

Research Report – Update

Investors should consider this report as only a single factor in making their investment decision.

Orchids Paper Products Company

Rating: Speculative Buy

John Nobile

July 2, 2015

TIS \$24.58 — (NYSE MKT)

| | <u>2013A</u> | <u>2014A</u> | <u>2015E</u> | <u>2016E</u> |
|---------------------|--------------|--------------|--------------|--------------|
| Revenues (millions) | \$116.4 | \$142.7 | \$173.5 | \$185.4 |
| Earnings per share | \$1.67 | \$1.11 | \$1.30 | \$1.66 |

| | | | |
|-------------------------------|-------------------|--------------------------|----------|
| 52-Week range | \$32.75 – \$21.42 | Fiscal year ends: | December |
| Shares outstanding a/o 5/1/15 | 10.3 million | Revenue per share (TTM) | \$17.51 |
| Approximate float | 8.7 million | Price/Sales (TTM) | 1.4X |
| Market capitalization | \$253 million | Price/Sales (FY2016)E | 1.4X |
| Tangible book value/share | \$8.51 | Price/Earnings (TTM) | 26.4X |
| Price/tangible book value | 2.9X | Price/Earnings (FY2016)E | 14.8X |
| Annual dividend | \$1.40 | Dividend Yield | 5.7% |

Orchids Paper Products, headquartered in Pryor, Oklahoma, manufactures bulk tissue paper, known as parent rolls, and converts parent rolls into a full line of tissue products, including paper towels, bathroom tissue and paper napkins for the private label segment of the consumer, or “at home,” market. The company has focused its product design and manufacturing on the discount retail market, primarily the dollar store retailers. (www.orchidspaper.com)

Key investment considerations:

Reiterating Speculative Buy rating but lowering 12-month price target to \$28.00 (from \$32.00) due to diminished valuation stemming from a reduction in earnings expectations. Our target implies a total (including dividend) year-ahead return of 20%.

The company’s five-year growth potential is substantial due to geographic expansion: the 2014 acquisition of Fabrica’s business in California, Nevada, Arizona, New Mexico and Utah, upgrading machines at its Oklahoma facility in 1H15, and a new integrated facility in South Carolina.

In April 2015, Orchids announced it intends to build an integrated tissue paper facility in Barnwell, SC with annual paper making capacity of up to 40,000 tons and converting capacity of up to 32,000 tons.

As the two-year option to purchase additional tonnage from Fabrica expires in 2H16, we project a reduction in 2016 Fabrica converted tonnage to 23,650 from 27,500 tons in 2015. The South Carolina plant should offset some of the reduction in Fabrica tonnage. We project total converted tonnage (from Oklahoma, Fabrica and South Carolina) at approximately 87,800 tons in 2016, up from 83,200 tons in 2015.

We project 2015 revenue of \$173.5 million and EPS of \$1.30 (previously \$169.9 million revenue and \$1.59 EPS). We project 2016 revenue of \$185.4 million and EPS of \$1.66 per share (previously \$170.2 million revenue and \$1.96 EPS). The changes in our projections stem primarily from increased converted product sales, higher interest expense and tax rate, and increased dilution from a 1.5 million share common stock offering.

Orchids reported (10Q released 5/8/15) 1Q15 revenue of \$37.4 million and EPS of \$0.14. We projected 1Q15 revenue of \$39.4 million and EPS of \$0.21. In the year earlier quarter, Orchids generated revenue of \$27.8 million and EPS of \$0.32.

Please view our disclosures on pages 14 - 16.

Recommendation and Valuation

Reiterating **Speculative Buy** rating but lowering **12-month price target to \$28.00** (from \$32.00) due to diminished valuation stemming from a reduction in earnings expectations. Our target implies a total (including dividend) year-ahead return of 20%.

Orchids' shares are currently trading at a multiple of 26X TTM earnings. With our reduced earnings outlook for 2015 and 2016, we believe the multiple will pull back from its current level. Applying a multiple of 17X to our 2016 EPS estimate of \$1.66, discounted to a twelve-month value of \$1.63, gives us a price target of approximately \$28.00 per share.

Plans for New Facility in South Carolina

In April 2015, Orchids announced it intends to build an integrated tissue paper facility in Barnwell, SC with paper making capacity of between 35,000 and 40,000 tons per year and converting capacity of between 30,000 and 32,000 tons per year.

The company intends to break ground during 2Q15. Build-out and start-up of the converting lines will come in phases, with the first line expected to become operational at the end of 2015 and the second line to become operational in 2Q16. Engineering and construction of the paper machine are expected to begin in 2Q15 and it is expected to become operational in early 2017.

Total cost of the facility is expected to be approximately \$110 million to \$127 million and will be deployed over the next two years, with approximately 40% occurring in 2015 and the remainder in 2016 and early 2017. Orchids expects to fund this project using the proceeds from a common stock offering, additional bank borrowings, and cash flow from operations.

Business

Orchids Paper Products, headquartered in Pryor, Oklahoma, manufactures bulk tissue paper, converting it into a full line of tissue products, including paper towels, bathroom tissue and paper napkins for the private label segment of the consumer or "at home" market. The company targets the discount retail market, primarily dollar store retailers, due to their consistent order patterns, limited number of stock keeping units (SKUs) and the growth in this channel of the retail market. Orchids has customers throughout the US, but its sales efforts are currently focused within a 500-mile radius of its northeast Oklahoma facility, a cost-effective shipping area.

