43.5 million.



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Overall

At October 29, 2017, our non-current deferred tax asset of \$491,000 pertains to our operations located in China. At October 30, 2016, our non-current deferred tax asset of \$581,000 represented \$109,000 and \$472,000 from our operations located in the U.S. and China, respectively. At April 30, 2017, our non-current deferred tax asset of \$419,000 pertained to our operations located in China.

At October 29, 2017, our non-current deferred tax liability of \$4.6 million represents \$2.5 million and \$2.1 million from our operations located in the U.S. and Canada, respectively. Our non-current deferred tax liability balance of \$1.7 million at October 30, 2016 pertained to our operations located in Canada. At April 30, 2017, our non-current deferred tax liability of \$3.6 million represented \$2.1 million and \$1.5 million from our operations located in Canada and the U.S., respectively.

Uncertainty In Income Taxes

At October 29, 2017, we had a \$12.6 million total gross unrecognized income tax benefit, of which \$12.1 million and \$487,000 were classified as non-current deferred income taxes and income taxes payable – long-term, respectively, in the accompanying consolidated balance sheets. At October 30, 2016, we had a \$15.1 million total gross unrecognized income tax benefit, of which \$11.4 million and \$3.7 million were classified as non-current deferred income taxes and income taxes payable – long-term, respectively, in the accompanying consolidated balance sheets. At April 30, 2017, we had \$12.2 million of total gross unrecognized income tax benefit, of which \$11.8 million and \$467,000 were classified as non-current deferred income taxes and income taxes payable – long-term, respectively, in the accompanying consolidated balance sheets.

At October 29, 2017, our \$12.6 million total gross unrecognized income tax benefit included \$487,000 that, if recognized, would favorably affect the income tax rate in future periods. At October 30, 2016, our \$15.1 million total gross unrecognized income tax benefit, included \$3.7 million that, if recognized, would favorably affect the income tax rate in future periods. At April 30, 2017, our \$12.2 million total gross unrecognized income tax benefit included \$467,000 that, if recognized, would favorably affect the income tax rate in future periods.

Our gross unrecognized income tax benefit of \$12.6 million at October 29, 2017, relates to tax positions for which significant change is reasonably possible within the next year (see below disclosure of ongoing income tax exams). This amount primarily relates to double taxation under applicable income tax treaties with foreign tax jurisdictions. United States federal and state income tax returns filed by us remain subject to examination for income tax years 2005 and subsequent due to loss carryforwards. Canadian federal and provincial (Quebec) returns filed by us remain subject to examination for income tax years 2013 and subsequent. Income tax returns associated with our operations located in China are subject to examination for income tax year 2012 and subsequent.

The Internal Revenue Service is examining our U.S. Federal income tax returns for fiscal years 2014 through 2016. As a result of this examination, the IRS proposed an adjustment approximating \$12.5 million of income taxes that relates to our transfer pricing with certain foreign subsidiaries. Management does not agree with the IRS' proposed adjustment and intends to vigorously defend its position. Currently, the ultimate outcome of this proposed adjustment and any potential cash settlement cannot be determined as it is dependent upon potential legal and competent authority proceedings, interpretation of income tax law, and utilization of available loss carryforwards and certain income tax credits associated with the fiscal years under exam. We believe our unrecognized income tax benefit balance of \$12.6 million has adequately provided for our uncertain income tax positions for all open income tax years and jurisdictions. Currently, we expect this examination to be completed during fiscal 2019.



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During the third quarter of fiscal 2017, Revenue Quebec commenced an examination of our Canadian provincial (Quebec) income tax returns for fiscal years 2013 through 2015, and no adjustments have been proposed at this time. We currently expect this examination to be completed during fiscal 2018.

In accordance with ASC Topic 740, an unrecognized income tax benefit for an uncertain income tax position can be recognized in the first interim period if the more-likely-than-not recognition threshold is met by the reporting period, or is effectively settled through examination, negotiation, or litigation, or the statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired. If it is determined that any of the above conditions occur regarding our uncertain income tax positions, an adjustment to our unrecognized income tax benefit will be recorded at that time.

14. Statutory Reserves

Our subsidiaries located in China are required to transfer 10% of their net income, as determined in accordance with the People's Republic of China (PRC) accounting rules and regulations, to a statutory surplus reserve fund until such reserve balance reaches 50% of the company's registered capital.

The transfer to this reserve must be made before distributions of any dividend to shareholders. As of October 29, 2017, the company's statutory surplus reserve was \$4.4 million, representing 10% of accumulated earnings and profits determined in accordance with PRC accounting rules and regulations. The surplus reserve fund is non-distributable other than during liquidation and can be used to fund previous years' losses, if any, and may be utilized for business expansion or converted into share capital by issuing new shares to existing shareholders in proportion to their shareholding or by increasing the par value of the shares currently held by them provided that the remaining reserve balance after such issue is not less than 25% of the registered capital.