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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

**FORM 10-Q**

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

For the quarterly period ended September 30, 2007

OR

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

Commission File Number 001-32563

**Orchids Paper Products Company**

(Exact name of Registrant as Specified in its Charter)

Delaware

23-2956944

(State or Other Jurisdiction of  
Incorporation or Organization)

(I.R.S. Employer  
Identification No.)

**4826 Hunt Street  
Pryor, Oklahoma 74361**

(Address of Principal Executive Offices and Zip Code)

**(918) 825-0616**

(Registrant's Telephone Number, Including Area Code)

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Number of shares outstanding of the issuer's Common Stock, par value \$.001 per share, as of November 2, 2007: 6,322,648 shares.

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. Financial Statements**

**ORCHIDS PAPER PRODUCTS COMPANY  
BALANCE SHEETS**

(Dollars in thousands, except share data)

	As of	
	September 30, 2007 (unaudited)	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash	\$ 3	\$ 3
Accounts receivable, net of allowance of \$123 in 2007 and \$100 in 2006	6,049	5,089
Inventories, net	4,863	4,379
Restricted certificate of deposit	—	1,500
Income taxes receivable	24	1,242
Prepaid expenses	472	306
Deferred income taxes	346	346
Total current assets	11,757	12,865
Property, plant and equipment	63,558	63,081
Accumulated depreciation	(7,290)	(5,042)
Net property, plant and equipment	56,268	58,039
Deferred debt issuance costs, net of accumulated amortization of \$561 in 2007 and \$424 in 2006	131	124
Total assets	\$ 68,156	\$ 71,028
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 4,027	\$ 3,772
Accrued liabilities	2,323	1,805
Current portion of long-term debt	2,299	2,263
Total current liabilities	8,649	7,840
Long-term debt, net of unamortized discount of \$51 in 2007 and \$74 in 2006	25,569	31,575
Deferred income taxes	7,155	6,909
Stockholders' equity:		
Common stock, \$.001 par value, 25,000,000 and 10,000,000 shares authorized in 2007 and 2006, respectively, 6,234,346 shares issued and outstanding	6	6
Additional paid-in capital	21,470	21,139
Common stock warrants	141	141
Retained earnings	5,166	3,418
Total stockholders' equity	26,783	24,704
Total liabilities and stockholders' equity	\$ 68,156	\$ 71,028

See notes to financial statements

**ORCHIDS PAPER PRODUCTS COMPANY**  
**STATEMENTS OF INCOME**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007 (unaudited)	2006 (unaudited)	2007 (unaudited)	2006 (unaudited)
	(Dollars in thousands, except share and per share data)			
Net sales	\$ 19,218	\$ 15,154	\$ 54,370	\$ 42,928
Cost of sales	15,802	13,297	46,136	38,502
Gross profit	3,416	1,857	8,234	4,426
Selling, general and administrative expenses	1,491	1,124	4,053	3,653
Operating income	1,925	733	4,181	773
Interest expense	635	836	2,216	1,126
Other (income) expense, net	(2)	(17)	(29)	(80)
Income (loss) before income taxes	1,292	(86)	1,994	(273)
Provision (benefit) for income taxes:				
Current	0	55	0	(54)
Deferred	156	10	246	43
	156	65	246	(11)
Net income (loss)	\$ 1,136	\$ (151)	\$ 1,748	\$ (262)
Net income (loss) per share:				
Basic	\$ 0.18	\$ (0.02)	\$ 0.28	\$ (0.04)
Diluted	\$ 0.18	\$ (0.02)	\$ 0.27	\$ (0.04)
Shares used in calculating net income (loss) per share:				
Basic	6,234,346	6,234,346	6,234,346	6,234,346
Diluted	6,421,111	6,234,346 *	6,425,527	6,234,346 *

\* Due to net loss, option and warrant shares are anti-dilutive and thus not considered.

See notes to financial statements.

**ORCHIDS PAPER PRODUCTS COMPANY**  
**STATEMENTS OF CASH FLOWS**

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
	(unaudited)	(unaudited)
	(Dollars in thousands)	
<b>Cash Flows From Operating Activities</b>		
Net income (loss)	\$ 1,748	\$ (262)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	2,404	1,641
Provision for doubtful accounts	15	45
Deferred income taxes	246	43
Stock option plan expense	331	201
Foreign currency transaction loss	—	35
Gain on foreign currency exchange contracts	—	(74)
Changes in cash due to changes in operating assets and liabilities:		
Accounts receivable	(975)	(762)
Inventories	(484)	(317)
Prepaid expenses	(166)	12
Income taxes receivable	1,218	(155)
Accounts payable	255	2,457
Accrued liabilities	518	(376)
Net cash provided by operating activities	<u>5,110</u>	<u>2,488</u>
<b>Cash Flows From Investing Activities</b>		
Purchases of property, plant and equipment	(477)	(17,268)
Proceeds from the sale of restricted certificate of deposit	<u>1,500</u>	<u>—</u>
Net cash provided by (used in) investing activities	1,023	(17,268)
<b>Cash Flows From Financing Activities</b>		
Borrowings on long-term debt	26,500	—
Retirement of borrowings on long-term debt	(25,866)	—
Principal payments on long-term debt	(1,720)	(1,130)
Net borrowings (repayments) on revolving credit line	(4,903)	535
Borrowings under construction loan	—	15,000
Deferred debt issuance cost	(144)	—
Net cash provided by (used in) financing activities	<u>(6,133)</u>	<u>14,405</u>
Net change in cash	—	(375)
Cash, beginning	<u>3</u>	<u>378</u>
Cash, ending	<u>\$ 3</u>	<u>\$ 3</u>
<b>Supplemental Disclosure:</b>		
Interest paid, net of amounts capitalized	<u>\$ 2,117</u>	<u>\$ 834</u>
Income taxes paid	<u>\$ —</u>	<u>\$ 221</u>

See notes to financial statements.

**ORCHIDS PAPER PRODUCTS COMPANY**  
**NOTES TO UNAUDITED INTERIM FINANCIAL STATEMENTS**

**Note 1 – Basis of Presentation**

Orchids Paper Products Company (“Orchids” or the “Company”) was formed in 1998 to acquire and operate the paper manufacturing facility, built in 1976, in Pryor, Oklahoma. Orchids Acquisition Group, Inc. (“Orchids Acquisition”) was established in November 2003, for the purpose of acquiring the common stock of Orchids. Orchids Acquisition closed the sale of its equity and debt securities on March 1, 2004, and immediately thereafter closed the acquisition of Orchids. In April 2005, Orchids Acquisition merged with and into Orchids, with Orchids as the surviving entity.

On July 20, 2005, the Company completed its public offering of 3,234,375 shares of its common stock. The public offering price of the shares was \$5.33. The net proceeds from the offering were \$15,011,000 after deducting the underwriting discount and offering expenses. The Company’s stock trades on the American Stock Exchange under the ticker symbol “TIS”.