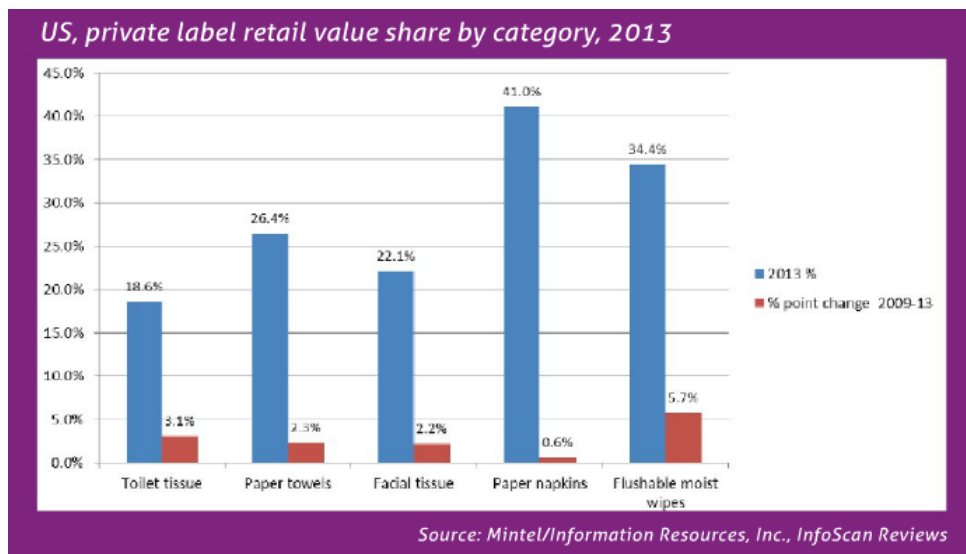
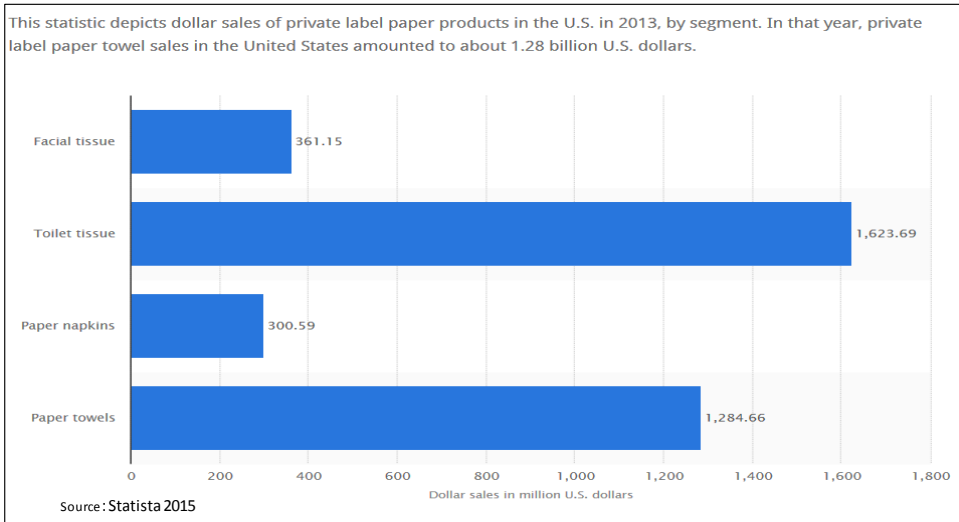
The company's products are sold primarily under its customers' private labels and, to a lesser extent, brand names such as Colortex® and Velvet®. Orchids does not have supply contracts with any of its customers. Orchids' products are daily consumable items so order streams are fairly constant with no significant seasonal fluctuations. Changes in the national economy do not materially affect the market for Orchids' products. However, local conditions might.

Private Label Paper Products Market and Outlook

In January 2015, the statistics website Statista.com reported that US sales of private label paper products were approximately \$3.6 billion in 2013. Toilet tissue accounted for the greatest percentage of sales at 45%, followed by paper towels at 36%, facial tissue at 10%, and paper napkins at 8% (see chart at top right on next page).

In December 2014, international consulting and engineering company Pöyry said that private label tissue products grew at a rate of 8% from 2008 to 2013. Pöyry cited improved product quality and enhanced packaging design as some of the key factors driving the success of private label tissue products.

The September/October 2014 issue of Tissue World magazine reported that private label sales of products in the tissue category (toilet tissue, paper towels, facial tissue, paper napkins, and flushable moist wipes) increased their US market share from 2009 to 2013 (see chart at right). Tissue World said that many consumers who traded down to private label products during the last recession never moved back to name brands. The Private Label Manufacturers Association (PLMA) says that the growth in private label sales is driven by the rising quality and value of private label products.



In an October 2014 sanitary paper product manufacturing industry report, IBISWorld said that large discount retailers such as Walmart (accounted for 9% of Orchids’ converted product sales in 2014) and Target were increasingly focusing on private-label goods that can provide higher margins. IBISWorld expects this trend to continue over the next five years. However, competition from lower-priced imports is expected to mitigate US growth resulting in moderate industry growth of 2% annually in the six years to 2020.

Economic Outlook

In April 2015, the International Monetary Fund (IMF) lowered its economic growth estimate for the US to 3.1% for 2015 and 2016, down from 3.6% in 2015 (January 2015) and 3.3% in 2016. The IMF said that US growth should be driven by domestic demand supported by low oil prices. Subsequent to the IMF’s economic growth estimates was the release (on May 29, 2015) of the US GDP 2nd estimate which showed the US economy contracted at an annual rate of 0.7% in 1Q15 as imports were revised upward and inventory investment and consumer spending were revised downward. On June 3, the US Federal Reserve released its Beige Book indicating that the US economy returned to modest-to-moderate growth during April and May 2015, after stalling in 1Q15.

In May 2015, the Federal Reserve Bank of the Tenth Federal Reserve District, which includes the Oklahoma area, released its survey of manufacturing activity. The survey reported that the region’s manufacturing activity declined sharply in May 2015 and producer’s expectations also fell, with both reaching their lowest levels since mid-2009.

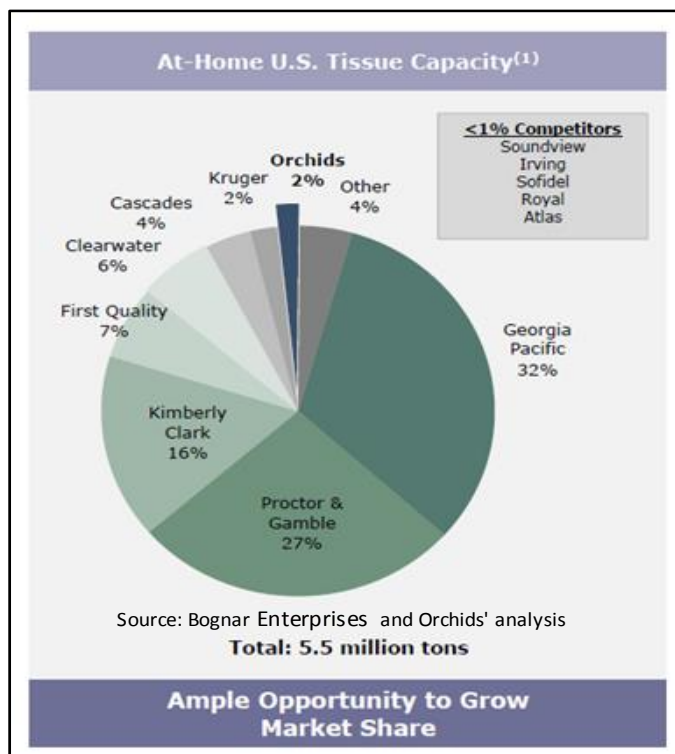
Although tissue products are considered consumer staples and changes in the economy do not typically affect sales of overall tissue products, the last recession did help in driving consumption to private label products such as Orchids’.

Market and Competition

In June 2015, IBISWorld estimated the 2015 US sanitary paper product market at \$13.3 billion with the tissue segment (paper towels, bathroom tissue, and paper napkins) at \$2.8 billion. The overall industry is projected to grow at an average annual growth rate of 1.9% over the next six years to \$14.9 billion by 2021.

