Orchids Paper Products CO /DE
Form 10-Q
November 04, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2014**

**OR**

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

**Commission File Number 001-32563**

**Orchids Paper Products Company**

(Exact name of Registrant as Specified in its Charter)

| | |
|---|---|
| **Delaware** | **23-2956944** |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

**4826 Hunt Street**

**Pryor, Oklahoma 74361**

(Address of Principal Executive Offices and Zip Code)

**(918) 825-0616**

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months. Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

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

Number of shares outstanding of the issuer's Common Stock, par value $.001 per share, as of October 31, 2014: 8,757,975 shares.

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

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**QUARTERLY REPORT ON FORM 10-Q**

**FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2014**

**PART I. FINANCIAL INFORMATION**

**ITEM 1. Financial Statements**

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**(Dollars in thousands, except share data)**

| | September 30, 2014 (Unaudited) | December 31, 2013 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash | $ 3,491 | $ 7,205 |
| Accounts receivable, net of allowance of $136 in 2014 and $135 in 2013 | 11,312 | 6,585 |
| Inventories, net | 10,144 | 10,921 |
| Short-term investments | - | 5,035 |
| Prepaid expenses | 1,163 | 863 |
| Other current assets | 2,725 | 146 |
| Deferred income taxes | 544 | 552 |
| Total current assets | 29,379 | 31,307 |
| | | |
| Property, plant and equipment | 158,172 | 137,750 |
| Accumulated depreciation | (48,750 ) | (42,005 ) |
| Net property, plant and equipment | 109,422 | 95,745 |
| | | |
| Intangible assets, net of accumulated amortization of $430 in 2014 | 17,560 | - |
| Goodwill | 7,560 | - |
| Deferred debt issuance costs, net of accumulated amortization of $7 in 2014 and $18 in 2013 | 199 | 40 |
| Total assets | $ 164,120 | $ 127,092 |
| | | |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 10,598 | $ 3,685 |
| Accrued liabilities | 5,393 | 4,030 |
| Current portion of long-term debt | 2,700 | 1,152 |

| | | |
|---|---|---|
| Total current liabilities | 18,691 | 8,867 |
| | | |
| Long-term debt, less current portion | 26,625 | 13,927 |
| Deferred income taxes | 17,943 | 19,449 |
| Stockholders' equity: | | |
| Common stock, $.001 par value, 25,000,000 shares authorized, 8,757,975 and 8,066,809 shares issued and outstanding in 2014 and 2013, respectively | 9 | 8 |
| Additional paid-in capital | 64,006 | 46,298 |
| Retained earnings | 36,846 | 38,543 |
| Total stockholders' equity | 100,861 | 84,849 |
| Total liabilities and stockholders' equity | $ 164,120 | $ 127,092 |

See notes to unaudited consolidated interim financial statements.

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**(Dollars in thousands, except share and per share data)**

| | **Three Months Ended September 30,** | | **Nine Months Ended September 30,** | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| | (unaudited) | (unaudited) | (unaudited) | (unaudited) |
| Net sales | $44,429 | $29,760 | $101,384 | $85,601 |
| Cost of sales | 35,645 | 22,620 | 81,092 | 64,938 |
| Gross profit | 8,784 | 7,140 | 20,292 | 20,663 |
| Selling, general and administrative expenses | 2,541 | 2,122 | 9,127 | 6,912 |
| Intangibles amortization | 322 | - | 430 | - |
| Operating income | 5,921 | 5,018 | 10,735 | 13,751 |
| Interest expense | 90 | 92 | 215 | 280 |
| Other (income) expense, net | 147 | (9) | 141 | (21) |
| Income before income taxes | 5,684 | 4,935 | 10,379 | 13,492 |
| Provision for income taxes: | | | | |
| Current | 3,041 | 1,110 | 4,858 | 3,259 |
| Deferred | (1,187) | 102 | (1,498) | 274 |
| | 1,854 | 1,212 | 3,360 | 3,533 |
| Net income | $3,830 | $3,723 | $7,019 | $9,959 |
| Net income per common share: | | | | |
| Basic | $0.44 | $0.47 | $0.84 | $1.27 |
| Diluted | $0.44 | $0.47 | $0.83 | $1.25 |
| Shares used in calculating net income per common share: | | | | |
| Basic | 8,753,308 | 7,964,254 | 8,363,913 | 7,813,762 |
| Diluted | 8,823,937 | 8,073,771 | 8,442,057 | 7,908,772 |
| Dividends per share | $0.35 | $0.35 | $1.05 | $1.00 |

See notes to unaudited consolidated interim financial statements.

