



ORCHIDS PAPER PRODUCTS COMPANY
2006 Annual Report
to Stockholders

Fellow Shareholders,

The last year was both challenging and rewarding. For the full year net sales increased 4% to \$60.2 million while operating earnings decreased 38% to 2.0 million. Net income for the year decreased 47% to \$0.73 million, resulting in diluted earnings per share of \$0.11.

Our new paper machine began production on schedule in mid June, 2006. Shortly after startup, we were able to discontinue the purchase of recycled parent rolls to support our converting operation. For the remainder of 2006, the production from the new machine and a combination of our old machines allowed full support of our converting operation while selling an additional 1,191 tons of parent rolls. The startup of the new machine met expectations and by the end of the calendar year, our effective production rates on the new machine were at approximately 85% of long term expected levels. Quality of the paper produced on the new machine has met all expectations and the improved physical properties of the paper has allowed a significant upgrade in our converted product, particularly our towel products. This improved quality provides us the opportunity to compete for business in higher quality requirement product lines.

To ultimately support conversion of all parent rolls from papermaking, the converting operations were moved to a four shift operating schedule. This will allow growth in converted product sales during 2007 and beyond. This transition required significant new hiring and training, but will ultimately allow full utilization of our installed converting capacity. With this new 24 hour schedule, we have the capacity to convert over 50,000 tons of paper in the existing facility.

Results in the first six months of the year were hampered by the high cost of purchasing outside parent rolls. These costs along with decreased production from our older machines limited profitability in that period. Other cost pressures we faced in 2006 included higher wastepaper prices, higher electricity costs, higher freight costs, and increased converting labor costs. Improved mill production along with higher converted case volumes and product configuration modifications will help offset these costs in 2007.

Our challenge in 2007 will be to capitalize on the investment we made in a new paper machine. All company personnel will be focused on increasing the efficiency of the new machine at design rates while building converted product sales to match expected machine production. Efficiency improvement in converting will improve costs and allow the capacity to effectively serve our customers. The expected expansion of converted product sales will allow the broadening of our customer base.

Finally, I would like to recognize the employees who put forth a tremendous effort towards the startup of the new machine. With this milestone behind us, we all look forward to making the best, and most profitable, use of this major capital expenditure.



Michael P. Sage

May 1, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2006

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

For the transition period from _____ to _____

Commission File Number: 001-32563



ORCHIDS PAPER PRODUCTS COMPANY

A Delaware Corporation
(State or other jurisdiction of
incorporation or organization)

23-2956944
(I.R.S. Employer
Identification Number)

4826 Hunt Street
Pryor, Oklahoma 74361
(Address of principal executive offices)

Registrant's telephone number, including area code:
(918) 825-0616

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Exchange on Which Registered</u>
Common Stock, \$0.001 Par Value	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of the registrant's common equity held by non-affiliates was \$52.0 million as of June 30, 2006.

As of March 1, 2007, there were outstanding 6,234,346 shares of common stock, none of which are held in treasury.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Registrant's 2007 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K.

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PART I

Throughout this Form 10-K report we “incorporate by reference” certain information from parts of other documents filed with the Securities and Exchange Commission (the “SEC”). The SEC allows us to disclose important information by referring to it in that manner. Please refer to such information.

In Item 1A., beginning on page 9, we discuss some of the business risks and factors that could cause actual results to differ materially from those stated in the forward-looking statements and from our historical results.

Item 1. BUSINESS

Overview of Our Business

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 consumer, or “at-home,” market. We market our products primarily to the private label segment of the consumer tissue market and have focused on serving the discount retail market. Our primary concentration within this market is the value retailers or dollar stores. We focus on the discount retail market because of the consistent order patterns and low number of stock keeping units or SKUs in this market. By value retailers, we mean retailers typically known as dollar stores, which offer a limited selection across a broad range of products at everyday low prices in a smaller store format. While we have customers located throughout the United States, we distribute most of our products within an approximate 900-mile radius of our Oklahoma facility. Our products are sold primarily under our customers’ private labels and, to a lesser extent, under our brand names such as Colortex® and Velvet®.

In 2006, we generated revenue of \$60.2 million, of which 52% came from paper towels, 39% came from bathroom tissue and 9% came from paper napkins. In 2006, 75% of our revenue came from six value retailers: Dollar General, Family Dollar, Fred’s, Dollar Tree, Variety Wholesale and Big Lots. The balance of 2006 revenue came from other discount retailers, grocery stores, grocery wholesalers and cooperatives, and convenience stores. Dollar General is the largest value retailer in the United States and our largest customer, accounting for 38% of our 2006 revenue.

We manufacture parent rolls in our paper mill located in Pryor, Oklahoma. Our facility manufactures parent rolls from recycled waste paper using four paper machines. Parent rolls are converted into finished tissue products at our converting facility, which contains ten lines of converting equipment and is located adjacent to our paper mill.

In June 2006, we started up the new paper machine with a rated capacity of 33,000 tons per year. Prior to adding the new paper machine, our paper mill generally operated 24 hours per day, 362 days per year and typically produced between 26,000 and 27,000 tons of paper per year. Our total papermaking capacity from our new machine and a combination of the old machines is expected to be approximately 47,000 tons per year. Soon after start-up, we were able to eliminate open market purchases of parent rolls, except for limited special purpose applications. During the last four months of 2006, we sold 1,191 tons of parent rolls on the open market and we anticipate further open market sales during 2007.

History

We were formed in April 1998 to acquire our present facilities located in Oklahoma out of a predecessor company’s bankruptcy and subsequently changed our name to Orchids Paper Products Company.

In March 2004, Orchids Acquisition Group, Inc. acquired us for a price of \$21.6 million. Orchids Acquisition Group, Inc. was formed by Taglich Brothers, Inc. and Weatherly Group, LLC exclusively for the purpose of acquiring all of the outstanding shares of Orchids Paper Products Company, and was subsequently merged into us.

In July 2005, we completed our initial public offering of 2,156,250 shares of common stock. Following the offering, 4,156,250 shares of common stock were outstanding. In July 2006, we effected a 3-for-2 stock split resulting in outstanding shares of 6,234,346. The results of operations presented herein for all periods prior to our acquisition by Orchids Acquisition Group, Inc. in March 2004 are referred to as the results of operations of the “predecessor.” The results of operations presented herein for all periods subsequent to the acquisition are referred to as the results of operations of the “successor.”

Our Competitive Strengths

Focus on supplying value retailers. Since 1995, when our predecessor company developed a new business plan, we have focused on supplying value retailers with private label tissue products. We believe we were among the first manufacturers to adopt this strategic focus. As a result of our long-term commitment to these customers, we believe we have developed a strong position as a reliable and responsive supplier to value retailers and built our competitive position in this market segment.

Proximity to key customers. We believe we are well situated to serve our existing customer base, as well as many prospective customers. We are one of the few paper mills located in the south central United States. In addition, Pryor, Oklahoma is situated in close proximity to three major interstate highways and is close to regional transportation hubs for several of the nation's largest trucking companies. As a result, many of the major population centers and our customers' distribution centers are within our cost-effective shipping area.

Experienced management team and trained workforce. Our senior management team of Michael Sage and Keith Schroeder has a combined 43 years of experience in the paper business. Mr. Sage has been involved in operating our facility since 1985. The average tenure of our hourly workers at the paper mill is 13 years and the average tenure of our hourly workers at the converting facility is seven years. We believe that this depth of experience creates operational efficiencies and better enables us to anticipate and plan for changes in our industry.

Low cost tissue manufacturers. Based on a number of critical cost components, we believe we are one of the lowest cost tissue producers in our market. We have an advantageous local employment market and relatively low wage rates. In addition, we qualify for special tax incentives under the Internal Revenue Code as a result of our location on former Indian land in Oklahoma, which further reduces our effective cost of labor and increases our rate of depreciation for tax purposes on new capital expenditures. In December 2006, this special tax incentive was extended through 2007. We are located in an industrial park that operates an onsite water treatment facility that offers water at reasonable rates. As a result of our location, we also have low property tax rates and access to electricity at relatively low and stable rates.

Our Strategy

Our goal is to be recognized as the supplier of choice of private label tissue products for the discount retail market, especially value retailers, within our geographic area. While the value retail channel is extremely competitive and price sensitive and several of our competitors are located in close proximity to our facility, we have targeted the value retail channel of the consumer market because it is experiencing rapid growth and follows a basic marketing strategy of stocking a low number of high turnover SKU's. The combination of a low number of SKU's and consistent product movement enables us to operate our facilities at a relatively low cost. Based on this target market, we have sought to establish a low-cost manufacturing platform and programs and practices necessary to provide outstanding customer service to our value retail customers. We believe significant opportunities exist to continue to increase our revenue and profitability by:

- successfully operating our new paper machine;
- leveraging our existing customer relationships in the value retail channel; and
- selectively expanding our customer base in other retail channels.

Installation and Operation of the New Paper Machine. During 2006, we completed the installation and start-up of our new paper machine with a rated production capacity of 33,000 tons per year. This facility enabled us to essentially cease the purchase of parent rolls on the open market and to sell 1,191 tons of parent rolls on the open market during the last few months of 2006. We purchased 6,970 and 12,153 tons of parent rolls on the open market in 2006 and 2005, respectively, at an average cost of \$1,062 and \$1,024 per ton, respectively. We anticipate being in a surplus parent roll situation during 2007. Furthermore, our average costs of producing paper, exclusive of depreciation, have declined from \$760 per ton and \$777 per ton in the first two quarters of 2006, respectively, to \$703 per ton and \$710 per ton in the final two quarters of 2006, respectively.

Leveraging Our Existing Customer Relationships in the Value Retail Channel. The value retail channel has experienced rapid growth over the past several years and we believe it continues to offer an attractive opportunity in

the private label tissue market. Overall, the value retail channel is projected to continue growing, however, our largest customer is executing a strategic rationalization of its store base in 2007, which could result in slower growth in the near term.

We have developed key customers in the value retail channel by capitalizing on our full line of products, focusing on value retailers and improving our low-cost manufacturing capabilities. As a result, we believe we are among the suppliers of choice for retailers who seek value tissue products. With the lower costs achieved through the addition of the new paper machine, we believe we have an opportunity to increase sales to our existing customers by expanding the number of distribution centers that we supply and expanding our product offering at distribution centers where we do not currently supply the complete private label line. The ability to produce all or substantially all of our own paper at lower costs will allow us to compete more effectively to supply these distribution centers. We also have opportunities to serve new distribution centers that may be opened by our customers in our cost-effective shipping area.

Selectively Expanding Our Customer Base in Other Retail Channels. In addition to the preceding growth opportunities identified with several of our key customers, we believe we have growth opportunities with certain discount retailers, grocery stores, grocery wholesalers and cooperatives, and various other merchandisers. We intend to penetrate these other important retail channels by replicating the model we used to successfully establish our value retail business.

Competitive Conditions

We believe the principal competitive factors in our market segments are price and service, and that our competitive strengths with respect to other private label manufacturers include long-standing relationships with value retailers, a full line of products and flexible converting capabilities, which enables us to produce tissue products in a variety of sizes, packs and weights. This flexibility allows us to meet the particular demands of individual retailers.

Competition in the value-end of the market is significantly impacted by geographic location, as freight costs represent a material portion of end product costs. We believe it is generally economically feasible to ship within approximately a 900-mile radius of the production site. In Oklahoma and the immediately surrounding area, we believe that Georgia-Pacific's Muskogee, Oklahoma plant and Cascades' Memphis, Tennessee plant are the only competitors' plants in this region. However, we face greater competition in the Southeast and Midwest regions of the U.S. Georgia-Pacific has additional plants in Georgia and Wisconsin and Cascades has plants in Pennsylvania and Wisconsin. We also face competition from other suppliers who have facilities in the Southwest, upper Midwest and Southeast regions of the United States.

We believe the number of competitors in private label segments will not significantly increase in the near future because of the large capital expenditures required to establish a paper mill and difficulties in obtaining environmental and local permits for tissue manufacturing facilities.

Product Overview

We offer our customers an array of private label products, including bathroom tissue, paper towels and paper napkins. In 2006, 52% of our finished case shipments were paper towels, 39% were bathroom tissue and 9% were paper napkins. Of our products sold in 2006, 81% were packaged as private label products in accordance with our customers' specifications. The remaining 19% were packaged under our brands Velvet®, Colortex®, Ultra Valu®, Dri-Mop®, Big Mopper® and Soft & Fluffy®. We do not actively promote our brand names and do not believe our brand names have significant market recognition. Our branded products are primarily sold to smaller customers, who use them as their in-store labels.

Customers

Our customers include value retailers, grocery stores, grocery wholesalers and cooperatives, and convenience stores. Our recent growth has come from serving customers in the value retail channel. We were among the first to focus on serving this retail channel and we have benefited from their increased emphasis on consumables, like tissue

products, as part of their merchandising strategies. By seeking to provide consistently low prices, superior customer service, and improved product quality, we believe we have differentiated ourselves from our competitors and generated momentum with value retailers. In 2006, approximately 75% of our revenue was derived from sales to the value retail channel.

Our ability to increase revenue depends significantly upon the growth of our largest customers, our ability to take market share from our competitors and our ability to increase business with other discount retailers, and in the grocery chains. Our largest customers have grown over the past several years and anticipate continuing to grow their operations in the future. We are attempting to diversify our customers by implementing private label programs with several regional supermarket chains, but it is likely our business will remain concentrated among value retailers for the foreseeable future.

We service the value retail channel primarily by supplying distribution centers within our cost-effective shipping area. Freight is a significant cost component which limits the competitive geography of a given manufacturing facility. We consider our current cost-effective shipping area to be within an approximate 900-mile radius of our facility. We supply a portion of or substantially all of the value private label products to over half of the value retail distribution centers located within our cost-effective shipping area.

The following several paragraphs provide additional detail regarding our largest customers.

Dollar General. Dollar General is our largest customer, accounting for 38% of our sales in 2006. With more than 8,000 stores in 35 states, Dollar General is the largest value retailer. According to its press release dated February 8, 2007, Dollar General increased its net number of stores by 380 during fiscal 2006. On November 29, 2006, Dollar General announced that it plans to close 400 stores and to open 300 stores during fiscal 2007. We currently supply substantially all of the value private label tissue products for three of Dollar General's eight distribution centers. We believe we have a good relationship with Dollar General.

Family Dollar. Family Dollar is our second largest customer, accounting for approximately 22% of our sales in 2006. Family Dollar has become one of the leading value retailers in the industry with more than 6,200 stores in 44 states. In a press release dated September 28, 2006, Family Dollar reported that it plans to open 400 stores during the fiscal year ending September 1, 2007. We anticipate that many of these new stores will be in our current cost-effective shipping area. Family Dollar currently has eight distribution centers. We currently supply substantially all of the value private label tissue products to two of the distribution centers and supply approximately half of the value private label tissue products to two other distribution centers.

Other Customers. Our other key customers include Fred's, Variety Wholesale, Wal-Mart, Dollar Tree and Big Lots. In 2006, each of these customers represented less than 5% of our revenue.

Sales and Marketing Team

We have attracted and retained an experienced sales staff and have established a network of independent brokers. Our sales staff and broker network are instrumental in establishing and maintaining strong relationships with our customers.

The sales staff directly services five customers representing approximately 32% of our sales in 2006. We also use a network of approximately 38 brokers. Our management team recognizes that these brokers have relationships with many of our customers and we work with these brokers in an effort to increase our business with these accounts. Our sales and marketing organization seeks to partner with our brokers to leverage these relationships. With each of our main customers, however, our senior management team participates with the independent brokers in all critical customer meetings to establish direct customer relationships.

A majority of brokers provide marketing support to their retail accounts which includes shelf placement of products and in-store merchandising activities to support our product distribution. We generally pay our brokers commissions ranging from 1% to 3% of revenue. Sales through our largest volume broker accounted for nearly two-fifths of our revenue for 2006 and slightly more than half of our revenue in 2005. Total commissions paid in the twelve months ended December 31, 2006 and 2005, were \$840,000 and \$879,000, respectively.

Manufacturing

We own and operate a paper manufacturing mill with two facilities and a converting facility at our headquarters in Pryor, Oklahoma. Our two paper mill facilities, which total 162,000 square feet, produce parent rolls that are then converted into tissue products at our adjacent converting facility. The paper mill facilities include four paper machines that produce paper made entirely from preconsumer solid bleached sulfate paper, or “SBS paper.”

The mill operates 24 hours a day, 362 days a year, with a three-day annual planned maintenance shutdown, at a high level of efficiency. The following table sets forth our volume of parent rolls manufactured, purchased and converted for each of the past five years:

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
			(Tons)		
Manufactured	31,662	26,051	26,382	26,701	25,683
Purchased	6,970	12,153	5,017	3,349	10,363
Converted	38,632	38,204	31,399	30,050	36,046

In order to expand our capacity and reduce our production costs, we have installed a new paper machine in a new building adjacent to our existing mill. Our new paper machine and a combination of the older machines will produce approximately 47,000 tons of paper per year or an increase of 80% over the amount produced prior to adding the new machine. This additional capacity allowed us to eliminate purchases of recycled parent rolls from third parties beginning in the third quarter of 2006, and to reduce the cost of internally produced parent rolls.

We convert parent rolls into finished tissue products at our converting facility. The converting process, which varies slightly by product category, generally includes embossing, laminating, and perforating or cutting the parent rolls as they are unrolled; pressing two or more plies together in the case of multiple-ply products; printing designs in certain cases and cutting into rolls or stacks; wrapping in polyethylene film; and packing in corrugated boxes for shipment.

Our 300,000 square-foot converting facility has the capacity to produce approximately 7.0 million cases of retail tissue products a year. To meet current demand of approximately 6.2 million cases a year, we operate the converting facility on a 24 hour a day, seven-day-a-week schedule. We designed the ten production lines in the plant to enhance capacity and maximize efficiency. Our converting operation utilizes relatively modern equipment and our recently purchased towel line, originally acquired under an operating lease in 2001, is high speed and offers four-color and process printing capabilities. One of the key advantages of our converting plant is its flexible manufacturing capabilities, which enables us to provide our customers with a variety of package sizes and format options and enables our customers to fit products into particular price categories. We believe our converting facility, together with our low direct labor costs and overhead, combine to produce low overall operating costs.