Dollar and variety stores, Orchids’ primary target markets, realized sales of \$63.6 billion in 2014. In March 2015, IBISWorld projected dollar and variety stores’ average revenue growth to decline 1.3% annually over the next six years to \$53 billion by 2021 as competition from rivals such as Walmart, Target and Costco increases.

Competition in the value-end of the market is significantly affected by proximity, as freight costs represent a material portion of delivered product costs. Over the past five years, competitors (Clearwater Paper, Georgia-Pacific, Cascades, and Pacific Paper) have moved into Orchids’ market areas, arguably drawn by attractive margins. The increased competition has reduced Orchids’ competitive cost advantage and reduced gross margins from 29.2% in 2009 to 17.0% in 2010, and 16.3% in 2011. Orchids was able to reverse this downward trend as growing sales of higher margin converted products increased Orchids’ gross margins to 22.4% in 2012, 24% in 2013. However, in 2014, gross margins fell to 18.7% due primarily to lower overhead coverage as the company shut down two of its older paper machines in September 2014 and started the construction and installation of a new paper machine. This reduced the absorption of fixed costs at Orchids’ Oklahoma plant and required the company to purchase parent rolls in the open market.



Clearwater Paper and Cascades are the only publicly held direct competitors. Revenue and gross margins for Orchids and its competitors are shown at right. These competitors’ lower gross margins versus Orchids’ could drive them to expand in Orchids’ market, increasing pressure on Orchids’ prices and margins.

| | Clearwater Paper | Cascades | Orchids Paper |
|-------------------|------------------|----------|---------------|
| 2014 Revenue | \$2.0B | \$3.1B | \$142.7M |
| 2014 Gross Margin | 13.1% | 14.0% | 18.7% |
| 2013 Revenue | \$1.9B | \$3.2B | \$116.4M |
| 2013 Gross Margin | 11.6% | 15.0% | 24.0% |

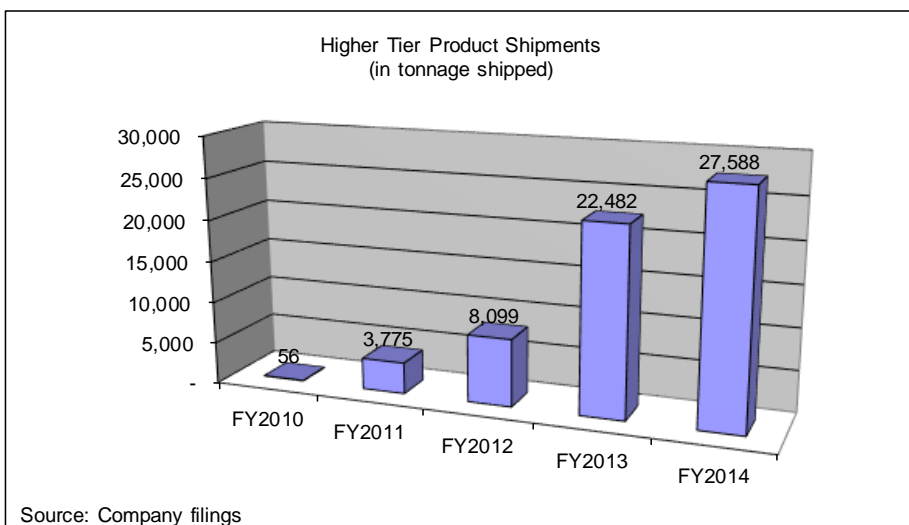
Strategy

Orchids aims to increase sales of its converted products, which yield higher margins. In June 2014, Orchids acquired Fabrica's US business, including certain manufacturing assets, and access to 19,800 metric tons of capacity each year to support the value, premium and ultra-premium requirements of the US market. The supply agreement with Fabrica provides access to an additional 7,700 tons in the first two years of the agreement for a total of up to 27,500 tons. The option for the additional tonnage expires at the end of 1H16. In April 2015, Orchids announced it intends to build an integrated tissue paper facility in Barnwell, SC with paper making capacity of between 35,000 and 40,000 tons per year and converting capacity of between 30,000 and 32,000 tons per year.

The company plans to upgrade one of its converting lines to further improve manufacturing flexibility and capacity. Orchids also plans to replace two existing paper machines with a new machine that is expected to increase its Oklahoma plant's annual capacity from 57,000 tons to over 70,000 tons. In 2014, Orchids' shipped all of its current annual capacity from its Oklahoma plant of approximately 54,000 tons of converted product. The upgrade to its converting line is expected to provide additional annual capacity of approximately 16,000 tons, bringing Orchids' total converted capacity to approximately 70,000 tons, in line with its increased paper making capacity. The cost for these projects is approximately \$38.9 million (\$25 million for paper machine project and \$13.9 million for converting line upgrade) over 2014 and 2015. The converting line project is expected to be completed and the paper machine is expected to be at full production in 2Q15.

Orchids plans to expand into retail channels such as grocery stores, mass merchandise and other discount retail sectors. Initial efforts to expand into these other channels previously had limited success due to capacity constraints and the inability to produce higher grade products. However, these shortcomings have been overcome by the additional converting line and new product initiatives (higher grade products).

The graph at right shows how shipments of Orchids' higher grade converted products have grown over the past five years. Growth was driven by sales of new higher quality products (with better paper, enhanced graphics, and improved embossing).



1Q15 Financial Results

Sales of \$37.4 million were up 35% compared to comparable period in 2014. Net income was \$1.2 million or \$0.14 per share versus net income of \$2.6 million or \$0.32 per share. We projected 1Q15 sales of \$39.4 million and net income of \$1.8 million or \$0.21 per share.

Converted product (paper towels, bathroom tissue, and paper napkins) sales increased 43% to \$37.4 million while parent roll (bulk tissue paper) sales were nil versus \$1.6 million in the year earlier period due to the demolition of two paper machines in conjunction with a new paper machine project. The increase in converted product sales was due to a 54% increase in tonnage shipped to 18,837, partly offset by a 7% decrease in net selling prices to \$1,986/ton. The decrease in net selling price was primarily due to product mix (away-from-home products acquired in the Fabrica transaction have lower selling prices than Orchids' core at-home products).

Orchids Paper Products Company

Gross margins decreased to 12.8% from 21.7% primarily due to the lower selling prices and the company shutting down two of its older paper machines in September 2014 which reduced the absorption of fixed costs at Orchids' Oklahoma plant and required the company to purchase parent rolls in the open market. This had the adverse effect of increasing COGS by approximately \$3 million or about 8%.

Selling, general and administrative (SG&A) expenses increased to \$2.5 million from \$2.2 million due primarily to an increase in non-cash stock option expense. The company recognized \$377,000 of amortization expense related to the intangible assets acquired in the Fabrica transaction. Operating income decreased to \$1.9 million or 5.1% of sales from \$3.8 million or 13.8% of sales.