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**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Dollars in thousands)**

| **Cash Flows From Operating Activities** | **Nine Months Ended September 30, 2014 (unaudited)** | **Nine Months Ended September 30, 2013 (unaudited)** |
|---|---|---|
| Net income | $ 7,019 | $ 9,959 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 7,286 | 5,696 |
| Provision for doubtful accounts | 1 | (5 ) |
| Deferred income taxes | (1,498 ) | 274 |
| Stock compensation expense | 1,609 | 380 |
| Loss on disposal of property, plant and equipment | 8 | - |
| Changes in cash due to changes in operating assets and liabilities: | | |
| Accounts receivable | (4,727 ) | (2,490 ) |
| Inventories | 777 | (1,527 ) |
| Income taxes receivable | - | (456 ) |
| Prepaid expenses | (300 ) | (492 ) |
| Other current assets | (2,579 ) | 44 |
| Accounts payable | 6,913 | (373 ) |
| Accrued liabilities | 1,362 | 708 |
| Net cash provided by operating activities | 15,871 | 11,718 |
| | | |
| **Cash Flows From Investing Activities** | | |
| Acquisition of Fabrica assets and U.S. business | (16,700 ) | - |
| Purchases of property, plant and equipment | (13,346 ) | (7,564 ) |
| Purchases of short-term investments | (2 ) | (6 ) |
| Proceeds from the sale of investment securities | 5,037 | - |
| Net cash used in investing activities | (25,011 ) | (7,570 ) |
| | | |
| **Cash Flows From Financing Activities** | | |
| Borrowings under long-term debt | 30,000 | - |
| Principal payments on long-term debt | (15,754 ) | (864 ) |

| | | |
|---|---|---|
| Dividends paid to stockholders | (8,716 ) | (7,893 ) |
| Proceeds from the exercise of stock options | 79 | 2,942 |
| Excess tax benefit of stock options exercised | 20 | 963 |
| Deferred debt issuance costs | (203 ) | - |
| Net cash provided by (used in) financing activities | 5,426 | (4,852 ) |
| | | |
| Net decrease in cash | $ (3,714 ) | $ (704 ) |
| Cash, beginning | 7,205 | 5,734 |
| Cash, ending | $ 3,491 | $ 5,030 |
| **Supplemental Disclosure:** | | |
| Interest paid | $ 350 | $ 279 |
| Income taxes paid | $ 3,671 | $ 2,753 |
| Tax benefits realized from stock options exercised | $ 16 | $ 329 |
| Stock issued for Fabrica assets and U.S. business | $ 16,000 | $ - |

See notes to unaudited consolidated interim financial statements.

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**Note 1 — Basis of Presentation**

Orchids Paper Products Company ("Orchids" or the "Company") was formed in 1998 to acquire and operate the paper manufacturing facility, built in 1976, in Pryor, Oklahoma. Orchids Acquisition Group, Inc. ("Orchids Acquisition") was established in November 2003, for the purpose of acquiring the common stock of Orchids. The sale of equity and debt securities closed in March 2004 and Orchids Acquisition acquired Orchids for a price of $21.6 million. Orchids Acquisition was subsequently merged into Orchids. In July 2005, the Company completed its initial public offering of its common stock. The Company's common stock trades on the NYSE MKT under the ticker symbol "TIS."

On June 3, 2014, the Company completed the acquisition of certain assets from Fabrica de Papel San Francisco, S.A. de C.V. ("Fabrica") pursuant to an Asset Purchase Agreement (see Note 2 and Note 6). In connection with the acquisition of these assets, the Company formed three wholly-owned subsidiaries: Orchids Mexico DE Holdings, LLC, Orchids Mexico DE Member, LLC, and OPP Acquisition Mexico, S. de R.L. de C.V ("Orchids Mexico"). The accompanying consolidated financial statements include the accounts of Orchids and these wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

The accompanying financial statements have been prepared without an audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted ("GAAP") in the United States have been condensed or omitted pursuant to the rules and regulations. However, the Company believes that the disclosures made are adequate to make the information presented not misleading when read in conjunction with the audited financial statements and the notes in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013, filed with the SEC on March 6, 2014. Management believes that the financial statements contain all adjustments necessary for a fair presentation of the results for the interim periods presented. All adjustments were of a normal, recurring nature. The results of operations for the interim period are not necessarily indicative of the results for the entire fiscal year.

**Note 2 — Acquisition of Fabrica Assets and U.S. Business**

On May 5, 2014, Orchids and its wholly owned subsidiary, Orchids Mexico, entered into an asset purchase agreement ("APA") with Fabrica to acquire certain assets and 100% of the U.S. business of Fabrica. One June 3, 2014, the Company closed on the transaction set forth in the APA, and in connection therewith, entered into a supply agreement ("Supply Agreement") and a lease agreement ("Equipment Lease Agreement"). Orchids expects these transactions to allow the Company to effectively and efficiently service customers in the western U. S.