The accompanying financial statements have been prepared without an audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “Commission”). Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to the rules and regulations. However, the Company believes that the disclosures made are adequate to make the information presented not misleading when read in conjunction with the audited financial statements and the notes thereto. Management believes that the financial statements contain all adjustments necessary for a fair statement of the results for the interim periods presented. All adjustments were of a normal, recurring nature. The results of operations for the interim period are not necessarily indicative of the results for the entire fiscal year.

**Note 2 — Purchase Commitment and Foreign Currency Derivatives**

During 2005, the Company entered into purchase agreements totaling \$8,700,000 with suppliers to construct a new paper machine. Down payments were required to these vendors with remaining periodic payments through the second quarter of 2006. One of these agreements was denominated in Euros. All of the Company’s obligations were discharged as of June 30, 2006.

The Company entered into foreign currency exchange contracts to purchase Euros at a fixed price in conjunction with the foreign currency portion of its obligations for the acquisition of its new paper machine. In May 2006, the Company made the final payment due on the machine and settled the last outstanding foreign currency exchange contract to exchange U.S. Dollars for Euros totaling \$760,000. The exchange contracts were carried at fair value on the balance sheet while they were outstanding. The exchange contracts were not identified as cash flow hedges as defined in SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities.” SFAS No. 133 requires the Company to recognize all derivatives as either assets or liabilities on the balance sheet and to measure those instruments at fair value. Further, since the transaction was not considered a hedged transaction, fair value adjustments affected the Company’s periodic net income.

The net foreign currency transaction gain resulting from the Company's Euro denominated obligations and Euro exchange contracts for the nine months ended September 30, 2006, of \$39,000 is included in other (income) expense, net.

On August 1, 2007, the Company received a new water discharge permit which requires the Company to expand its existing pre-treatment facility to reduce biological oxygen demand and total suspended solids from its effluent stream. Under the new permit, the Company is required to complete the expansion and make operational its pre-treatment facility by August 1, 2009. The project is in the pre-engineering phase and is expected to cost between \$2 million and \$3 million.

### **Note 3 – Capitalized Interest**

The new paper machine began producing saleable paper on June 9, 2006. Accordingly, interest costs for the period from January 1, 2006 through June 8, 2006 totaling \$992,000 were capitalized. No interest costs were capitalized for the three-month period ended September 30, 2006 or in the nine-month period ended September 30, 2007.

### **Note 4 – Credit Agreements**

On April 9, 2007, the Company entered into a credit agreement with its existing bank group with the following terms:

- a \$6.0 million revolving credit facility with a three-year term; (\$0 outstanding at September 30, 2007). In addition, \$157,000 of bank overdrafts are included with long-term debt at September 30, 2007. The borrowing base for the revolving credit facility is determined by adding qualified receivables and inventory. At September 30, 2007, the borrowing base for the revolving credit facility was \$6.6 million, limited to the \$6.0 million amount of the facility;
- a \$10.0 million term loan A with a ten-year term that has no principal repayments for the first 24 months of the loan and then will be amortized as if the loan had an 18-year life (\$10.0 million outstanding at September 30, 2007);
- a \$16.5 million term loan B with a four-year term that is being amortized as if the loan had a six-year life (\$15.6 million outstanding at September 30, 2007); and
- a \$3.0 million capital expenditures facility with a four-year term that will be amortized as if the loan had a five-year life (\$0 outstanding at September 30, 2007).

Under the terms of the credit agreement, amounts outstanding under the revolving credit facility bear interest at Orchids' election at the prime rate or LIBOR plus a margin and amounts outstanding under term loan B and the capital expenditures facility bear interest at LIBOR plus a margin. The margin is set quarterly and based on the ratio of funded debt to EBITDA less income taxes paid. Amounts outstanding under term loan A bear interest at LIBOR plus 180 basis points. For the revolving credit facility, the margin ranges from a negative 50 basis points to 150 basis points for prime rate loans and 200 to 375 basis points for LIBOR-based loans. For term loan B, the margin ranges from 200 basis points to 300 basis points over LIBOR. For the capital expenditures facility, the margin ranges from 150 basis points to 250 basis points over LIBOR. At September 30, 2007, the Company's weighted average borrowing rate was 7.89% under this credit agreement.

The amount available under the revolving credit line may be reduced in the event that the Company's borrowing base, which is based upon qualified receivables and qualified inventory, is less than \$6.0 million. Obligations under the amended and restated credit agreement are secured by substantially all of the Company's assets. The agreement contains representations and warranties, and affirmative and negative covenants customary for financings of this type, including, but not limited to, a covenant prohibiting the Company from declaring or paying dividends. The financial covenants in the agreement require the Company to maintain specific ratios of funded debt to EBITDA and debt service coverage which are tested as of the end of each quarter and places a limit on the amount of annual non-financed capital expenditures. The maximum allowable funded debt to EBITDA ratio is 4.0-to-1.0 and the minimum allowable debt service coverage ratio is 1.25-to-1.0. Annual expenditures for non-financed capital equipment are limited to \$1.5 million per fiscal year.

In connection with the re-financing, the \$1.5 million restricted certificate of deposit was released and applied to outstanding balances under the revolving credit facility.

### Note 5 – Earnings per Share

The computation of basic and diluted net income per share for the three-month and nine-month periods ended September 30, 2007 and 2006 is as follows:

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Net income (loss) — (\$ thousands)	<u>\$ 1,136</u>	<u>\$ (151)</u>	<u>\$ 1,748</u>	<u>\$ (262)</u>
Weighted average shares outstanding	6,234,346	6,234,346	6,234,346	6,234,346
Effect of stock options	84,819	—	90,999	—
Effect of dilutive warrants	<u>101,946</u>	<u>—</u>	<u>100,182</u>	<u>—</u>
Weighted average shares outstanding — assuming dilution	<u>6,421,111</u>	<u>6,234,346</u>	<u>6,425,527</u>	<u>6,234,346</u>
Earnings (loss) per common share:				
Basic	\$ 0.18	\$ (0.02)	\$ 0.28	\$ (0.04)
Diluted	\$ 0.18	\$ (0.02) *	\$ 0.27	\$ (0.04) *

\* Due to net loss, option and warrant shares of 329,623 and 363,793 for the three and nine months ended September 30, 2006, respectively, are anti-dilutive and thus not considered.

### Note 6 – Stock Incentive Plan

In April 2005, the board of directors and the stockholders approved the 2005 Stock Incentive Plan (the "Plan"). The Plan provides for the granting of incentive stock options to employees selected by the board's compensation committee. The Plan authorizes up to 697,500 shares to be issued. The compensation committee subsequently awarded options for 405,000 shares to officers of the Company at an exercise price of \$5.33, which was equal to the initial public offering price of the stock. The options vest 20% on the date of grant and then ratably 20% over the following four years and have a ten-year term. All share and per share amounts have been adjusted for the 3-for-2 stock split that was effected in July 2006. During the third quarter of 2007, options for 93,000 shares were forfeited by Michael Sage, the Company's former President and CEO who retired effective July 15, 2007. Options for 225,000 shares were granted effective August 20, 2007, to Robert Snyder, the Company's new President and CEO, at an exercise price of \$6.81, the market price on the date of the grant. The options vest 20% on the date of the grant and then ratably 20% over the following four years and have a ten-year term.