Liquidity - Based on our forecasts, Orchids should need to raise approximately \$42 million in additional debt over the next two years in order to meet its financial obligations through 2016. We believe the company will raise funds through debt offerings as it recently (April 2015) expanded its loan facility for this purpose. We project increased interest payments through 2016. As of March 31, 2014, Orchids had cash of \$3.3 million, a current ratio of 1.4X versus 0.8X for the paper products industry, and a debt/equity ratio of 0.5X versus 0.4X for the industry. Orchids' total debt has more than tripled in a little over a year to over \$48 million in 1Q15 from approximately \$15 million at the end of 2013. The increase in debt was to fund the Fabrica transaction and capital expenditures (details provided below).

Cash from operations of \$5.6 million in the first three months of 2015 was primarily due to cash earnings of \$3.8 million and a \$1.7 million decrease in working capital. The decrease in working capital was primarily due to decreases in accounts receivable and prepaid expenses, and increases in accounts payable and accrued liabilities, offset in part by an increase in inventory. Cash from operations, capital expenditures of \$10.9 million, a \$10.7 million net increase in debt, and \$3.1 million in dividend payments resulted in a \$2.3 million increase in cash to \$3.3 million as of March 31, 2015.

In June 2014, Orchids entered into a \$75 million credit agreement with U.S. Bank National Association. The agreement includes a \$45 million revolving credit line due June 2019 and a \$30 million term loan due June 2020. The agreement effectively extended and increased Orchids' revolving working capital line of credit from \$15 million to \$25 million, increased Orchids' revolving line of credit to include \$20 million for the purchase and construction of assets in Oklahoma, and refinanced Orchids' \$10.8 million real estate loan and \$7.2 million machinery and equipment loan into a single \$30 million term loan, which also provided funding for the \$16.7 million paid in accordance with the Fabrica agreement. As of March 31, 2015, the company's interest rate was 1.43%.

The credit agreement contains covenants that require Orchids to maintain specific fixed charge coverage and leverage ratios. As of March 31, 2015, the company was in compliance with those covenants.

In September 2014, Orchids entered into an agreement with the Oklahoma Development Finance Authority (ODFA) whereby the ODFA agreed to provide the company up to \$3.5 million to fund a portion of the cost of a new paper production line. The agreement provides for Orchids' Oklahoma state withholding payroll taxes to be placed into a revolving fund held by ODFA. Each year on September 1, beginning in 2015 and ending in 2020, the ODFA will return these state withholding taxes in the revolving fund to the company, up to an amount totaling \$3.5 million. These amounts are recognized as a note receivable in other current assets in the balance sheet and in other income in the income statement. The company recognized income of \$185,000 in 1Q15 related to this agreement.

In April 2015, Orchids sold 1.5 million shares of its common stock at \$23.00 per share for gross proceeds of \$34.5 million.

In June 2015, Orchids entered into an amended, five year, \$187.3 million credit agreement with US Bank National Association. The agreement includes a \$25 million revolving credit line, a \$47.3 million term loan, a \$115 million delayed draw term loan with a two year draw period, and an accordion feature allowing the

revolving credit line and/or delayed draw commitment to be increased by up to \$50 million at any time during the credit agreement. Advances under the facility bear interest at a variable rate of LIBOR plus a margin of 1.25% to 2.50% depending on the company's leverage ratio, or a base rate plus a margin of up to 0.25% at the company's option.

Projections

Fabrica contributed approximately 13,750 tons of converted product in 2014 with approximately one-half years' worth of contribution. With a full year of shipments from Fabrica and Orchids' 2014 core growth rate of 3%, we project approximately 83,200 tons of converted products being shipped in 2015. For 2015, we project selling prices of \$2,030/ton for converted products and \$895/ton for parent rolls. The decrease in converted product selling prices in 2015 is due to a full year of contribution from Fabrica with its lower selling prices. The increase in 2015 parent roll selling prices is consistent with the 1.5% increase in paper selling prices projected by IBISWorld. Paper price gains are supported by the fact that falling demand is being outpaced by contracting supply which should result in slowly increasing prices. Our selling price projection may prove to be conservative as Orchids' average selling prices have increased at an average annual rate of 3.6% over the past three years while paper industry selling prices have remained relatively flat.

| <u>Revenue Model</u> | | | |
|----------------------|--------------|-------------------|-------------------|
| <u>2013</u> | | | |
| | Tons Shipped | Selling Price/Ton | Revenue (\$,000) |
| Converted | 52,592 | \$ 2,084 | \$ 109,611 |
| Parent Roll | 6,726 | \$ 1,006 | \$ 6,763 |
| Total | 59,318 | \$ 1,962 | \$ 116,374 |
| <u>2014</u> | | | |
| | Tons Shipped | Selling Price/Ton | Revenue (\$,000) |
| Converted | 67,870 | \$ 2,039 | \$ 138,382 |
| Parent Roll | 4,922 | \$ 882 | \$ 4,342 |
| Total | 72,792 | \$ 1,961 | \$ 142,724 |
| <u>2015</u> | | | |
| | Tons Shipped | Selling Price/Ton | Revenue (\$,000) |
| Converted | 83,244 | \$ 2,030 | \$ 168,985 |
| Parent Roll | 5,000 | \$ 895 | \$ 4,475 |
| Total | 88,244 | \$ 1,966 | \$ 173,460 |
| <u>2016</u> | | | |
| | Tons Shipped | Selling Price/Ton | Revenue (\$,000) |
| Converted | 87,816 | \$ 2,060 | \$ 180,901 |
| Parent Roll | 5,000 | \$ 908 | \$ 4,540 |
| Total | 92,816 | \$ 1,998 | \$ 185,441 |

Source: Company filings and Taglich Brothers estimates

We have increased our parent roll shipment forecasts for 2015 and 2016 to 5,000 tons (previously 1,000 tons) as the new paper machine in Oklahoma started up in March 2015 with production expected to ramp up quickly.

Orchids' agreement with Fabrica provides for the purchase of up to 19,800 tons of converted product annually with the option to purchase an additional 7,700 tons annually in each of the first two years. As the option to purchase the additional tonnage ends in 2H16, we project a reduction in 2016 Fabrica converted tonnage to 23,650 from 27,500 tons in 2015. Helping to offset this reduction in tonnage should be the contribution from Orchids' new plant in South Carolina. Orchids' believes it could sell out its converted product line (capacity of approximately 30,000 tons) in South Carolina within two years based on a marketing analysis with existing and new customers in the area. In an effort to be conservative, we project it will take Orchids three years to sell out its converted product line in South Carolina.

We project Orchids will sell approximately 20% of its South Carolina capacity in 2016 or roughly 6,700 tons. Total converted tonnage (from Oklahoma, Fabrica and South Carolina) is projected at approximately 87,800 tons in 2016. Orchids is currently shipping to customers on the East Coast and the new South Carolina location should reduce overall freight costs. However, as the new paper machine is not expected to be operational until early 2017, Orchids will be buying parent rolls in the secondary market in 2016 which we believe will limit gross margins in that region to approximately 16%. We project 2016 selling prices of \$2,060/ton for converted products and \$908/ton for parent rolls, consistent with the 1.5% increase in paper selling prices projected by IBISWorld.