Distribution

Our products are delivered to our customers in truck-load quantities. Most of our customers arrange for transportation of our products to their distribution centers. We have established a drop-and-hook program where the customer returns its empty trailer to our warehouse and departs with a full, preloaded trailer. This provides a means for several key customers to minimize freight costs. For our remaining customers, we arrange for third-party freight companies to deliver the products.

Raw Materials and Energy

The principal raw materials used to manufacture our parent rolls are recycled waste paper and water. Recycled waste paper accounts for 100% of the fiber requirement for our parent rolls. The de-inking process at the paper mill is currently configured to process a particular class of recycled waste paper known as SBS paper. We source the majority of our SBS paper from two paper brokers. If we were unable to purchase a sufficient quantity of SBS paper or if prices materially increased, we could reconfigure the de-inking process to process other forms of waste paper or use an alternative type of waste paper with our existing de-inking process. Reconfiguring our de-inking plant would require additional capital expenditures, which could be substantial. Alternative types of waste paper could

result in higher costs. We also seek to assure adequate supplies of SBS paper by maintaining approximately a three-week inventory.

Energy is a key cost factor and we experienced significant increases in electricity costs during 2006. We source our electricity from the Grand River Dam Authority. As part of our new paper machine project, we installed a boiler to supply our own steam. We do not have any fixed price contracts or hedges in place with natural gas suppliers. We purchase our natural gas through a broker. Our broker purchases natural gas using a combination of fixed price contracts, options, spot purchases and other means to reduce our risk.

Backlog

Our tissue products generally require short production times. Typically, we have a backlog of approximately two weeks of sales. As of December 31, 2006, our backlog of customer orders was 260,000 cases of finished converted products and 60 tons of parent rolls or approximately \$2.9 million. As of December 31, 2005 our backlog was 206,000 cases or approximately \$2.2 million.

Trademarks and Trade Names

Our price/value consumer tissue products are sold under various brand names, including Colortex®, Velvet®, Ultra Valu®, Dri-Mop®, Big Mopper® and Soft & Fluffy®. We intend to renew our registered trademarks prior to expiration. We do not believe these trademarks are significant corporate assets. Our branded products are primarily sold to smaller customers, who use them as their in-store labels.

Employee and Labor Relations

As of December 31, 2006, we had approximately 310 full time employees of whom 265 were union hourly employees and 45 were non-union salaried employees. Of our employees, approximately 285 were engaged in manufacturing and production, 23 were engaged in sales, clerical and administration, and two were engaged in engineering. Our hourly employees are represented under collective bargaining agreements with the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial & Service Workers International Union Local 5-930 and Local 5-1480 at the mill and converting facilities, respectively. The current contract with our hourly employees at the mill facility expires February 2, 2008, while the contract with our hourly employees at the converting facility expires June 23, 2007. We have not experienced a work stoppage or request for arbitration in the last ten years and no requests for arbitration, grievance proceedings, labor disputes, strikes or labor disturbances are currently pending or threatened against us. We believe we have good relations with our union employees at each of our facilities.

Environmental, Health and Safety Matters

Our operations are subject to various environmental, health and safety laws and regulations promulgated by federal, state and local governments. These laws and regulations impose stringent standards on us regarding, among other things, air emissions, water discharges, use and handling of hazardous materials, use, handling and disposal of waste, and remediation of environmental contamination. Since our products are made from SBS paper, we do not make extensive use of chemicals.

The U.S. Environmental Protection Agency (the "EPA") has required that certain pulp and paper mills meet stringent air emissions and revised wastewater discharge standards for toxic and hazardous pollutants. These proposed standards are commonly known as the "Cluster Rules." Our operations are not subject to further control as a result of the current "Cluster Rules" and, therefore, no related capital expenditures are anticipated.

We believe our manufacturing facilities are in compliance in all material respects with all existing federal, state and local environmental regulations, but we cannot predict whether more stringent air, water and solid waste disposal requirements will be imposed by government authorities in the future. Pursuant to the requirements of applicable federal, state and local statutes and regulations, we believe that we, or the industrial park in which we are located, possess all of the environmental permits and approvals necessary for the operation of our facilities.

We have been notified by the operator of the industrial park in which we operate, Oklahoma Ordinance Works Authority (“OOWA”), that the level of biological oxygen demand (“BOD”) and total suspended solids (“TSS”) we are allowed to send to the OOWA following pre-treatment at our facility, may be reduced. The OOWA holds the waste water permit that covers our facility. The amount of any reduction to our BOD and TSS has not been determined. Any reduction in the permitted level of BOD and TSS will likely result in a need to expand our pre-treatment facility. Because the level of reduction has not been firmly established, estimates of the cost to expand our pre-treatment facility to meet the stricter standards are difficult and subject to a higher degree of uncertainty. Based upon the best information available, we currently estimate a cost of \$3 million to expand our pre-treatment facility, which will be likely be incurred within the next two years.

Executive Officers and Key Employees

Set forth below is the name, age as of March 1, 2007, position and a brief account of the business experience of each of our executive officers.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Michael P. Sage	60	Chief Executive Officer and President, Director
Keith R. Schroeder	51	Chief Financial Officer

Michael P. Sage, 60, Chief Executive Officer and President, Director

Mr. Sage has been our Chief Executive Officer and President since April 1998. From 1985 to 1998, Mr. Sage served in a number of management positions with our predecessor company, including Executive Vice President (1995-1998), Vice President of Mill Operations responsible for tissue mills in Oklahoma, Arizona and Oregon (1991-1995), and Manager of Paper Manufacturing (1985-1989). From 1989 to 1991, he was Vice President of Operations for Pentair’s Niagara Division. From 1969 to 1985, he held a number of manufacturing positions with Procter & Gamble. Mr. Sage holds a BS degree in Chemical Engineering from Montana State University.

Keith R. Schroeder, 51, Chief Financial Officer

Mr. Schroeder has been our Chief Financial Officer since January 2002. Prior to joining us, he served as Corporate Finance Director for Kruger Inc.’s tissue operations from October 2000 to December 2001 and as Vice President of Finance and Treasurer of Global Tissue from 1996 to October 2000. Global Tissue was acquired by Kruger Inc. in 1999. Prior to joining Global Tissue, Mr. Schroeder held a number of finance and accounting positions with Cummins Engine Company (1989-1996) and Atlas Van Lines (1978-1989). Mr. Schroeder is a certified public accountant and holds a BS degree in Business Administration with an accounting major from the University of Evansville.

Available Information

We file annual, quarterly and current reports and other information with the SEC. You may read and copy any document we file with the SEC at the SEC’s public reference room at 450 Fifth Street, NW, Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for information on the public reference room. The SEC maintains an internet site that contains annual, quarterly and current reports, proxy and information statements and other information that issuers (including Orchids Paper Products Company) file electronically with the SEC. The SEC’s internet site is www.sec.gov.

Item 1A. RISK FACTORS

We operate in a changing environment that involves numerous known and unknown risks and uncertainties that could materially affect our operations. The risks, uncertainties and other factors set forth below may cause our actual results, performances or achievements to be materially different from those expressed or implied by our forward-looking statements. If any of these risks or events occur, our business, financial condition or results of operations may be adversely affected. We may amend or supplement the risk factors described below from time to time in other reports we file with the SEC in the future.

Risks Related To Our Business

We face intense competition and if we cannot successfully compete in the marketplace, our business, financial condition and operating results may be materially adversely affected.

The consumer market for private label tissue products is highly competitive. Many of our competitors have greater financial, managerial, sales and marketing and capital resources than we do, which may allow them to respond more quickly to new opportunities or changes in customer requirements. These competitors may also be larger in size or scope than us, which may allow them to achieve greater economies of scale or allow them to better withstand periods of declining prices and adverse operating conditions.

Our ability to compete successfully depends upon a variety of factors, including:

- aggressive pricing by competitors, which may force us to decrease prices in order to maintain market share;
- our ability to maintain and improve plant efficiencies and operating rates and lower manufacturing costs;
- the availability, quality and cost of raw materials, particularly recycled waste paper and labor; and
- the cost of energy.

Our paper products are commodity products, and if we do not maintain competitive prices, we may lose significant market share. Our ability to keep our prices at competitive levels depends in large part on our ability to control our costs. In addition, consolidation among retailers in the value retail channel may put additional pressure on us to reduce our prices in order to maintain market share. If we are unable to effectively adjust our cost structure to address such increased competitive pressures, our sales level and profitability could be harmed and our operations could be materially adversely affected.

A substantial percentage of our revenues are attributable to two large customers, which may decrease or cease purchases at any time.

Our largest customer, Dollar General, accounted for 38% of our revenue in 2006. Our second largest customer, Family Dollar, accounted for approximately 22% of our revenues in 2006. We currently supply substantially all of the value private label tissue products at three of Dollar General's eight distribution centers, substantially all of the value private label tissue products at two of Family Dollar's eight distribution centers and approximately half of the value private label tissue products at two other Family Dollar distribution centers. We expect that sales to a limited number of customers will continue to account for a substantial portion of our revenues for the foreseeable future. Sales to these customers are made pursuant to purchase orders and not supply agreements. We may not be able to keep our key customers or these customers may cancel purchase orders or reschedule or decrease their level of purchases from us. Any substantial decrease or delay in sales to one or more of our key customers would harm our sales and financial results. In particular, the loss of sales to one or more distribution centers would result in a sudden and significant decrease in sales. If sales to current key customers cease or are reduced, we may not obtain sufficient orders from other customers necessary to offset any such losses or reductions.

We have significant indebtedness which limits our free cash flow and subjects us to restrictive covenants relating to the operation of our business.

During 2006 we borrowed \$15.0 million pursuant to our construction loan facility to finance our new paper machine. As a result, our total indebtedness increased from \$18.6 million as of December 31, 2005 to \$33.8 million as of December 31, 2006. To refinance the outstanding debt under our current credit agreement, which expires on April 30, 2007, we have negotiated a commitment letter with our current agent bank for a new credit facility with revised terms. Due to the increased borrowings described above and based on the terms of our proposed new credit agreement, we anticipate our annual interest costs in 2007 to increase to approximately \$2.7 million from the \$1.6 million, including capitalized interest of \$411,000, incurred in 2005. We anticipate our principal payments in 2007 to approximate \$2.3 million, considering the effects of our proposed credit facility. Our principal payments in the year 2006 totaled \$1.6 million. Operating with this substantial amount of leverage requires us to direct a significant portion of our cash flow from operations to make payments on our debt, which reduces the funds otherwise available for operations, capital expenditures, future business opportunities and other purposes. It also

limits our flexibility in planning for, or reacting to, changes in our business and our industry and impairs our ability to obtain additional financing.

The terms of our existing term loan agreement and proposed credit agreement require us to meet specified financial ratios and other financial and operating covenants which restrict our ability to incur additional debt or place liens on our assets, make capital expenditures, effect mergers or acquisitions, dispose of assets or pay dividends in certain circumstances. If we fail to meet those financial ratios and covenants and our lenders do not waive them, we will be required to pay fees and penalties and our lenders could also accelerate the maturity of our debt and proceed against any pledged collateral, which would force us to seek alternative financing. If this were to happen, we may be unable to obtain additional financing or it may not be available on terms acceptable to us.

The availability of and prices for energy will significantly impact our business.

All of the energy necessary to produce our paper products is purchased on the open market and, as a result, the price and other terms of those purchases are subject to change based on factors such as worldwide supply and demand and government regulation. We rely primarily on electric energy and natural gas. In particular, natural gas prices are highly volatile. During 2006, our consumption of both natural gas and electricity increased substantially following the start-up of our new paper machine. During the twelve months ending December 31, 2006, we consumed 313,000 MMBTU of natural gas at a total cost of \$2.4 million. During the same period of 2005 we consumed 263,500 MMBTU at a total cost of \$2.0 million. During 2006 our electric supplier instituted a rate increase. Our usage increased from 35.1 million kilowatt hours in 2005 to 44.0 million kilowatt hours in 2006. The total cost of electricity rose from \$1.5 million in the twelve months ending December 31, 2005 to \$2.2 million for the same period in 2006. If our energy costs increase, our cost of sales will increase, and our operating results may be materially adversely affected. Furthermore, we may not be able to pass increased energy costs on to our customers if the market does not allow us to raise the prices of our finished products. If price adjustments significantly trail the increase in energy costs or if we cannot effectively hedge against price increases, our operating results may be materially adversely affected.

Our exposure to variable interest rates may affect our financial health.

Debt incurred under our existing revolving credit and term loan agreements accrues interest at a variable rate. During 2006, our bank debt interest rates rose from 8.44% at the start of the year to a weighted average of 9.36% at year-end. Any further increase in the interest rates on our debt would result in a higher interest expense which would require us to dedicate more of our cash flow from operations to make payments on our debt and reduce funds available to us for our operations and future business opportunities which could have a material adverse effect on our results of operations. For more information on our liquidity, see "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources."

We depend on our management team to operate the Company and execute our business plan.

We are highly dependent on the principal members of our management staff, in particular Michael Sage, our Chief Executive Officer, and Keith Schroeder, our Chief Financial Officer. We have entered into employment agreements with Michael Sage and Keith Schroeder that expire in 2009. The loss of any of the executive officers or our inability to attract and retain other qualified personnel could harm our business and our ability to compete.

We exclusively use preconsumer solid bleached sulfate paper, or SBS paper, to produce parent rolls and any disruption in our supply or increase in the cost of preconsumer SBS paper could disrupt our production and harm our ability to produce tissue at competitive prices.

We do not produce any of the waste paper we use to produce our parent rolls. We depend heavily on access to sufficient, reasonably-priced quantities of waste paper to manufacture our tissue products. Our paper mill is configured to convert waste paper, specifically SBS paper, into paper pulp for use in our paper production lines. In 2006, we purchased approximately 41,500 tons of SBS paper at a total cost of \$8.7 million compared to 34,000 tons of SBS paper at a total cost of \$6.7 million in 2005. The additional waste paper requirements necessitated by the start-up of our new paper machine have resulted in additional demand on the SBS waste paper market and could

have an effect on the market prices of this commodity. We purchase all of our SBS paper from two paper brokers. These brokers in turn source SBS paper from numerous producers of preconsumer SBS paper. We purchase our SBS paper on a purchase order basis and do not have a contractual right to an adequate supply, quality or acceptable pricing on a long-term basis.

Prices for SBS paper have fluctuated significantly in the past and will likely continue to fluctuate significantly in the future, principally due to market imbalances between supply and demand. In addition, the market price of SBS waste paper can also be influenced by market swings in the price of virgin pulp and other waste paper grades. If either the available supply of SBS paper diminishes or the demand for SBS paper increases, it could result in any of the following effects; substantially increase the cost of SBS paper; require us to purchase alternate waste paper grades at increased costs; cause a production slow-down or stoppage until we are able to identify new sources of SBS paper; or cause us to reconfigure our de-inking facilities to process other available forms of waste paper or other sources of paper fiber. We could experience a material adverse effect on our business, financial condition and results of operations should the price or supply of SBS paper be disrupted.

Labor interruptions would adversely affect our business.

All of our hourly paid employees are represented by the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial & Service Workers International Union. The collective bargaining agreement with Local 5-930, which represents the paper mill workers, will expire on February 2, 2008, and the collective bargaining agreement with Local 5-1480, which represents the converting facility workers, will expire on June 23, 2007. Negotiations of new collective bargaining agreements may result in significant increases in the cost of labor or could breakdown and result in a strike or other disruption of our operations. If any of the preceding were to occur, it could impair our ability to manufacture our products and result in increased costs and/or decreased operating results. In addition, some of our key customers and suppliers are also unionized. Disruption in their labor relations could also have an adverse effect on our business.

Our paper mill may experience shutdowns adversely affecting our financial position and results of operations.

We currently manufacture and process our paper at a single facility in Pryor, Oklahoma. Any natural disaster or other serious disruption to this facility due to tornado, fire or any other calamity could damage our capital equipment or supporting infrastructure and materially impair our ability to manufacture and process paper. Even a short-term disruption in our production output could damage relations with our customers, causing them to reduce or eliminate the amount of finished products they purchase from us. Any such disruption could result in lost revenues, increased costs and reduced profits.

Our pre-existing paper machines are approximately 50 years old. Unexpected production disruptions could cause us to shut down our paper mill. Those disruptions could occur due to any number of circumstances, including shortages of raw materials, disruptions in the availability of transportation, labor disputes and mechanical or process failures.

If our mill is shut down, it may experience a prolonged start up period, regardless of the reason for the shutdown. Those start up periods could range from several days to several months, depending on the reason for the shutdown and other factors. The shutdown of our mill for a substantial period of time for any reason could have a material adverse effect on our financial position and results of operations.

Our operations require substantial capital, and we may not have adequate capital resources to provide for all of our cash requirements.

Expansion or replacement of existing facilities or equipment may require substantial capital expenditures. We will likely need to acquire an additional converting line to meet the additional parent roll capacity from our new paper machine project and allow access to new markets, which we currently estimate would cost approximately \$6 million. In addition, we may be required to build a water treatment facility costing approximately \$3 million to reduce biological oxygen demand and total suspended solids from our effluent stream. The timing and amount of this expenditure is uncertain as the amount and timing of any requirement to reduce BOD and TSS levels have not

been determined. Our capital resources may not be sufficient for these purposes. If our capital resources are inadequate to provide for our operating needs, capital expenditures and other cash requirements, this shortfall could have a material adverse effect on our business and liquidity.

We may not be able to refinance our bank debt on terms acceptable to us.

Our bank debt totaling \$31.8 million at December 31, 2006 will mature on April 30, 2007. If we are unable to complete the refinancing of this indebtedness, we would face an immediate cash flow deficiency. We may not be able to negotiate final terms and conditions under a new credit agreement that are as favorable as our current terms and conditions. Although we have obtained a commitment letter from our current agent bank and we fully intend to complete the refinancing before the April 30, 2007 deadline, we have no assurances that we can complete the refinancing or obtain the terms in the commitment letter.

Our business is subject to extensive governmental regulations and any imposition of new regulations or failure to comply with existing regulations could involve significant additional expense.