The following table details the options granted to certain members of the board of directors and management during the first nine months of 2006 and 2007 and the assumptions used in the Black-Scholes option valuation model for those option grants :

Grant Date	Number of Shares	Exercise Price	Risk-Free Interest Rate	Estimated Volatility	Dividend Yield	Forfeiture Rate	Expected Life
Feb-06	3,750	\$ 7.61	4.56%	41%	None	0%	5 years
Jun-06	11,250	\$ 10.05	4.97%	40%	None	0%	5 years
Feb-07	3,750	\$ 8.58	4.83%	40%	None	0%	5 years
Jun-07	28,750	\$ 5.18	5.09%	38%	None	0%	5 years
Aug-07	225,000	\$ 6.81	4.63%	40%	None	0%	5-7 years

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, options valuation models require the input of highly subjective assumptions including the expected stock price volatility.

In connection with the approval of the Plan, the Company adopted SFAS No. 123 (R) "Share-Based Payments" and expenses the cost of options granted over the vesting period of the option based on the grant-date fair value of the award. The Company recognized an expense of \$163,000 and \$47,000 for the three months ended September 30, 2007 and 2006, respectively, related to options granted under the Plan. The Company recognized an expense of \$331,000 and \$201,000 for the nine months ended September 30, 2007 and 2006, respectively, related to options granted under the Plan.

#### **Note 7 – Major Customers and Concentration of Credit Risk**

Credit risk for the Company is concentrated in four significant customers. Three are finished goods customers, each of whom operates discount retail stores located throughout the United States. The fourth customer is a broker for third party sales of parent rolls. During the three months ended September 30, 2007 and 2006, sales to the four significant customers accounted for approximately 65% and 68% of the Company's total sales, respectively. For the nine months ended September 30, 2007 and 2006, sales to the four significant customers accounted for approximately 69% and 65% of the Company's total sales, respectively. At September 30, 2007 and 2006, respectively, approximately \$4,655,000 (75%) and \$4,080,000 (81%) of accounts receivable was due from these four significant customers. No other customers of the Company accounted for more than 10% of sales during these periods. The Company generally does not require collateral from its customers and has not incurred any significant losses on uncollectible accounts receivable.

#### **Note 8 – New Accounting Standards**

FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" (FIN 48) was issued in June 2006. It clarifies recognition and derecognition criteria for tax positions taken in a return that may be subject to challenge upon audit. If it is "more likely than not" that the tax position will be sustained upon examination, the benefit is to be recognized in the financial statements. Conversely, if the position is less likely than not to be sustained, the benefit should not be recognized. The recognition/derecognition decision should be reflected in the first interim period when the status changes and not deferred to a future settlement upon audit. General tax reserves to cover aggressive positions taken in filed returns are no longer allowable. Each issue must be

judged on its own merits and a recognition/derecognition decision recorded in the financial statements. The Company adopted FIN 48 beginning January 1, 2007. Because the Company knowingly takes no aggressive positions in its tax returns and, accordingly, carries no income tax “reserves” on its books, this Interpretation did not have an effect during the first nine months of 2007 and is not expected to have a material effect on the Company’s financial position or results of operations in future periods.

In September 2006, the FASB issued SFAS No. 157 “Fair Value Measurements” which amends and puts in one place guidance on the use of fair value measurements which had been spread through four APB Opinions and 37 FASB Standards. No extensions of the use of fair value measurements are contained in this new pronouncement and with some special industry exceptions (e.g., broker-dealers), no significant changes in practice should ensue. The standard is to be applied to financial statements beginning after November 15, 2007. The adoption of SFAS No. 157 is not expected to have a material impact on Orchids’ financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159 “Fair Value Option for Financial Assets and Financial Liabilities – including an amendment of FASB Statement No. 115.” This standard permits the use of fair value measurement of financial assets and liabilities in the balance sheet with the net change in fair value recognized in periodic net income. The Standard is effective for fiscal years beginning after November 15, 2007. The adoption of this standard is not expected to have a material effect on the Company’s financial position or results of operations.

## **ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations**

### **Forward-Looking Information**

The following Management’s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements. These statements relate to, among other things:

- our business strategy;
- the market opportunity for our products, including expected demand for our products;
- our estimates regarding our capital requirements; and
- any of our other plans, objectives, and intentions contained in this report that are not historical facts.

These statements relate to future events or future financial performance, and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as “may,” “should,” “could,” “expects,” “plans,” “intends,” “anticipates,” “believes,” “estimates,” “predicts,” “potential” or “continue” or the negative of such terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. These statements are only predictions.

You should not place undue reliance on forward-looking statements because they involve known and unknown risks, uncertainties, and other factors that are, in some cases, beyond our control and that could materially affect actual results, levels of activity, performance or achievements.

Factors that could materially affect our actual results, levels of activity, performance or achievements include, without limitation, those detailed under the caption “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, as filed with the Securities and Exchange Commission, and the following items:

- we face intense competition in our market and our profitability would be reduced if aggressive pricing by our competitors forces us to decrease our prices;
- a substantial percentage of our finished goods revenues are attributable to three large customers which may decrease or cease purchases at any time;
- we have significant indebtedness which limits our free cash flow and subjects us to restrictive covenants relating to the operation of our business;
- the availability of and prices for energy could significantly affect our business;
- our exposure to variable interest rates may affect our financial health;
- the disruption in supply or cost of waste paper;
- the loss of key personnel;
- labor interruptions;
- natural disaster or other disruption to our facility;
- ability to finance the capital requirements of our business;
- cost to comply with government regulations; and
- failure to maintain an effective system of internal controls necessary to accurately report our financial results and prevent fraud.

If any of these risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary significantly from what we projected. Any forward-looking statement you read in the following Management’s Discussion and Analysis of Financial Condition and Results of Operations reflects our current views with respect to future events and is subject to these and other risks, uncertainties, and assumptions relating to our operations, results of operations, growth strategy, and liquidity. We assume no obligation to publicly update or revise these forward-looking statements for any reasons, whether as a result of new information, future events, or otherwise.

## **Overview**

We manufacture bulk tissue paper, known as parent rolls, and convert parent rolls into a full line of tissue products, including paper towels, bathroom tissue and paper napkins for the private label segment of the consumer, or “at home,” market. We have focused our product design and manufacturing on the discount retail market, primarily the dollar store retailers, due to their consistent order patterns, limited number of stock keeping units, or SKUs, offered and the growth being experienced in this channel of the retail market. While we have customers located throughout the United States, we distribute most of our products within approximately 900 miles

of our northeast Oklahoma facility, which we consider to be our cost-effective shipping area. Our products are sold primarily under our customers' private labels and, to a lesser extent, under our brand names such as Colortex® and Velvet®. All of our revenue is derived pursuant to truck load purchase orders from our customers. We do not have supply contracts with any of our customers. Revenue is recognized when title passes to the customer. Because our product is a daily consumable item, the order stream from our customer base is fairly consistent with no significant seasonal fluctuations. Changes in the national economy do not materially affect the market for our product.