There are no sales contracts guaranteeing these orders. However, customer order streams are fairly constant and typically last several years.

Orchids Paper Products Company

Orchids' gross margins have steadily improved since 2011 as growing sales of higher margin converted products have increased. However, in 2014, gross margins fell due primarily to lower selling prices, the company shutting down and demolishing two of its older paper machines in 2H14, starting the construction and installation of a new paper machine, and purchasing parent rolls

| | 2011A | 2012A | 2013A | 2014A | 2015E | 2016E |
|--------------|--------|--------|--------|--------|--------|--------|
| Conv. Tons | 39,104 | 43,661 | 52,592 | 67,870 | 83,244 | 87,816 |
| Total Tons | 55,514 | 53,995 | 59,318 | 72,792 | 88,244 | 92,816 |
| Conv. Ton % | 70.4% | 80.9% | 88.7% | 93.2% | 94.3% | 94.6% |
| Gross Margin | 16.3% | 22.4% | 24.0% | 18.7% | 19.0% | 22.0% |

Source: Company filings and Taglich Brothers estimates

in the open market. This had the adverse effect of increasing COGS by approximately \$2.1 million in 2014. Excluding these adverse effects, 2014 gross margins would have been approximately 20.2%. The seasonality of higher energy and transportation costs in the Mexicali plant adversely affects gross margins by approximately 3% in the second half of a year. The company said that higher energy costs typical in Mexico during the summer months flow through the supply agreement in the trailing quarters (Q3 and Q4). Thus we are projecting gross margins to be lower in the second half of a year than the first half. We project gross margins gradually increasing in 2015 and 2016 (see table at right) as converted product sales increase.

We project 2015 revenue of \$173.5 million and net income of \$13 million or \$1.30 per share. The change in our projections (previously \$169.9 million revenue and \$14 million or \$1.59 per share net income) stems primarily from increased parent roll sales (5,000 tons versus 1,000 tons previously as the new paper machine in Oklahoma started up in March 2015 with production expected to ramp up quickly), higher interest expense from increased debt levels (recently expanded loan facility to finance expansion), a higher estimated tax rate (34.4% versus 32% previously), and increased per share dilution from the recent 1.5 million share common stock offering.

We project SG&A expenses of \$10.9 million in 2015 (of which approximately 1.1% or \$1.9 million of sales are commission-related), lower by \$800,000 from 2014 due primarily to the absence of \$1.6 million costs related to the Fabrica transaction. Operating margins are projected to increase to 11.9% from 10% due primarily to the gross profit gains discussed earlier and lower SG&A expenses. The tax rate is estimated at 34.4%.

For 2015 we project Orchids will generate \$29.5 million cash from operations primarily from cash earnings. Cash from operations will not cover our projected \$69.4 million in capital expenditures (primarily for South Carolina facility) and \$12.3 million in dividend payments requiring the company to raise \$34.5 million from the sale of common stock (which it did in April 2015) and \$21.3 million from increased debt (\$12.4 million increase in debt as of March 31, 2015). We project a \$2 million increase in cash to \$3 million at December 31, 2015.

We project 2016 revenue of \$185.4 million and net income of \$17.2 million or \$1.66 per share. The change in our projections (previously \$170.2 million revenue and \$17.3 million or \$1.96 per share net income) stems primarily from increased converted product and parent roll sales, higher interest expense from increased debt levels, a higher estimated tax rate (34.4% versus 32% previously), and increased per share dilution from the recent 1.5 million share common stock offering.

We project SG&A expenses of \$11.8 million in 2016 (of which approximately 1.1% or \$2.2 million of sales are commission-related). Operating margins are projected to increase to 15% from 11.9% due primarily to gross profit gains. The tax rate is estimated at 34.4%.

For 2016 we project Orchids will generate \$36.8 million cash from operations primarily from cash earnings. Cash from operations will not cover our projected \$59 million in capital expenditures (primarily for South Carolina facility) and \$12.3 million in dividend payments requiring the company to raise \$33.3 million from increased debt. We project a \$1.1 million decrease in cash to \$2 million at December 31, 2016.

Risks

Customer concentration

Four customers (Dollar General, HEB, Family Dollar and Wal-Mart) accounted for approximately 72% of total sales in 2014. Any substantial decrease or delay in sales to one or more of Orchids' key customers would harm sales and financial results.

Competition

Competitors have penetrated Orchids' operating region. More intense competition in the company's market has reduced some of its competitive cost advantages and put pressure on selling prices.

Orchids may not be able to sell the capacity from its expanded converting line

Underutilization of capacity could lead to unabsorbed overhead and gross margin compression.

Fabrica acquisition

In June 2014, Orchids acquired various assets and business operations from Fabrica. There can be no assurance that Orchids will fully realize the anticipated benefits of the transaction. Further, as a result of the Fabrica transaction, Orchids' indebtedness is now greater than it was prior to the acquisition.

South Carolina construction project

Orchids' South Carolina construction project is anticipated to begin in 2Q15 with the first converting line expected to be operational at the end of 2015, the second in 2Q16, and the new paper machine in early 2017. Total cost is estimated at \$110 million to \$127 million over a two year period. There can be no assurance that the construction, installation, and ramp of production will proceed as scheduled, for the anticipated costs, or at all.

No reliance on contracts

Sales contracts are not the norm in the industry. Although orders typically result in multi-year revenue streams, there can be no guarantee as to their length.

Liquidity risk

Microcap stocks typically have small trading floats and very low trading volume and can lead to large spreads and high volatility in stock price. Orchids has 8.7 million shares in the float with an average daily volume of approximately 110,000 shares.

Miscellaneous risks

The company's financial results and equity values are subject to other risks, including competition, operations, financial markets, regulatory risk, and/or other events. These risks may cause actual results to differ from expected results.