Our operations are subject to various environmental, health and safety laws and regulations promulgated by federal, state and local governments. These laws and regulations impose stringent standards on us regarding, among other things, air emissions, water discharges, use and handling of hazardous materials, use, handling and disposal of waste, and remediation of environmental contamination. Any failure to comply with applicable environmental laws, regulations or permit requirements may result in civil or criminal fines or penalties or enforcement actions. These may include regulatory or judicial orders enjoining or curtailing operations or requiring corrective measures, installing pollution control equipment or remedial actions, any of which could involve significant expenditures. Future development of such laws and regulations may require capital expenditures to ensure compliance. We may discover currently unknown environmental problems or conditions in relation to our past or present operations, or we may face unforeseen environmental liabilities in the future. These conditions and liabilities may require site remediation or other costs to maintain compliance or correct violations of environmental laws and regulations; or result in governmental or private claims for damage to person, property or the environment, either of which could have a material adverse effect on our financial condition and results of operations. In addition, we may be subject to strict liability and, under specific circumstances, joint and several liability for the investigation and remediation of the contamination of soil, surface and ground water, including contamination caused by other parties, at properties that we own or operate and at properties where we or our predecessors arranged for the disposal of regulated materials.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud and, as a result, our business could be harmed and current and potential stockholders could lose confidence in us, which could cause our stock price to fall.

We will be evaluating our internal control systems to allow management to report on, and our independent auditors to attest to, our internal controls. We will be performing the system and process evaluation and testing (and any necessary remediation) required to comply with the management certification and auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act of 2002. As a result, we expect to incur substantial additional expenses and diversion of management's time. We cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or their effect on our operations since there is presently only limited guidance on how to document financial processes and to measure compliance adequacy. The Securities and Exchange Commission and the Public Company Accounting Oversight Board are currently considering additional guidance and auditing procedures and making the rules better fit the circumstances of smaller public companies. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, we may not be able to accurately report our financial results or prevent fraud and might be subject to sanctions or investigation by regulatory authorities such as the SEC or the American Stock Exchange. Any such action could harm our business or investors' confidence in us, and could cause our stock price to fall.

Risks Related To Our Common Stock

We do not pay cash dividends on our capital stock, and we do not anticipate paying any cash dividends in the future.

Since January 2003, we have not paid cash dividends on our capital stock and we do not anticipate paying any cash dividends in the foreseeable future. Instead, we intend to reduce our debt and retain our future earnings to fund the development and growth of our business. In addition, the terms of our loan agreement prohibit us from declaring dividends without the prior consent of our lender.

Our certificate of incorporation and bylaws, and Delaware law contain provisions that could discourage a takeover.

Our certificate of incorporation and bylaws and Delaware law contain provisions that might enable our management to resist a takeover. These provisions may:

- discourage, delay or prevent a change in the control of our company or a change in our management;
- adversely affect the voting power of holders of common stock; and
- limit the price that investors might be willing to pay in the future for shares of our common stock.

Our future operating results may be below securities analysts' or investors' expectations, which could cause our stock price to decline.

Our revenue and income potential depends on expanding our production capacity and finding buyers for our additional production, and we may be unable to generate significant revenues or grow at the rate expected by securities analysts or investors. In addition, our costs may be higher than we, securities analysts or investors expect. If we fail to generate sufficient revenues or our costs are higher than we expect, our results of operations will suffer, which in turn could cause our stock price to decline. Our results of operations will depend upon numerous factors, including:

- our ability to reduce production costs;
- demand for our products; and
- our ability to develop sales and marketing capabilities.

Our operating results in any particular period may not be a reliable indication of our future performance. In some future quarters, our operating results may be below the expectations of securities analysts or investors. If this occurs, the price of our common stock will likely decline.

Our common stock has only been publicly traded for a short period of time, and we expect that the price of our common stock could fluctuate substantially, possibly resulting in class action securities litigation.

Before our initial public offering on July 15, 2005, there was no public market for shares of our common stock. Since the 3-for-2 stock split effected in July 2006, the average daily trading volume of our common stock has been approximately 2,800 shares. The market price for our common stock is affected by a number of factors, including:

- actual or anticipated variations in our results of operations or those of our competitors;
- changes in earnings estimates or recommendations by securities analysts or our failure to achieve analysts' earnings estimates; and
- developments in our industry.

The stock prices of many companies in the paper products industry have experienced wide fluctuations that have often been unrelated to the operating performance of these companies. Because of the low trading volume, our stock price is subject to greater volatility. Following periods of volatility in the market price of a company's securities, stockholders have often instituted class action securities litigation against those companies. Class action

securities litigation, if instituted against us, could result in substantial costs and a diversion of our management resources, which could significantly harm our business.

Our directors have limited personal liability and rights of indemnification from us for their actions as directors.

Our certificate of incorporation limits the liability of directors to the maximum extent permitted by Delaware law. Delaware law provides that directors of a corporation will not be personally liable for monetary damages for breach of their fiduciary duties as directors, except liability for:

- any breach of their duty of loyalty to the corporation or its stockholders;
- acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- unlawful payments of dividends or unlawful stock repurchases or redemptions; or
- any transaction from which the director derived an improper personal benefit.

This limitation of liability does not apply to liabilities arising under the federal securities laws and does not affect the availability of equitable remedies such as injunctive relief or rescission.

Our certificate of incorporation and bylaws provide that we will indemnify our directors and executive officers and other officers and employees and agents to the fullest extent permitted by law.

We entered into separate indemnification agreements with each of our directors and officers which are broader than the specific indemnification provision under Delaware law. Under these agreements, we are required to indemnify them against all expenses, judgments, fines, settlements and other amounts actually and reasonably incurred, in connection with any actual, or any threatened, proceeding if any of them may be made a party because he or she is or was one of our directors or officers.

If any litigation or proceeding were pursued against any of our directors, officers, employees or agents where indemnification is required or permitted, we could incur significant legal expenses and be responsible for any resulting settlement or judgment.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

We own a 36-acre property in Pryor, Oklahoma and conduct all of our business from that location. Parent roll production is housed in two facilities. The older facility comprises approximately 135,000 square feet and houses three paper machines and related processing equipment. The newer facility housing the new paper machine comprises approximately 27,000 square feet. Adjacent to our paper mill, we have a converting facility which has ten lines of converting equipment and comprises approximately 300,000 square feet.

<u>Facility</u>	<u>Annual Capacity</u>	<u>Sq. Ft.</u>
Paper making — three machines	14,000 tons	135,000
Paper making — new machine	33,000 tons	27,000
Converting	7,000,000 cases	300,000

We believe our facilities are well maintained and adequate to serve our present and near term operating requirements.

Item 3. LEGAL PROCEEDINGS

From time to time, we are involved in litigation relating to claims arising out of our operations in the normal course of business. As of the date of this report, we were not engaged in any legal proceedings which are expected, individually or in the aggregate, to have a material adverse effect on us.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of stockholders, through the solicitation of proxies or otherwise, during the fourth quarter of the fiscal year ended December 31, 2006.

PART II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock has been traded on the American Stock Exchange under the symbol "TIS" since July 15, 2005. The following table sets forth the high and low closing prices of our common stock for the periods indicated and reported by the American Stock Exchange. Prices have been adjusted for the 3-for-2 stock split that was effected in July 2006.

	<u>High</u>	<u>Low</u>
Year Ended December 31, 2005:		
July 15, 2005 to September 30, 2005	\$ 6.97	\$5.67
Fourth Quarter	\$ 7.03	\$6.43
Year Ended December 31, 2006:		
First Quarter	\$ 9.31	\$6.70
Second Quarter	\$10.53	\$9.00
Third Quarter	\$11.36	\$8.99
Fourth Quarter	\$ 9.34	\$8.20

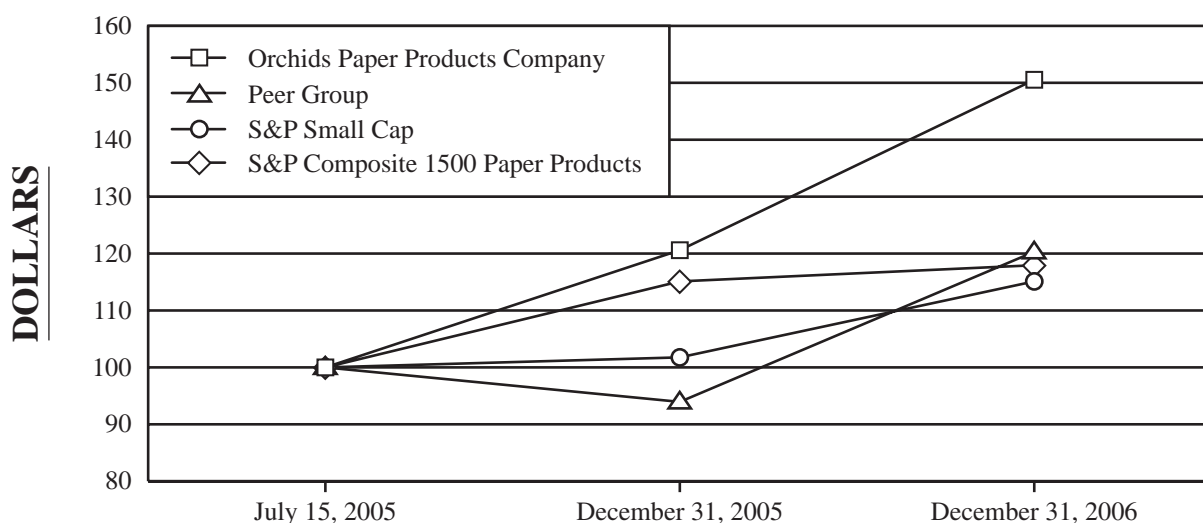
As of March 1, 2007, there were approximately 900 beneficial owners of our common stock. On March 1, 2007, the last reported sale price of our common stock on the American Stock Exchange was \$8.21.

The following Performance Graph and related information shall not be deemed “soliciting material” or to be “filed” with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933 or Securities Exchange Act of 1934, each as amended, except to the extent that we specifically incorporate it by reference into such filing.

Performance Graph

The following graph compares the cumulative total stockholder return on our Common Stock since the first day of trading following our initial public offering on July 14, 2005, with the cumulative total return of the Standard & Poor’s Small Cap Price Index, the Standard & Poor’s Paper and Paper Products Index and our selected peer group comprised of Potlatch, Wausau Paper, and Cascades. These comparisons assume the investment of \$100 on July 15, 2005, and the reinvestment of dividends.

These indices are included only for comparative purposes as required by the SEC and do not necessarily reflect management’s opinion that such indices are an appropriate measure of the relative performance of the Common Stock. They are not intended to forecast possible future performance of the common stock.



	July 15, 2005	December 31, 2005	December 31, 2006
Orchids Paper Products Company	\$100	\$120.59	\$150.53
Peer Group	\$100	\$ 93.94	\$120.31
S & P Small Cap	\$100	\$101.76	\$115.61
S & P Composite 1500 Paper Products	\$100	\$115.11	\$117.95

Dividends

Since January 2003, we have not paid cash dividends on our capital stock. We anticipate that we will retain any earnings to support operations, reduce our debt and to finance the growth and development of our business. Additionally, under our credit facilities, we are prohibited from declaring dividends without the prior consent of our lender. Therefore, we do not expect to pay cash dividends in the foreseeable future. Any future determination relating to our dividend policy will be made at the discretion of our board of directors and will depend on a number of factors, including future earnings, capital requirements, financial conditions, future prospects and other factors that the board of directors may deem relevant.

Recent Sales of Unregistered Securities

None.

Initial Public Offering and Use of Proceeds from Recent Securities Offerings

See “LIQUIDITY AND CAPITAL RESOURCES — Overview” discussion under Item 7 of this report.

Repurchase of Equity Securities

We do not have any programs to repurchase shares of our common stock and no such repurchases were made during the quarter ended December 31, 2006.

Item 6. SELECTED FINANCIAL DATA

The following selected financial data should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” following this section and our financial statements and related notes included in Item 8 of this Form 10-K. The following tables set forth selected financial data as of and for the years ended December 31, 2006 and 2005, the period from March 1, 2004 through December 31, 2004, the period from January 1, 2004 through February 29, 2004, and the years ending December 31, 2003 and 2002. The selected financial data as of and for the years ended December 31, 2006 and 2005, the period from March 1, 2004 through December 31, 2004, the period from January 1, 2004 through February 29, 2004, and as of and for the years ended December 31, 2003, 2002 and 2001, were derived from our and the Predecessor’s audited financial statements. Orchids, as it existed prior to its acquisition by Orchids Acquisition Group, Inc., is referred to as “predecessor.” The consolidated financial information of Orchids and Orchids Acquisition Group, Inc. as it existed on and after March 1, 2004, is referred to as “successor.” Our audited financial statements as of December 31, 2006 and 2005, and for each of the three years in the period ended December 31, 2006, are included below under Item 8 of

this Form 10-K. The historical results are not necessarily indicative of the operating results to be expected in any future period.

	Successor		Ten-Months Ended December 31, 2004	Predecessor	Combined Year Ended December 31, 2004	Predecessor	
	Year Ended December 31, 2006	Year Ended December 31, 2005		Two-Months Ended February 29, 2004		Year Ended December 31, 2003	Year Ended December 31, 2002
	(In thousands, except Tons and per Ton data)						
Net Sales	\$ 60,190	\$ 57,700	\$ 39,736	\$7,191	\$ 46,927	\$44,524	\$53,202
Cost of Sales	53,205	49,769	33,390	6,156	39,546	36,673	44,261
Gross Profit	6,985	7,931	6,346	1,035	7,381	7,851	8,941
Selling, General and Administrative Expenses	4,936	4,629	3,363	1,196	4,559	4,069	4,623
Operating Income (Loss) . . .	2,049	3,302	2,983	(161)	2,822	3,782	4,318
Interest Expense	1,980	1,213	1,052	45	1,097	347	574
Other (Income) Expense, net	(99)	(102)	(5)	—	(5)	19	320
Income (Loss) Before Income Taxes	168	2,191	1,936	(206)	1,730	3,416	3,424
Provision (Benefit) for Income Taxes	(564)	799	642	66	708	1,367	1,026
Net Income (Loss)	\$ 732	\$ 1,392	\$ 1,294	\$ (272)	\$ 1,022	\$ 2,049	\$ 2,398
Operating Data							
Tons Shipped	39,823	38,204	27,769	4,575	32,344	29,960	36,046
Net Selling Price per Ton . .	\$ 1,511	\$ 1,510	\$ 1,431	\$1,572	\$ 1,451	\$ 1,486	\$ 1,476
Total Paper Usage — Tons	38,632	38,204	26,824	4,575	31,399	30,050	36,046
Total Paper Cost per Ton . .	\$ 788	\$ 822	\$ 710	\$ 671	\$ 705	\$ 690	\$ 701
Total Paper Cost	\$ 31,381	\$ 31,420	\$ 19,050	\$3,071	\$ 22,121	\$20,729	\$25,260
Cash Flow Data							
Cash Flow Provided by (Used in):							
Operating Activities	\$ 2,607	\$ 2,644	\$ 4,722	\$ 847	\$ 5,569	\$ 3,846	\$ 6,796
Investing Activities	\$(18,133)	\$(19,238)	\$(19,794)	\$ (112)	\$(19,906)	\$ (619)	\$ (966)
Financing Activities	\$ 15,151	\$ 16,487	\$ 15,067	\$ (445)	\$ 14,622	\$ (3,247)	\$ (5,622)

	As of December 31,				
	Successor			Predecessor	
	2006	2005	2004	2003	2002
Working Capital	\$ 5,025	\$ 4,514	\$ 3,399	\$ 3,194	\$ 2,349
Net Property, Plant and Equipment	\$58,039	\$42,194	\$24,492	\$14,335	\$15,701
Total Assets	\$71,028	\$53,710	\$33,407	\$22,960	\$23,805
Long-Term Debt, net of current portion	\$31,575	\$17,002	\$15,145	\$ 4,846	\$ 7,657
Total Stockholders' Equity	\$24,704	\$23,712	\$ 6,941	\$10,050	\$ 8,001

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion of our financial condition and results of operations in conjunction with the audited financial statements and the notes to those statements included elsewhere in this Form 10-K. This discussion contains forward-looking statements that involve risks and uncertainties. You should specifically

consider the various risk factors identified in this filing that could cause actual results to differ materially from those anticipated in these forward-looking statements.

Executive Overview

What were our key 2006 financial results?

- Our net sales were \$60.2 million in 2006, up 4% from \$57.7 million in 2005.
- We generated operating income of \$2.0 million in 2006, down 38% from operating income of \$3.3 million in 2005.
- Our earnings per diluted share were \$0.11 per diluted common share in 2006 compared with \$0.30 per diluted common share in 2005.
- We generated \$2.6 million in positive operating cash flow in 2006 and have generated positive operating cash flow each of the last six years.

What did we focus on in 2006?

Our focus in 2006 was on two major initiatives. The first initiative was related to our strategy to eliminate our reliance on third-party parent rolls and reduce our production costs by installing and starting up a new paper machine. Our recent business growth increased our converting requirements beyond the paper-making capacity of our older paper machines. In the first six months of 2006 and in the year 2005, approximately 32% of our converting requirements were met through purchases of parent rolls from third parties which were at costs well above our internal cost of production. In addition to providing adequate paper-making capacity to meet our current converting requirements, the new paper machine will produce paper at a lower overall cost per ton than our older machines due to its high operating speeds and modern technology, thereby reducing our total paper costs per ton. Our goal of a successful on-time start-up and ramp-up of our new paper machine was achieved by working with our project management engineering firm. The official start-up date of June 9, 2006 was within 30 days of our targeted start-up date set in 2004 and we achieved rated speeds on bathroom tissue by November and achieved 90% of rated speeds on towel paper by the end of 2006.

Our second initiative was to continue to profitably grow the business. Our goal was to attain a level of converted product business that would consume our total paper-making capacity. By the fourth quarter of 2006, we had attained a level of converted product business that consumed approximately 82% of our total paper-making capacity.

What challenges and opportunities did our business face in 2006?

Our new paper machine initiative which included an on-time completion, a successful start-up and meeting the planned ramp-up period was a major challenge for our management. Achieving these objectives consumed a significant amount of management attention. We experienced some operational difficulties during the project which affected our waste paper mix and paper machine yield during the first and second quarters of 2006 due to new equipment installation and process changes. These issues were resolved in the third and fourth quarters.