Our profitability depends on several key factors, including:

- the market price of our product;
- the cost of recycled paper used in producing paper;
- the efficiency of operations in both our paper mill and converting plant; and
- energy costs.

The private label segment of the tissue industry is highly competitive, and discount retail customers are extremely price sensitive. As a result, it is difficult to effect price increases. We expect these competitive conditions to continue.

In June 2006, we began operating a new paper machine with an annual capacity of approximately 33,000 tons. In the second quarter of 2007, we began running all of our older machines on a full-time basis. The capacity of the new machine, in addition to the capacity of our older machines, increased our total production capacity to approximately 54,000 tons per year. As a result, beginning in the third quarter of 2006, we were able to eliminate the requirement to purchase recycled parent rolls on the open market. We continue to buy a small quantity of premium virgin fiber-based parent rolls. Prior to the third quarter of 2006, we had purchased parent rolls on the open market since 1998 because our own parent roll production had not adequately supplied the requirements of our converting facility. We purchased approximately 6,970, 12,200 and 5,000 tons of paper on the open market in 2006, 2005 and 2004, respectively, to supplement our paper-making capacity. Parent rolls are a commodity product and thus are subject to market price and availability. We experienced significantly higher parent roll prices beginning in early 2004, as well as limited availability, which negatively affected our profitability.

#### **Comparative Three-Month Periods Ended September 30, 2007 and 2006**

##### **Net Sales**

	<u>Three Months Ended September 30,</u>	
	<u>2007</u>	<u>2006</u>
	<u>(in thousands, except price per ton and tons)</u>	
Net sales	\$19,218	\$15,154
Total tons shipped	13,390	10,574
Average price per ton	\$ 1,435	\$ 1,433

Net sales increased 27%, to \$19.2 million in the quarter ended September 30, 2007, compared to \$15.2 million in the same period of 2006. Net sales figures include gross selling price, including freight, less discounts and pricing allowances. The increase in net sales is primarily the result of increased sales of parent rolls, an increase in the price per ton of converted product, and an increase in tons of converted product shipped to customers. Total shipments increased by 2,816

tons, or 27%, to 13,390 tons compared to 10,574 tons in the same period of 2006, primarily due to a 400% increase in parent roll shipments and, to a lesser extent, a 4% increase in the tonnage of converted product shipments. The increase in parent roll shipments is attributable to the incremental production capacity provided by our new paper machine which was in a start-up phase in the third quarter of 2006. Our net selling price in the third quarter of 2007 was \$1,435 per ton compared with \$1,433 per ton in the same period of 2006. The net selling price per ton was relatively unchanged in the quarter due to an approximate 8% increase in converted product selling price per ton, primarily due to sheet count reductions effected in the first quarter of 2007, being basically offset by the mix effect of increased sales of parent rolls which are sold at lower prices than converted products.

### Cost of Sales

	<u>Three Months Ended September 30,</u>	
	<u>2007</u>	<u>2006</u>
	(in thousands, except gross profit margin %)	
Cost of paper	\$ 9,819	\$ 7,755
Non-paper materials, labor, supplies, etc.	5,233	4,845
Sub-total	15,052	12,600
Depreciation	750	697
Cost of sales	<u>\$ 15,802</u>	<u>\$ 13,297</u>
Gross Profit	\$ 3,416	\$ 1,857
Gross Profit Margin %	17.8%	12.3%

Major components of cost of sales are the cost of internally produced paper, raw materials, direct labor and benefits, freight costs of products shipped to customers, insurance, repairs and maintenance, energy, utilities and depreciation.

Cost of sales increased approximately \$2.5 million, or 19%, to \$15.8 million for the quarter ended September 30, 2007, compared to \$13.3 million in the same period of 2006. As a percentage of net sales, cost of sales declined from 88% to 82% of net sales. The decline in cost of sales as a percentage of net sales in the quarter ended September 30, 2007 was primarily attributed to higher selling prices and higher overall selling volume. The following chart depicts the major factors that influence our paper costs.

	<u>Three Months Ended September 30,</u>	
	<u>2007</u>	<u>2006</u>
<b>Paper usage (tons)</b>		
Converted-internal	10,151	9,255
Converted-purchased	237	732
Total converted	10,388	9,987
Third-party parent roll sales	3,002	587
<b>Paper costs per ton</b>		
Cost per ton produced internally	\$ 726	\$ 703
Cost per ton purchased from third parties	\$ 1,140	\$ 1,142
Total cost per ton consumed	\$ 733	\$ 733
<b>Total paper costs (in thousands)</b>		
Cost of internally produced paper	\$ 9,549	\$ 6,919
Cost of paper purchased from third parties	270	836
Total paper costs	\$ 9,819	\$ 7,755

Our overall cost of paper was unchanged in the quarter ended September 30, 2007 at \$733 per ton compared to the same period of 2006. A higher cost of production for internally produced paper was offset by the effects of lower volume of paper purchases from third-party suppliers. Our cost of internally produced paper, excluding depreciation, increased \$23 per ton to \$726 per ton in the quarter ended September 30, 2007, compared to \$703 per ton in the same period in 2006. A higher cost of waste paper was partially offset by the effect of increased paper production on labor and semi-fixed costs per ton. The prices we paid for waste paper increased approximately 25% in the third quarter of 2007 compared with the same period in 2006 as an overall tight waste paper market resulted in significant price increases across all grades of waste paper.

### Gross Profit

Gross profit in the quarter ended September 30, 2007 increased \$1.5 million, or 84%, to \$3.4 million compared to \$1.9 million in the same period last year. Gross profit as a percentage of net sales in the 2007 quarter was 17.8% compared to 12.3% in the 2006 quarter. The effect of higher selling prices and higher overall selling volumes were the major reasons for increase in gross profit and gross profit as a percentage of net sales.

### Selling, General and Administrative Expenses

	<u>Three Months Ended September 30,</u>	
	<u>2007</u>	<u>2006</u>
<i>(In thousands, except SG&amp;A as a % of net sales)</i>		
Commission expense	\$ 224	\$ 188
Other S,G&A expenses	1,267	936
Selling, General & Adm exp	\$ 1,491	\$ 1,124
SG&A as a % of net sales	7.8%	7.4%

Selling, general and administrative expenses include salaries, commissions to brokers and other miscellaneous expenses. Selling, general and administrative expenses increased \$367,000, or 33%, to \$1.5 million in the quarter ended September 30, 2007 compared to \$1.1 million in the comparable 2006 period, mainly as a result of the expensing of stock options granted to our new

CEO, executive search expenses and expenses related to compliance with Section 404 of the Sarbanes-Oxley Act of 2002. As a percent of net sales, selling, general and administrative expenses increased to 7.8% in the third quarter of 2007 compared to 7.4% in the same period of 2006.

### **Operating Income**

As a result of the foregoing factors, operating income for the quarter ended September 30, 2007 was \$1.9 million compared to operating income of \$733,000 for the same period of 2006.