Orchids Paper Products Company

Consolidated Balance Sheets
(in thousands \$)

| | 2012A | 2013A | 2014A | 3/15A | 2015E | 2016E |
|--|----------------|----------------|----------------|----------------|----------------|----------------|
| Cash | 5,734 | 7,205 | 1,021 | 3,274 | 3,042 | 1,992 |
| Accounts receivable | 5,406 | 6,585 | 9,121 | 8,106 | 11,085 | 11,851 |
| Inventories | 10,275 | 10,921 | 9,650 | 11,191 | 11,692 | 12,039 |
| Short term investments | 5,027 | 5,035 | - | - | - | - |
| Income taxes receivable | 607 | - | 634 | 634 | 634 | 634 |
| Prepaid expenses | 637 | 863 | 1,285 | 958 | 958 | 958 |
| Receivable from related party | - | - | 1,086 | 737 | 737 | 737 |
| VAT receivable | - | - | 1,734 | 1,664 | 1,664 | 1,664 |
| Other | 44 | 146 | 887 | 1,073 | 1,073 | 1,073 |
| Deferred income taxes | 393 | 552 | 614 | 611 | 611 | 611 |
| Total current assets | 28,123 | 31,307 | 26,032 | 28,248 | 31,497 | 31,558 |
| Property, plant and equipment | 91,188 | 95,745 | 119,720 | 128,575 | 175,704 | 217,869 |
| Intangible assets | - | - | 17,237 | 16,860 | 15,737 | 14,537 |
| Goodwill | - | - | 7,560 | 7,560 | 7,560 | 7,560 |
| Deferred debt issuance costs | 47 | 40 | 190 | 183 | 183 | 183 |
| Total Assets | <u>119,358</u> | <u>127,092</u> | <u>170,739</u> | <u>181,426</u> | <u>230,681</u> | <u>271,707</u> |
| Bank overdrafts | - | - | 1,706 | - | - | - |
| Accounts payable | 3,685 | 3,685 | 11,391 | 12,217 | 13,802 | 14,211 |
| Accrued liabilities | 2,832 | 4,030 | 3,747 | 4,619 | 4,554 | 4,868 |
| Current portion of long-term debt | 1,152 | 1,152 | 2,700 | 2,700 | 2,700 | 2,700 |
| Total current liabilities | 7,669 | 8,867 | 19,544 | 19,536 | 21,055 | 21,779 |
| Long-term debt | 15,079 | 13,927 | 33,662 | 46,060 | 54,962 | 88,262 |
| Deferred income taxes | 19,432 | 19,449 | 17,020 | 16,856 | 16,856 | 16,856 |
| Total liabilities | 42,180 | 42,243 | 70,226 | 82,452 | 92,873 | 126,897 |
| Total stockholders' equity | <u>77,178</u> | <u>84,849</u> | <u>100,513</u> | <u>98,974</u> | <u>137,807</u> | <u>144,810</u> |
| Total liabilities & stockholders' equity | <u>119,358</u> | <u>127,092</u> | <u>170,739</u> | <u>181,426</u> | <u>230,681</u> | <u>271,707</u> |

Source: Company filings and Taglich Brothers' estimates

Orchids Paper Products Company

Income Statements for the Fiscal Years Ended
(in thousands \$)

| | <u>2012A</u> | <u>2013A</u> | <u>2014A</u> | <u>2015E</u> | <u>2016E</u> |
|-------------------------------|---------------------|----------------------|---------------------|----------------------|----------------------|
| Net sales | 100,819 | 116,374 | 142,724 | 173,460 | 185,441 |
| Cost of sales | <u>78,253</u> | <u>88,494</u> | <u>115,985</u> | <u>140,530</u> | <u>144,694</u> |
| Gross profit | 22,566 | 27,880 | 26,739 | 32,930 | 40,747 |
| Intangibles amortization | | | 753 | 1,500 | 1,200 |
| SG&A expenses | <u>8,456</u> | <u>9,471</u> | <u>11,675</u> | <u>10,875</u> | <u>11,753</u> |
| Operating income (loss) | 14,110 | 18,409 | 14,311 | 20,555 | 27,794 |
| Interest expense | 407 | 371 | 271 | 964 | 1,600 |
| Other (income) expense | <u>302</u> | <u>(173)</u> | <u>181</u> | <u>(186)</u> | <u>-</u> |
| Income (loss) before taxes | 13,401 | 18,211 | 13,859 | 19,777 | 26,194 |
| Income tax expense (benefit) | <u>4,144</u> | <u>4,892</u> | <u>4,394</u> | <u>6,803</u> | <u>9,011</u> |
| Net income (loss) | <u><u>9,257</u></u> | <u><u>13,319</u></u> | <u><u>9,465</u></u> | <u><u>12,974</u></u> | <u><u>17,183</u></u> |
| EPS | 1.18 | 1.67 | 1.11 | 1.30 | 1.66 |
| Shares Outstanding | 7,832 | 7,937 | 8,539 | 9,952 | 10,328 |
| <u>Margin Analysis</u> | | | | | |
| Gross margin | 22.4% | 24.0% | 18.7% | 19.0% | 22.0% |
| SG&A expenses | 8.4% | 8.1% | 8.2% | 6.3% | 6.3% |
| Operating margin | 14.0% | 15.8% | 10.0% | 11.9% | 15.0% |
| Net margin | 9.2% | 11.4% | 6.6% | 7.5% | 9.3% |
| Tax rate | 30.9% | 26.9% | 31.7% | 34.4% | 34.4% |
| <u>Year / Year Growth</u> | | | | | |
| Total Revenues | 3.0% | 15.4% | 22.6% | 21.5% | 6.9% |
| Net Income | 49.4% | 43.9% | (28.9%) | 37.1% | 32.4% |
| EPS | 47.3% | 41.3% | (33.6%) | 17.6% | 27.6% |

Source: Company filings and Taglich Brothers' estimates

Orchids Paper Products Company

Quarterly Income Statement for the Fiscal Years Ending December 31, 2014, 2015, and 2016
(in thousands \$)