We experienced cost pressures during the year in our waste paper prices, energy rates and packaging costs. Our waste paper prices increased approximately 24% during the third and fourth quarters of 2006 compared to the prices paid in the first quarter of 2006. Our electrical rates increased approximately 33% beginning in the third quarter of 2006. Prices paid for packaging increased approximately 8% during the year.

Focusing on 2007

In 2007, we will continue to pursue profitable growth of our converted product business to sell out our remaining paper-making capacity. We will pursue this strategy through a combination of increased business with existing customers and new business in grocery and drug store retail channels. Any paper-making capacity that is not consumed by the converting business will be sold as parent rolls in the third-party market.

Optimizing the operation of our new paper machine and other assets is a major focus for 2007. Now that the paper machine start-up is completed, management attention can be fully focused on improving our overall operating efficiency. Continuous improvement of our operations will be critical in helping combat cost pressures.

Business Overview

We are a manufacturer and converter of tissue paper for the private label segment of the value retail consumer tissue market. We have focused our product design and manufacturing on the discount retail market, primarily the dollar stores, 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. 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, in general, do not materially affect the market for our products.

Our profitability depends on several key factors, including:

- the market price of our product;
- the cost of recycled waste 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. The capacity of the new machine in addition to the capacity of a combination of our older machines increased our total production capacity to approximately 47,000 tons per year. As a result, beginning in the third quarter of 2006, we were able to eliminate the requirement to purchase parent rolls on the open market. 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. We anticipate that the parent roll market will remain tight for the foreseeable future, resulting in a continuation of the high prices and limited availability.

Comparative Years Ended December 31, 2006, 2005 and 2004

Net Sales

	<u>Successor</u>		<u>Predecessor</u>		<u>Combined</u>
	<u>Year Ended</u>	<u>Period from</u>	<u>Period from</u>	<u>Year Ended</u>	
	<u>December 31,</u>	<u>March 1 -</u>	<u>January 1 -</u>	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>	<u>December 31,</u>	<u>February 29,</u>	<u>2004</u>
			<u>2004</u>	<u>2004</u>	<u>2004</u>
	(In thousands, except average price per ton and tons)				
Net sales	\$60,190	\$57,700	\$39,736	\$7,191	\$46,927
Total tons shipped	39,823	38,204	27,769	4,575	32,344
Average price per ton.	\$ 1,511	\$ 1,510	\$ 1,431	\$1,572	\$ 1,451

Net sales increased \$2.5 million, or 4.3%, to \$60.2 million for the year ended December 31, 2006, compared to \$57.7 million for the year ended December 31, 2005. Net sales figures include gross selling price, including freight, less discounts and pricing allowances. The increase in net sales experienced in 2006 was due primarily to higher sales of both converted products and parent rolls. For the twelve months ended December 31, 2006, net sales of

converted products increased approximately 2.4% as compared to the same period in 2005, the result of higher selling prices and increased shipments. The increase in net selling prices is primarily due to sales price increases implemented in the first and second quarters of 2005. On a per ton basis, selling prices increased 1.4% in the twelve months ended December 31, 2006, compared to the same period in 2005. Tons of converted product shipped in the 2006 period increased approximately 1% compared to the 2005 period. In addition, we shipped approximately 1,200 tons of parent rolls to third parties in the 2006 period following the mid-year 2006 start-up of our new paper machine and we did not ship any parent rolls in the 2005 period.

Net sales increased \$10.8 million, or 23.0%, to \$57.7 million for the year ended December 31, 2005, compared to \$46.9 million for the year ended December 31, 2004. The increase in net sales experienced in 2005 was due primarily to servicing an additional distribution center at one of our large value retail customers, higher overall business with our larger value retail customers and to a lesser extent fill-in business to one large customer's distribution center to remedy supply chain interruptions following Hurricane Katrina. This fill-in business ceased in the fourth quarter of 2005. We gained the additional distribution center in the latter part of the second quarter of 2004. Our net selling price per ton in the year ended December 31, 2005, was \$1,510 compared with \$1,451 per ton in the same period of 2004. This increase in price per ton was primarily due to price increases implemented in the first and second quarters of 2005 and to a lesser extent, the price received for parent roll sales in the 2004 period.

Cost of Sales

	Successor		Predecessor		Combined
	Year Ended December 31, 2006	2005	Period from March 1 - December 31, 2004	Period from January 1 - February 29, 2004	
	(In thousands, except gross profit margin %)				
Cost of paper	\$31,381	\$31,420	\$19,050	\$3,071	\$22,121
Non-paper materials, labor, supplies, etc.	19,570	16,848	13,052	2,701	15,753
Sub-total	50,951	48,268	32,102	5,772	37,874
Depreciation	2,254	1,501	1,288	384	1,672
Cost of sales	\$53,205	\$49,769	\$33,390	\$6,156	\$39,546
Gross Profit	\$ 6,985	\$ 7,931	\$ 6,346	\$1,035	\$ 7,381
Gross Profit Margin %	11.6%	13.7%	16.0%	14.4%	15.7%

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

Cost of sales increased approximately \$3.4 million, or 6.9%, to \$53.2 million for the year ended December 31, 2006, compared to \$49.8 million for the same period in 2005. As a percentage of net sales, cost of sales increased to 88.4% in the 2006 period compared to 86.3% in the 2005 period. Cost of sales as a percentage of net sales in the year ended December 31, 2006, was unfavorably affected by higher converting labor costs, depreciation, an unfavorable sales mix and higher costs of packaging materials, which were partially offset by lower overall paper costs. The unfavorable mix is the result of an increase in bathroom tissue shipments as compared to towel shipments. A change in the level of overall business with certain large customers is the primary reason for the mix swing. Depreciation for the year ended December 31, 2006 increased approximately \$753,000 to \$2.3 million as a result of the start-up of the \$34.6 million paper machine project in June 2006.

Cost of sales increased approximately \$10.3 million, or 25.9%, to \$49.8 million for the year ended December 31, 2005, compared to \$39.5 million for the same period in 2004. As a percentage of net sales, cost of sales increased to 86.3% in 2005 compared to 84.3% in 2004. Cost of sales as a percentage of net sales in the year ended December 31, 2005 was unfavorably affected by an increased quantity of parent rolls purchased from third parties, higher average cost of parent rolls and packaging materials, partially offset by reduced sheet counts on some finished products and lower operating lease payments. In the first quarter of 2005, we implemented sheet count

reductions on certain finished products to several large customers. The sheet count reduction was implemented in lieu of an increase in selling prices.

In July 2004, we purchased a towel converting line that was leased in 2001 under an operating lease by exercising an early buyout option. The purchase price for the early buyout was approximately \$4.0 million. Prior to the buyout, the \$1.15 million annual payment made pursuant to the operating lease was reflected in cost of sales. The converting line has an estimated remaining useful life of, and is being depreciated over, 15 years. This transaction had the effect of reducing other cost of sales by \$577,000 and increasing depreciation expense by \$134,000, or a net reduction in cost of sales of \$443,000 in 2005 compared to 2004.

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

	<u>Successor</u>		<u>Period from March 1 - December 31, 2004</u>	<u>Predecessor</u>	<u>Combined</u>
	<u>Year Ended December 31,</u>			<u>Period from January 1 - February 29, 2004</u>	<u>Year Ended December 31, 2004</u>
	<u>2006</u>	<u>2005</u>			
<i>Paper usage (tons)</i>					
Converted-internal	31,662	26,051	21,976	4,406	26,382
Converted-purchased	6,970	12,153	4,848	169	5,017
Total converted	38,632	38,204	26,824	4,575	31,399
Third-party parent roll sales	1,191	—	945	—	945
<i>Paper costs per ton</i>					
Cost per ton produced internally	\$ 730	\$ 729	\$ 661	\$ 667	\$ 662
Cost per ton purchased from third parties	\$ 1,062	\$ 1,024	\$ 933	\$ 781	\$ 928
Total cost per ton	\$ 788	\$ 822	\$ 710	\$ 671	\$ 705
<i>Total paper costs (in thousands)</i>					
Cost of internally produced paper	\$23,979	\$18,979	\$14,526	\$2,939	\$17,465
Cost of paper purchased from third parties	<u>7,402</u>	<u>12,441</u>	<u>4,524</u>	<u>132</u>	<u>4,656</u>
Total paper costs	\$31,381	\$31,420	\$19,050	\$3,071	\$22,121

Our overall cost of paper was \$788 per ton in the twelve months ended December 31, 2006, compared to \$822 per ton in the year ended December 31, 2005. The reduction in our overall per ton cost of paper is due to an increase in the consumption of internally produced paper in the last half of 2006, following the start-up of our new paper machine. For the year ended December 31, 2006, approximately 82% of the paper consumed in our converting operation was internally produced compared to 68% for the same period in 2005. Beginning in the third quarter of 2006, parent roll production from our new paper machine eliminated the need to purchase recycled parent rolls from third parties and allowed us to sell approximately 1,200 tons of parent rolls during the last four months of 2006. We expect our overall parent roll production in 2007 to exceed our requirements for recycled converted product and we intend to sell our excess recycled parent rolls. For the twelve months ended December 31, 2006, our internal cost of paper production, excluding depreciation, was \$730 per ton which was slightly higher than the \$729 per ton experienced in the same period of 2006. Increased waste paper and electrical costs were mostly offset by lower per ton costs of fixed and semi-variable costs. An increase in waste paper costs experienced during the 2006 period, primarily in the third and fourth quarters, and lower yields in the first three quarters of the 2006 period during the final construction and start-up period of our new paper machine resulted in an 8% increase per ton in this component of our paper costs.

The increase in cases shipped in the year ended December 31, 2005, compared to 2004 required us to increase purchases of paper from third-party suppliers by 7,136 tons to 12,153 tons or approximately 32% of total tons consumed. The cost per ton of parent rolls purchased was higher in 2005 as the parent roll market continued to experience shortages and also due to increasing energy costs. Our average cost of parent rolls purchased from third-

party suppliers increased to \$1,024 per ton in the year ended December 31, 2005, compared to \$928 per ton in 2004. Our cost of internally produced paper also increased in the year over year period. The cost of internally produced paper was \$729 per ton for the year ended December 31, 2005, compared to \$662 per ton in 2004. Energy costs were the primary reason for the increased cost as we experienced a \$30 per ton increase in 2005 compared with 2004.

Gross Profit

Gross profit decreased by \$946,000, or 11.9%, to \$7.0 million for the year ended December 31, 2006, compared to \$7.9 million for the year ended December 31, 2005. As a percent of net sales, gross profit dropped to 11.6% in 2006 compared to 13.7% in 2005. The major reasons for the reduction in gross profit as a percentage of net sales were the previously discussed higher cost of converting labor, increased level of depreciation, unfavorable sales mix and higher packaging costs being partially offset by a lower overall cost of parent rolls.

Gross profit increased by \$550,000, or 7.5%, to \$7.9 million for the year ended December 31, 2005, compared to \$7.4 million for the year ended December 31, 2004. As a percent of net sales, gross profit dropped to 13.7% in 2005 compared to 15.7% in 2004. The major reasons for the reduction in gross profit as a percentage of net sales were the previously discussed increase in both the quantity and cost per ton of parent rolls purchased from third-party suppliers and higher cost of internally produced paper being partially offset by reduced sheet counts on certain finished case items and lower operating lease payments.

Selling, General and Administrative Expenses

	Successor		Predecessor		Combined
	Year Ended December 31,	Period from March 1 - December 31,	Period from January 1 - February 29,	Year Ended December 31,	
	2006	2005	2004	2004	2004
	(In thousands, except SG&A as a % of net sales)				
Commission expense	\$ 840	\$ 879	\$ 661	\$ 127	\$ 788
Management incentive payments . . .	—	—	—	625	625
Other S,G&A expenses	4,096	3,750	2,702	444	3,146
Selling, General & Adm exp	\$4,936	\$4,629	\$3,363	\$1,196	\$4,559
SG&A as a % of net sales	8.2%	8.0%	8.5%	16.6%	9.7%

Selling, general and administrative expenses include salaries, commissions to brokers and other miscellaneous expenses. Selling, general and administrative expenses for the year ended December 31, 2006, increased \$307,000, or 6.6%, to \$4.9 million, compared to \$4.6 million in the same period in 2005. As a percentage of net sales, selling, general and administrative expenses increased to 8.2% for the year ended December 31, 2006, compared to 8.0% in the same period in 2005. An increase in costs directly related to being a public company and higher artwork-related expenditures were partially offset by lower costs related to a management services agreement and a lower level of stock option expense. Public company expenses were approximately \$624,000 in the year ended December 31, 2006, compared with \$152,000 in the same period in 2005. Public company expenses were lower in 2005 because we were a privately-held company until July 2005. Artwork-related expenditures increased approximately \$118,000 in the 2006 period compared to the 2005 period due to a higher than normal number of packaging changes by existing customers and packing development with new customer accounts. Costs related to our management services agreement were lower in the twelve months ended December 31, 2006, by \$250,000 as compared to the same period in 2005 due to a \$150,000 lump sum payment made in 2005 which reduced our annual costs under the agreement from \$325,000 to \$125,000. The management services agreement has been terminated effective March 2, 2007. In the twelve months ended December 31, 2006, we recognized approximately \$260,000 of stock option expense, including \$186,000 of ongoing expense for options issued to management in April 2005 and \$74,000 for options issued to certain members of the board of directors in February 2006, June 2006 and December 2006. In the twelve months ended December 31, 2005, we recognized approximately \$368,000 in stock option expense, including \$337,000 for options issued to management and \$31,000 for options issued to certain members of the board of directors in September 2005 and December 2005. In April 2005, the 2005 Stock Incentive Plan was approved by the board of directors and stockholders and in April 2005, options for an aggregate of

405,000 shares of common stock were awarded to certain members of management. The management options vested 20% on the date of grant and 20% on each anniversary of the grant over the succeeding four years. The board options vested 100% on the date of the grant. Quarterly charges for the management stock options will approximate \$47,000 through the vesting period ending in the first quarter of 2009.

Selling, general and administrative expenses were relatively flat in the year ended December 31, 2005, increasing \$70,000, or 1.5%, to \$4.6 million compared to the prior year. In the year ended December 31, 2005, we recognized \$368,000 in stock-based compensation expense, a \$150,000 lump sum payment made as part of an amendment to the management services agreement and higher broker commissions, which were partially offset by the non-recurrence of \$625,000 in payments made under the management incentive plan in 2004 and lower ongoing fees under our management services agreement. The amended management services agreement reduced the annual management fee from \$325,000 to \$125,000 in exchange for the \$150,000 lump sum payment. Commission expense increased at a rate lower than the net sales increase due to increased sales to customers where we do not utilize a broker.

Operating Income

As a result of the foregoing factors, operating income for the twelve months ended December 31, 2006, 2005 and 2004 was \$2.0 million, \$3.3 million, and \$2.8 million, respectively.

Interest and Other Expense

	Successor		Predecessor		Combined Year Ended December 31, 2004
	Year Ended December 31, 2006	2005	Period from March 1 - December 31, 2004	Period from January 1 - February 29, 2004	
	(In thousands)				
Interest expense	\$ 1,980	\$ 1,213	\$ 1,052	\$ 45	\$ 1,097
Other (income) expense, net	\$ (99)	\$ (102)	\$ (5)	\$ —	\$ (5)

Interest expense includes interest paid and accrued on all debt and amortization of both deferred debt financing costs and of the discount on our subordinated debt related to warrants issued with the debt. See “Liquidity and Capital Resources” below. Interest expense for the twelve months ended December 31, 2006, was \$2.0 million, net of \$992,000 of capitalized interest, compared to interest expense in the 2005 period of \$1.2 million, net of \$411,000 of capitalized interest. Including the capitalized interest, total interest cost, including amortization, increased \$1.4 million, to \$3.0 million in the 2006 period compared to \$1.6 million in the 2005 period. Gross interest expense increased as a result of borrowings in 2006 under our construction loan to fund our new paper machine, higher average borrowings under our revolving credit agreement, and higher interest rates. During 2006 we borrowed \$15.0 million on the construction loan, the full amount available under the loan agreement. We capitalized interest under the requirements of SFAS No. 34 “Capitalization of Interest Cost” in relation to our new paper machine project.

Interest expense increased \$116,000 to \$1.2 million in the year ended December 31, 2005, compared to \$1.1 million for the year ended December 31, 2004. The increase in interest expense is primarily due to the additional debt we incurred in March 2004 as part of the acquisition of the predecessor company, borrowings under a new term loan to finance the previously discussed purchase of a towel converting line in July 2004 and the rise in interest rates during the comparative periods. Our acquisition of the predecessor company was financed with \$6.1 million of proceeds from the sale of common stock and a net increase in borrowings of approximately \$11.0 million.

Other income was \$99,000 in the twelve months ended December 31, 2006, compared to \$102,000 in the same period of 2005. Other income in the 2006 period was mainly comprised of \$66,000 in interest income earned from a restricted certificate of deposit with our lending institution and a \$39,000 foreign currency transaction gain. Other income in the 2005 period was mainly comprised of \$138,000 of income earned from the investment of our unused proceeds from our initial public offering which was partially offset by a net foreign currency exchange loss of \$39,000. In 2004 we entered into certain purchase agreements related to our new paper machine project. 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. We made the final payment under the exchange contract and on the purchase order in the second quarter of 2006. The exchange contracts were carried at fair value and any adjustments to fair value affected net income. In the 2005 period, the net proceeds of our initial public offering were used to fund the monthly construction costs of our new paper machine project. The unused proceeds were invested in short-term instruments such as high-grade commercial paper and bank certificates of deposit until such time as they were required for construction funding. As of December 31, 2005, the remaining unused net proceeds totaled \$373,000, which were consumed in January 2006.

Other income increased \$97,000 to \$102,000 for the year ended December 31, 2005, compared to \$5,000 in the year ended December 31, 2004. The increase is due to income of \$138,000 earned from the investment of our unused net proceeds from our initial public offering being partially offset by a net foreign currency exchange loss of \$39,000. At December 31, 2005, our outstanding foreign exchange contracts totaled \$760,000. The exchange contracts were carried at fair value and any adjustments to fair value affected net income. In the year ended December 31, 2005, we recorded a loss in our exchange contracts of \$74,000. Our minimum unpaid obligation under this purchase agreement as of December 31, 2005, was \$681,000 and was accrued in accrued liabilities. Adjusting the obligation to the December 31, 2005, exchange rate resulted in a foreign currency transaction gain of \$35,000.

