Neenah Paper Inc
Form 10-Q
November 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from to

Commission File Number: 001-32240

NEENAH PAPER, INC.

(Exact name of registrant as specified in its charter)

Delaware	**20-1308307**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3460 Preston Ridge Road Alpharetta, Georgia	**30005**
(Address of principal executive offices)	(Zip Code)

(678) 566-6500

(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 requirements for the past 90 days.

Yes x No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

As of October 31, 2006, there were 14,784,158 shares of the Company s common stock outstanding.

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Part I FINANCIAL INFORMATION

Item 1. Financial Statements

NEENAH PAPER, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions, except share and per share data)

(Unaudited)

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Net sales	$ 141.4	$ 127.7	$ 417.1	$ 398.7
Cost of products sold	121.4	103.4	347.5	313.8
Gross profit	20.0	24.3	69.6	84.9
Selling, general and administrative expenses	13.1	12.4	40.0	36.9
Gain on sale of woodlands (Note 3)	(1.5)		(124.1)	
Other income - net	(2.1)	(3.5)	(5.7)	(4.8)
Operating income	10.5	15.4	159.4	52.8
Interest expense-net	2.8	4.5	11.4	13.8
Income from continuing operations before income taxes	7.7	10.9	148.0	39.0
Provision for income taxes	3.1	3.9	55.8	14.0
Income from continuing operations	4.6	7.0	92.2	25.0
Loss from discontinued operations (Note 4)	(19.0)	(8.5)	(32.4)	(17.0)
Net income (loss)	$ (14.4)	$ (1.5)	$ 59.8	$ 8.0
Earnings (Loss) Per Common Share				
Basic				
Continuing operations	$ 0.31	$ 0.48	$ 6.25	$ 1.70
Discontinued operations	(1.29)	(0.58)	(2.20)	(1.16)
	$ (0.98)	$ (0.10)	$ 4.05	$ 0.54
Diluted				
Continuing operations	$ 0.31	$ 0.47	$ 6.22	$ 1.69
Discontinued operations	(1.28)	(0.57)	(2.19)	(1.15)
	$ (0.97)	$ (0.10)	$ 4.03	$ 0.54
Weighted Average Common Shares Outstanding (in thousands)				
Basic	14,756	14,739	14,749	14,739
Diluted	14,846	14,789	14,823	14,789
Cash Dividends Declared Per Share of Common Stock	$ 0.10	$ 0.10	$ 0.30	$ 0.30

See Notes to Condensed Consolidated Financial Statements

NEENAH PAPER, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions)

(Unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets		
Cash and cash equivalents	$ 160.4	$ 12.6
Accounts receivable (less allowances of $4.2 and $3.6, respectively)	72.6	79.1
Inventories	44.5	87.1
Other current assets	17.3	25.5
Total current assets	294.8	204.3
Property, plant and equipment, at cost	628.1	616.8
Less accumulated depreciation	413.4	398.9
Property, plant and equipment-net	214.7	217.9
Prepaid and intangible pension costs	62.2	71.7
Other assets	16.4	43.1
TOTAL ASSETS	$ 588.1	$ 537.0
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Debt payable within one year	$ 1.4	$ 1.2
Accounts payable	32.0	40.4
Income taxes payable	1.3	
Accrued expenses	45.7	38.8
Total current liabilities	80.4	80.4
Long-term debt	225.3	226.3
Other noncurrent liabilities	53.0	65.0
TOTAL LIABILITIES	358.7	371.7
Commitments and contingencies (Note 11)		
STOCKHOLDERS EQUITY	229.4	165.3
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 588.1	$ 537.0

See Notes to Condensed Consolidated Financial Statements

NEENAH PAPER, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

(Unaudited)

	Nine Months Ended September 30, 2006	2005
OPERATING ACTIVITIES		
Net income	$ 59.8	$ 8.0
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	21.0	21.5
Amortization of stock-based compensation	3.9	0.7
Asset impairment loss		0.8
Loss on disposal of Terrace Bay	6.5	
Loss on curtailment and partial settlement of pension plan	26.4	
Contribution to settle pension liabilities	(10.8)	
Deferred income tax provision	28.4	1.7
Gain on sale of woodlands (Note 3)	(124.1)	
(Gain) loss on other asset dispositions	(0.2)	0.2
Decrease in working capital	38.5	14.1
Pension and other post-employment benefits	1.9	0.5
Other	1.4	(1.2)
NET CASH PROVIDED BY OPERATING ACTIVITIES	52.7	46.3
INVESTING ACTIVITIES		
Capital expenditures	(15.4)	(18.0)
Net proceeds from sale of woodlands	134.8	
Payment for transfer of Terrace Bay	(18.6)	
Other	(0.9)	(0.1)
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	99.9	(18.1)
FINANCING ACTIVITIES		
Proceeds from issuance of long-term debt		3.4
Repayments of long-term debt	(0.9)	(0.8)
Short-term borrowings	0.6	2.3
Repayments of short-term borrowings	(0.5)	(2.1)
Cash dividends paid	(4.4)	(4.4)
Proceeds from exercise of stock options	0.4	
NET CASH USED IN FINANCING ACTIVITIES	(4.8)	(1.6)
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS		0.2
NET INCREASE IN CASH AND CASH EQUIVALENTS	147.8	26.8
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	12.6	19.1
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 160.4	$ 45.9
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during period for interest	$ 8.4	$ 7.9
Cash paid during period for income taxes	$ 1.5	$ 6.9

See Notes to Condensed Consolidated Financial Statements

NEENAH PAPER, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Background and Basis of Presentation

Background

Neenah Paper, Inc. (Neenah or the Company), a Delaware corporation, was incorporated in April 2004 in contemplation of the spin-off by Kimberly-Clark Corporation (Kimberly-Clark) of its fine paper and technical products businesses in the United States and its Canadian pulp business (collectively, the Pulp and Paper Business). In November 2004, Kimberly-Clark completed the distribution of all of the shares of Neenah s common stock to the stockholders of Kimberly-Clark (the Spin-Off). Kimberly-Clark stockholders received a dividend of one share of Neenah s common stock for every 33 shares of Kimberly-Clark common stock held. As a result of the Spin-Off, Kimberly-Clark transferred all of the assets and liabilities of the Pulp and Paper Business to Neenah. Following the Spin-Off, Neenah is an independent public company and Kimberly-Clark has no continuing stock ownership.

The fine paper business is a leading producer of premium writing, text, cover and specialty papers. The technical products business is a leading producer of durable, saturated and coated base papers for a variety of end uses. At the time of the Spin-Off, the Canadian pulp business consisted of pulp mills in Terrace Bay, Ontario and Pictou, Nova Scotia and the related woodlands (including 1,000,000 acres in Nova Scotia).