*Asset Purchase Agreement and Assignment and Assumption of Supply Agreement*

Pursuant to the terms of the APA, Orchids Mexico acquired a paper machine, two converting lines, Fabrica's U.S. customer list, exclusive rights to all of Fabrica's trademarks in the United States, and Fabrica's covenant not to compete in the United States for a purchase price of 411,650 shares of Orchids' common stock valued at $12.0 million based on the closing price of the Company's shares on the closing date, with a fair market value of $9.6 million on the closing date due to restrictions on the sale of the stock. In connection with closing the Purchase Agreement, Orchids also entered into an Assignment and Assumption of Supply Agreement with Elgin Finance & Investment Corp. ("Elgin") for $16.7 million in cash and 274,433 shares of Orchids' common stock valued at $8.0 million based on the closing price of the Company's shares on the closing date, with a fair market value of $6.4 million on the closing date due to restrictions on the sale of the stock, in exchange for the assignment to Orchids of Elgin's supply agreement with Fabrica which provided Elgin with exclusive supply rights with respect to Fabrica's U.S. business.

Under the Supply Agreement, the Company has the right to purchase from Fabrica up to 18,000 metric tons of parent rolls and equivalent converting capacity for certain specified product during each twelve month period following the effective date of the Supply Agreement. The Company may purchase up to an additional 7,000 metric tons annually in each of the first two years of the agreement. Pursuant to the terms of the Supply Agreement, Fabrica and its affiliates will be subject to a non-compete provision with respect to business in the U. S. The Supply Agreement has an initial term of twenty years. In the event of a termination of the Supply Agreement due to (i) a material breach as a result of intentional, willful or grossly negligent conduct by Fabrica, (ii) a breach of Fabrica's covenant not to compete, or (iii) a voluntary filing of bankruptcy by Fabrica, Fabrica must pay the Company $100 million in liquidated damages. In the event of a change of control of Fabrica, the Company will have a two year right to terminate the Supply Agreement, and in such event, Fabrica would be required to pay the Company liquidated damages of $36.7 million.

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (continued)**

*Lease Agreement*

Pursuant to the terms of the Equipment Lease Agreement, Orchids Mexico will lease the paper making and converting assets acquired under the APA back to Fabrica. The rental fee will be based upon the number of metric tons shipped by Fabrica to the Company, subject to annual adjustment based on the calculation of the annual purchase price in the Supply Agreement. The Equipment Lease Agreement has a term of twenty years, but will terminate automatically upon termination of the Supply Agreement.

Upon the earlier of (i) the termination of the Equipment Lease Agreement or (ii) the purchase by Orchids of a separate paper making or converting asset and the entry into of an equipment lease agreement between Orchids and Fabrica with respect to such purchased asset, Orchids Mexico shall have the right to sell to Fabrica the paper assets leased under the Equipment Lease Agreement on an as-is-where-is basis, for $12.0 million.

Income earned under the lease agreement is recognized as an offset to cost of goods sold under the supply agreement in accordance with U.S. GAAP for collaborative arrangements.  Income earned under the lease agreement was $779,000 and $977,000 in the three and nine-month periods ended September 30, 2014, respectively.

*Purchase Price Allocation*

The acquisition of Fabrica's U.S. business is being accounted for under the Financial Accounting Standards Board's (the "FASB") Accounting Standards Codification 805, "Business Combinations".  The $32.7 million purchase price of $16.7 million in cash (financed by a term loan) and $16.0 million in common stock was allocated as follows (in thousands):

| | |
|---|---|
| Total purchase price | $32,700 |
| Less: net assets acquired | |
| Machinery & Equipment | 7,150 |
| Intangible Asset - Supply and Lease Agreement | 12,800 |

| | |
|---|---|
| Intangible Asset - Licenses/Trademarks | 1,350 |
| Intangible Asset - Non-Compete Agreement | 1,150 |
| Intangible Asset - Customer Relationships | 2,690 |
| Goodwill | $7,560 |

The purchase price allocation is subject to further refinement as management completes its assessment of the valuation of certain assets.

*Intangibles and Goodwill*

Intangible assets acquired totaled $18.0 million. The Company amortizes these assets on a straight-line basis over the expected lives of the assets: Supply and Lease Agreement — 20 years; Licenses/Trademarks — 20 years; Non-Compete Agreement — 2 years; Customer Relationships — 12 years, resulting in a weighted-average amortization period of 12 years. Intangible assets at September 30, 2014 were:

| | Life (in years) | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
|---|---|---|---|---|
| | | | (in thousands) | |
| Intangible Asset - Supply and Lease Agreement | 20 | $ 12,800 | $183 | $ 12,617 |
| Intangible Asset - Licenses/Trademarks | 20 | 1,350 | 19 | $ 1,331 |
| Intangible Asset - Non-Compete Agreement | 2 | 1,150 | 164 | $ 986 |
| Intangible Asset - Customer Relationships | 12 | 2,690 | 64 | $ 2,626 |
| | | $ 17,990 | $430 | $ 17,560 |

Goodwill of $7.6 million represents the premium the Company was willing to pay to enter into a long-term relationship with Fabrica and the benefits the Company expects to receive from being able to cost effectively serve its current customers with distribution centers in the western United States. The relationship with Fabrica is expected to provide opportunities for future production capacity and sales growth. Goodwill is not amortized, but is tested at least annually for impairment, or if circumstances occur that more likely than not will reduce the fair value of the reporting unit to below its carrying amount. No goodwill impairment has been recorded as of September 30, 2014. All of the goodwill related to the Fabrica acquisition is expected to be tax-deductible.