Income Before Income Taxes

As a result of the foregoing factors, income before income taxes decreased \$2.0 million to \$168,000 for the year ended December 31, 2006, compared to \$2.2 million for the year ended December 31, 2005. Income before income taxes increased by \$461,000 to \$2.2 million for the year ended December 31, 2005 compared to \$1.7 million for the year ended December 31, 2004.

Income Tax Provision (Benefit)

For the year ended December 31, 2006, the income tax benefit amounted to \$564,000, resulting in an effective tax rate of a negative 336%. The primary reason for the benefit was the Oklahoma Investment Tax Credit (OITC) associated with our investment in a new paper machine. Also benefiting the tax provision was the federal Indian Employment Credit (IEC), which was reinstated in December 2006. The law authorizing the IEC had effectively lapsed at year-end 2005. Accordingly, the Company was not able to recognize the IEC in its tax provisions during the first three quarters of 2006. Partially offsetting these benefits was the effect of the previously discussed non-deductible stock option expense. The current tax benefit of \$1.0 million primarily results from the carryback of net operating losses for tax purposes to tax years 2005 and 2004. The deferred provision of \$483,000 is the result of substantial tax depreciation in excess of financial depreciation, partially offset by the recognition of investment, employment and other tax carryforwards for financial reporting purposes. The law extending the IEC also reinstated accelerated depreciation deductions, the most important of which was a four year tax life on investments in machinery and equipment placed in service on former Indian lands in Oklahoma. Accelerated depreciation will continue to benefit our current tax position for the next few years, as will the OITC, which is earned ratably over five years. We expect to claim \$720,000 in OITC in each of the next four years.

For the year ended December 31, 2005, income tax expense was \$799,000 resulting from an effective tax rate of 36.5%. It is higher than the statutory rate because of non-deductible stock option expense being partially offset by the utilization of federal Indian employment credits.

For the year ended December 31, 2004, income tax expense was \$708,000 resulting from an effective tax rate of 41%. Our income tax expense was higher than the federal statutory rate in 2004 due to adjustment of amounts previously claimed for federal Indian employment credits. For the ten-month period ended December 31, 2004, state income taxes were fully offset by investment and employment credits.

LIQUIDITY AND CAPITAL RESOURCES

Overview

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 short-term investments. Our cash requirements have historically been satisfied through a combination of cash flows from operations and debt financings. Our strategy to eliminate the need to purchase paper from third-party suppliers through the purchase of a new paper machine was funded through the net proceeds of our initial public offering, additional bank financing and cash flows from operations. The total cost of the paper machine project was \$34.6 million, exclusive of capitalized interest.

On July 20, 2005, we completed our initial public offering of 2,156,250 shares of common stock, which included the exercise in full of the underwriter's option to purchase 281,250 shares of common stock to cover overallotments. The shares were registered on Form S-1 (file number 333-124173), which the SEC declared effective on July 14, 2005. The public offering price of the shares was \$8.00. Following the offering, 4,156,250 shares of common stock, par value \$.001 per share, were outstanding. In July, 2006 we effected a 3-for-2 stock split increasing the shares of common stock outstanding to 6,234,346 shares outstanding. Net proceeds from the offering were \$15.0 million with gross proceeds totaling \$17.25 million and with costs related to offering totaling \$2.25 million as follows:

- underwriting discount of 8% or \$1.4 million (charged against additional paid-in-capital); and
- direct expenses of \$859,000 (charged against additional paid-in capital), including legal fees, printing costs, accounting fees, qualified independent underwriter fees and other miscellaneous direct expenses.

As of December 31, 2005, all but \$373,000 of the net proceeds had been used to fund expenditures for our new paper machine project. The remaining funds were invested in short-term investment grade, interest-bearing instruments. In January 2006, we expended the remaining \$373,000 on the paper machine project and we began to draw on the construction loan facility at that time.

Cash decreased by \$375,000 during 2006 to \$3,000 at December 31, 2006. The decrease was attributable to the application of remaining funds from the public offering to the paper machine project.

The Company has recorded a current income tax receivable at December 31, 2006 in the amount of \$1.2 million to recover federal income taxes paid in 2006, 2005 and 2004. This asset should be realized during 2007. This is the result of net operating losses (NOL) for tax purposes due largely to accelerated depreciation deductions for the new paper machine. Furthermore, the Company estimates NOL carryforwards of \$1.1 million (federal) and \$2.0 million (state) which are available to offset future taxable income. In addition, the Company plans to claim \$1.1 million in Oklahoma Investment Tax Credit (OITC) carryforward as of December 31, 2006, which is available to offset future Oklahoma income tax liability. The OITC carryforward is expected to grow over the next four years as it is earned ratably over five years at two percent per year on qualified investments. We expect to claim \$720,000 in OITC in each of the next four years. The combination of accelerated depreciation deductions and the OITC will likely eliminate all Oklahoma income tax liability for the next few years.

Cash decreased by \$107,000 during 2005 to \$378,000 at December 31, 2005. In addition to the cash balances, we maintained \$1.5 million of short-term investments in certificates of deposit at December 31, 2006 and 2005. The \$1.5 million is restricted under the provisions of our term loan agreement until April 30, 2007, the term date of our existing credit agreement. We anticipate that the \$1.5 million will be used to reduce the principal amount of our bank debt.

The following table summarizes key cash flow information for the years ended December 31, 2006 and 2005, the ten-month period ended December 31, 2004 and the two-month period ended February 29, 2004.

Successor		Predecessor		Combined
Year Ended December 31,	2005	Period from March 1 - December 31, 2004	Period from January 1 - February 29, 2004	Year Ended December 31, 2004
2006	2005	2004	2004	2004

(In thousands)

Cash Flow Data

Cash flow provided by (used in):

Operating activities	\$ 2,607	\$ 2,644	\$ 4,722	\$ 847	\$ 5,569
Investing activities	\$(18,133)	\$(19,238)	\$(19,794)	\$(112)	\$(19,906)
Financing activities	\$ 15,151	\$ 16,487	\$ 15,067	\$ (445)	\$ 14,622

Cash provided by operations totaled \$2.6 million in the year ended December 31, 2006, essentially level with the same period in 2005. An increase in income taxes receivable in 2006 was mainly attributable to accelerated depreciation on the new paper machine. The recently extended tax benefits for property placed in service on former Indian lands added to the net operating loss for tax purposes. This increase was largely offset by the absence of the inventory increase incurred during 2005. The absence was due to a scarcity of third party parent rolls available on the open market at year-end 2004. Accounts receivable increased during the year ended December 31, 2006, reflecting higher sales volumes. Accounts payable increased during the year ended December 31, 2006, reflecting higher levels of purchasing.

Cash used in investing activities was \$18.1 million, mostly related to the new paper machine project. Capital expenditures for the new machine amounted to \$17.5 million in 2006, inclusive of capitalized interest of \$992,000. The start-up date for the project was June 9, 2006. Annual maintenance capital expenditures are estimated to be approximately \$750,000 per year over the next several years which we expect to fund from operating cash flow. In order to increase our converting capacity, we anticipate purchasing an additional converting equipment line in 2007 or 2008 at an estimated capital cost of \$6 million. We also may be required to build a wastewater pre-treatment facility at an estimated cost of \$3 million, probably some time after 2007. Funding for these expenditures is expected to come from a combination of additional borrowings from lenders and operating cash flow.

Cash provided from financing activities amounted to \$15.2 million in the year ended December 31, 2006, mainly attributable to borrowings under a construction loan agreement with established bank creditors. Cash provided from financing activities decreased from \$16.5 million in the year ended December 31, 2005 due to the absence of the proceeds from the initial public offering and reduced borrowing under the revolving credit line. Principal payments on the bank debt remained level at \$1.6 million in each period.

Cash provided by operations decreased \$3.0 million to \$2.6 million for the year ended December 31, 2005, compared to \$5.6 million for the year ended December 31, 2004. The primary cause for the decrease was an investment in inventories and higher accounts receivable balances which were somewhat offset by higher earnings. The inventory increase was primarily in parent roll and finished case inventory. Year-end 2004 inventories were at below normal levels due to a lack of adequate availability of parent rolls in the fourth quarter of 2004 which affected production of finished goods and parent roll inventory levels. Accounts receivable also increased substantially in 2005 due to higher year over year sales volumes.

Cash used in investing activities was \$19.2 million in the year ended December 31, 2005. The amount was due to capital expenditures of \$18.5 million, of which \$18.3 million were expenditures on our new paper machine project.

Cash used in investing activities also included a net purchase of investment securities of \$750,000 resulting from the initial investment of our net proceeds from our initial public offering and the subsequent sale of substantially all of those securities and \$750,000 of short-term investments held at December 31, 2004, to fund capital expenditures on our new paper machine project.

Cash provided by financing activities increased \$1.9 million, or 13%, to \$16.5 million in the year ended December 31, 2005, compared to \$14.6 million in the same period in 2004. In 2005, the cash provided was primarily

a result of the \$15.0 million in net proceeds from our initial public offering and borrowings under the revolving credit agreement, partially offset by \$1.6 million in term loan principal payments.

We entered into an amended and restated agent credit agreement with a bank group headed by the Bank of Oklahoma in June 2005, to allow for the establishment of a construction loan needed to fund our new paper machine project. This agreement expires on April 30, 2007. We intend to refinance these obligations on a long-term basis prior to the expiration of the agreement. We have received a commitment letter from a bank group headed by the Bank of Oklahoma to refinance the credit facility as described later in this document. Under the current amended agreement, we maintain:

- a \$5.0 million revolving credit facility, of which there was \$3.3 million outstanding as of December 31, 2006, on an eligible borrowing base of \$5.3 million, which was limited to \$5.0 million per the terms of the agreement. For reporting purposes, as of December 31, 2006, \$1.8 million of bank overdrafts were included in the Long-term debt section of the balance sheet;
- a \$14.1 million term loan, with a seven-year amortization period, of which there was \$11.8 million outstanding as of December 31, 2006; and
- a \$15.0 million term loan, with a ten-year amortization period, of which there was \$14.9 million outstanding as of December 31, 2006.

Amounts outstanding under the revolving line of credit and the \$14.1 million term loan bear interest at our election at the prime rate or LIBOR plus a margin based on the ratio of funded debt to EBITDA less income taxes paid. The margin is set quarterly and ranges from negative 50 basis points to 150 basis points for prime rate loans and from 225 to 425 basis points for LIBOR-based loans. At December 31, 2006, our borrowing rate on these loans was 9.61%. As of December 31, 2006, our interest rate margin was prime plus 150 basis points or LIBOR plus 425 basis points. The \$15.0 million term loan bears interest at our election at a floating rate of either 100 basis points over prime or 375 basis points over LIBOR. At December 31, 2006 our borrowing rate on this loan was 9.11%. LIBOR elections are made for 30, 60 or 90 days periods.

Pursuant to the credit agreement, we are required to maintain a balance of at least \$1.5 million in a separate interest reserve account until April 2007 or until the agreement is re-financed, at which time these funds will be released.

Borrowings under the revolving credit agreement are limited to a borrowing base, which is calculated on a percentage of eligible accounts receivable and inventory. Our revolving credit facility may be used for general corporate purposes, including working capital and equipment purchases.

Our credit facility includes covenants that, among other things, require us to maintain, on a quarterly basis, a specific ratio of funded debt to EBITDA, a minimum level of tangible net worth, a specific debt service coverage ratio and limits our capital expenditures. We amended our credit agreement in June 2006 and October 2006 to increase the funded debt to EBITDA ratio and lower the debt service coverage ratio in order to avoid non-compliance with the covenants for each quarter end. In the October 2006 amendment, we increased the funded debt to EBITDA ratio to 4.5-to-1 for the quarter ended September 30, 2006, and reverted the ratio to 4.0-to-1 for the remainder of the term of the agreement and decreased the debt service coverage ratio to 1.20-to-1 for the quarter ended September 30, 2006, and 1.05-to-1 for the quarter ended December 31, 2006. The debt service coverage ratio reverts to the original 1.25-to-1 for the remainder of the term of the agreement. Until April 2007, effects of the \$15 million term loan, which directly related to the paper machine project, are excluded from the covenant calculations. As of December 31, 2006, we were in compliance with all financial covenants. The loan facility includes an excess cash flow recapture provision. The revolving credit facility and term loan agreement are secured by substantially all of our assets.

On March 1, 2004, Orchids Acquisition Group, Inc., which subsequently merged with and into us, sold units consisting of \$2.2 million principal amount of subordinated debentures and common stock warrants to help finance our acquisition. The subordinated debentures were sold in units of \$1,000 bearing interest at 12% per year, payable quarterly, with each note including a warrant to purchase 57 shares of common stock at an exercise price of \$2.43 per share.

On March 9, 2007, we received a commitment letter from the Bank of Oklahoma, NA. to re-finance our existing credit facility. We intend to move forward with a re-financing of the credit facility under the following terms and expect to complete the re-financing prior to the April 30, 2007 expiration date of our current credit facility. The proposed credit facility in the commitment letter consists of the following:

- a \$6.0 million revolving credit facility with a 3-year term;
- a \$10.0 million term loan A with a ten-year term and twenty-year amortization;
- a \$16.5 million term loan B with a four year-term and six-year amortization; and
- a \$3.0 million capital expenditures facility with a four-year term and a five-year amortization.

Under the terms of the commitment letter, amounts outstanding under the revolving credit facility will 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 will 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 will 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.

The credit facility will contain covenants that will, 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. The current \$1.5 million restricted certificate of deposit will be released and applied to the revolving credit facility.

Contractual Obligations

As of December 31, 2006, our contractual cash obligations were limited to our long-term debt. We do not have any leasing commitments or debt guarantees outstanding as of December 31, 2006. We do not have any defined benefit pension plans nor do we have any obligation to fund any postretirement benefit obligations for our work force.

Maturities of these contractual obligations consist of the following:

<u>Contractual Cash Obligations</u>	<u>Payments Due by Period</u>				
	<u>Total</u>	<u>Years</u>			
		<u>1</u>	<u>2 and 3</u>	<u>4 and 5</u>	<u>After 5</u>
	(\$ thousands)				
Long-term debt(1)	\$33,838	\$31,762	\$2,076	\$—	\$—
Interest payments(2)(3).	\$ 1,487	\$ 1,186	\$ 301	\$—	\$—
Total	<u>\$35,325</u>	<u>\$32,948</u>	<u>\$2,377</u>	<u>\$—</u>	<u>\$—</u>

- (1) This schedule has been prepared based on our existing credit facility, which expires on April 30, 2007. A commitment letter was received on March 9, 2007 from the Bank of Oklahoma, N.A. to re-finance our existing credit facility, and we expect to close the agreement later in March or early in April of 2007. Re-financing our existing credit facility will extend the Long-term debt payments shown in the above table. See Note 6 — “Long-Term Debt” and Note 14 — “Subsequent Event” to the financial statements in Item 8 in this Form 10-K for further discussion. Under Orchids’ revolving credit and term loan agreement, the maturity of outstanding debt could be accelerated if we do not maintain certain financial covenants. At December 31, 2006, we were in compliance with our loan covenants, as amended.
- (2) These amounts assume interest payments at the year-end borrowing amount and rate for our revolving credit facility. The amount borrowed in future periods is dependent on our free cash flow from time-to-time.
- (3) Interest payments on the term loans have been calculated based on the interest rate in effect as of December 31, 2006.

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 of America requires management to make estimates and judgments that affect our reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going 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 a provision 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 provisions established, there can be no assurance that we will continue to experience the same credit loss rates as in the past. Accounts receivable balances that have been written-off in the years ended December 31, 2006, 2005, and 2004 were \$11,000, \$11,000, and \$38,000, respectively.

Inventory. Our inventory consists of converted finished goods, bulk paper rolls and raw materials and is based on standard cost, specific identification, or FIFO (first-in, first-out). Standard costs approximate actual costs on a first-in, first-out basis. Material, labor and factory overhead necessary to produce the inventories are included in the standard cost. 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 year ended December 31, 2006, we increased the inventory valuation reserve by \$1,000. During the year ended December 31, 2005, we decreased the inventory valuation reserve by \$15,000. During the year ended December 31, 2004, we increased the inventory valuation reserve by \$12,000.

New Accounting Pronouncements

The Financial Accounting Standards Board ("FASB") periodically issues new accounting standards in a continuing effort to improve standards of financial accounting and reporting. We have reviewed the recently issued pronouncements and concluded that the following new accounting standards are applicable to us.

In February 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 155 "Accounting for Certain Hybrid Financial Instruments" amending SFAS No. 133 and SFAS No. 140. SFAS No. 155 eliminates the exemption from applying SFAS No. 133 to securitized financial assets. The provisions of SFAS No. 155 are to be applied to financial instruments issued or acquired during fiscal periods beginning after September 15, 2006. The adoption of SFAS No. 155 is not expected to have a material impact on our financial position or results of operations.

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. FIN 48 is effective for fiscal years beginning after December 15, 2006. Because the Company knowingly takes no aggressive positions in its tax

returns and, accordingly, carries no income tax “reserves” on its books, this interpretation is not expected to have a material effect on our 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.

Also in September 2006, the FASB issued SFAS No. 158 “Employers’ Accounting for Defined Benefit Pension Plans and Other Postretirement Plans — an amendment of FASB Statements No. 87, 88, 106 and 132[®]”. This standard requires recognition in the balance sheet of the funded status of pension plans, rather than footnote disclosure which has been current practice. Publicly traded companies are to reflect the new standard in financial statements ending after December 15, 2006, and non-public companies are to apply it in statements ending after June 15, 2007. Because we do not maintain a defined benefit pension plan and have no plans to do so, this standard should not have any 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 because the majority of its debts and investment assets are variable rate and thus fair value approximates recorded value.

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 backing out 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 analysis of our results as reported under GAAP. Some of these limitations are:

- it does not reflect our cash expenditures for capital expenditures;
- 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 only supplementally.