| | <u>3/14A</u> | <u>6/14A</u> | <u>9/14A</u> | <u>12/14A</u> | <u>2014A</u> | <u>3/15A</u> | <u>6/15E</u> | <u>9/15E</u> | <u>12/15E</u> | <u>2015E</u> | <u>3/16E</u> | <u>6/16E</u> | <u>9/16E</u> | <u>12/16E</u> | <u>2016E</u> |
|------------------------------|--------------|--------------|--------------|---------------|--------------|--------------|--------------|--------------|---------------|---------------|--------------|--------------|--------------|---------------|---------------|
| Net sales | 27,759 | 29,196 | 44,429 | 41,340 | 142,724 | 37,415 | 42,500 | 48,000 | 45,545 | 173,460 | 43,441 | 47,500 | 48,500 | 46,000 | 185,441 |
| Cost of sales | 21,741 | 23,706 | 35,645 | 34,893 | 115,985 | 32,629 | 34,000 | 37,920 | 35,981 | 140,530 | 33,276 | 36,385 | 38,509 | 36,524 | 144,694 |
| Gross profit | 6,018 | 5,490 | 8,784 | 6,447 | 26,739 | 4,786 | 8,500 | 10,080 | 9,564 | 32,930 | 10,165 | 11,115 | 9,991 | 9,476 | 40,747 |
| Intangibles amortization | | 108 | 322 | 323 | 753 | 377 | 377 | 373 | 373 | 1,500 | 300 | 300 | 300 | 300 | 1,200 |
| SG&A expenses | 2,179 | 4,407 | 2,541 | 2,548 | 11,675 | 2,497 | 2,670 | 2,913 | 2,795 | 10,875 | 2,790 | 2,970 | 3,060 | 2,933 | 11,753 |
| Operating income (loss) | 3,839 | 975 | 5,921 | 3,576 | 14,311 | 1,912 | 5,453 | 6,794 | 6,396 | 20,555 | 7,075 | 7,845 | 6,631 | 6,243 | 27,794 |
| Interest expense | 13 | 112 | 90 | 56 | 271 | 214 | 250 | 250 | 250 | 964 | 400 | 400 | 400 | 400 | 1,600 |
| Other (income) expense | 1 | (7) | 147 | 40 | 181 | (186) | - | - | - | (186) | - | - | - | - | - |
| Income (loss) before taxes | 3,825 | 870 | 5,684 | 3,480 | 13,859 | 1,884 | 5,203 | 6,544 | 6,146 | 19,777 | 6,675 | 7,445 | 6,231 | 5,843 | 26,194 |
| Income tax expense (benefit) | 1,182 | 324 | 1,854 | 1,034 | 4,394 | 648 | 1,790 | 2,251 | 2,114 | 6,803 | 2,296 | 2,561 | 2,143 | 2,010 | 9,011 |
| Net income (loss) | <u>2,643</u> | <u>546</u> | <u>3,830</u> | <u>2,446</u> | <u>9,465</u> | <u>1,236</u> | <u>3,413</u> | <u>4,293</u> | <u>4,032</u> | <u>12,974</u> | <u>4,379</u> | <u>4,884</u> | <u>4,088</u> | <u>3,833</u> | <u>17,183</u> |
| EPS | 0.32 | 0.07 | 0.44 | 0.28 | 1.11 | 0.14 | 0.33 | 0.42 | 0.39 | 1.30 | 0.42 | 0.47 | 0.40 | 0.37 | 1.66 |
| Shares Outstanding | 8,153 | 8,346 | 8,824 | 8,823 | 8,539 | 8,824 | 10,328 | 10,328 | 10,328 | 9,952 | 10,328 | 10,328 | 10,328 | 10,328 | 10,328 |
| <u>Margin Analysis</u> | | | | | | | | | | | | | | | |
| Gross margin | 21.7% | 18.8% | 19.8% | 15.6% | 18.7% | 12.8% | 20.0% | 21.0% | 21.0% | 19.0% | 23.4% | 23.4% | 20.6% | 20.6% | 22.0% |
| SG&A expenses | 7.8% | 15.1% | 5.7% | 6.2% | 8.2% | 6.7% | 6.3% | 6.1% | 6.1% | 6.3% | 6.4% | 6.3% | 6.3% | 6.4% | 6.3% |
| Operating margin | 13.8% | 3.3% | 13.3% | 8.7% | 10.0% | 5.1% | 12.8% | 14.2% | 14.0% | 11.9% | 16.3% | 16.5% | 13.7% | 13.6% | 15.0% |
| Net margin | 9.5% | 1.9% | 8.6% | 5.9% | 6.6% | 3.3% | 8.0% | 8.9% | 8.9% | 7.5% | 10.1% | 10.3% | 8.4% | 8.3% | 9.3% |
| Tax rate | 30.9% | 37.2% | 32.6% | 29.7% | 31.7% | 34.4% | 34.4% | 34.4% | 34.4% | 34.4% | 34.4% | 34.4% | 34.4% | 34.4% | 34.4% |
| <u>Year / Year Growth</u> | | | | | | | | | | | | | | | |
| Total Revenues | 4.3% | (0.1%) | 49.3% | 34.3% | 22.6% | 34.8% | 45.6% | 8.0% | 10.2% | 21.5% | 16.1% | 11.8% | 1.0% | 1.0% | 6.9% |
| Net Income | (14.5%) | (82.6%) | 2.9% | (27.2%) | (28.9%) | (53.2%) | NMF | 12.1% | 64.8% | 37.1% | 254.3% | 43.1% | (4.8%) | (4.9%) | 32.4% |
| EPS | (17.3%) | (83.4%) | (6.4%) | (34.0%) | (33.6%) | (56.8%) | NMF | (5.5%) | 40.8% | 17.6% | 202.7% | 43.1% | (4.8%) | (4.9%) | 27.6% |

Source: Company filings and Taglich Brothers' estimates

Orchids Paper Products Company

Statement of Cash Flows for the Periods Ended
(in thousands \$)

| | <u>2012A</u> | <u>2013A</u> | <u>2014A</u> | <u>3mos15A</u> | <u>2015E</u> | <u>2016E</u> |
|--|----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Net income(loss) | 9,257 | 13,319 | 9,465 | 1,236 | 12,974 | 17,183 |
| Depreciation and amortization | 7,548 | 7,621 | 9,749 | 2,476 | 14,916 | 18,035 |
| Provision for doubtful accounts | (20) | 10 | 20 | - | 20 | 20 |
| Deferred income taxes | 648 | (142) | (2,491) | (160) | (164) | - |
| Stock based compensation | 346 | 346 | 1,879 | 267 | 2,000 | 2,000 |
| (Gain) loss on disposal of property, plant and equipment | <u>336</u> | <u>(146)</u> | <u>8</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| Cash earnings | 18,115 | 21,008 | 18,630 | 3,819 | 29,746 | 37,238 |
| <i>Changes in assets and liabilities</i> | | | | | | |
| Accounts receivable | 1,553 | (1,189) | (2,556) | 1,015 | (1,964) | (766) |
| Inventories | (2,464) | (646) | 1,272 | (1,541) | (2,042) | (346) |
| Prepaid expenses | (107) | (226) | (422) | 327 | 327 | - |
| Income taxes receivable | (322) | 607 | (634) | - | 413 | (20) |
| Other current assets | 294 | 44 | (3,560) | 233 | (186) | - |
| Accounts payable | 165 | - | 7,706 | 826 | 2,411 | 409 |
| Accrued liabilities | <u>217</u> | <u>1,198</u> | <u>(284)</u> | <u>872</u> | <u>807</u> | <u>315</u> |
| (Increase) decrease in working capital | <u>(664)</u> | <u>(212)</u> | <u>1,522</u> | <u>1,732</u> | <u>(235)</u> | <u>(409)</u> |
| Net Cash Provided by (Used in) Operations | 17,451 | 20,796 | 20,152 | 5,551 | 29,511 | 36,830 |
| Acquisition of Fabrica's US business | - | - | (16,700) | - | - | - |
| Proceeds from the sale of investment securities | - | (8) | 5,037 | - | - | - |
| Purchase of investment securities | (3,008) | - | (2) | - | - | - |
| Purchase of property and equipment | <u>(6,780)</u> | <u>(12,171)</u> | <u>(25,769)</u> | <u>(10,943)</u> | <u>(69,400)</u> | <u>(59,000)</u> |
| Net Cash Provided by (Used in) Investing | (9,788) | (12,179) | (37,434) | (10,943) | (69,400) | (59,000) |
| Proceeds from the sale of common stock | - | - | - | - | 34,500 | - |
| Borrowings on long-term debt | - | - | 30,000 | - | - | - |
| Principal payments on long-term debt | (1,152) | (1,152) | (16,429) | (675) | (2,700) | (2,700) |
| Net borrowings (repayments) on revolving credit line | - | - | 7,712 | 13,073 | 24,000 | 36,000 |
| Bank overdrafts | - | - | 1,706 | (1,706) | (1,706) | - |
| Proceeds from the exercise of stock options | 974 | 3,305 | 79 | 22 | 100 | 100 |
| Excess tax benefit of stock options exercised | 395 | 1,409 | 20 | 1 | 20 | 20 |
| Deferred debt issuance cost | - | - | (209) | (4) | (4) | - |
| Dividends paid | <u>(6,443)</u> | <u>(10,708)</u> | <u>(11,781)</u> | <u>(3,066)</u> | <u>(12,300)</u> | <u>(12,300)</u> |
| Net Cash Provided by (Used in) Financing | (6,226) | (7,146) | 11,098 | 7,645 | 41,910 | 21,120 |
| Net Change in Cash | 1,437 | 1,471 | (6,184) | 2,253 | 2,021 | (1,050) |
| Cash - Beginning of Period | <u>4,297</u> | <u>5,734</u> | <u>7,205</u> | <u>1,021</u> | <u>1,021</u> | <u>3,042</u> |
| Cash - End of Period | <u>5,734</u> | <u>7,205</u> | <u>1,021</u> | <u>3,274</u> | <u>3,042</u> | <u>1,992</u> |
| Cash Flow from Operations | 17,451 | 20,796 | 20,152 | 5,551 | 29,511 | 36,830 |
| Capital Expenditures | <u>(6,780)</u> | <u>(12,171)</u> | <u>(25,769)</u> | <u>(10,943)</u> | <u>(69,400)</u> | <u>(59,000)</u> |
| Free Cash Flow | 10,671 | 8,625 | (5,617) | (5,392) | (39,889) | (22,170) |