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**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (continued)**

*Operating Results of Business Acquired*

The consolidated statements of income include the following revenues and earnings related to the U.S. business acquired from Fabrica:

| | **Three Months Ended September 30,** | | **Nine Months Ended September 30,** | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| | **(in thousands)** | | **(in thousands)** | |
| Revenues | $11,452 | $ - | $14,345 | $ - |
| Earnings | $2,369 | $ - | $2,945 | $ - |

Transaction costs of $84,000 and $1.6 million are recognized in selling, general and administrative expenses in the consolidated statements of income for the three and nine-month periods ended September 30, 2014.

*Pro Forma Information*

The following pro forma information presents a summary of the operating results of the Company for the three and nine months ended September 30, 2014 as if the U.S. business acquired from Fabrica had been included in our results of operations as of January 1, 2013:

| | **Three Months Ended September 30,** | | **Nine Months Ended September 30,** | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| | **(in thousands)** | | **(in thousands)** | |

| | | | | |
|---|---|---|---|---|
| Pro forma net sales | $44,429 | $36,437 | $115,546 | $104,252 |
| Pro forma net income | $3,914 | $3,789 | $9,081 | $8,890 |
| Pro forma net income per share - basic | $0.45 | $0.44 | $1.04 | $1.05 |
| Pro forma net income per share - diluted | $0.44 | $0.43 | $1.03 | $1.03 |

Pro forma adjustments to net income include amortization costs related to the intangibles acquired, acquisition related costs, and the tax effect of the historical results of operations of Fabrica's U.S. business, excluding certain mark-up and selling, general and administrative costs that will not be incurred by Orchids.

The pro forma amounts are presented for informational purposes only and are not intended to represent or be indicative of the Company's consolidated results of operations or financial condition that would have been reported had the acquisition been completed as of the beginning of the periods presented and should not be taken as indicative of the Company's future consolidated results of operations or financial condition.

**Note 3 — Fair Value Measurements**

The Company does not report any assets or liabilities at fair value in the financial statements. However, the estimated fair value of the Company's short-term investments, which consist of commercial deposits in money market funds, was $0 and $5,035,000 at September 30, 2014 and December 31, 2013, respectively. These short-term investments are considered Level 1 measurements in the fair value valuation hierarchy. The fair value of the Company's long-term debt is estimated by management to approximate the carrying value of $29,325,000 and $15,079,000 at September 30, 2014 and December 31, 2013, respectively. Management's estimates are based on periodic comparisons of the characteristics of the Company's obligations, including floating interest rates, credit rating, maturity and collateral, to current market conditions as stated by an independent third-party financial institution. Such valuation inputs are considered a Level 2 measurement in the fair value valuation hierarchy.

There were no transfers among Level 1, Level 2 or Level 3 assets or liabilities during the first nine months in 2014 or 2013.

**Note 4 — Commitments and Contingencies**

The Company may be involved from time to time in litigation arising from the normal course of business. In management's opinion, as of the date of this report, the Company is not engaged in legal proceedings which individually or in the aggregate are expected to have a materially adverse effect on the Company's results of operations or financial condition.

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (continued)**

In October 2008, the Company entered into a contract to purchase 334,000 MMBTU per year of natural gas. This contract has been extended through December 2016 and provides for approximately 60% to 70% of the Company's natural gas requirements through December 31, 2016. In September 2014, the Company entered into a similar contract with a different vendor for natural gas requirements in 2017. Commitments under these contracts are as follows:

| **Period** | **MMBTUs** | **Price per MMBTU** | **Management fee per MMBTU** |
|---|---|---|---|
| April 2012 - March 2013 | 334,207 | $ 5.50 | $ 0.07 |
| April 2013 - December 2014 | 556,886 | $ 4.905 | $ 0.07 |
| April 2013 - September 2013 | additional 5,000/month | $ 4.70 | $ 0.07 |
| October 2013 - March 2014 | additional 5,000/month | $ 4.75 | $ 0.07 |
| April 2014 - December 2014 | additional 5,000/month | $ 4.70 | $ 0.07 |
| January 2015 - March 2015 | 95,900 | $ 4.50 | $ 0.07 |
| April 2015 - June 2015 | 93,600 | $ 4.30 | $ 0.07 |
| July 2015 - September 2015 | 92,300 | $ 4.35 | $ 0.07 |
| October 2015 - December 2015 | 91,900 | $ 4.50 | $ 0.07 |
| January 2016 - March 2016 | 95,900 | $ 4.53 | $ 0.07 |
| April 2016 - June 2016 | 93,600 | $ 4.17 | $ 0.07 |
| July 2016 - September 2016 | 92,300 | $ 4.26 | $ 0.07 |
| October 2016 - December 2016 | 91,900 | $ 4.42 | $ 0.07 |
| January 2017 - December 2017 | 467,505 | $ 4.06 | $ - |