The following table reconciles EBITDA to net income for the years ended December 31, 2006, 2005 and, 2004:

	Successor		Period from March 1 - December 31, 2004	Predecessor	Combined
	Year Ended December 31, 2006	2005		Period from January 1 - February 29, 2004	Year Ended December 31, 2004
	(In thousands, except % of net sales)				
Net income (loss)	\$ 732	\$1,392	\$1,294	\$(272)	\$1,022
Plus: Interest expense, net	1,980	1,213	1,052	45	1,097
Plus: Income tax expense (benefit)	(564)	799	642	66	708
Plus: Depreciation	2,254	1,501	1,288	384	1,672
EBITDA	\$4,402	\$4,905	\$4,276	\$ 223	\$4,499
% of net sales	7.3%	8.5%	10.8%	3.1%	9.6%

EBITDA decreased \$503,000 to \$4.4 million, or 7.3% of net sales, for the year ended December 31, 2006, compared to \$4.9 million, or 8.5% of net sales, for the year ended December 31, 2005. The foregoing factors discussed in the net sales, cost of sales and selling, general and administrative expenses sections are the reasons for the change.

EBITDA increased \$406,000 to \$4.9 million, or 8.5% of net sales, for the year ended December 31, 2005, compared to \$4.5 million, or 9.6% of net sales, for the year ended December 31, 2004. The foregoing factors discussed in the net sales, cost of sales and selling, general and administrative expenses sections are the reasons for the change. However, the largest single cause for the decrease in EBITDA as a percentage of sales was higher paper costs.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-K, including the sections entitled “The Business,” “Risk Factors” and “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;
- our value proposition;
- 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, expectations and intentions contained in this Form 10-K 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 achievement 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.

Factors that may cause our actual results to differ materially from our forward-looking statements include, among others;

- competition in our industry;
- adverse developments in our relationships with key customers;
- impairment of ability to meet our obligations and restrictions on future operations due to our substantial debt;
- availability and price of energy;
- variable interest rate exposure;
- the loss of key personnel;
- disruption in supply or cost of SBS paper;
- 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.

You should read this Form 10-K completely and with the understanding that our actual results may be materially different from what we expect. We undertake no duty to update these forward-looking statements after the date of this Form 10-K, even though our situation may change in the future. We qualify all of our forward-looking statements by these cautionary statements.

Item 7A. 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 a variable interest rate that is tied to market indices and, therefore, our statement of income and our cash flows will be exposed to changes in interest rates. As of December 31, 2006, we had floating-rate borrowings of \$30.0 million, excluding bank overdrafts, which are classified with bank debt in the balance sheet, but which bear no interest. 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. We considered the historical volatility of short-term interest rates and determined that it would be reasonably possible that an adverse change of 100 basis points could be experienced in the near term. Based on the current borrowing, a 100 basis point increase in interest rates would result in a pre-tax \$300,000 increase to our annual interest expense.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of
Orchids Paper Products Company

We have audited the accompanying balance sheets of Orchids Paper Products Company as of December 31, 2006 and 2005, and the related statements of income, changes in stockholders' equity and cash flows for the years and the ten-month period, respectively, then ended. We have audited the accompanying statements of income, changes in stockholders' equity and cash flows of the Company's Predecessor for the two-month period ended February 29, 2004. Our audits also included the financial statement schedule listed in Item 15(a)(2). These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2005 and 2004, and the results of its operations and its cash flows for the years and the ten-month period then ended for the Company and for the two-month period ended February 29, 2004, for the Predecessor in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements, taken as a whole, present fairly in all material respects the information set forth therein.

/s/ TULLIUS TAYLOR SARTAIN & SARTAIN LLP

Tulsa, Oklahoma
March 16, 2007

ORCHIDS PAPER PRODUCTS COMPANY

BALANCE SHEETS

	As of	
	December 31, 2006	December 31, 2005
	(Dollars in thousands, except share data)	
ASSETS		
Current assets:		
Cash	\$ 3	\$ 378
Accounts receivable, net of allowance of \$100 in 2006 and \$125 in 2005	5,089	4,180
Inventories, net	4,379	4,420
Restricted certificate of deposit	1,500	1,500
Income taxes receivable	1,242	94
Prepaid expenses	306	458
Deferred income taxes	346	200
Total current assets	12,865	11,230
Property, plant and equipment	63,081	44,983
Accumulated depreciation	(5,042)	(2,789)
Net property, plant and equipment	58,039	42,194
Deferred debt issuance costs, net of accumulated amortization of \$424 in 2006 and \$232 in 2005	124	286
Total assets	<u>\$71,028</u>	<u>\$53,710</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 3,772	\$ 2,877
Accrued liabilities	1,805	2,137
Unrealized loss on forward currency exchange contracts	—	74
Current portion of long-term debt	2,263	1,628
Total current liabilities	7,840	6,716
Long-term debt, net of unamortized discount of \$74 in 2006 and \$101 in 2005 . .	31,575	17,002
Deferred income taxes	6,909	6,280
Stockholders' equity:		
Common stock, \$.001 par value, 10,000,000 shares authorized, 6,234,346 shares issued and outstanding in 2006 and 2005	6	6
Additional paid-in capital	21,139	20,879
Common stock warrants	141	141
Retained earnings	3,418	2,686
Total stockholders' equity	24,704	23,712
Total liabilities and stockholders' equity	<u>\$71,028</u>	<u>\$53,710</u>

See notes to financial statements.

ORCHIDS PAPER PRODUCTS COMPANY

STATEMENTS OF INCOME

**Years ended December 31, 2006 and 2005, the Ten-Month Period ended December 31, 2004,
and the Two-Month Period ended February 29, 2004**

	Successor			Predecessor
	Year Ended December 31, 2006	Year Ended December 31, 2005	Ten-Months Ended December 31, 2004	Two-Months Ended February 29, 2004
	(Dollars in thousands, except share and per share data)			
Net sales	\$ 60,190	\$ 57,700	\$ 39,736	\$7,191
Cost of sales	<u>53,205</u>	<u>49,769</u>	<u>33,390</u>	<u>6,156</u>
Gross profit	6,985	7,931	6,346	1,035
Selling, general and administrative expenses	<u>4,936</u>	<u>4,629</u>	<u>3,363</u>	<u>1,196</u>
Operating income (loss)	2,049	3,302	2,983	(161)
Interest expense	1,980	1,213	1,052	45
Other (income) expense, net	<u>(99)</u>	<u>(102)</u>	<u>(5)</u>	<u>—</u>
Income (loss) before income taxes	168	2,191	1,936	(206)
Provision (benefit) for income taxes:				
Current	(1,047)	663	470	(46)
Deferred	<u>483</u>	<u>136</u>	<u>172</u>	<u>112</u>
	<u>(564)</u>	<u>799</u>	<u>642</u>	<u>66</u>
Net income (loss)	<u>\$ 732</u>	<u>\$ 1,392</u>	<u>\$ 1,294</u>	<u>\$ (272)</u>
Net income per share:				
Basic	\$ 0.12	\$ 0.31	\$ 0.43	
Diluted	\$ 0.11	\$ 0.30	\$ 0.42	
Shares used in calculating net income per share:				
Basic	6,234,346	4,453,254	3,000,000	
Diluted	6,558,454	4,594,412	3,078,807	

See notes to financial statements

ORCHIDS PAPER PRODUCTS COMPANY

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

**Years ended December 31, 2005 and 2006, the Ten-Month Period ended December 31, 2004,
and the Two-Month Period ended February 29, 2004**

	Common Stock		Additional Paid-in Capital	Common Stock Warrants		Retained Earnings	Total
	Shares	Value		Shares	Value		
(Dollars in thousands, except share amounts)							
<i>Predecessor</i>							
Balance at December 31, 2003	100	\$—	\$ 8,001	—	\$ —	\$2,049	\$10,050
Net loss	—	—	—	—	—	(272)	(272)
Balance at February 29, 2004	<u>100</u>	<u>\$—</u>	<u>\$ 8,001</u>	<u>—</u>	<u>\$ —</u>	<u>\$1,777</u>	<u>\$ 9,778</u>
<i>Successor</i>							
Issuance of Common Stock	728,751	\$ 1	\$ 6,049	—	\$ —	\$ —	\$ 6,050
Valuation of Warrants issued with Subordinated Debt	—	—	—	82,607	141	—	141
Valuation of management shares issued.	—	—	103	—	—	—	103
Cost of common stock and warrants issued.	—	—	(647)	—	—	—	(647)
Net income	—	—	—	—	—	1,294	1,294
Effect of 2.744-for-1 stock split	<u>1,271,249</u>	<u>1</u>	<u>(1)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Balance at December 31, 2004	2,000,000	2	5,504	82,607	141	1,294	6,941
Issuance of Common Stock , net of offering expenses of \$2,239	2,156,250	2	15,009	—	—	—	15,011
Stock based compensation	—	—	368	—	—	—	368
Net income	—	—	—	—	—	1,392	1,392
Balance at December 31, 2005	4,156,250	4	20,881	82,607	141	2,686	23,712
Effect of 3-for-2 stock split	2,078,096	2	(2)	—	—	—	—
Stock based compensation	—	—	260	—	—	—	260
Net income	—	—	—	—	—	732	732
Balance at December 31, 2006	<u>6,234,346</u>	<u>\$ 6</u>	<u>\$21,139</u>	<u>82,607</u>	<u>\$141</u>	<u>\$3,418</u>	<u>\$24,704</u>

See notes to financial statements.

ORCHIDS PAPER PRODUCTS COMPANY

STATEMENTS OF CASH FLOWS

**Years ended December 31, 2006 and 2005, the Ten-Month Period ended December 31, 2004,
and the Two-Month Period ended February 29, 2004**

	Successor			Predecessor
	Year Ended December 31, 2006	Year Ended December 31, 2005	Ten Months Ended December 31, 2004	Two Months Ended February 29, 2004
	(Dollars in thousands)			
Cash Flows From Operating Activities				
Net income (loss)	\$ 732	\$ 1,392	\$ 1,294	\$(272)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation and amortization	2,472	1,688	1,372	386
Provision for doubtful accounts	(19)	46	23	5
Deferred income taxes	483	136	172	112
Stock based compensation	260	368	103	—
Foreign currency transaction gain	35	(35)	—	—
Unrealized loss on foreign exchange contracts	(74)	74	—	—
Changes in cash due to changes in operating assets and liabilities, net of acquisition:				
Accounts receivable, net	(890)	(617)	688	(347)
Inventories	41	(1,372)	396	344
Prepaid expenses	152	(128)	112	49
Income taxes receivable	(1,148)	188	(167)	(49)
Accounts payable	895	697	751	133
Accrued liabilities	(332)	207	(22)	486
Net cash provided by operating activities	2,607	2,644	4,722	847
Cash Flows From Investing Activities				
Acquisition of business, net of cash acquired	—	—	(14,506)	—
Purchases of investment securities and restricted certificate of deposit	—	(17,259)	(750)	—
Proceeds from the sale of investment securities	—	16,509	—	—
Purchases of property, plant and equipment	(18,133)	(18,488)	(4,538)	(112)
Net cash used in investing activities	(18,133)	(19,238)	(19,794)	(112)
Cash Flows From Financing Activities				
Proceeds from issuance of common stock	—	17,250	6,050	—
Cost of common stock and warrants issued	—	(2,239)	(647)	—
Proceeds from issuance of subordinated debt and common stock warrants	—	—	2,150	—
Proceeds from issuance of long-term debt	—	—	17,399	—
Borrowings under construction loan	15,000	—	—	—
Principal payments on bank debt	(1,586)	(1,643)	(9,568)	(445)
Net borrowings on revolving credit line	1,767	3,293	—	—
Deferred debt issuance costs	(30)	(174)	(317)	—
Net cash provided by (used in) financing activities	15,151	16,487	15,067	(445)
Net increase (decrease) in cash	(375)	(107)	(5)	290
Cash, beginning	378	485	490	200
Cash, ending	\$ 3	\$ 378	\$ 485	\$ 490
Supplemental Disclosure:				
Interest paid	\$ 2,615	\$ 1,445	\$ 884	\$ 48
Income taxes paid	\$ 221	\$ 475	\$ 765	\$ —
Supplemental Disclosure of Non-Cash Investing and Financing Activities:				
Contractual obligation for purchase of paper machine	\$ —	\$ 681	\$ —	\$ —

See notes to financial statements.

ORCHIDS PAPER PRODUCTS COMPANY

NOTES TO FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

Note 1 — Summary of Significant Accounting Policies

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. On April 19, 2005, Orchids Acquisition merged with and into Orchids, with Orchids as the surviving entity. The accompanying financial statements of Orchids prior to March 1, 2004, are labeled “Predecessor.” The consolidated financial statements of Orchids Acquisition and Orchids as of March 1, 2004, and thereafter are labeled “Successor.”

Business

Orchids operates a paper mill and converting plant used to produce a full range of paper tissue products. The mill produces bulk rolls of paper, referred to as parent rolls, from recycled paper stock. The parent rolls are transferred to the converting plant for further processing. Tissue products produced in the converting plant include paper towels, bathroom tissue, and napkins, which the Company primarily markets to domestic value retailers.

Summary of Significant Accounting Policies

Fair value of financial instruments

The carrying amounts of the Company’s financial instruments, cash, accounts receivable, investments, accounts payable and accrued liabilities approximate fair value due to their short maturity. The fair value of the Company’s long-term debt is estimated by management to approximate fair value based on the obligations’ characteristics, including floating interest rate, credit ratings, maturity and collateral.

Accounts receivable

Accounts receivable are carried at original invoice amount less an estimate made for doubtful receivables based on a review of all outstanding amounts. A trade receivable is considered to be past due if it is outstanding for more than five days past terms. Management determines the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer’s financial condition, credit history, and current economic conditions. Receivables are written-off when deemed uncollectible. Recoveries of receivables previously written-off are recorded when received. The Company does not typically charge interest on trade receivables.

Inventories

Inventories are stated at the lower of cost or market. The Company’s cost is based on standard cost, specific identification, or FIFO (first-in, first-out). Standard costs approximate actual costs on a first-in, first-out basis. Material, labor, and factory overhead necessary to produce the inventories are included in the standard cost.

Investments and restricted certificate of deposit

As more fully described in Note 6 to these financial statements, the Company is required to maintain \$1,500,000 in a separate interest reserve account until a date which is seven months after completion of its new paper machine project and the satisfaction of certain conditions. In December 2005, the Company purchased \$1,500,000 in a certificate of deposit to satisfy this requirement. This investment is carried at cost, which approximates market value.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

Property, plant and equipment

Property, plant and equipment are stated at cost. Depreciation of property, plant and equipment is computed using the straight-line method over the estimated useful lives of the assets. The Company expenses normal maintenance and repair costs as incurred.

Impairment of long-lived assets

The Company reviews its long-lived assets, primarily property, plant and equipment, for impairment whenever events or changes in circumstances indicate that the carrying values may not be recoverable. Impairment evaluation is based on estimates of remaining useful lives and the current and expected future profitability and cash flows. The Company had no impairment of long-lived assets during the year ended December 31, 2006, the year ended December 31, 2005, the period ended December 31, 2004, or the period ended February 29, 2004.

Income taxes

Deferred income taxes are computed using the liability method and are provided on all temporary differences between the financial basis and the tax basis of the Company's assets and liabilities. Future tax benefits are recognized to the extent that realization of those benefits is considered to be more likely than not. A valuation allowance would be provided for deferred tax assets for which realization is not likely.

Deferred debt issuance costs

Costs incurred in obtaining debt funding are deferred and amortized on an effective interest method over the terms of the loans which expire April 30, 2007. Debt issuance costs of \$548,000 relating to the renegotiated bank debt (including the revolving credit agreement), the subordinated debentures entered into in March 2004, the new construction loan and extensions of the term loan and revolving credit line in 2005, and covenant waivers in 2006 are being amortized over the terms of the debt. Amortization expense for 2006, 2005 and 2004 was \$219,000, \$163,000 and \$32,000, respectively, and has been classified with interest expense in the income statement.

Discount on debt securities issued

Discount on Subordinated Debt issued of \$141,000 is being amortized over the term of the debt using the effective interest method.

Stock splits

On July 21, 2006, the Company effected a 3-for-2 stock dividend, pursuant to a resolution of the board of directors. All common and per share amounts of the Company have been restated to reflect this stock split. On April 14, 2005, the Company's and Orchids Acquisition's boards of directors approved the merger of Orchids Acquisition into Orchids with Orchids as the surviving entity. The number of authorized common shares was increased to 10,000,000 and the number of common shares outstanding was split on a 2.744-for-1 basis. All common and per share amounts of the Successor have been restated to reflect a 2.744-for-1 stock split.

Stock option expense

The Company adopted the provisions of SFAS No. 123[®] in connection with its stock option plan. Grant-date option costs are being recognized on a straight-line basis over the vesting periods of the options.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

Revenue recognition

Revenues for products loaded on customer trailers are recognized when the customer has accepted custody and left the Company's dock. Revenues for products shipped to customers are recognized when title passes upon shipment. Customer discounts and pricing allowances are included in net sales.

Shipping and handling costs

Costs incurred to ship raw materials to the Company's facilities are included in inventory and cost of sales. Costs incurred to ship finished goods to customer locations of \$1,455,000 for the year ended December 31, 2006, \$993,000 for the year ended December 31, 2005, \$1,098,000 for the ten-month period ended December 31, 2004 and \$279,000 for the two-month period ended February 29, 2004 are included in cost of sales.

Advertising costs

Advertising costs are expensed when incurred and totaled \$231,000 for the year ended December 31, 2006, \$121,000 for the year ended December 31, 2005, \$156,000 for the ten-month period ended December 31, 2004 and \$1,000 for the two-month period ended February 29, 2004, and are included in selling, general and administrative expenses.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

New pronouncements

The Financial Accounting Standards Board ("FASB") periodically issues new accounting standards in a continuing effort to improve standards of financial accounting and reporting. Orchids has reviewed the recently issued pronouncements and concluded that the following new accounting standards are applicable to the Company.

In February 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 155 "Accounting for Certain Hybrid Financial Instruments" amending SFAS No. 133 and SFAS No. 140. SFAS No. 155 eliminates the exemption from applying SFAS No. 133 to securitized financial assets. The provisions of SFAS No. 155 are to be applied to financial instruments issued or acquired during fiscal periods beginning after September 15, 2006. The adoption of SFAS No. 155 is not expected to have a material impact on the Company's financial position or results of operations.

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. FIN 48 is effective for fiscal years beginning after December 15, 2006. Because the Company knowingly takes no aggressive positions in its tax returns and accordingly, carries no income tax "reserves" on its books, this Interpretation 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

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

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.