In June 2006, the Company completed the sale of approximately 500,000 acres of woodlands in Nova Scotia for $139.1 million (proceeds net of transaction costs were $134.8 million). The agreement includes a fiber supply agreement to secure a source of fiber for the Company s Pictou pulp mill. The transaction resulted in a net pre-tax gain of $131.6 million. Approximately $9.0 million of such gain was deferred and will be recognized in income pro-rata through December 2007. See Note 3, Sale of Woodlands .

In May 2006, the Company announced a tentative agreement to transfer the Terrace Bay mill and related woodlands operations to certain affiliates of Buchanan Forest Products Ltd. (Buchanan). In August 2006, the Company consummated the agreement by transferring the mill and related woodlands operations (excluding certain working capital amounts and post-employment obligations) and $18.6 million to Buchanan. For the three and nine months ended September 30, 2006, the results of operations of the Terrace Bay mill and the loss on transfer are reflected as discontinued operations in the condensed consolidated statements of operations. The consolidated results of operations for all prior periods have been restated to reflect the results of operations of the Terrace Bay mill as discontinued operations. See Note 4, Discontinued Operations .

Basis of Consolidation and Presentation

These statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) and, in accordance with those rules and regulations, do not include all information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). Management believes that the disclosures made are adequate for a fair presentation of the Company s results of operations, financial position and cash flows. In the opinion of management, the condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the results of operations, financial position and cash flows for the interim periods presented herein. The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make extensive use of estimates and assumptions that affect the reported amounts and disclosures. Actual results may vary from such estimates.

The condensed consolidated interim financial statements should be read in conjunction with the consolidated and combined financial statements and notes thereto included in the Company s most recent Annual Report on Form 10-K. The results of operations for any interim period are not necessarily indicative of the results of operations to be expected for the full year.

The condensed consolidated interim financial statements of Neenah and its subsidiaries included herein are unaudited, except for the December 31, 2005 condensed consolidated balance sheet, which was derived from audited financial statements. The condensed consolidated financial statements include the financial statements of the Company, and its wholly owned and majority owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

Earnings per Share (EPS)

Basic EPS was computed by dividing net income by the weighted-average number of shares of common stock outstanding during the 2006 and 2005 reporting periods. Diluted EPS was calculated to give effect to all potentially dilutive common shares using the Treasury Stock method. Outstanding stock options, restricted shares, restricted stock units and restricted stock units with performance conditions represent the only potentially dilutive effects on the Company s weighted-average shares. For the three months and nine months ended September 30, 2006, there were 90,000 and 74,000 dilutive shares, respectively for purposes of computing EPS. For the three and nine months ended September 30, 2005, there were 50,000 dilutive shares for purposes of computing EPS. For the three and nine months ended September 30, 2006, approximately 1,125,000 and 1,095,000 potentially dilutive options, respectively, that were out-of-the-money were excluded from the computation of dilutive common shares For the three and nine months ended September 30, 2005, approximately 965,000 and 705,000, respectively, of such potentially dilutive options were excluded from the computation of dilutive common shares.

Note 2. New Accounting Standards

In June 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

The evaluation of a tax position in accordance with FIN 48 is a two-step process. The first step is recognition: the enterprise determines whether it is more likely than not that a tax position will be sustained upon examination. The second step is measurement: a tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of expense or benefit to recognize in the financial statements. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is evaluating FIN 48 and is currently unable to predict the effect of adoption on the Company s financial position, results of operations or cash flows.

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In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements. SFAS 157 does not require any new fair value measurements.

The definition of fair value in SFAS 157 retains the exchange price notion in earlier definitions of fair value and emphasizes that fair value is a market-based measurement, not an entity-specific measurement. SFAS 157 expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is evaluating SFAS 157 and is currently unable to predict the effect of adoption on its financial position, results of operations or cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (SFAS 158) which requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. SFAS 158 requires disclosure of additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statement No. 87, *Employers Accounting for Pensions*, or FASB Statement No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions*.

SFAS 158 is effective for fiscal years ending after December 15, 2006 for employers with publicly traded equity securities. The requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008; however, the Company currently measures the funded status of its benefit plans as of year-end. The Company will adopt the balance sheet recognition provision of SFAS 158 as of December 31, 2006. The Company is evaluating SFAS 158 and assuming current economic conditions continue, the Company expects that adoption of SFAS 158 will reduce Stockholders equity by approximately $60 million.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on the consideration to be given to prior year misstatements when quantifying misstatements in current year financial statements for purposes of determining whether the financial statements are materially misstated. SAB 108 requires the quantification of misstatements based on their impact to both the balance sheet and the statement of operations to determine materiality. The guidance provides for a one-time cumulative-effect adjustment to correct for misstatements for errors that were not deemed material under a company s prior approach but are material under the SAB 108 approach. SAB 108 is effective as of December 31, 2006 for calendar year companies. The implementation of SAB 108 is not expected to have a material impact on the Company s financial position or results of operations.

Note 3. Sale of Woodlands

In June 2006, the Company completed the sale of approximately 500,000 acres of woodlands in Nova Scotia to Atlantic Star Forestry LTD and Nova Star Forestry LTD (collectively, the Purchaser) for $139.1 million (proceeds net of transaction costs were $134.8 million). The Company received the total proceeds from the sale in cash at closing. The Company also entered into a fiber supply agreement (the FSA) with the Purchaser to secure a source of fiber for the Company s Pictou pulp mill. Following the sale, the Company has approximately 500,000 acres of owned and 200,000 acres of licensed or managed woodlands in Nova Scotia.

Pursuant to the terms of the FSA, the Purchaser is required to make available to the Company sufficient woodlands acreage to yield 200,000 metric tons of softwood timber annually. The Company is required to bear all costs associated with harvesting the timber. Timber purchases under the FSA are at market-based prices subject to semi-annual adjustment. The FSA expires on December 31, 2010 and the Company has the option to unilaterally extend the contract for an additional five years. The FSA can be extended for a subsequent five years upon the mutual agreement of the Company and the Purchaser.

The sale qualified for gain recognition under the full accrual method described in Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate* (SFAS 66). The Company s commitment to accept acreage offered by the Purchaser to satisfy the timber requirements for the first 18 months of the FSA represents a constructive obligation . As a result, the Company recognized a net pre-tax gain on the sale of approximately $122.6 million in the three and six months ended June 30, 2006 and deferred approximately $9.0 million, which represents the Company s estimated maximum exposure to loss of profit due to the constructive obligation under the FSA. The deferral related to the constructive obligation will be amortized through December 2007. For the three and nine months ended September 30, 2006, the Company recognized approximately $1.5 million of such deferred gain.