Purchases under the gas contract were $0.5 million for each of the three months ended September 30, 2014 and 2013, and $1.4 million for each of the nine-month periods ended September 30, 2014 and 2013. If the Company is unable to purchase the contracted amounts and the market price at that time is less than the contracted price, the Company would be obligated under the terms of the agreements to reimburse an amount equal to the difference between the contracted amount and the amount actually purchased, multiplied by the difference between the contract price and a price designated in the contract (approximates spot price).

In November 2013, we announced two projects to upgrade our paper making and converting assets at our Pryor, Oklahoma facility: a project to replace two existing paper machines with a new paper machine in our paper mill, and a project to upgrade an existing converting line. These projects have a total estimated cost of $30.4 million. As part of these projects, we have entered into purchase orders to: (i) purchase a paper machine, (ii) purchase a converting rewinder and (iii) purchase construction and installation services for the new paper machine. As of September 30, 2014, our remaining obligations under these purchase orders total $11.6 million. The purchase order to purchase a paper machine is denominated in Euros. The amounts included herein were translated to US dollars using the spot exchange rate as of September 30, 2014.

**Note 5 — Inventories**

Inventories at September 30, 2014 and December 31, 2013 were as follows:

| | **September 30, 2014** | **December 31, 2013** |
|---|---|---|
| | (in thousands) | |
| Raw materials | $4,139 | $ 3,587 |
| Bulk paper rolls | 2,527 | 2,125 |
| Converted finished goods | 3,611 | 5,314 |
| Inventory valuation reserve | (133 ) | (105 ) |
| | $10,144 | $ 10,921 |

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (continued)**

**Note 6 — Long-Term Debt and Revolving Line of Credit**

In June 2014, the Company entered into a Credit Agreement (the "Credit Agreement") with U.S. Bank National Association ("U.S. Bank") consisting of the following:

a $45 million revolving credit line due June 2019:

$25 million permitted for domestic working capital purposes; and
$20 million permitted for the purchase and construction of a paper machine and upgrade of one of the converting lines at the Company's Pryor, Oklahoma facility.

a $30 million term loan with a 6-year term due June 2020 and amortized as follows:

Real estate debt amortized as if it had a 22-year life;
Equipment debt amortized as if it had a 7-year life; and
Debt incurred in connection with the acquisition of a supply agreement with Fabrica (see Note 2) amortized as if it had a 10-year life.

The Credit Agreement had the effect of (i) extending and increasing the Company's revolving working capital line of credit from $15 million to $25 million, (ii) increasing the Company's revolving line of credit to include $20 million for the purchase and construction of assets in Oklahoma, and (iii) refinancing and extending the Company's $10.8 million Real Estate loan ($9.5 million outstanding) and $7.2 million Machinery and Equipment loan ($5.1 million outstanding) into a single $30 million term loan, used to provide funding for the $16.7 million paid to close the strategic alliance with Fabrica described in Note 2.

Under the terms of the Credit Agreement, amounts outstanding will bear interest at a variable rate of LIBOR plus a specified margin, depending upon the Company's quarterly Leverage Ratio, as defined in the Credit Agreement. Additionally, the Company will pay a commitment fee for the available portion of its revolving credit line at the applicable rate, as follows:

| Leverage Ratio | Interest Margin | Commitment Fee |
|---|---|---|
| Less than 1.00 | 1.00 % | 0.15 % |
| Greater than or equal to 1.00 but less than 2.00 | 1.25 % | 0.20 % |
| Greater than or equal to 2.00 but less than 3.00 | 1.50 % | 0.25 % |
| Greater than or equal to 3.00 | 2.00 % | 0.30 % |

The Company’s leverage ratio at September 30, 2014 was approximately 0.94.

Long-term debt at September 30, 2014 and December 31, 2013 consists of:

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | (in thousands) | |
| Revolving line of credit, maturing on June 3, 2019 | $- | $ - |
| Term Loan 1, maturing on April 24, 2021, due in monthly installments of $36,000, excluding interest paid separately | - | 9,684 |
| Term Loan 2, maturing on July 1, 2018, due in monthly installments of $60,000, excluding interest paid separately | - | 5,395 |
| Term Loan, maturing on June 3, 2020, due in quarterly installments of $675,000 for the first two years and $1,000,000 thereafter, excluding interest paid separately | 29,325 | - |
| | $29,325 | $ 15,079 |
| Less current portion | 2,700 | 1,152 |
| | $26,625 | $ 13,927 |

The amount available under the revolving credit line may be reduced in the event that the Company’s borrowing base, which is based upon qualified receivables and qualified inventory, is less than $25 million.