### **Interest and Other Expense**

	<b>Three Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(In thousands)</b>	
Interest expense	\$635	\$836
Other (income) expense, net	\$ (2)	\$ (17)

Interest expense includes interest on all debt and amortization of both deferred debt issuance costs and the discount on our subordinated debt related to warrants issued with that debt. Interest expense decreased \$201,000 to \$635,000 in the quarter ended September 30, 2007, compared to \$836,000 in the quarter ended September 30, 2006, primarily as a result of lower interest margins under our new credit agreement that closed on April 9, 2007 and lower borrowings under our revolving credit line.

Other income decreased from \$17,000 in the third quarter of 2006 to \$2,000 in the third quarter of 2007, primarily due to the absence of interest on the restricted certificate of deposit which was released in connection with the closing of our new credit facility.

### **Income (Loss) Before Income Taxes**

As a result of the foregoing factors, income (loss) before income taxes increased \$1.38 million to income of \$1.29 million in the quarter ended September 30, 2007, compared to a loss of \$86,000 in the same period in 2006.

### **Income Tax Provision (Benefit)**

For the quarter ended September 30, 2007, our effective income tax rate was 12%. It is lower than the statutory rate because of Oklahoma Investment Tax Credits associated with our investment in a new paper machine, the utilization of Federal Indian Employment Credits and the recognition of deferred tax benefits associated with non-qualified option grants to our directors and officers, including a true-up. These factors were partially offset by state income taxes. As of September 30, 2006, we estimated our annual effective income tax rate to be 4%. Due to the fact that previous quarters of 2006 were estimated at a higher tax rate, the third quarter benefit was negative. The 2006 effective tax rate was lower than the statutory rate because of the Oklahoma Investment Tax Credits, partially offset by non-deductible stock option expense and state income taxes. Federal Indian Employment Credits were not reinstated until December 2006 and thus were not considered in the September 30, 2006 tax provision.

## Comparative Nine-Month Periods Ended September 30, 2007 and 2006

### Net Sales

	Nine Months Ended September 30,	
	2007	2006
	(in thousands, except price per ton and tons)	
Net sales	\$54,370	\$42,928
Total tons shipped	37,367	28,548
Average price per ton	\$ 1,455	\$ 1,504

Net sales increased 27%, to \$54.4 million in the nine months ended September 30, 2007, compared to \$42.9 million in the same period of 2006. Net sales figures include gross selling price, including freight, less discounts and pricing allowances. The increase in net sales is primarily the result of increased sales of parent rolls, an increase in tons of converted product shipments and an increase in the price per ton of converted products sold. Total shipments increased by 8,819 tons, or 31%, to 37,367 tons compared to 28,548 tons in the same period of 2006. Parent roll tonnage shipped significantly increased primarily due to the incremental production capacity provided by the start-up of our new paper machine in June of 2006 and, to a lesser extent, an 8% increase in the tonnage of converted product shipments. Our net selling price in the first nine months of 2007 was \$1,445 per ton compared with \$1,504 per ton in the same period of 2006. The net selling price per ton decreased primarily due to the mix effect of increased sales of parent rolls, which are sold at lower prices than converted products, being partially offset by the 5% increase in converted product pricing.

### Cost of Sales

	Nine Months Ended September 30,	
	2007	2006
	(in thousands, except gross profit margin %)	
Cost of paper	\$ 27,926	\$ 23,136
Non-paper materials, labor, supplies, etc.	15,962	13,883
Sub-total	\$ 43,888	37,019
Depreciation	2,248	1,483
Cost of sales	\$ 46,136	\$ 38,502
Gross Profit	\$ 8,234	\$ 4,426
Gross Profit Margin %	15.1%	10.3%

Major components of cost of sales are the cost of internally produced paper, the cost of parent rolls purchased from third parties, raw materials, direct labor and benefits, freight costs of products shipped to customers, insurance, repairs and maintenance, energy, utilities and depreciation.

Cost of sales increased approximately \$7.6 million, or 20%, to \$46.1 million for the nine months ended September 30, 2007, compared to \$38.5 million in the same period of 2006. As a percentage of net sales, cost of sales declined from 90% to 85% of net sales. Cost of sales as a percentage of net sales in the nine months ended September 30, 2007 reflected a lower overall cost of paper, which was primarily due to the reduced quantity of parent rolls purchased, higher selling prices and sales volumes, which factors were partially offset by depreciation expense and

higher converting labor costs. The following chart depicts the major factors that influence our paper costs.

	<u>Nine Months Ended September 30,</u>	
	<u>2007</u>	<u>2006</u>
<b><i>Paper usage (tons)</i></b>		
Converted-internal	29,104	21,513
Converted-purchased	1,023	6,448
Total converted	30,127	27,961
Third-party parent roll sales	7,240	587
<b><i>Paper costs per ton</i></b>		
Cost per ton produced internally	\$ 736	\$ 740
Cost per ton purchased from third parties	\$ 1,151	\$ 1,053
Total cost per ton consumed	\$ 747	\$ 810
<b><i>Total paper costs (in thousands)</i></b>		
Cost of internally produced paper	\$ 26,749	\$ 16,344
Cost of paper purchased from third parties	<u>1,177</u>	<u>6,792</u>
Total paper costs	\$ 27,926	\$ 23,136

Our overall cost of paper decreased by \$63 per ton in the nine months ended September 30, 2007 to \$747 per ton compared to \$810 per ton in the same period of 2006. The main reason for the decrease is the reduction in the quantity of parent rolls purchased from third parties following the start-up of our new paper machine in June 2006. As a result of the production from the new paper machine, beginning in the third quarter of 2006 purchases of recycled parent rolls were no longer required, resulting in purchases of 1,023 tons of premium virgin fiber-based parent rolls in the first nine months of 2007, compared to total purchases of 6,448 tons of primarily recycled parent rolls in the same period of 2006. Our cost of internally produced paper, excluding depreciation, decreased \$4 per ton to \$736 per ton in the nine months ended September 30, 2007, compared to \$740 per ton in the same period in 2006. Higher waste paper costs were partially offset by the effect of increased paper production on labor and semi-fixed costs per ton. The prices we paid for waste paper increased approximately 30% in the first nine months of 2007 compared with the same period in 2006 as an overall tight waste paper market resulted in significant price increases across all grades of waste paper.

### **Gross Profit**

Gross profit in the nine months ended September 30, 2007 increased \$3.8 million, or 86%, to \$8.2 million compared to \$4.4 million in the same period last year. Gross profit as a percentage of net sales in the nine months ended September 30, 2007 increased to 15.1% compared to 10.3% in the same period in 2006. The effect of reduced purchases of externally purchased parent rolls, higher selling prices and sales volumes were partially offset by higher depreciation expense and converting labor costs.