Note 4. Discontinued Operations

Transfer of the Terrace Bay mill

Manufacturing operations at the Terrace Bay mill were suspended in February 2006 due to a lack of wood fiber for its operations. The mill s fiber supply was exhausted as a result of a strike started in January 2006 by the approximately 250 workers employed by the Longlac woodlands operations that supplies wood fiber to the mill. Most of the approximately 400 hourly and salaried workers employed at the mill were laid off for an indefinite period during the two weeks following the suspension of manufacturing activities. In 2005, the Terrace Bay mill produced approximately 375,000 metric tons of pulp.

In May 2006, the Company announced a tentative agreement to transfer the Terrace Bay mill and related woodlands operations to certain affiliates of Buchanan. In August 2006, the Company consummated the agreement by transferring the mill and related woodlands operations (excluding certain working capital amounts and post-employment obligations) and $18.6 million in cash to Buchanan. The Terrace Bay mill holds non-exclusive rights under a sustainable forest license to harvest wood off approximately 4.6 million acres of land owned by the Province of Ontario.

At closing, the Company retained certain working capital amounts, primarily trade accounts receivable, finished goods inventory and trade accounts payable. In addition, the Company retained certain long-term disability obligations for current and former mill employees and post-employment medical and life insurance liabilities for current retirees.

In conjunction with the transfer of the Terrace Bay mill to Buchanan and as a closing condition of the agreement, the Company initiated plans to curtail and settle its Ontario, Canada defined benefit pension plan. In August 2006, the Company made a payment to the pension trust of approximately $10.8 million for the purchase of annuity contracts to settle its pension liability for current retirees. As a result of the transaction, the Company recognized a pension curtailment and settlement loss of approximately $26.4 million in the three months ended September 30, 2006. In addition, the Company expects to record a settlement loss of approximately $40 million and make a payment of approximately $6 million related to the future settlement of pension obligations for active employees. The timing and amount of the payment and recognition of the loss to settle the liability for active employees is dependent upon, among other things, an actuarial determination of the value of the obligations being settled, the cost of annuity contracts, regulatory approval to settle the plan and employee elections.

The results of operations and loss on disposal of the Terrace Bay mill are reflected as discontinued operations in the condensed consolidated statements of operations for each period presented. The following table presents the results of discontinued operations:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Net sales, net of intersegment sales	$ 2.2	$ 40.0	$ 46.0	$ 154.9
Discontinued Operations:				
Loss from operations	$ (30.3)	$ (13.9)	$ (46.0)	$ (27.6)
Loss on disposal	(0.5)		(6.5)	
Loss before income taxes	(30.8)	(13.9)	(52.5)	(27.6)
Benefit for income taxes	11.8	5.4	20.1	10.6
Loss from discontinued operations	$ (19.0)	$ (8.5)	$ (32.4)	$ (17.0)

Note 5. Comprehensive Income

Comprehensive income includes, in addition to net income, unrealized gains and losses recorded directly to stockholders equity. These unrealized gains and losses are referred to as other comprehensive income items. Accumulated other comprehensive income (loss) consists of unrealized foreign currency translation gains (losses), deferred gains (losses) on cash flow hedges and minimum pension liability adjustments. Unrealized foreign currency translation gains (losses) that relate to indefinite investments in the Company s Canadian pulp operations are not adjusted for income taxes. At September 30, 2006 and December 31, 2005, accumulated other comprehensive income was $58.2 million and $53.9 million, respectively.

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The components of comprehensive income are as follows.

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Net income (loss)	$ (14.4)	$ (1.5)	$ 59.8	$ 8.0
Other comprehensive income:				
Change in unrealized foreign currency translation losses	(0.2)	12.6	8.3	6.2
Change in unrealized gains (losses) on cash flow hedges	(0.3)	1.9	(4.0)	8.8
Comprehensive income	$ (14.9)	$ 13.0	$ 64.1	$ 23.0

Note 6. Risk Management

The Company is exposed to risks such as changes in foreign currency exchange rates and pulp prices. A variety of practices are employed to manage these risks, including operating and financing activities and, where deemed appropriate, the use of derivative instruments. Derivative instruments are used only for risk management purposes and not for speculation or trading. All foreign currency derivative instruments are either exchange traded or entered into with major financial institutions. Credit risk is considered minimal in view of the financial strength of the counterparties. The notional amounts of the Company s derivative instruments do not represent amounts exchanged by the parties and, as such, are not a measure of exposure to credit loss. The amounts exchanged are determined by reference to the notional amounts and the other terms of the contracts.

In accordance with Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, the Company records all derivative instruments as assets (included in Other current assets and Other assets) or liabilities (included in Accrued expenses or Other noncurrent liabilities) on the condensed consolidated balance sheets at fair value. Changes in the fair value of derivative instruments are recorded in either income or other comprehensive income, as appropriate. Unrealized gains or losses from changes in the fair value of highly effective derivatives designated as cash flow hedges are recorded in accumulated other comprehensive income (loss) in the period that changes in fair value occur and are reclassified to income in the same period that the hedged item affects income.

Pulp Price and Foreign Currency Risk

The operating results, cash flows and financial condition of the Company are subject to pulp price risk. The profitability of the Company s pulp operations is subject to foreign currency risk because the price of pulp is established in U.S. dollars and the Company s cost of producing pulp is incurred principally in Canadian dollars. The Company uses foreign currency forward and pulp futures contracts to manage its foreign currency and pulp price risks. The use of these instruments allows management of this transactional exposure to exchange rate and pulp price fluctuations because the gains or losses incurred on the derivative instruments are intended to offset, in whole or in part, losses or gains on the underlying transactional exposure. (See Cash Flow Hedges below). The translation exposure related to the Company s net investment in its Canadian subsidiaries is not hedged.

Cash Flow Hedges

At September 30, 2006, the Company had outstanding foreign currency forward exchange contracts designated as cash flow hedges of U.S dollar denominated pulp sales in a notional amount of $78 million

Canadian dollars. The fair value of the contracts was a current asset of $5.5 million U.S. dollars. The weighted-average exchange rate for the foreign currency contracts at September 30, 2006 was $0.827 U.S. dollars per Canadian dollar. The contracts extend through October 2007 with the highest value of contracts maturing in October 2006. The Company recorded net pre-tax gains of $2.3 million and $8.6 million on foreign currency contracts as the forecasted transactions occurred in the three and nine months ended September 30, 2006, respectively. The Company recorded net pre-tax gains of $1.7 million and $0.8 million on foreign currency contracts as the forecasted transactions occurred in the three and nine months ended September 30, 2005, respectively. Realized gains and losses on currency derivatives are recorded in Other (income) expense - net on the condensed consolidated statements of operations.

Gains and losses on foreign currency forward exchange contracts related to the operations of the Terrace Bay mill have been reclassified from Other (income) expense - net on the condensed consolidated statements of operations and recorded in Loss from discontinued operations. For the three and nine months ended September 30, 2006, $0.2 million and $2.6 million of such gains have been reclassified from continuing to discontinued operations. Gains of $0.9 million and $0.2 million for the three and nine months ended September 30, 2005, have been reclassified to Loss from discontinued operations.