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (continued)**

Obligations under the Credit Agreement are secured by substantially all of the Company's assets. The Credit Agreement contains representations and warranties, and affirmative and negative covenants customary for financings of this type, including, but not limited to, limitations on additional borrowings, additional investments and asset sales. The financial covenants, which are tested as of the end of each fiscal quarter, require the Company to maintain the following specific ratios: fixed charge coverage (minimum of 1.20 to 1.0) and leverage (maximum of 3.50 to 1.0).

**Note 7 — Income Taxes**

The Company is subject to income tax in the United States and Mexico. Our earnings in Mexico will be subject to the country's 30% income tax rate. Tax liabilities in Mexico are currently immaterial. The Company does not currently provide for U.S. federal income taxes on the undistributed earnings of its foreign subsidiaries as such earnings are expected to be reinvested indefinitely rather than repatriated back to the United States. The amount of undistributed earnings of the Company's foreign subsidiary is currently immaterial.

As of September 30, 2014, our annual estimated effective income tax rate is 32.4%. This compares to an estimated effective tax rate of 32.0% as of June 30, 2014, resulting in an effective tax rate for the quarter ended September 30, 2014 of 32.6%. The annual estimated effective tax rate for 2014 differs from the statutory rate due primarily to U.S. manufacturing tax credits. For the quarter and nine-month period ended September 30, 2013, our actual effective income tax rate was 24.6% and 26.2%, respectively. The annual estimated effective tax rate for 2013 is lower than the statutory rate due primarily to U.S. manufacturing tax credits and Indian employment tax credits ("IECs"). Recognition of the IEC for 2012 was deferred until the first quarter of 2013 as the American Taxpayer Relief Act of 2012, which extended the IEC, was not signed into law by the President of the United States until 2013.

**Note 8 — Earnings per Share**

During the first quarter of 2013, the Company granted restricted stock to certain employees. These awards include a nonforfeitable right to receive dividends and therefore are considered to participate in undistributed earnings with common shareholders. Therefore, the Company calculates basic and diluted earnings per common share using the two-class method, under which net earnings are allocated to each class of common stock and participating security. The computation of basic and diluted net income per common share for the three-month and nine-month periods ended September 30, 2014 and 2013 is as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Net income - ($ thousands) | $3,830 | $3,723 | $7,019 | $9,959 |
| Less: distributed earnings allocable to participating securities | (2) | (6) | (6) | (16) |
| Less: undistributed earnings allocable to participating securities | - | (2) | 1 | (4) |
| Distributed and undistributed earnings allocable to common shareholders | $3,828 | $3,715 | $7,014 | $9,939 |
| | | | | |
| Weighted average shares outstanding | 8,753,308 | 7,964,254 | 8,363,913 | 7,813,762 |
| Effect of stock options | 70,629 | 109,517 | 78,144 | 95,010 |
| Weighted average shares outstanding - assuming dilution | 8,823,937 | 8,073,771 | 8,442,057 | 7,908,772 |
| Net income per common share: | | | | |
| Basic | $0.44 | $0.47 | $0.84 | $1.27 |
| Diluted | $0.44 | $0.47 | $0.83 | $1.25 |
| | | | | |
| Stock options not considered above because they were anti-dilutive | 560,000 | - | 520,000 | - |

**Note 9 — Stock Incentives**

In April 2014, the Board of Directors and the stockholders approved the Orchids Paper Products Company 2014 Stock Incentive Plan (the “2014 Plan”), which replaced the Orchids Paper Products Company 2005 Stock Incentive Plan (the “2005 Plan”).  No further grants can be made under the 2005 Plan.  Equity awards granted under the 2005 Plan will continue in full force and effect under the terms of the 2005 Plan and are not changed or modified.  The 2014 Plan provides for the granting of stock options and other stock based awards to employees and board members selected by the board’s compensation committee.  A total of 400,000 shares may be issued pursuant to the 2014 Plan.  As of September 30, 2014, there were 355,000 shares available for issuance under the 2014 Plan.