## Selling, General and Administrative Expenses

	<u>Nine Months Ended September 30,</u>	
	<u>2007</u>	<u>2006</u>
Commission expense	\$ 702	\$ 579
Other S,G&A expenses	<u>3,351</u>	<u>3,074</u>
Selling, General & Adm exp	\$ 4,053	\$ 3,653
SG&A as a % of net sales	7.5%	8.5%

Selling, general and administrative expenses include salaries, commissions to brokers and other miscellaneous expenses. Selling, general and administrative expenses increased \$400,000, or 11%, to \$4.1 million in the nine months ended September 30, 2007 compared to the comparable 2006 period mainly as a result of stock option expense for our new CEO, executive search costs, costs related to compliance with Section 404 of the Sarbanes-Oxley Act of 2002 and higher commission expense reflecting higher sales levels, partially offset by lower artwork expense. As a percent of net sales, selling, general and administrative expenses decreased to 7.5% in the nine months ended September 30, 2007 compared to 8.5% in the same period of 2006.

## Operating Income

As a result of the foregoing factors, operating income for the nine months ended September 30, 2007 was \$4.2 million compared to \$773,000 for the same period of 2006.

## Interest and Other Expense

	<u>Nine Months Ended September 30,</u>	
	<u>2007</u>	<u>2006</u>
Interest expense	\$2,216	\$1,126
Other (income) expense, net	\$ (29)	\$ (80)

Interest expense includes interest on all debt and amortization of both deferred debt issuance costs and the discount on our subordinated debt related to warrants issued with that debt. Interest expense increased \$1.1 million to \$2.2 million in the nine months ended September 30, 2007, compared to \$1.1 million in the nine months ended September 30, 2006. Interest expense in the first nine months of 2006 were net of the capitalization of \$992,000 of interest related to our new paper machine project. Excluding the interest capitalization, interest expenditures increased \$98,000 in the first nine months of 2007 compared to the same period in 2006. The primary reason for the increase was additional borrowings during 2006 on the construction loan which funded the new paper machine. Partially offsetting these increases were lower interest expenses in the second and third quarter of 2007 as a result of our new credit facility that closed on April 9, 2007, which reduced interest margins, and lower borrowings under the revolving credit line during the third quarter of 2007.

Other income decreased from \$80,000 in the first nine months of 2006 to \$29,000 in the same period of 2007, primarily due to the absence of a net foreign currency exchange gain recorded in the second quarter of 2006. We entered into certain purchase agreements in 2004 related to our

project to build a new paper machine. One of these purchase agreements was denominated in Euros. We entered into foreign currency exchange contracts in the second quarter of 2005 to fix the price of this purchase agreement. In May 2006, we made the final payment due on the machine and settled the last outstanding foreign currency exchange contract to exchange U.S. Dollars for Euros totaling \$760,000. The exchange contract was carried at fair value and any adjustments to fair value affected net income. The net foreign currency transaction gain resulting from our Euro denominated obligations and Euro exchange contracts for the nine months ended September 30, 2006 was \$39,000.

### **Income (Loss) Before Income Taxes**

As a result of the foregoing factors, income (loss) before income taxes increased \$2.3 million to income of \$2.0 million in the nine months ended September 30, 2007, compared to a loss of \$273,000 in the same period in 2006.

### **Income Tax Provision (Benefit)**

For the nine months ended September 30, 2007, our effective income tax rate was 12%. It is lower than the statutory rate because of Oklahoma Investment Tax Credits associated with our investment in a new paper machine, the utilization of Federal Indian Employment Credits and the recognition of deferred tax benefits associated with non-qualified option grants to our directors and officers, including a true-up. These factors were partially offset by state income taxes. As of September 30, 2006, we estimated our annual effective income tax rate to be 4%. It was lower than the statutory rate because of the Oklahoma Investment Tax Credit, partially offset by non-deductible stock option expense and state income taxes. Federal Indian Employment Credits were not reinstated until December 2006 and thus were not considered in the September 30, 2006 tax provision.

### **Liquidity and Capital Resources**

Liquidity refers to the liquid financial assets available to fund our business operations and pay for near-term obligations. These liquid financial assets consist of cash as well as unused borrowing capacity under our revolving credit facility. Our cash requirements have historically been satisfied through a combination of cash flows from operations and debt financings.

Cash was unchanged in the nine months ended September 30, 2007 at \$3,000. Cash decreased \$375,000 at September 30, 2006, to \$3,000 compared with \$378,000 as of December 31, 2005, as the remaining unused net proceeds from our 2005 initial public offering were applied to the paper machine project during January 2006.

The following table summarizes key cash flow information for the nine-month periods ended September 30, 2007 and 2006:

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
	(in thousands)	
Cash flow provided by (used in):		
Operating activities	\$ 5,110	\$ 2,488
Investing activities	\$ 1,023	\$(17,268)
Financing activities	\$(6,133)	\$ 14,405

Cash flow provided by operating activities was \$5.1 million in the nine-month period ended September 30, 2007, which primarily consisted of earnings before non-cash charges, the receipt of \$1.2 million in federal tax refunds representing interim tax payments made early in 2006 and carryback claims for taxes paid in 2005 and 2004 and an increase in accrued liabilities, which were partially offset by increases in accounts receivable and inventories.

Cash flows provided by investing activities were \$1.0 million in the nine-month period ended September 30, 2007, reflecting the release of the \$1.5 million restricted certificate of deposit in connection with the re-financing of the Company's credit facility. Several maintenance capital expenditure projects were partly offsetting.

Cash used in financing activities was \$6.1 million in the nine-month period ended September 30, 2007 and was primarily attributable to a \$4.9 million net reduction in the revolving credit balance and \$1.7 million repayments of principal on our term loans, partly offset by net additional term loan borrowings in connection with the re-financing of the Company's bank debt in April 2007. The reduction in the revolving credit balance is due primarily to the application of the \$1.5 million restricted certificate of deposit, the \$1.2 million in federal income tax refunds received, and positive cash flows from operations during the second and third quarters of 2007. The effect of these incremental term loan borrowings was to reduce the revolving credit balance.

Cash flow provided by operating activities was \$2.5 million in the nine-month period ended September 30, 2006, which primarily consisted of earnings before non-cash charges and credits and an increase in accounts payable, which was partly offset by an increase in accounts receivable.

Cash used in investing activities was \$17.3 million in the nine-month period ended September 30, 2006. The amount was attributable to capital expenditures on a new paper machine.

Cash provided by financing activities was \$14.4 million in the nine-month period ended September 30, 2006, and was primarily attributable to borrowings under the construction loan facility.

On April 9, 2007, we closed the re-financing of our credit facility with our existing bank group under the following terms:

- a \$6.0 million revolving credit facility with a three-year term (\$0 outstanding at September 30, 2007. In addition, \$157,000 of bank overdrafts were included in the long-term debt section of the balance sheet at September 30, 2007). The borrowing base for the revolving credit facility is determined by adding qualified receivables and inventory.

At September 30, 2007, the borrowing base for the revolving credit facility was \$6.6 million, limited to the \$6.0 million amount of the facility;

- a \$10.0 million term loan A with a ten-year term that has no principal repayments for the first 24 months of the loan and then will be amortized as if the loan had an 18-year life (\$10.0 million outstanding at September 30, 2007);
- a \$16.5 million term loan B with a four-year term that is being amortized as if the loan had a six-year life (\$15.6 million outstanding at September 30, 2007); and
- a \$3.0 million capital expenditures facility with a four-year term that will be amortized as if the loan had a five-year life (\$0 outstanding at September 30, 2007).