At September 30, 2006, the Company had outstanding pulp future contracts, to hedge fluctuations in pulp prices, for 54,000 net metric tons of pulp with a notional amount of approximately $36 million. The fair value of the contracts was a current liability of $6.0 million. The weighted-average price for the pulp futures contracts at September 30, 2006 was $674 per metric ton. The contracts extend through December 2006 and expire at the rate of 18,000 metric tons per month. The Company recorded net pre-tax losses of $4.2 million and $8.2 million on pulp futures contracts as the forecasted transactions occurred in the three and nine months ended September 30, 2006, respectively. The Company recorded net pre-tax gains of $1.5 million and $0.4 million on pulp futures contracts as the forecasted transactions occurred in the three and nine months ended September 30, 2005, respectively. Realized gains and losses on pulp derivatives are recorded in Net sales on the condensed consolidated statements of operations.

Gains and losses on pulp futures contracts related to the operations of the Terrace Bay mill have been reclassified from Net sales on the condensed consolidated statements of operations and recorded in Loss from discontinued operations. For the nine months ended September 30, 2006, $1.5 million of such losses have been reclassified from continuing to discontinued operations. Gains of $0.8 million and $0.1 million for the three and nine months ended September 30, 2005, have been reclassified to Loss from discontinued operations.

For the three months ended September 30, 2006, the Company s cash flow hedges were highly effective and changes in the fair value of the derivative instruments were reflected in other comprehensive income. If future market rates are consistent with the rates assumed at September 30, 2006, a net pre-tax gain of approximately $1.3 million (or $0.8 million after-tax) is expected to be recognized in earnings during the next 12 months.

Foreign Currency Transactions

In May 2006, the Company entered into a foreign currency forward contract to eliminate variability in the U.S. dollar proceeds from the sale of woodlands in Nova Scotia, Canada (see Note 3 Sale of Woodlands). The Company settled the contract on June 30, 2006 and had no realized gain or loss on settlement. The foreign currency forward contract had a notional value of $155 million Canadian dollars and an exchange rate of $0.902 U.S. dollars per Canadian dollar. Realized gains and losses on the foreign currency forward contract are recorded in Other (income) expense - net on the condensed consolidated statements of operations.

Gains and losses resulting from foreign currency transactions (transactions denominated in a currency other than the entity s functional currency) are included in Other (income) net in the condensed consolidated statements of operations. Net foreign currency transaction gains/(losses) for the three and nine months ended September 30, 2006 were $6 thousand and $(0.8) million, respectively. Net foreign currency transaction losses for the three and nine months ended September 30, 2005 were $2.3 million and $0.4 million, respectively.

Gains and losses resulting from foreign currency transactions related to the operations of the Terrace Bay mill have been reclassified from Other (income) net on the condensed consolidated statements of operations and recorded in Loss from discontinued operations. For the three and nine months ended September 30, 2006, $21 thousand and $(0.4) million of such gains/(losses) have been reclassified. Losses of $4.9 million and $4.4 million for the three and nine months ended September 30, 2005, have been reclassified to Loss from discontinued operations

Note 7. Inventories

The following presents inventories by major class as of September 30, 2006 and December 31, 2005.

	September 30, 2006	December 31, 2005
Raw materials	$ 15.2	$ 30.5
Work in progress	7.8	8.2
Finished goods	26.1	47.8
Supplies and other	3.2	7.6
	52.3	94.1
Excess of FIFO over LIFO cost	(7.8)	(7.0)
Total	$ 44.5	$ 87.1

The FIFO values of total inventories valued on the LIFO method were $38.2 million and $35.2 million at September 30, 2006 and December 31, 2005, respectively.

Note 8. Debt

The following debt was incurred either as a result of or since the Spin-Off. The Company did not have debt prior to November 30, 2004.

Senior Unsecured Notes

On November 30, 2004, the Company completed an underwritten offering of 10-year senior unsecured notes (the Senior Notes) at face amount of $225 million. The Senior Notes bear interest at a rate of 7.375%, payable May 15 and November 15 of each year and mature on November 15, 2014. As of September 30, 2006, the Senior Notes were fully and unconditionally guaranteed by all of the Company s subsidiaries.

Secured Revolving Credit Facility

On November 30, 2004, the Company entered into a Credit Agreement by and among Neenah, certain of its subsidiaries, the lenders listed in the Credit Agreement and JP Morgan Chase Bank, N.A. as agent for the lenders, as amended, (the Credit Agreement). Under the Credit Agreement, the Company had a secured revolving credit facility (the Revolver) that provided for borrowings of up to $150 million. Availability under the Credit Agreement will fluctuate over time depending on the value of the Company s inventory, receivables and various capital assets. The Credit Agreement is secured by substantially all of the Company s assets, including the capital stock of its subsidiaries and is guaranteed by Neenah Paper Company of Canada, a wholly-owned subsidiary. The Credit Agreement originally terminated on November 30, 2008.

At September 30, 2006, approximately $145 thousand was outstanding under the Revolver. Borrowing availability under the Revolver is reduced by outstanding letters of credit. At September 30, 2006, the Company had approximately $2.9 million of letters of credit outstanding and $119.0 million of borrowing availability under the Revolver.

The Credit Agreement and the indenture governing the Senior Notes contain, among other provisions, covenants with which the Company must comply during the term of the agreements. Such covenants restrict the Company s ability to, among other things, incur certain additional debt, make specified restricted payments and capital expenditures, authorize or issue capital stock, enter into transactions with affiliates, consolidate or merge with or acquire another business, sell certain of its assets or liquidate, dissolve or wind-up. In addition, the terms of the Revolver require the Company to achieve and maintain certain specified financial ratios. As of September 30, 2006, the Company was in compliance with all such covenants.

Credit Agreement Amendment

In October 2006, the Company entered into the Third Amendment (the Third Amendment) to the Credit Agreement. The Third Amendment, among other things, (i) increases availability under the Revolver from $150 million to $165 million, (ii) extends the termination date of the Credit Agreement to November 30, 2010, (iii) sets the interest rate under the Revolver to either (A) the Prime Rate (as defined) plus a percentage ranging from 0% to 0.75%, or (B) LIBOR plus a percentage ranging from 1.25% to 2.25%, (iv) reduces the commitment fee pricing on the Revolver, and (iv) makes other definitional, administrative and covenant modifications to the Credit Agreement.

In the Third Amendment, the lenders also consented to consummation of the Company s announced purchase of Neenah Germany (see Note 15, Subsequent Event). Neenah Germany is not a borrower or guarantor with respect to the Revolver. However, the Company pledged 65% of its equity interest in Neenah Germany as security for the obligations of the Company and its subsidiaries under the Credit Agreement.