Also in September 2006, the FASB issued SFAS No. 158 "Employers' Accounting for Defined Benefit Pension Plans and Other Postretirement Plans — an amendment of FASB Statements No. 87, 88, 106 and 132®". This standard requires recognition in the balance sheet of the funded status of pension plans, rather than footnote disclosure which has been current practice. Publicly traded companies are to reflect the new standard in financial statements ending after December 15, 2006, and non-public companies are to apply it in statements ending after June 15, 2007. Because Orchids does not maintain a defined benefit pension plan and has no plans to do so, this standard should not have any impact on the Company's 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 because the majority of its debts and investment assets are variable rate and thus fair value approximates recorded value.

Note 2 — Acquisition of Orchids Paper Products Company

On March 1, 2004, Orchids Acquisition completed the acquisition of all of the outstanding shares of capital stock of Orchids. The adjusted purchase price of \$21,598,000 was paid in cash and assumed debt of \$7,092,000. Orchids Acquisition financed the purchase by sale of its common stock for \$6,050,000 and units consisting of subordinated debentures and warrants to purchase the Company's common stock for \$2,150,000, and debt proceeds. The cost of the acquisition included an advisory fee of \$750,000 paid to the founders of Orchids Acquisition. It was determined through the Company's due diligence procedures that, with the exception of inventory and certain plant equipment, the book value of the assets and liabilities of Orchids approximated fair value. The purchase price was allocated to raw materials and bulk paper rolls on the basis of estimated replacement cost. The purchase price was allocated to finished goods at estimated selling price, less costs of disposal and a reasonable profit allowance for the selling effort. After allocation of the purchase price to all assets and liabilities other than machinery and equipment, the remaining purchase price to be allocated was \$15,811,000. The fair value of machinery and equipment, determined by an independent appraisal in 2002, plus the cost of subsequent additions aggregated \$18,067,000. Because the physical condition of the machinery and equipment had not changed substantially, and economic factors affecting fair value of the Company's machinery and equipment had not changed substantially since 2002, management allocated all of the remaining \$15,811,000 purchase price to machinery and equipment. The Company does not have long-term contracts with customers, and the majority of its products are produced as privately owned brands. Consequently, the Company did not allocate any portion of the purchase price to trademarks or customer relationships. In connection with the common stock purchase, the Company retains its basis of assets and liabilities for income tax purposes. Deferred income taxes were computed on the difference between the carryover tax basis and the adjusted financial basis of assets and liabilities.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

The following table summarizes the allocation of the purchase price to the assets and liabilities at March 1, 2004:

	<u>(\$ thousands)</u>
Assets	
Current assets	\$ 8,886
Property, plant and equipment	<u>21,243</u>
Total assets	30,129
Liabilities	
Current liabilities	2,683
Long-term debt	7,092
Deferred taxes	<u>5,848</u>
Total liabilities	<u>15,623</u>
Net assets acquired	<u><u>\$14,506</u></u>

The following table sets forth the unaudited pro forma results of operations of the Company for the year ended December 31, 2004. The unaudited pro forma financial information summarizes the results of operations as if the Orchids acquisition had occurred at the beginning of 2004. The results prior to the acquisition date are adjusted to include the pro forma impact of: increase in depreciation expense for the step-up in basis and the adjustment of estimated depreciable lives of plant equipment and interest expense on the bank debt and the subordinated debentures used to fund the acquisition. These pro forma amounts do not purport to be indicative of the results that would have actually been obtained if the acquisition occurred as of the beginning of 2004 or that may be obtained in the future.

	<u>2004</u>
Net income (\$ thousands)	\$1,028
Earnings per share:	
Basic	\$ 0.34
Diluted	\$ 0.33

Note 3 — 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 first quarter of 2006. One of these agreements was denominated in Euros. One of the purchase agreements contained a cancellation agreement, which limited the Company's liability to the supplier's out-of-pocket expenditures and committed liabilities. The Company's minimum unpaid obligation under these agreements of \$681,000 was accrued at December 31, 2005, and included in accrued liabilities.

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. At December 31, 2005, the Company had one outstanding foreign exchange contract to exchange U.S. Dollars for Euros totaling \$760,000 for the final payment due on the equipment. The exchange contract was carried at fair value on the balance sheet. 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.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

The net foreign currency gain resulting from the Company's Euro denominated obligations and Euro exchange contracts for the year ended December 31, 2006, of \$39,000 and the net foreign currency loss of \$39,000 for the year ended December 31, 2005 are included in other (income) expense, net.

Note 4 — Inventories

Inventories at December 31 were:

	<u>2006</u>	<u>2005</u>
	(\$ thousands)	
Raw materials	\$1,577	\$1,669
Bulk paper rolls	536	1,396
Converted finished goods	<u>2,266</u>	<u>1,355</u>
	<u>\$4,379</u>	<u>\$4,420</u>

Note 5 — Property, Plant and Equipment

The principal categories and estimated useful lives of property, plant and equipment at December 31 were:

	<u>2006</u>	<u>2005</u>	<u>Estimated Useful Lives</u>
	(\$ thousands)		
Land	\$ 379	\$ 379	—
Buildings	10,394	3,571	40
Machinery and equipment	49,979	20,624	5to30
Vehicles	295	131	5
Nondepreciable machinery and equipment (parts and spares)	1,965	1,751	—
Construction-in-process	<u>69</u>	<u>18,527</u>	—
	<u>\$63,081</u>	<u>\$44,983</u>	

Included in machinery and equipment and buildings above at December 31, 2006, is \$1,403,000 of capitalized interest for the new paper machine. All interest incurred from January 1, 2006, through start up on June 8, 2006, was capitalized because cumulative spending on the project exceeded outstanding debt. Included in construction-in-process above at December 31, 2005, is \$411,000 of capitalized interest for the new paper machine. Interest was capitalized based on the weighted average borrowing rate incurred on the Company's long-term debt of 7.97% applied to cumulative project spending.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

Note 6 — Long-Term Debt

Long-term debt at December 31 consists of:

	2006	2005
	(\$ thousands)	
Revolving line of credit	\$ 5,060	\$ 3,293
Term note, due in monthly installments of \$224,000, including interest	11,779	13,288
Construction loan, converted to term note, due in monthly installments of \$192,000, including interest	14,923	—
Subordinated debentures at face value less unamortized discount of \$74,000 and \$101,000 at December 31, 2006 and 2005, respectively	2,076	2,049
	33,838	18,630
Less current portion	2,263	1,628
	\$31,575	\$17,002

The following is a description of the Company's credit agreement which matures on April 30, 2007. The classification and reported scheduled debt maturities are based on the refinancing described in Note 14, "Subsequent Event".

On June 24, 2005, the Company entered into an amended and restated credit agreement among Bank of Oklahoma, N.A., Bancfirst and Commerce Bank, with Bank of Oklahoma acting as agent. Under this agreement, the Company maintained a \$5.0 million revolving credit line which matures on April 30, 2007, of which there was a \$3.3 million outstanding balance at December 31, 2006. For reporting purposes, as of December 31, 2006, \$1,793,000 of bank overdrafts were included in the Long-term debt section of the balance sheet. The borrowing base is determined by adding qualifying receivables and inventory. At December 31, 2006, the borrowing base for the revolving credit line was \$5.3 million, which was limited by the credit facility to \$5.0 million.

In addition, under this agreement the Company maintains a term loan and construction loan which was converted to a new term loan in October 2006. These loans mature in April 2007. At December 31, 2006, there was \$11.8 million outstanding under the term loan and \$14.9 million outstanding under the former construction loan. Amounts outstanding under the revolving credit agreement and the term loan bear interest (9.61% at December 31, 2006) at the Company's election at the prime rate or LIBOR, plus a margin based on the ratio of funded debt to EBITDA less income taxes paid. The margin ranges from negative 50 basis points to 150 basis points for prime rate loans and ranges from 225 to 425 basis points for LIBOR-based loans. The margin for the former construction loan is set at 375 basis points above the LIBOR rate resulting in an interest rate of 9.11% at December 31, 2006. In addition, the Company is required to reduce the outstanding principal amount of the term loans annually by an amount equal to 40% of excess cash flow, as defined in the agreement. Obligations under the revolving credit facility and the term loans are secured by substantially all of the Company's assets.

The agreement contains restrictive covenants that include requirements to maintain certain financial ratios, restricts capital expenditures and the payment of dividends. In October 2006, the Company amended its credit agreement to change the Funded Debt to EBITDA and Debt Service Coverage Ratio covenant limits for the quarter ended September 30, 2006, to 4.5-to-1 and 1.20-to-1, respectively, and for the Debt Service Coverage Ratio for the quarter ended December 31, 2006, to 1.05-to-1 from the previous limits of 4.0-to-1 and to 1.25-to-1, respectively. The covenant limits revert to the 4.0-to-1 for Funded Debt to EBITDA and 1.25-to-1 for Debt Service Coverage Ratio for all future quarterly measurement periods for the remainder of the credit agreement term. The Company was in compliance with all covenants, as amended, at December 31, 2006. As a condition of funding the construction loan, the agreement required the Company to establish an interest reserve account of at least \$1.5 million.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

As a part of the financing for the Orchids acquisition, Orchids Acquisition sold 2,000,000 shares of common stock and 2,150 Units. Each Unit was comprised of (1) a subordinated debenture in the principal amount of \$1,000, bearing interest payable quarterly at 12% per annum, due March 1, 2009, and (2) a warrant to purchase 57 shares of the Company's common stock at \$2.43 per share, exercisable at the option of the holder for a period of five years. The debentures stipulate that principal payments are subordinated to the prior payment in full of the debt obligations to Bank of Oklahoma, N.A. The debentures and warrants were recorded at their pro rata fair values in relation to the proceeds received. As a result, the warrants were valued at \$141,000. The difference between pro rata fair value and face value of the Subordinated Debentures is being amortized over the life of the debentures utilizing the effective interest rate of 14.6%. The Company recorded \$27,000, \$24,000 and \$15,000 as interest expense related to amortization of the discount during the years ended December 31, 2006 and 2005 and the ten-month period ended December 31, 2004, respectively.

The fair value of the warrants was estimated on the date of issuance using the Black-Scholes option pricing model with the following weighted-average assumptions: risk-free interest rate of 4%; expected dividend yield of 0%; expected lives of 5 years; and estimated volatility of 48%.

Orchids Acquisition sold its common stock for \$2.43 per share, except for shares issued to Founders who paid \$.09 per share. The Company's management was allowed to participate as Founders. The difference between \$2.43 per share and \$.09 per share paid by management, totaling \$103,000, is reported as compensation expense in the ten-month period ended December 31, 2004. The share and per share data have been restated to reflect the 3-for-2 stock split effected in July 2006.

After completion of the bank debt refinancing discussed in Note 14 "Subsequent Event", estimated scheduled maturities are as follows:

<u>Year</u>	<u>Annual Payment Amount</u> (\$ thousands)
2007	\$ 2,263
2008	2,348
2009	4,907
2010	6,338
2011	7,499
after 2011	<u>9,194</u>
	<u>\$32,549</u>

Note 7 — Leases

The Company leased equipment from a third party under an operating lease which expired in 2006. In July 2004, the Company elected to terminate the lease and purchase the leased assets by paying the lessor \$3,994,000, the amount specified in the lease.

Rental expense was \$0 for the years ended December 31, 2006 and 2005, \$384,000 for the ten-month period ended December 31, 2004, and \$193,000 for the two-month period ended February 29, 2004.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

Note 8 — Income Taxes

Significant components of the Company's deferred income tax assets and liabilities at December 31 were:

	<u>2006</u>	<u>2005</u>
	(\$ thousands)	
Deferred income taxes — current Inventories	\$ 311	\$ 118
Prepaid expenses	(125)	(72)
Accounts receivable	38	48
Accrued vacation	122	91
Foreign exchange loss.	—	15
Deferred income tax assets — current	<u>\$ 346</u>	<u>\$ 200</u>
Deferred income taxes — noncurrent Plant and equipment.	\$(8,810)	\$(6,280)
Federal NOL Carryforward	367	—
State NOL Carryforward, net of Federal tax effect.	81	—
State Investment Tax Credit Carryforward, net of Federal tax effect	730	—
Indian Employment Credit Carryforward.	647	—
Alternative Minimum Tax Credit Carryforward	76	—
Deferred income tax liabilities — noncurrent.	<u>\$(6,909)</u>	<u>\$(6,280)</u>

The Company has a federal net operating loss carryforward of \$1,079,000 for regular tax purposes (\$1,515,000 for purposes of the Alternative Minimum Tax). These are available to offset future taxable income through 2026. Because the Company believes that its future income will be sufficient to realize the benefits of these carryforwards, a deferred tax asset has been recognized at the appropriate tax rate.

The Company also has significant carryforwards for State of Oklahoma net operating losses (\$2,035,000) and for the Oklahoma Investment Tax Credit (\$1,105,000), mostly associated with the Company's investment in a new paper machine. The Company believes that its future state taxable income will be sufficient to allow realization within the 20 year carryforward period. Accordingly, deferred tax assets have been recognized, net of the federal tax effects of reduced deductions for state income taxes.

The Company will be required to adjust Indian Employment Credits (IEC) previously recorded in 2004 and 2005, because it will be using net operating loss carrybacks to recover taxes paid in those years. The Company projects profitable operations during the 20 year carryforward period for the IEC and, accordingly, it has recognized a deferred tax asset for the IEC carryforward, which amounted to \$647,000 at December 31, 2006.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

The following table summarizes the differences between the U.S. federal statutory rate and the Company's effective tax rate for financial statement purposes:

	<u>Year Ended December 31, 2006</u>	<u>Year Ended December 31, 2005</u>	<u>Ten Months Ended December 31, 2004</u>	<u>Two Months Ended February 29, 2004</u>
Statutory tax rate	34.0%	34.0%	34.0%	(34.0)%
State income taxes, net of U.S. federal tax benefit	11.9%	1.2%	0.0%	0.9%
Indian employment credits	(87.5)%	(5.7)%	(3.0)%	68.6%
Employee and board stock compensation	52.4%	6.9%	1.9%	0.0%
State investment tax credits	(351.8)%	0.0%	0.0%	0.0%
Other	<u>5.3%</u>	<u>0.1%</u>	<u>0.3%</u>	<u>(3.7)%</u>
	<u>(335.7)%</u>	<u>36.5%</u>	<u>33.2%</u>	<u>31.8%</u>

As a result of an examination by the Internal Revenue Service, the Company adjusted amounts previously claimed for IEC. The adjustment affected the amounts available for carryover for which a deferred tax asset had been provided at December 31, 2003. The adjustment resulted in a decrease in available credits of \$211,000. The related deferred tax asset was adjusted during the two-month period ended February 29, 2004.

Note 9 — Earnings per Share

The computation of basic and diluted net income per share for the years ended December 31, 2006 and 2005, and the ten-month period ended December 31, 2004, is as follows:

	<u>Year Ended December 31, 2006</u>	<u>Year Ended December 31, 2005</u>	<u>Ten Months Ended December 31, 2004</u>
Net income (\$ thousands)	\$ 732	\$ 1,392	\$ 1,294
Weighted average shares outstanding	6,234,346	4,453,254	3,000,000
Effect of Stock Options	166,527	62,441	—
Effect of dilutive warrants	<u>157,581</u>	<u>78,717</u>	<u>78,807</u>
Weighted average shares outstanding — assuming dilution	<u>6,558,454</u>	<u>4,594,412</u>	<u>3,078,807</u>
Earnings per common share: (2005 and 2004 restated to reflect 3-for-2 stock split) Basic	\$ 0.12	\$ 0.31	\$ 0.43
Diluted	\$ 0.11	\$ 0.30	\$ 0.42

Note 10 — 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 vested 20% on the date of grant and then ratably 20% over the following four years and have a ten-year term.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

In December 2006, the board of directors authorized the issuance of options for 3,750 shares of stock pursuant to the Plan to a new member of the board of directors at an exercise price of \$8.37, the current market price on the date of the grant. In June 2006, the board of directors authorized the issuance of options totaling 11,250 shares of stock to certain directors of the Company at an exercise price of \$10.05, which was equal to the current market price of the Company's stock on the date of the grant. In February 2006, the board of directors authorized the issuance of options for 3,750 shares of stock to a new member of the board of directors at an exercise price of \$7.61, the current market price on the date of the grant. In September 2005, the board of directors authorized the issuance of options totaling 11,250 shares of stock to certain directors of the Company at an exercise price of \$6.53, the current market price on the date of the grant. All of the board options have a ten-year term and were fully vested on the date of grant.

In connection with the approval of the Plan, the Company adopted SFAS No. 123[®] "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. For the years ended December 31, 2006 and 2005, the Company recognized an expense of \$260,000 and \$368,000, respectively.

The following table summarizes information concerning the Plan.

	<u>Number</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Fair Value of Options Granted</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Aggregate Intrinsic Value</u>
Balance, December 31, 2004	—	—	—	—	
Granted	416,250	\$5.37	\$2.40	—	
Forfeited	<u>12,000</u>	\$5.33	—	—	
Balance, December 31, 2005	404,250	\$5.37	—	9.25 years	\$ 593,000
Granted	<u>18,750</u>	\$9.23	\$3.93	—	
Balance, December 31, 2006	<u>423,000</u>	\$5.53	—	8.39 years	\$1,269,000
Exercisable at December 31, 2006 . .	189,000	—	—	8.47 years	\$ 535,000
Exercisable at December 31, 2007 . .	267,000	—	—	—	
Exercisable at December 31, 2008 . .	345,000	—	—	—	
Exercisable at December 31, 2009 . .	423,000	—	—	—	

Fair values were estimated at the date of grant of the options using the Black-Scholes option valuation model with the following assumptions: risk-free interest rate of 3.92% for the employee grant, 4.03% for the 2005 board grant. The weighted average interest rate for the 2006 board grants was 4.79%, volatility factor of the expected market price of the Company's common stock of 40% for the employee grant, 42% for the 2005 board grant and a weighted average of 40% for the 2006 board grants, no dividend yield on the Company's common stock, and weighted average expected life of the options of 6 years for the employee grant and 5 years for the 2005 and 2006 board grants. 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, option valuation models require the input of highly subjective assumptions including the expected stock price volatility.