Under the terms of the new credit agreement, amounts outstanding under the revolving credit facility bear interest at our election at the prime rate or LIBOR plus a margin and amounts outstanding under term loan B and the capital expenditures facility bear interest at LIBOR plus a margin, which is set quarterly and based on the ratio of funded debt to EBITDA less income taxes paid. Amounts outstanding under term loan A bear interest at LIBOR plus 180 basis points. For the revolving credit facility, the margin ranges from a negative 50 basis points to 150 basis points for loans with a prime rate election and 200 to 375 basis points for loans with a LIBOR election. For term loan B, the margin ranges from 200 basis points to 300 basis points over LIBOR. For the capital expenditures facility, the margin ranges from 150 basis points to 250 basis points over LIBOR. At September 30, 2007, our weighted average borrowing rate was 7.89% under this credit agreement. At April 8, 2007 under the predecessor credit facility, our weighted average borrowing rate was 9.28%.

The credit agreement contains covenants that, among other things, require us to maintain a specific funded debt to EBITDA ratio, debt service coverage ratio and an annual limit on un-financed capital expenditures. In connection with the re-financing, the \$1.5 million restricted certificate of deposit was released and applied to the revolving credit facility. The amount available under the revolving credit line may be reduced in the event that our borrowing base, which is based upon our qualified receivables and qualified inventory, is less than \$6.0 million. Obligations under the amended and restated credit agreement are secured by substantially all of our assets. The agreement contains representations and warranties, and affirmative and negative covenants customary for financings of this type, including, but not limited to, a covenant prohibiting us from declaring or paying dividends. The financial covenants in the agreement require us to maintain specific ratios of funded debt to EBITDA and debt service coverage which are tested as of the end of each quarter and places a limit on the amount of annual non-financed capital expenditures. The maximum allowable funded debt to EBITDA ratio is 4.0-to-1.0 and the minimum allowable debt service coverage ratio is 1.25-to-1.0. Our annual expenditures for non-financed capital equipment are limited to \$1.5 million per fiscal year.

The capital expenditures facility is intended to fund an expansion of our wastewater pre-treatment. A new water discharge permit was issued effective August 1, 2007 which requires us to expand our existing pre-treatment facility to reduce biological oxygen demand and total suspended solids from our effluent stream. Under the new permit, we are required to complete the expansion and make operational our pre-treatment facility by August 1, 2009. The project is in the pre-engineering phase and is expected to cost between \$2 million and \$3 million.

If an event of default occurs, the agent may declare the banks' obligation to make loans terminated and all outstanding indebtedness, and all other amounts payable under the credit agreement, due and payable.

On March 1, 2004, we sold units consisting of \$2.2 million principal amount of subordinated debentures and common stock warrants. The subordinated debentures were sold in units of \$1,000 bearing interest at 12% per year, payable quarterly and mature on March 1, 2009, with each note including a warrant to purchase 57 shares of common stock at an exercise price of \$2.43 per share. We have the right to prepay, without premium or penalty, any unpaid principal on the subordinated debentures. The subordinated debentures are expressly subordinated to the prior payment in full of amounts owed under our revolving line of credit and term loans. The subordinated debentures contain customary covenants and events of default.

### **Critical Accounting Policies and Estimates**

The preparation of our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and judgments that affect our reported amounts of assets and liabilities, revenue and expense, and related disclosures of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates and assumptions based upon historical experience and various other factors and circumstances. Management believes that our estimates and assumptions are reasonable under the circumstances; however, actual results may vary from these estimates and assumptions under different future circumstances. We have identified the following critical accounting policies that affect the more significant judgments and estimates used in the preparation of our financial statements:

*Accounts Receivable.* Accounts receivable consist of amounts due to us from normal business activities. Our management must make estimates of accounts receivable that will not be collected. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer's creditworthiness as determined by our review of their current credit information. We continuously monitor collections and payments from our customers and maintain an allowance for estimated losses based on historical experience and specific customer collection issues that we have identified. Trade receivables are written-off when all reasonable collection efforts have been exhausted, including, but not limited to, external third party collection efforts and litigation. While such credit losses have historically been within management's expectations and the allowance provided, there can be no assurance that we will continue to experience the same credit loss rates as in the past. During the nine-month periods ended September 30, 2007 and 2006, provisions for doubtful accounts were recognized in the amount of \$15,000 and \$45,000, respectively. In addition, \$8,000 of recoveries of accounts previously written off were credited to the allowance during the first nine months of 2007. There were no recoveries during the first nine months of 2006. There were no accounts receivable balances written off in the nine-month periods ended September 30, 2007 and 2006.

*Inventory.* Our inventory consists of finished goods and raw materials and is stated at the lower of cost or market. Our management regularly reviews inventory quantities on hand and records a provision for excess and obsolete inventory based on the age of the inventory and forecasts of product demand. A significant decrease in demand could result in an increase in the amount of excess inventory quantities on hand. During the first nine months of 2007, \$65,000 was provided and \$8,000 was charged against the valuation reserve. During the first nine months of 2006, \$45,000 was provided and \$47,000 was charged against the reserve.

## **New Accounting Pronouncements**

FASB Interpretation No. 48 “Accounting for Uncertainty in Income Taxes” (FIN 48) was issued in June 2006. It clarifies recognition and derecognition criteria for tax positions taken in a return that may be subject to challenge upon audit. If it is “more likely than not,” that the tax position will be sustained upon examination, the benefit is to be recognized in the financial statements. Conversely, if the position is less likely than not to be sustained, the benefit should not be recognized. The recognition/derecognition decision should be reflected in the first interim period when the status changes and not deferred to a future settlement upon audit. General tax reserves to cover aggressive positions taken in filed returns are no longer allowable. Each issue must be judged on its own merits and a recognition/derecognition decision recorded in the financial statements. The Company adopted FIN 48 beginning January 1, 2007. Because the Company knowingly takes no aggressive positions in its tax returns and accordingly, carries no income tax “reserves” on its books, this Interpretation did not have an effect during the first nine months of 2007 and is not expected to have a material effect on the Company’s financial position or results of operations in future periods.

In September 2006, the FASB issued SFAS No. 157 “Fair Value Measurements” which amends and puts in one place guidance on the use of fair value measurements which had been spread through four APB Opinions and 37 FASB Standards. No extensions of the use of fair value measurements are contained in this new pronouncement, and with some special industry exceptions (e.g., broker-dealers), no significant changes in practice should ensue. The standard is to be applied to financial statements beginning after November 15, 2007. The adoption of SFAS No. 157 is not expected to have a material impact on our financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159 “Fair Value Option for Financial Assets and Financial Liabilities – including an amendment of FASB Statement No. 115.” This standard permits the use of fair value measurement of financial assets and liabilities in the balance sheet with the net change in fair value recognized in periodic net income. The Standard is effective for fiscal years beginning after November 15, 2007. The adoption of this standard is not expected to have a material effect on the Company’s financial position or results of operations.