The Company s ability to borrow under the Revolver is limited by the Third Amendment to the lowest of (a) $165 million, (b) the Company s borrowing base (as determined in accordance with the amended Credit Agreement), and (c) the applicable cap on the amount of credit facilities under the indenture. As of October 3, 2006, the Company s borrowing base was approximately $150 million. The amount of the borrowing base is subject to change from time to time in accordance with the terms of the Credit Agreement.

In anticipation of completing the purchase of Neenah Germany, the Company borrowed $58.0 million in principal amount under the Revolver on October 6, 2006, and as of October 31, 2006, the total amount outstanding under the Revolver was approximately $50.3 million. The weighted average interest rate on such borrowings was 7.13%. Interest on amounts borrowed under the Revolver is paid monthly. All principal amounts outstanding under the Revolver are due and payable on the date of termination of the Revolver.

The Revolver, as amended, contains events of default customary for financings of this type, including failure to pay principal or interest, materially false representations or warranties, failure to observe covenants and other terms of the Revolver, cross-defaults to other indebtedness, bankruptcy, insolvency, various ERISA violations, the incurrence of material judgments and changes in control.

Other Financing

During the first quarter of 2005, the Company obtained third-party financing to fund its purchase of enterprise resource planning (ERP) software. At inception, the present value of the financing agreement was $3.6 million (discounted at 7.375%) payable in quarterly installments through January 2008. At September 30, 2006, $1.6 million of such third-party financing was outstanding of which $1.3 million was due in the next 12 months. In the first quarter of 2005, the Company issued a short-term note for $2.3 million to finance insurance premiums.

Note 9. Pension and Other Post-employment Benefits

Pension Plans

Substantially all active employees of the Pulp and Paper Business participated in Kimberly-Clark s defined benefit pension plans and defined contribution retirement plans. On November 30, 2004, the Company assumed responsibility for pension and post-employment benefit obligations for active employees of the Pulp and Paper Business and retired employees of the Canadian pulp operations. Pension and post-employment benefit obligations related to retired employees of the U.S. paper operations were retained by Kimberly-Clark.

The following table presents the components of net periodic benefit cost:

Components of Net Periodic Benefit Cost

	Pension Benefits		Post-Employment Benefits Other than Pensions	
	Three Months Ended September 30,			
	2006	2005	2006	2005
Service cost	$ 1.8	$ 2.6	$ 0.5	$ 0.4
Interest cost	5.4	5.7	1.0	0.8
Expected return on plan assets (a)	(7.5)	(6.9)		
Recognized net actuarial loss	1.9	1.8	0.3	0.2
Amortization of unrecognized transition asset	(0.1)	(0.1)		
Amortization of prior service cost	0.4	0.5	0.1	
Net periodic benefit cost	$ 1.9	$ 3.6	$ 1.9	$ 1.4

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	Pension Benefits		Post-Employment Benefits Other than Pensions	
	Nine Months Ended September 30,			
	2006	2005	2006	2005
Service cost	$ 6.2	$ 7.9	$ 1.6	$ 1.2
Interest cost	17.1	16.3	3.1	2.3
Expected return on plan assets (a)	(23.4)	(20.5)		
Recognized net actuarial loss	6.0	5.3	1.2	0.5
Amortization of unrecognized transition asset	(0.2)	(0.2)		
Amortization of prior service cost	1.2	1.0	0.3	
Net periodic benefit cost	$ 6.9	$ 9.8	$ 6.2	$ 4.0

(a) The expected return on plan assets is determined by multiplying the fair value of plan assets at the prior year-end (adjusted for estimated current year cash benefit payments and contributions) by the expected long-term rate of return.

In conjunction with the transfer of the Terrace Bay mill to Buchanan (see Note 4, Discontinued Operations) and as a closing condition of the agreement, the Company initiated plans to curtail and settle its Ontario, Canada defined benefit pension plan. In August 2006, the Company made a payment to the pension trust of approximately $10.8 million for the purchase of annuity contracts to settle its pension liability for current retirees. As a result of the transaction, the Company recognized a pension curtailment and settlement loss of approximately $26.4 million in the three months ended September 30, 2006. In addition, the Company expects to record a settlement loss of approximately $40 million and make a payment of approximately $6 million related to the future settlement of pension obligations for active employees. The timing and amount of the payment and recognition of the loss to settle the liability for active employees is dependent upon, among other things, an actuarial determination of the value of the obligations being settled, the cost of annuity contracts, regulatory approval to settle the plan and employee elections. For the three and nine months ended September 30, 2006, $(0.2) million and $0.4 million, respectively, of the pension (income) expense described above related to the operations of the Terrace Bay mill and have been classified as Loss from discontinued operations on the condensed consolidated statements of operations. Such amounts for the three and nine months ended September 30, 2005 were $1.3 million and $4.1 million, respectively.

Pursuant to the terms of the transfer agreement, Buchanan assumed responsibility for post-employment medical and life insurance benefits for active employees at the Terrace Bay mill. As a result, $0.6 million and $2.4 million of post-employment benefits other than pensions (described above) for the three and nine months ended September 30, 2006, respectively, have been classified as Loss from discontinued operations on the condensed consolidated statements of operations. Such amounts for the three and nine months ended September 30, 2005 were $0.7 million and $1.9 million, respectively.

Based on September 30, 2006 exchange rates, the Company expects to contribute approximately $25 million to its pension trusts in 2006, including $10.8 million to purchase annuity contracts to settle pension liabilities under the Company s Ontario, Canada defined benefit pension plan for current retirees. For the nine months ended September 30, 2006, the Company made contributions to its pension trusts of approximately $21.0 million.

Note 10. Stock Compensation Plan

The Company adopted and established the 2004 Omnibus Stock and Incentive Plan (the Omnibus Plan) under unanimous written consent of its Board of Directors on December 1, 2004. The Company reserved 3,500,000 shares of $0.01 par value common stock (Common Stock) for issuance under the Omnibus Plan. Pursuant to the terms of the Omnibus Plan, the compensation committee of the Company s Board of Directors may grant various types of equity-based compensation awards, including incentive and nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units (RSUs), restricted stock units with performance conditions (Performance Shares) and performance units, in addition to certain cash-based awards. All grants under the Omnibus Plan will be made at fair market value and no grant may be repriced. In general, the options expire ten years from the date of grant and vest over a three-year service period. At September 30, 2006, a total of 1,975,879 shares of Common Stock were reserved for future issuance under the Omnibus Plan.

On January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share Based Payment* (SFAS 123R) using the modified-prospective transition method. The restatement of prior year periods for the adoption of SFAS 123R is not permitted under the modified-prospective transition method. Stock-based compensation cost recognized under SFAS 123R in the three and nine months ended September 30, 2006 consisted of (a) compensation cost for all unvested stock-based grants outstanding as of January 1, 2006, based on the grant date fair value estimated in accordance with the pro forma provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123) and (b) compensation cost for all stock-based awards granted subsequent to adoption based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. The amount of stock-based compensation cost recognized is based on the fair value of grants that are ultimately expected to vest and is recognized pro-rata over the requisite service period for the entire award.