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (continued)**

*Stock Options with Time-Based Vesting Conditions*

The grant date fair value of the following option grants was estimated using the Black-Scholes option valuation model. Option valuation models require the input of highly subjective assumptions including the expected stock price volatility. The following table details the options granted to certain members of the board of directors and management that were valued using the Black-Scholes valuation model and the assumptions used in the valuation model for those grants during the nine months ended September 30, 2014 and 2013:

| Grant Date | Number of Shares | Exercise Price | Grant Date Fair Value | Risk-Free Interest Rate | | Estimated Volatility | | Dividend Yield | | Expected Life (years) |
|---|---|---|---|---|---|---|---|---|---|---|
| February-13 | 3,750 | $ 21.695 | $ 5.68 | 2.02 | % | 43 | % | 4.61 | % | 5 |
| May-13 | 40,000 | $ 22.95 | $ 5.28 | 1.87 | % | 43 | % | 5.88 | % | 5 |
| May-14 | 35,000 | $ 29.65 | $ 7.50 | 2.62 | % | 41 | % | 4.72 | % | 5 |
| June-14 | 5,000 | $ 30.09 | $ 7.67 | 2.63 | % | 41 | % | 4.65 | % | 5 |

The Company expenses the cost of these options granted over the vesting period of the option based on the grant-date fair value of the award.

*Stock Options with Market-Based Vesting Conditions*

During the first nine months of 2014, the Board of Directors granted options to purchase 145,000 shares of the Company's common stock to certain members of management. These options will become exercisable in four equal tranches, if at all, if and when the share price of the common stock closes at a certain percentage of the purchase price of the option for three consecutive business days, in accordance with the following vesting schedule:

**Share price**

| | **required to achieve vesting** |
|---|---|
| Tranche 1 | $ 34.788 |
| Tranche 2 | $ 42.350 |
| Tranche 3 | $ 51.425 |
| Tranche 4 | $ 60.500 |

Any unvested portion of the options shall expire five years from the date of grant and the options shall terminate ten years after the date of grant. As these options include a market condition, the grant date fair value and implicit service period of these option grants were estimated using a Monte Carlo option valuation model. The following table details the options granted to certain members of management that were valued using the Monte Carlo valuation model and the assumptions used in the valuation model for those grants during the nine months ended September 30, 2014. No options granted during the nine months ended September 30, 2013 were valued using the Monte Carlo option valuation model.

| **Grant Date** | **Number of Shares** | **Exercise Price** | **Grant Date Fair Value** | **Risk-Free Interest Rate** | **Estimated Volatility** | **Dividend Yield** | **Expected Life (years)** | **Derived Service Period (years)** |
|---|---|---|---|---|---|---|---|---|
| January 14 - Tranche 1 | 10,000 | $ 31.125 | $ 5.64 | 1.98 % | 31 % | 4.50 % | 5.15 | 0.31 |
| January 14 - Tranche 2 | 10,000 | $ 31.125 | $ 5.46 | 1.98 % | 31 % | 4.50 % | 5.58 | 1.15 |
| January 14 - Tranche 3 | 10,000 | $ 31.125 | $ 5.03 | 1.98 % | 31 % | 4.50 % | 5.97 | 1.94 |
| January 14 - Tranche 4 | 10,000 | $ 31.125 | $ 4.27 | 1.98 % | 31 % | 4.50 % | 6.25 | 2.50 |
| February 14 - Tranche 1 | 25,000 | $ 30.88 | $ 5.51 | 1.98 % | 31 % | 4.60 % | 5.17 | 0.35 |
| February 14 - Tranche 2 | 25,000 | $ 30.88 | $ 5.35 | 1.98 % | 31 % | 4.60 % | 5.60 | 1.19 |
| February 14 - Tranche 3 | 25,000 | $ 30.88 | $ 4.88 | 1.98 % | 31 % | 4.60 % | 5.99 | 1.98 |
| February 14 - Tranche 4 | 25,000 | $ 30.88 | $ 4.15 | 1.98 % | 31 % | 4.60 % | 6.27 | 2.54 |
| May 14 - Tranche 1 | 1,250 | $ 28.185 | $ 5.06 | 2.03 % | 31 % | 4.70 % | 5.36 | 0.71 |
| May 14 - Tranche 2 | 1,250 | $ 28.185 | $ 4.74 | 2.03 % | 31 % | 4.70 % | 5.78 | 1.56 |
| May 14 - Tranche 3 | 1,250 | $ 28.185 | $ 4.02 | 2.03 % | 31 % | 4.70 % | 6.14 | 2.29 |
| May 14 - Tranche 4 | 1,250 | $ 28.185 | $ 3.29 | 2.03 % | 31 % | 4.70 % | 6.39 | 2.79 |

The Company expenses the cost of these options granted over the implicit, or derived, service period of the option based on the grant-date fair value of the award. During the nine months ended September 30, 2014, 25,000 options that were granted in January 2014 were forfeited when an employee left the Company. No options were forfeited during the nine months ended September 30, 2013.