## **Non-GAAP Discussion**

In addition to our GAAP results, we also consider non-GAAP measures of our performance for a number of purposes. We use EBITDA as a supplemental measure of our performance that is not required by, or presented in accordance with, GAAP. EBITDA is not a measurement of our financial performance under GAAP and should not be considered as an alternative to net income, operating income or any other performance measure derived in accordance with GAAP, or as an alternative to cash flow from operating activities or a measure of our liquidity.

EBITDA represents net income before net interest expense, income tax expense, depreciation and amortization. We believe EBITDA facilitates operating performance comparisons from period to period and company to company by eliminating potential differences caused by variations in capital structures (affecting relative interest expense), tax positions (such as the impact on periods or companies of changes in effective tax rates or net operating losses) and the age and book depreciation of facilities and equipment (affecting relative depreciation expense).

EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for any of our results as reported under GAAP. Some of these limitations are:

- it does not reflect our cash expenditures for capital assets;
- it does not reflect changes in, or cash requirements for, our working capital requirements;
- it does not reflect the interest expense, or the cash requirements necessary to service interest or principal payments on our indebtedness;
- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and EBITDA does not reflect cash requirements for such replacements; and
- other companies, including other companies in our industry, may calculate these measures differently than we do, limiting their usefulness as a comparative measure.

Because of these limitations, EBITDA should not be considered as a measure of discretionary cash available to us to invest in the growth of our business or to reduce our indebtedness. We compensate for these limitations by relying primarily on our GAAP results and using EBITDA on a supplemental basis.

The following table reconciles EBITDA to net income for the quarters ended September 30, 2007 and 2006:

	<b>Three Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(In thousands, except % of net sales)</b>	
Net income (loss)	\$ 1,136	\$ (151)
Plus: Interest expense	635	836
Plus: Income tax expense	156	65
Plus: Depreciation	<u>750</u>	<u>697</u>
EBITDA	\$ 2,677	\$ 1,447
% of net sales	13.9%	9.5%

EBITDA increased \$1.23 million to \$2.68 million in the quarter ended September 30, 2007, compared to \$1.45 million in the same period of 2006. EBITDA as a percent of net sales increased to 13.9% in the current year quarter compared to 9.5% in the prior year quarter. The foregoing factors discussed in the net sales and cost of sales and selling, general and administrative sections are the reasons for these changes. The largest causes of the increase in EBITDA as a percentage of net sales were higher selling prices and higher selling volumes.

The following table reconciles EBITDA to net income for the nine months ended September 30, 2007 and 2006:

	<u>Nine Months Ended September 30,</u>	
	<u>2007</u>	<u>2006</u>
	(In thousands, except % of net sales)	
Net income (loss)	\$ 1,748	\$ (262)
Plus: Interest expense, net	2,216	1,126
Plus: Income tax (benefit) expense	246	(11)
Plus: Depreciation	<u>2,248</u>	<u>1,483</u>
EBITDA	\$ 6,458	\$ 2,336
% of net sales	11.9%	5.4%

EBITDA was \$6.46 million in the nine months ended September 30, 2007, an increase of \$4.12 million compared to \$2.34 million in the same period of 2006. EBITDA as a percent of net sales increased to 11.9% in the current year nine-month period compared to 5.4% in the comparable prior year period. The foregoing factors discussed in the net sales and cost of sales sections are the primary reasons for these changes. The largest cause of the increase in EBITDA as a percentage of net sales was lower paper costs due to the elimination of purchases of recycled parent rolls and higher selling prices and sales volumes.

### **ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

Our market risks relate primarily to changes in interest rates. Our revolving line of credit and our term loans carry variable interest rates that are tied to market indices and, therefore, our statement of income and our cash flows will be exposed to changes in interest rates. As of September 30, 2007, we have borrowings totaling \$25.6 million that carry a variable interest rate. Outstanding balances under our line of credit and term loans bear interest at the prime rate or LIBOR, plus a margin based upon the debt service coverage ratio or a fixed margin over LIBOR. Based on the borrowings on September 30, 2007, a 100 basis point change in interest rates would result in a \$256,000 change to our annual interest expense.

### **ITEM 4. Controls and Procedures**

Our management, under the supervision and with the participation of our chief executive officer and our chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended), as of the end of the period covered by this Quarterly Report on Form 10-Q. Any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Based on such evaluation, our chief executive officer and our chief financial officer have concluded that our disclosure controls and procedures were effective as of September 30, 2007.

## **PART II. OTHER INFORMATION**

### **ITEM 1. Legal Proceedings**

None.

### **ITEM 1A. Risk Factors**

There have been no material changes from the risk factors disclosed in the Company's Annual Report on Form 10-K dated March 19, 2007.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

*(a) Unregistered Sales of Equity Securities*

None.

*(b) Initial Public Offering and Use of Proceeds from the Sale of Registered Securities*

None.

*(c) Repurchases of Equity Securities*

The Company does not have any programs to repurchase shares of its common stock and no such repurchases were made during the three months ended September 30, 2007.

**ITEM 3. Defaults Upon Senior Securities**

None.

**ITEM 4. Submission of Matters to a Vote of Security Holders**

None.

**ITEM 5. Other Information**

None.

**ITEM 6. Exhibits**

See the Exhibit Index following the signature page to this Form 10-Q, which Exhibit Index is hereby incorporated by reference herein.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**ORCHIDS PAPER PRODUCTS COMPANY**

Date: November 5, 2007

By: /s/ Keith R. Schroeder  
Keith R. Schroeder  
Chief Financial Officer  
(On behalf of the registrant and  
as Chief Accounting Officer)

## Exhibit Index

<u>Exhibit</u>	<u>Description</u>
3.1	Amended and Restated Certificate of Incorporation of the Registrant incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 (File No. 333-124173) filed with the Securities and Exchange Commission on April 19, 2005.
3.1.1	Amendment to the Amended and Restated Certificate of Incorporation of the Registrant incorporated by reference to the Form 10-Q filed with the Securities and Exchange Commission on August 14, 2007.
3.2	Amended and Restated Bylaws of the Registrant incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-1 (File No. 333-124173) filed with the Securities and Exchange Commission on April 19, 2005.
10.1	Employment Agreement dated August 20, 2007, between Robert A. Snyder and the Registrant's incorporated by reference to Exhibit 10.2 to the Form 8-K filed with the Securities and Exchange Commission on August 22, 2007.
10.2	Amendment One to Second Amended and Restated Agented Credit Agreement dated October 25, 2007, among the Registrant, Bank of Oklahoma, N.A., Bancfirst and Commerce Bank, N.A.
31.1	Certification of Chief Executive Officer Pursuant to Section 302.
31.2	Certification of Chief Financial Officer Pursuant to Section 302.
32.1	Certification of Chief Executive Officer Pursuant to Section 906.
32.2	Certification of Chief Financial Officer Pursuant to Section 906.