SFAS 123R amends Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows,* to require the reporting of excess tax benefits related to the exercise or vesting of stock-based awards as cash provided by financing activities rather than as a reduction in income taxes paid and reported as cash provided by operations. For the nine months ended September 30, 2006, the Company recognized $29 thousand of excess tax benefits related to the exercise or vesting of stock-based awards. The Company did not recognize any excess tax benefits for the nine months ended September 30, 2005.

Valuation and Expense Information Under SFAS 123R

The following table summarizes stock-based compensation costs and related income tax benefits. All stock-based compensation expense has been recorded in selling, general and administrative expenses.

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Stock-based compensation expense	$ 1.2	$ 0.2	$ 3.9	$ 0.7
Income tax benefit	(0.5)	(0.1)	(1.5)	(0.3)
Stock-based compensation, net of income tax benefits	$ 0.7	$ 0.1	$ 2.4	$ 0.4

The adoption of SFAS 123R resulted in additional stock-based compensation expense of $0.9 million and income tax benefits of $0.3 million and reduced EPS by $0.04 for the three months ended

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September 30, 2006. For the nine months ended September 30, 2006 additional stock-based compensation and related income tax benefits were $3.0 million and $1.1 million and reduced EPS by $0.13.

The following table summarizes total compensation costs related to the Company s equity awards and amounts recognized in the nine months ended September 30, 2006.

	Stock Options	Restricted Stock
Unrecognized compensation cost December 31, 2005	$ 4.8	$ 1.8
Add: Grant date fair value current year grants	1.8	1.5
Less: Compensation expense recognized	2.7	1.2
Less: Grant date fair value of shares forfeited		0.1
Unrecognized compensation cost September 30, 2006	$ 3.9	$ 2.0
Expected amortization period (in years)	1.3	2.2

Stock Options

For the nine months ended September 30, 2006, the Company granted options to purchase 153,082 shares of common stock to participants in its Long-Term Incentive Plan (the LTIP), options to purchase 11,220 shares of common stock to members of the board of directors (Board Members) and options to purchase 5,000 shares to other employees. The options expire in ten years and the exercise price of the options was equal to the market price of the Company s common stock on the date of grant. Except for options awarded to Board Members, one-third of the options vest on each of the first three anniversaries of the date of grant. Options granted to Board Members vest one year from the date of grant. For the nine months ended September 30, 2006, the weighted average exercise price for options granted was $28.88 per share. For the nine months ended September 30, 2005, the Company granted options to purchase 125,700 shares and 11,250 shares of common stock to LTIP participants and Board Members, respectively. The weighted average exercise price and grant date fair value of such options was $32.52 and $12.46, respectively (see Pro Forma Information Under SFAS 123 for Periods Prior to January 1, 2006).

The weighted-average grant date fair value for stock options granted during the three and nine months ended September 30, 2006 was $11.63 and $11.23, respectively, and was estimated using the Black-Scholes option valuation model with the following assumptions:

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Expected life in years	5.9	5.9
Interest rate	5.0 %	4.8 %
Volatility	38.3 %	38.0 %
Dividend yield	1.4 %	1.4 %

The expected term was estimated based upon historical data for Kimberly-Clark stock option awards and the expected volatility was estimated by reference to the historical stock price performance of a peer group of companies. The risk-free interest rate was based on the yield on U.S. Treasury bonds with a remaining term approximately equivalent to the expected term of the stock option award. Forfeitures were estimated at the date of grant.

The following table summarizes stock option activity under the Omnibus Plan for the nine months ended September 30, 2006:

	Number of Stock Options	Weighted-Average Exercise Price
Options outstanding December 31, 2005	1,284,428	$ 31.90
Add: Options granted	169,302	$ 28.88
Less: Options exercised	15,021	$ 25.95
Less: Options forfeited/cancelled	13,850	$ 32.05
Options outstanding September 30, 2006	1,424,859	$ 31.60

The status of outstanding and exercisable stock options as of September 30, 2006, summarized by exercise price follows:

	Options Outstanding				Options Exercisable		
Exercise Price	**Number of Options**	**Weighted-Average Remaining Contractual Life**	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value(a)**	**Number of Options**	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value(a)**
$24.01 - $26.04	197,901	5.9	$ 24.24	$ 2.0	197,901	$ 24.24	$ 2.0
$26.95 - $31.70	285,493	7.6	$ 29.36	1.4	93,307	$ 29.80	0.4
$32.60 - $37.59	941,465	6.8	$ 33.83	1.0	581,993	$ 34.52	0.5
	1,424,859	6.8	$ 31.60	$ 4.4	873,201	$ 31.68	$ 2.9

(a) Represents the total pre-tax intrinsic value as of September 30, 2006 that option holders would have received had they exercised their options as of such date. The pre-tax intrinsic value is based on the closing market price for the Company s common stock of $34.23 on September 30, 2006.

The aggregate pre-tax intrinsic value of stock options exercised during the nine months ended September 30, 2006 was $0.1 million. No stock options were exercised during the nine months ended September 30, 2005.

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The following table summarizes the status of the Company s unvested stock options as of September 30, 2006 and activity for the nine months then ended:

	Number of Stock Options	Weighted-Average Grant Date Fair Value
Outstanding December 31, 2005	544,144	$ 12.98
Add: Options granted	169,302	$ 11.23
Less: Options vested	200,640	$ 13.25
Less: Options forfeited/cancelled	13,580	$ 12.36
Outstanding September 30, 2006	499,226	$ 12.30

For the nine months ended September 30, 2006, the aggregate grant date fair value of options vested was $2.1 million. As of September 30, 2006, certain participants met age and service requirements that allowed their options to qualify for accelerated vesting upon retirement. For the nine months ended September 30, 2006, there were 52,432 stock options subject to accelerated vesting that such participants would have been eligible to exercise if they had retired as of September 30, 2006. The aggregate grant date fair value of options subject to accelerated vesting was $0.6 million. For the three and nine months ended September 30, 2006, stock-based compensation expense for such options was $0.3 million and $0.6 million, respectively. Stock options that reflect accelerated vesting for expense recognition become exercisable according to the contract terms of the stock option grant.

Restricted Stock and RSUs

In February 2006, the Company granted 48,100 Performance Shares to LTIP participants. The measurement period for the Performance Shares is January 1, 2006 through December 31, 2006. Based on Company performance compared to revenue growth and return on invested capital targets, RSUs equal to between 30% and 225% of the performance award will be issued. The RSUs carry a promise to pay out in Common Stock at a future date. In general, the RSUs issued will become 100% vested two years from the end of the performance period. During the vesting period, the holders of RSUs are entitled to dividends, but are not permitted to vote such shares and the RSUs are forfeited in the event of termination of employment (as defined). The grant date fair value for the performance shares was $27.58 per share and was equal to the market price of the Company s common stock on the date of grant. Compensation cost is recognized pro rata over the vesting period.