Source: Company filings and Taglich Brothers' estimates

Price Chart



Taglich Brothers' Current Ratings Distribution



31.82 % Buy 60.61 % Hold 6.06 % Not Rated 1.52 % Sell

| Investment Banking Services for Companies Covered in the Past 12 Months | | |
|--|---|---|
| Rating | # | % |
| Buy | 2 | 8 |
| Hold | | |
| Sell | | |
| Not Rated | | |

Important Disclosures

As of the date of this report, Taglich Brothers, Inc. and/or its affiliates, own more than 1% of TIS common stock. Michael Taglich, President of Taglich Brothers, Inc., owns or has a controlling interest in 124,473 shares of TIS common stock. Robert Taglich, Managing Director of Taglich Brothers, Inc., owns or has a controlling interest in 67,268 shares of TIS common stock and 135,413 shares of restricted stock. Richard Oh, Managing Director of Taglich Brothers, Inc., owns 13,864 shares of TIS common stock. Doug Hailey, Director of Investment Banking at Taglich Brothers, Inc. and a Director of Orchids Paper Products Company, owns 44,150 shares of TIS common stock and 38,750 stock options. Taglich Brothers, Inc. had an Investment Banking relationship with the company mentioned in this report. In March 2004, 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 the company. In July 2005, Orchids completed its initial public offering (of which Taglich Brothers, Inc. was the managing underwriter) and began trading on the American Stock Exchange under the symbol TIS.

All research issued by Taglich Brothers, Inc. is based on public information. From April 2008 to December 2012, the company paid a monthly monetary fee of \$2,000 (USD) to Taglich Brothers, Inc. for the creation and dissemination of research reports.

General Disclosures

The information and statistical data contained herein have been obtained from sources, which we believe to be reliable but in no way are warranted by us as to accuracy or completeness. We do not undertake to advise you as to changes in figures or our views. This is not a solicitation of any order to buy or sell. Taglich Brothers, Inc. is fully disclosed with its clearing firm, Pershing, LLC, is not a market maker and does not sell to or buy from customers on a principal basis. The above statement is the opinion of Taglich Brothers, Inc. and is not a guarantee that the target price for the stock will be met or that predicted business results for the company will occur. There may be instances when fundamental, technical and quantitative opinions contained in this report are not in concert. We, our affiliates, any officer, director or stockholder or any member of their families may from time to time purchase or sell any of the above-mentioned or related securities. Analysts and members of the Research Department are prohibited from buying or selling securities issued by the companies that Taglich Brothers, Inc. has a research relationship with, except if ownership of such securities was prior to the start of such relationship, then an Analyst or member of the Research Department may sell such securities after obtaining expressed written permission from Compliance.

Analyst Certification

I, John Nobile, the research analyst of this report, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities and issuers; and that no part of my compensation was, is, or will be, directly, or indirectly, related to the specific recommendations or views contained in this report.

Public Companies Mentioned in this Report

Cascades (OTC PK: CADNF)
Clearwater Paper (NYSE: CLW)
Dollar General (NYSE: DG)
Family Dollar (NYSE: FDO)
Wal-Mart (NYSE: WMT)

Meaning of Ratings

Buy – The growth prospects, degree of investment risk, and valuation make the stock attractive relative to the general market or comparable stocks.

Speculative Buy – Long term prospects of the company are promising but investment risk is significantly higher than it is in our BUY-rated stocks. Risk-reward considerations justify purchase mainly by high risk-tolerant accounts. In the short run, the stock may be subject to high volatility and could continue to trade at a discount to its market.

Neutral – Based on our outlook the stock is adequately valued. If investment risks are within acceptable parameters, this equity could remain a holding if already owned.

Sell – Based on our outlook the stock is significantly overvalued. A weak company or sector outlook and a high degree of investment risk make it likely that the stock will underperform relative to the general market.

Dropping Coverage – Research coverage discontinued due to the acquisition of the company, termination of research services, non-payment for such services, diminished investor interest, or departure of the analyst.

Some notable Risks within the Microcap Market

Stocks in the Microcap segment of the market have many risks that are not as prevalent in Large-cap, Blue Chips or even Small-cap stocks. Often it is these risks that cause Microcap stocks to trade at discounts to their peers. The most common of these risks is liquidity risk, which is typically caused by small trading floats and very low trading volume which can lead to large spreads and high volatility in stock price. In addition, Microcaps tend to have significant company specific risks that contribute to lower valuations. Investors need to be aware of the higher probability of financial default and higher degree of financial distress inherent in the microcap segment of the market.

From time to time our analysts may choose to withhold or suspend a rating on a company. We continue to publish informational reports on such companies; however, they have no ratings or price targets. In general, we will not rate any company that has too much business or financial uncertainty for our analysts to form an investment conclusion, or that is currently in the process of being acquired.