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (continued)**

*Options Issued Outside of the 2014 Plan*

In April 2014, the Company's stockholders voted to approve the options granted to Mr. Jeffrey S. Schoen, the Company's President and Chief Executive Officer, on November 8, 2013. Upon his appointment as an officer of the Company, Mr. Schoen was granted an option to purchase up to 400,000 shares of the common stock of the Company at a purchase price of $30.25 per share. The option will become exercisable, if at all, if and when the share price of the Company's common stock closes at a certain percentage of the purchase price of the option for three consecutive business days, in accordance with the following vesting schedule:

| Share price closes at or above the following percentage of the purchase price for the Option | Number of shares that become vested |
|---|---|
| 115% (share price $34.788) | 100,000 |
| 140% (share price $42.35) | 100,000 |
| 170% (share price $51.425) | 100,000 |
| 200% (share price $60.50) | 100,000 |

These options were granted outside of the 2005 Plan and the 2014 Plan. Any unvested portion of the option shall expire five years from the date of grant and the option shall terminate ten years after the date of grant. The Company used a Monte Carlo option valuation model to estimate the grant date fair value of each tranche of 100,000 options, as they include a market condition. The Company will expense the cost of the options granted over the implicit service period of the options based on the completed Monte Carlo models. The following table details the assumptions used in the valuation model for the options granted to Mr. Schoen:

| | Number of Shares | Exercise Price | Grant Date Fair Value | Risk-Free Interest Rate | Estimated Volatility | Dividend Yield | Expected Life (years) | Derived Service Period (years) |
|---|---|---|---|---|---|---|---|---|
| Tranche 1 | 100,000 | $ 30.25 | $ 5.18 | 2.10 % | 30 % | 4.60 % | 4.99 | 0.40 |
| Tranche 2 | 100,000 | $ 30.25 | $ 5.04 | 2.10 % | 30 % | 4.60 % | 5.42 | 1.25 |
| Tranche 3 | 100,000 | $ 30.25 | $ 4.31 | 2.10 % | 30 % | 4.60 % | 5.79 | 2.00 |
| Tranche 4 | 100,000 | $ 30.25 | $ 3.50 | 2.10 % | 30 % | 4.60 % | 6.04 | 2.50 |

*Total Option Expense*

The Company recognized the following expenses related to all options granted during the three-month and nine-month periods ended September 30, 2014 and 2013 under the 2005 Plan, the 2014 Plan and the Schoen options:

| | **Three Months Ended September 30,** | | **Nine Months Ended September 30,** | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Time-Based Vesting Options | $1,000 | $18,000 | $307,000 | $303,000 |
| Market-Based Vesting Options | 427,000 | - | 1,264,000 | - |
| Total compensation expense related to stock options | $428,000 | $18,000 | $1,571,000 | $303,000 |

*Future Expected Market-Based Stock Option Expense*

The grant of options that vest based on a market condition will have a material impact on the Company's results of operations. Based on the derived service periods of the options, the Company expects to expense the compensation cost related to these options as shown in the following table. However, if the market condition is achieved for any tranche of these options prior to the end of the derived service period, all remaining expense related to that tranche would be recognized in the period in which the market condition is achieved.

| | **2014** | | | | **2014** | **2015** | **2016** |
|---|---|---|---|---|---|---|---|
| | **Q1** | **Q2** | **Q3** | **Q4** | **Total** | **Total** | **Total** |
| | **(in thousands)** | | | | | | |
| Tranche 1 | $96 | $423 | $196 | $2 | $717 | $- | $- |
| Tranche 2 | 26 | 141 | 122 | 135 | 424 | 240 | - |
| Tranche 3 | 15 | 76 | 66 | 72 | 229 | 289 | 59 |
| Tranche 4 | 10 | 50 | 43 | 47 | 150 | 189 | 136 |
| Total expense | $147 | $690 | $427 | $256 | **$1,520** | **$718** | **$195** |

*Restricted Stock*

During the three months ended March 31, 2013, the Company granted 16,000 shares of restricted stock to certain employees under the 2005 Plan. These awards were valued at the arithmetic mean of the high and low market price of the Company's stock on the grant date, which was $21.695 per share, and vest ratably over a three year period beginning on the first anniversary of the grant date. During 2013, 8,000 of these shares were forfeited. Accordingly, the first third of the remaining shares, or 2,666 shares, vested in February 2014. In July 2014, an additional 667 shares were forfeited. The Company expenses the cost of restricted stock granted over the vesting period of the shares based on the grant-date fair value of the award. The Company recognized expense of $9,000 and $29,000 for the three-month periods ended September 30, 2014 and 2013, respectively, and $38,000 and $77,000 for the nine-month periods ended September 30, 2014 and 2013, respectively, related to the shares granted under the 2005 Plan.

**ORCHIDS PAPER PRODUCTS COMPANY AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (continued)**

**Note 10 — Major Customers and Concentration of Credit Risk**

The Company sells its paper production in the form of parent rolls and converted products. Revenues from converted product sales and parent roll sales in the three and nine months ended September 30, 2014 and 2013 were:

| Three Months Ended September 30, | Nine Months Ended September 30, |
|---|---|