In February 2006, the Company granted 48,100 Performance Shares to LTIP participants. The measurement period

During the nine months ended September 30, 2006, the Company awarded 3,510 RSUs to Board Members. The RSUs vest one year from the date of grant. During the vesting period, the holders of RSUs are entitled to dividends, but are not permitted to vote such shares and the RSUs are forfeited in the event holder does not continue to serve as a Board Member (as defined). The grant date fair value for the RSUs was $32.84 per share and was equal to the market price of the Company s common stock on the date of grant. Compensation cost is recognized pro rata over the vesting period.

In December 2004, the Company awarded 40,800 and 3,450 RSUs (Fresh Start Grants) to LTIP participants and non-employee members of the Company s Board of Directors, respectively. The RSUs carry a promise to pay out in Common Stock at a future date. The Fresh Start Grants awarded to LTIP participants vest over a five year period, with one-third vesting on the third anniversary of the date of grant, one-third vesting on the fourth anniversary, and the balance vesting on the fifth anniversary. The RSUs awarded to non-employee members of the Board of Directors vest on the first anniversary of the date of grant. At September 30, 2006, 54,163 RSUs were outstanding, with 17,650 shares, 23,380 shares and 13,133 shares vesting in 2007, 2008 and 2009, respectively.

In February 2006, the Company granted 48,100 Performance Shares to LTIP participants. The measurement period

At the time of the Spin-Off, the vesting schedule of Kimberly-Clark restricted stock awards for employees of the Pulp and Paper Business were adjusted so that the awards vested on a prorated basis determined by the number of full years of employment with Kimberly-Clark during the restriction period. Unvested restricted shares of Kimberly-Clark common stock were forfeited. In December 2004, the Company awarded 25,360 replacement restricted shares to employees whose restricted shares of Kimberly-Clark common stock were forfeited. The number of restricted shares was calculated using a ratio conversion methodology approved under FASB Interpretation No. 44 based on the fair market value of the Company s common stock on the date of grant. At September 30, 2006, 22,871 of such restricted shares were outstanding, with 3,681 shares, 2,025 shares, 16,591 shares and 574 shares vesting in 2006, 2007, 2008 and 2009, respectively.

The following table summarizes the activity of the Company s unvested stock-based awards (other than stock options) for the nine months ended September 30, 2006:

	Restricted Stock	**Weighted-Average Grant Date Fair Value**	**Performance Shares/RSUs**	**Weighted-Average Grant Date Fair Value**
Outstanding December 31, 2005	22,871	$ 34.28	55,193	$ 31.68
Add: Shares granted(a)			51,663	$ 27.94
Less: Shares vested			2,934	$ 33.31
Less: Shares expired or cancelled			2,759	$ 30.03
Outstanding September 30, 2006(b)	22,871	$ 34.28	101,163	$ 29.77

(a) Includes the grant of 53 RSUs to Canadian employees and directors in lieu of cash dividends. Such dividends-in-kind vest concurrently with the underlying RSU.

(b) The aggregate pre-tax intrinsic value of restricted stock and RSUs/Performance Shares at September 30, 2006 was $0.8 million and $3.4 million, respectively.

Pro Forma Information Under SFAS 123 for Periods Prior to January 1, 2006

Prior to January 1, 2006, the Company applied the intrinsic value method permitted by Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations to account for stock option grants as permitted by SFAS 123. No employee compensation expense related to stock options has been charged to earnings because the exercise prices of all stock options granted were equal to the market value of the Company or Kimberly-Clark s common stock on the date of grant. SFAS 123R requires the recognition of compensation costs for stock-based awards subject to accelerated vesting upon retirement over a service period ending no later than the earliest date the employee becomes eligible for retirement, generally age 55 with five years of vested service. Prior to the adoption of SFAS 123R, the Company recognized compensation cost over the explicit service period for restricted stock and RSU awards subject to accelerated vesting upon retirement. For such awards and other stock-based awards granted prior to, but unvested as of, January 1, 2006, compensation cost will be recognized pro-rata over the explicit service period for the award and any remaining unamortized compensation cost will be recognized upon the employees retirement.

In February 2006, the Company granted 48,100 Performance Shares to LTIP participants. The measurement period

The following table presents the effects on net income and earnings per share if the Company had adopted the fair value recognition provisions of SFAS 123 for options granted in the three and nine months ended September 30, 2005.

(In millions, except per share)	**Three Months Ended September 30, 2005**	**Nine Months Ended September 30, 2005**
Reported net income	$ (1.5)	$ 8.0
Add: Stock-based compensation expense, net of tax effects, included in net income as reported	0.1	0.4
Less: Pro forma compensation expense, net of tax	(0.6)	(1.9)
Pro forma net income	$ (2.0)	$ 6.5
Reported earnings per share:		
Basic	$ (0.10)	$ 0.54
Diluted	$ (0.10)	$ 0.54
Pro forma earnings per share:		
Basic	$ (0.14)	$ 0.44
Diluted	$ (0.14)	$ 0.44

The weighted-average grant date fair value for stock options granted during the three and nine months ended September 30, 2005 was estimated using the Black-Scholes option valuation model with the following assumptions:

	Three Months Ended September 30, 2005	**Nine Months Ended September 30, 2005**
Expected life in years	5.9	5.9
Interest rate	4.1 %	3.9 %
Volatility	38.4 %	39.0 %
Dividend yield	1.3 %	1.2 %

The expected term was estimated based upon historical data for Kimberly-Clark stock option awards and expected volatility was estimated by reference to the historical stock price performance of a peer group of companies. The grant date fair market value of stock options awarded during the three and nine months ended September 30, 2005 was $12.16 and $12.46, respectively. Forfeitures were estimated at the date of grant.

Note 11. Contingencies and Legal Matters

Litigation

The Company is involved in certain legal actions and claims arising in the ordinary course of business. While the outcome of these legal actions and claims cannot be predicted with certainty, it is the opinion of management that the outcome of any claim which is pending or threatened, either individually or on a combined basis, will not have a material adverse effect on the consolidated financial condition, results of operations or liquidity of the Company.