As of December 31, 2006, there was \$430,000 of total unrecognized compensation expense related to nonvested share-based compensation arrangements under the Plan. That cost is expected to be recognized on a straight-line basis over a period of 2.25 years.

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

Note 11 — Major Customers and Concentration of Credit Risk

Credit risk for the Company is concentrated in two major customers, each of whom operates discount retail stores located throughout the United States. During the years ended December 31, 2006 and 2005, the period ended December 31, 2004 and the period ended February 29, 2004, sales to the two significant customers accounted for approximately 61%, 69%, 66% and 63% of the Company's total sales, respectively. At December 31, 2006, and 2005, approximately \$3,210,000 (62%) and \$3,112,000 (75%), respectively, of accounts receivable was due from the two 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.

At one bank, the Company maintains several accounts, which are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$100,000. Deposits at the institution in excess of the FDIC limit totaled \$1,538,000 and \$1,926,000 at December 31, 2006 and 2005, respectively.

Note 12 — Employee Incentive Bonus and Retirement Plans

Effective September 1, 1999, Orchids' board of directors approved an incentive bonus plan which provided for incentive compensation payable to key employees in the event of a sale of the business. The bonus was payable in cash or the Company's common stock, at the Company's option, in an amount not to exceed 9½% of the stockholders' profit on the Company's sale. As a result of the sale of 100% of the Company's common stock in 2004, \$624,000 was accrued as compensation in the two-month period ended February 29, 2004.

The Company sponsors three separate defined contribution plans covering substantially all employees. Company contributions are based on either a percentage of participant contributions or as required by collective bargaining agreements. The participant vesting period varies across the three plans. Contributions to the plans by the Company were \$232,000, \$212,000, \$135,000 and \$50,000 for the years ended December 31, 2006 and 2005, the ten-month period ended December 31, 2004, and the two-month period ended February 29, 2004, respectively.

Note 13 — Related Party Transactions

In March 2004, the Company entered into a management services agreement with the founders of Orchids Acquisition. Under the agreement, these parties agreed to provide advisory and management services to the Company in consideration of an annual management fee of \$325,000 and additional fees, based on a formula if the Company engages in certain major transactions. The agreement expires February 28, 2009. In 2005, the agreement was amended to reduce the annual fee to \$125,000, in consideration of a \$150,000 lump sum payment. During 2006, 2005 and 2004, the Company paid \$125,000, \$375,000 and \$271,000, respectively, under this agreement. Pursuant to a resolution of the Company's Board of Directors, this agreement was terminated effective March 2, 2007.

In February 2007, the Company entered into a management services arrangement with Jay Shuster, a new member of the board of directors. The arrangement calls for a fee of \$70,000 per annum, payable monthly. The term of Mr. Shuster's contract is unspecified.

Note 14 — Subsequent Event

On March 9, 2007, Orchids received a commitment letter from the Bank of Oklahoma, N.A. to re-finance its existing credit facility. Orchids intends to move forward with a re-financing of the credit facility under the following terms and expect to complete the re-financing prior to the April 30, 2007 expiration date of its current credit facility. The proposed credit facility in the commitment letter consists of the following:

- a \$6.0 million revolving credit facility with a 3-year term;
- a \$10.0 million term loan A with a ten-year term and twenty-year amortization;

ORCHIDS PAPER PRODUCTS COMPANY
NOTES TO FINANCIAL STATEMENTS — (Continued)

- a \$16.5 million term loan B with a four year-term and six-year amortization; and
- a \$3.0 million capital expenditures facility with a four-year term and a five-year amortization.

Under the terms of the commitment letter, amounts outstanding under the revolving credit facility will 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 will 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 will 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.

The credit facility will contain covenants that will, among other things, require Orchids to maintain a specific funded debt to EBITDA ratio, debt service coverage ratio and an annual limit on un-financed capital expenditures. The current \$1.5 million restricted certificate of deposit will be released and applied to the revolving credit facility.

Note 15 — Selected Quarterly Financial Data (Unaudited)

	2006			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(Dollars in thousands, except per share data)			
Sales	\$14,099	\$13,675	\$15,154	\$17,262
Gross Profit	\$ 1,563	\$ 1,006	\$ 1,857	\$ 2,559
Operating Income (Loss)	\$ 315	\$ (275)	\$ 733	\$ 1,276
Net Income (Loss)	\$ 182	\$ (293)	\$ (151)	\$ 994
Basic Earnings (Loss) per share	\$ 0.03*	\$ (0.05)	\$ (0.02)	\$ 0.16
Diluted Earnings (Loss) per share	\$ 0.03*	\$ (0.05)	\$ (0.02)	\$ 0.15
Price per common share				
High	\$ 9.31*	\$ 10.53	\$ 11.36	\$ 9.34
Low	\$ 6.70*	\$ 9.00	\$ 8.99	\$ 8.20

	2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(Dollars in thousands, except per share data)			
Sales	\$12,542	\$13,681	\$15,435	\$16,042
Gross Profit	\$ 1,817	\$ 1,981	\$ 2,263	\$ 1,870
Operating Income	\$ 858	\$ 773	\$ 1,029	\$ 642
Net Income	\$ 346	\$ 114	\$ 480	\$ 452
Basic Earnings per share	\$ 0.11*	\$ 0.04*	\$ 0.09*	\$ 0.07*
Diluted Earnings per share	\$ 0.11*	\$ 0.04*	\$ 0.09*	\$ 0.06*
Price per common share				
High	n/a	n/a	\$ 6.97*	\$ 7.03*
Low	n/a	n/a	\$ 5.67*	\$ 6.43*

* Earnings per share and Price per common share have been restated to reflect the 3-for-2 stock split effected in July 2006.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A. CONTROLS AND PROCEDURES

(a) *Disclosure Controls and Procedures:*

Our management, under the supervision of and with the participation of our principal executive officer and principal 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, (the “Exchange Act”)), as of December 31, 2006. Any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on such evaluation, our principal executive officer and principal financial officer have concluded that, as of the end of such period, our disclosure controls and procedures provided reasonable assurance that the disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the report that is filed or submitted under the Exchange Act.

(b) *Internal Control Over Financial Reporting*

Our management, with the participation of our principal executive officer and principal financial officer, also conducted an evaluation of our internal control over financial reporting to determine whether any changes occurred during the quarter ended December 31, 2006, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there has been no such change during such quarter.

Item 9B. OTHER INFORMATION

None.

PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information concerning directors of the registrant is contained in the Company’s Proxy Statement to be issued in connection with its Annual Meeting of Stockholders under the caption “ELECTION OF DIRECTORS,” which information is incorporated herein by reference.

Information concerning executive officers of the registrant is contained in this report under Item 1, “BUSINESS -Executive Officers and Key Employees,” which information is incorporated herein by reference.

The information required by Item 405 of Regulation S-K is contained in the Company’s Proxy Statement to be issued in connection with its Annual Meeting of Stockholders under the caption “Section 16(a) Beneficial Ownership Reporting Compliance.”

Our Board of Directors adopted a Business Conduct Policy for all of our directors, officers and employees effective June 22, 2005. We have posted our Business Conduct Policy on our website (www.orchidpaper.com). In addition, stockholders may request a free copy of our Business Conduct Policy from our Chief Financial Officer as follows:

Orchids Paper Products Company
Attention: Keith R. Schroeder
4826 Hunt Street
Pryor, Oklahoma 74361
(918) 825-0616

To the extent required by law or the rules of the American Stock Exchange, any amendments to, or waivers from, any provision of the Business Conduct Policy will be promptly disclosed publicly. To the extent permitted by such requirements, we intend to make such public disclosure by posting the relevant material on our website in accordance with SEC rules.

Item 11. EXECUTIVE COMPENSATION

Information concerning executive compensation is contained in the Company’s Proxy Statement to be issued in connection with its Annual Meeting of Stockholders under the caption “EXECUTIVE COMPENSATION,” which information is incorporated herein by reference.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information concerning security ownership of certain beneficial owners and management is contained in the Company’s Proxy Statement to be issued in connection with its Annual Meeting of Stockholders under the caption “ELECTION OF DIRECTORS — Information Relating to Directors, Nominees and Executive Officers” and “SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS,” which information is incorporated herein by reference.

Securities Authorized for Issuance Under Equity Compensation Plan

<u>Plan Category</u>	<u>Number of Securities to be Issued Upon Exercise of Outstanding Options Warrants and Rights</u> (a)	<u>Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights</u> (b)	<u>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))</u> (c)
Equity compensation plans approved by security holders	423,000	\$5.54	274,500
Equity compensation plans not approved by security holders	<u>225,000</u>	\$6.40	<u>—</u>
Total	<u>648,000</u>		<u>274,500</u>

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information concerning certain relationships and related transactions required by Item 404 of Regulation S-K is contained in the Company’s Proxy Statement to be issued in connection with its Annual Meeting of Stockholders under the caption “CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS,” which information is incorporated herein by reference.

Information concerning director independence required by Item 407(a) of Regulation S-K is contained in the Company’s Proxy Statement to be issued in connection with its Annual Meeting of Stockholders under the caption “ELECTION OF DIRECTORS,” which information is incorporated herein by reference.

Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information concerning accountant fees and services is contained in the Company’s Proxy Statement to be issued in connection with its Annual Meeting of Stockholders under the caption “FEES PAID TO INDEPENDENT AUDITORS,” which information is incorporated herein by reference.

PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements

The information required by this item is included in Item 8 of Part II of the Form 10-K.

(a)(2) Financial Statement Schedules.

Schedule II — Valuation and Qualifying Accounts is included below. The rest of the schedules required by this item have been omitted as they are not required, not applicable or are included in Item 8 of Part II of this report.

Orchids Paper Products Company

Schedule II — Valuation and Qualifying Accounts
Years ended December 31, 2006 and 2005, the Ten-month Period ended
December 31, 2004, and the Two-month Period ended February 29, 2004

	<u>Balance at Beginning of Period</u>	<u>Additions Charged (Credited) to Costs and Expenses</u>	<u>Deductions Describe (1)(2)</u>	<u>Balance at End of Period</u>
	(In thousands)			
Accounts Receivable Reserve:				
Year ended December 31, 2006				
Bad Debt Reserve	\$125	\$(19)	\$ 6	\$100
Year ended December 31, 2005				
Bad Debt Reserve	\$ 90	\$ 46	\$11	\$125
Ten-month period ended December 31, 2004				
Bad Debt Reserve	\$105	\$ 23	\$38	\$ 90
Two-month period ended February 29, 2004				
Bad Debt Reserve	\$100	\$ 5	\$—	\$105
Inventory Valuation Reserve:				
Year ended December 31, 2006				
Inventory Valuation Reserve	\$ 24	\$ 45	\$44	\$ 25
Year ended December 31, 2005				
Inventory Valuation Reserve	\$ 39	\$ —	\$15	\$ 24
Ten-month period ended December 31, 2004				
Inventory Valuation Reserve	\$ 27	\$ 12	\$—	\$ 39
Two-month period ended February 29, 2004				
Inventory Valuation Reserve	\$ 27	\$ —	\$—	\$ 27

- (1) Write-off of uncollectible accounts, net of recoveries
(2) Write-off of obsolete inventory and physical inventory adjustments
 (a)(3) Exhibits

The exhibits listed below in the Exhibit Index are filed or incorporated by reference as part of this report.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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

By: /s/ Michael P. Sage

Michael P. Sage
Chief Executive Officer

By: /s/ Keith R. Schroeder

Keith R. Schroeder
Chief Financial Officer

Date: March 19, 2007

POWER OF ATTORNEY

Each person whose signature appears below hereby constitutes and appoints Michael P. Sage and Keith R. Schroeder, and each of them, his or her true and lawful attorneys-in-fact and agents, with full power of substitution, to sign any amendments to this Annual Report on Form 10-K and to file such amendments and any related documents with the Securities and Exchange Commission, and ratifies and confirms the actions that any such attorney-in-fact and agents, or their substitutes, may lawfully do or cause to be done under this power of attorney.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signatures</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Douglas E. Hailey</u> Douglas E. Hailey	Chairman of the Board of Directors	March 19, 2007
<u>/s/ Michael P. Sage</u> Michael P. Sage	Chief Executive Officer and Director (Principal Executive Officer)	March 19, 2007
<u>/s/ Gary P. Arnold</u> Gary P. Arnold	Director	March 19, 2007
<u>/s/ Steven Berlin</u> Steven Berlin	Director	March 19, 2007
<u>/s/ John G. Guttilla</u> John G. Guttilla	Director	March 19, 2007
<u>/s/ Jeff Schoen</u> Jeff Schoen	Director	March 19, 2007
<u>/s/ Jay Shuster</u> Jay Shuster	Director	March 19, 2007
<u>/s/ Keith R. Schroeder</u> Keith R. Schroeder	Chief Financial Officer (Principal Financial and Accounting Officer)	March 19, 2007

Exhibit Index

(c) *EXHIBITS*

- 3.1 Amended and Restated Certificate of Incorporation of the Registrant, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated April 19, 2005, exhibit 3.1.
- 3.2 Amended and Restated Bylaws of the Registrant, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated April 19, 2005, exhibit 3.2.
- 4.1 Specimen Stock Certificate, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated June 24, 2005, exhibit 4.1.
- 4.2 Form of Subordinated Debenture, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated April 19, 2005, exhibit 4.8.
- 10.1 Amended and Restated Management Services Agreement, dated April 19, 2005, between Weatherly Group, LLC, Taglich Brothers, Inc. and the Registrant, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated April 19, 2005, exhibit 10.1.
- 10.2# 2005 Stock Incentive Plan, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated April 19, 2005, exhibit 10.2.
- 10.3# Employment Agreement dated March 1, 2004, between Michael P. Sage and the Registrant, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated April 19, 2005, exhibit 10.3.
- 10.4# Employment Agreement dated March 1, 2004, between Keith R. Schroeder and the Registrant, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated April 19, 2005, exhibit 10.4.
- 10.5# Form of Indemnification Agreement between Registrant and each of its Directors and Officers, incorporated by reference to Orchids Paper Products Company Form S-1/A (File No. 333-124173) dated June 1, 2005, exhibit 10.5.
- 10.6 Form of Warrant issued by Orchids Acquisition Group, Inc. in connection with the acquisition of Orchards Paper Products Company, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated April 19, 2005, exhibit 10.6.
- 10.7 Form of Warrant issuable to designees of the Underwriter, incorporated by reference to Orchids Paper Products Company Form S-1/A (File No. 333-124173) dated June 1, 2005, exhibit 10.7.
- 10.8 Purchasing documents for tissue machine, incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated April 19, 2005, exhibit 10.8.
- 10.9 Amended and Restated Agented Credit Agreement, dated as of June 24, 2005, among the Registrant, Bank of Oklahoma, N.A., BancFirst and Commerce Bank, N.A., incorporated by reference to Orchids Paper Products Company Form S-1 (File No. 333-124173) dated June 24, 2005, exhibit 4.9.
- 10.10 Amendment One to Amended and Restated Agented Credit Agreement dated June 30, 2006, among the Registrant, Bank of Oklahoma, N.A., BancFirst and Commerce Bank, N.A., incorporated by reference to Orchids Paper Products Company Form 10-Q (File No. 001-32563) dated August 4, 2006, exhibit 4.1.
- 10.11 Amendment Two to Amended and Restated Agented Credit Agreement dated June 30, 2006, among the Registrant, Bank of Oklahoma, N.A., BancFirst and Commerce Bank, N.A., incorporated by reference to Orchids Paper Products Company Form 10-Q (File No. 001-32563) dated November 3, 2006, exhibit 4.1.
- 21 Subsidiaries of the Company.
- 23.1 Consent of Independent Registered Public Accounting Firm — Tullius Taylor Sartain & Sartain LLP.
- 31.1 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
- 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Indicates management contract or compensatory plan

**Directors Standing for Election to the
Orchids Paper Products Company
Board of Directors**

Douglas E. Hailey

Managing Director, Investment Banking Division
Taglich Brothers, Inc.

Gary P. Arnold

Retired, formerly Chairman and
Chief Executive Officer of Analogy, Inc.

Steven R. Berlin

Retired, formerly Vice-President and
Chief Financial Officer of
Kaiser-Francis Oil Company

John C. Guttilla

Partner, Rotenberg Meril
Solomon Bertiger & Guttilla, P.C.

Jeffrey S. Schoen

Retired, formerly Executive Vice President of
Cumberland Swan

Jay Shuster

Founder, Shuster Group LLC

Corporate Management

Michael P. Sage

President and Chief Executive Officer

Keith R. Schroeder

Chief Financial Officer

Stockholder Reference Information

Stock transfer and registrar

American Stock Transfer & Trust Company
59 Maiden Lane – Plaza Level
New York, NY 10038
800-937-5449
www.amstock.com

Investor Relations inquiries should be directed to

Orchids Paper Products Company
Attn: Keith R. Schroeder
4826 Hunt Street
Pryor, OK 74361
E-mail: krschroeder@orchidspaper.com
918-825-0616
www.orchidspaper.com

Common Stock

Orchids Paper Products Company's common stock
is listed on the American Stock Exchange
under the symbol "TIS".

Annual Meeting of Stockholders

The annual meeting will be held on June 19, 2007.
A notice of the meeting, together with a form of Proxy
and a Proxy Statement, will be mailed to stockholders on
or about May 7, 2007, at which time proxies will be
solicited by the Board of Directors.

Availability of Proxy Statement and Form 10-K

The Proxy Statement and the Form 10-K are
available on the Internet at www.orchidspaper.com.
A copy of the Proxy Statement and/or Form 10-K may
be obtained without charge by contacting the Investor
Relations contact listed above.

Independent Registered Public Accounting Firm

Tullius Taylor Sartain & Sartain LLP
2424 East 21st Street, Suite 200
Tulsa, OK 74114-1736

Non-Incorporation of Form 10-K Wrap

Orchids Paper Products Company's 2006 Form 10-K,
as filed with the SEC, is included within this Annual
Report. Other than the Form 10-K, all other portions of
this Annual Report are not "filed" with the SEC and
should not be deemed so.

Certifications

The most recent certifications by our Chief Executive Officer
and Chief Financial Officer pursuant to Sections 302 and 906
of the Sarbanes-Oxley Act of 2002 are filed as exhibits to our
Form 10-K.



Orchids Paper Products Company

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Pryor, OK 74361

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