Indemnifications

In conjunction with the transfer of the Terrace Bay mill, the Company entered into a pulp manufacturing agreement (the Pulp Manufacturing Agreement) with Buchanan. Pursuant to the Pulp Manufacturing Agreement, Buchanan will make available to the Company sufficient tonnage of pulp produced at the Terrace Bay mill to satisfy the Company s supply obligations under an amended pulp supply agreement with Kimberly-Clark (as amended, the Pulp Supply Agreement). The price paid by the Company under the Pulp Manufacturing Agreement will equal the price paid by Kimberly-Clark pursuant to the Pulp Supply Agreement. With respect to the Terrace Bay mill, Buchanan has agreed to assume responsibility for discharging all of the Company s supply obligations under the Pulp Supply Agreement. In addition, Buchanan has agreed to unconditionally indemnify the Company for any claims arising from Terrace Bay s performance under the Pulp Manufacturing Agreement. The Pulp Manufacturing Agreement will terminate on December 31, 2010 or sooner by mutual agreement by the parties or upon the occurrence of certain events (as defined in the Pulp Manufacturing Agreement).

Pursuant to the Distribution Agreement, the Pulp Supply Agreement, the Employee Matters Agreement and the Tax Sharing Agreement, the Company has agreed to indemnify Kimberly-Clark for certain liabilities or risks related to the Spin-Off. Many of the potential indemnification liabilities under these agreements are unknown, remote or highly contingent. Furthermore, even in the event that an indemnification claim is asserted, liability for indemnification is subject to determination under the terms of the applicable agreement. For these reasons, the Company is unable to estimate the maximum potential amount of the possible future liability under the indemnity provisions of these agreements. However, the Company accrues for any potentially indemnifiable liability or risk under these agreements for which it believes a future payment is probable and a range of loss can be reasonably estimated. As of September 30, 2006, management believes the Company s liability under such indemnification obligations was not material to the consolidated financial statements.

Employees and Labor Relations

Hourly employees at the Pictou pulp mill are represented by Local 440 of the Communications, Energy and Paperworkers Union of Canada pursuant to a collective bargaining agreement expiring on May 31, 2009.

In December 2005, hourly employees at the Munising paper mill, represented by Locals 7-0087 and 7-0096 of the United Steelworkers Union (the USW) and the Company executed a new collective bargaining agreement expiring on July 15, 2009. In January 2006, hourly employees at the Whiting paper mill, represented by Local 7-370 of the USW and the Company executed a new collective bargaining agreement expiring on February 1, 2009. In February 2006, hourly employees at the Neenah paper mill, represented by Local 7-1170 of the USW and the Company executed a new collective bargaining agreement expiring on July 1, 2009. Additionally, these mills have bargained jointly with the union on pension matters. The agreements on pension matters for these mills expire June 30, 2007.

Note 12. Restructuring Costs and Asset Impairment Loss

The Company closed the smaller of the two single-line pulp mills at the Terrace Bay facility (the No. 1 Mill) on May 1, 2005. The No. 1 Mill was originally constructed in 1948 and had annual capacity of approximately 125,000 metric tons of bleached kraft pulp. In conjunction with the closure, approximately 150 employees accepted early retirement and severance packages.

During 2005, the Company recorded approximately $5.0 million for one-time termination benefits related to early retirement, severance and defined benefit pension plans in connection with the closure of the No.1 Mill and approximately $0.3 million for other exit costs. Approximately $1.7 million and $5.2 million of such early retirement and severance costs were recognized in the three and nine months ended September 30, 2005. As of September 30, 2006, termination benefits of approximately $4.9 million had been paid to 147 employees. With respect to certain termination benefits that remain unpaid (approximately $55 thousand at September 30, 2006), such benefits relate to three employees that cannot be terminated until they return from long-term disability leave.

During the first six months of 2005, the Company recorded a pre-tax, non-cash asset impairment loss of approximately $0.8 million related to the remaining value of the long-lived assets of the No. 1 Mill. As a result of the transfer of the Terrace Bay mill to Buchanan, costs associated with the closure were reclassified to Loss from discontinued operations on the condensed consolidated statements of operations.

Note 13. Business Segment Information

The Company reports its operations in three segments: Fine Paper, Technical Products and Pulp. The Fine Paper business is a leading producer of premium writing, text, cover and specialty papers. The Technical Products business is a leading producer of durable, saturated and coated base papers for a variety of end uses. The Pulp business consists of a pulp mill in Nova Scotia, Canada and related woodlands, which produce northern bleached softwood and hardwood kraft pulp. Each segment requires different technologies and marketing strategies. Corporate expenses that are identifiable as directly supporting the operations of the business segments are allocated to the business segments. General corporate expenses that do not directly support the operations of the business segments are shown as Unallocated corporate costs. Disclosure of segment information is on the same basis that management uses internally for evaluating segment performance and allocating resources. The results of operations of the Terrace Bay mill were previously reported in the Pulp business segment. As a result of the transfer of the Terrace Bay mill to Buchanan (see Note 4, Discontinued Operations), the results of operations of the Terrace Bay mill have been reclassified to discontinued operations and the results of Pulp business segment have been restated for all periods presented.

The following table summarizes the net sales and income before interest and taxes (Operating income) for each of the Company s business segments.

	Three Months Ended September 30,		Nine Months Ended September 30,	
Net sales	**2006**	**2005**	**2006**	**2005**
Fine Paper	$ 53.8	$ 52.2	$ 169.2	$ 166.9
Technical Products	33.5	28.7	100.3	99.0
Pulp	54.2	47.7	149.4	133.9
Intersegment sales	(0.1)	(0.9)	(1.8)	(1.1)
Consolidated	$ 141.4	$ 127.7	$ 417.1	$ 398.7

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Operating income	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Fine Paper	$ 12.8	$ 12.3	$ 43.9	$ 45.3
Technical Products	0.9	0.2	5.8	8.0
Pulp	(0.3)	4.6	119.2	4.6
Unallocated corporate costs	(2.9)	(1.7)	(9.5)	(5.1)
Consolidated	$ 10.5	$ 15.4	$ 159.4	$ 52.8

Note 14. Condensed Consolidating Financial Information

Neenah Paper Company of Canada, Neenah Paper Michigan, Inc. and Neenah Paper Sales, Inc. (the Subsidiary Guarantors) guarantee the Company s Senior Notes. The Subsidiary Guarantors are 100% owned by the Company and all guarantees are full and unconditional. The following condensed consolidating financial information is presented in lieu of consolidated financial statements for the Subsidiary Guarantors as of September 30, 2006 and December 31, 2005 and for the three and nine months ended September 30, 2006 and 2005.

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

For the Three Months Ended September 30, 2006

	Neenah Paper, Inc	Subsidiary Guarantors	Consolidating Adjustments	Consolidated Amounts
Net sales	$ 21.7	$ 136.4	$ (16.7)	$ 141.4
Cost of products sold	16.7	121.4	(16.7)	121.4
Gross profit	5.0	15.0		20.0
Selling, general and administrative expenses	1.5	11.6		13.1
Gain on sale of woodlands (Note 3)		(1.5)		(1.5)
Equity in earnings of subsidiaries	15.0		(15.0)	
Other (income) expense - net				