SCHWEITZER MAUDUIT INTERNATIONAL INC
Form 10-Q
August 08, 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 June 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**

1-13948
(Commission file number)

SCHWEITZER-MAUDUIT INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware	**62-1612879**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
100 North Point Center East, Suite 600 **Alpharetta, Georgia**	**30022**
(Address of principal executive offices)	(Zip code)

1-800-514-0186
(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.

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

There were 15,450,339 shares of Common Stock, par value $0.10 per share, of the registrant outstanding as of August 7, 2006.

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* These Section 906 certifications are not being incorporated by reference into the Form 10-Q filing or otherwise deemed to be filed with the Securities and Exchange Commission.

PART I

ITEM 1. FINANCIAL STATEMENTS

SCHWEITZER-MAUDUIT INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(dollars in millions, except per share amounts)

(Unaudited)

	Three Months Ended June 30, 2006	June 30, 2005	Six Months Ended June 30, 2006	June 30, 2005
Net Sales	$ 162.1	$ 168.2	$ 327.5	$ 328.8
Cost of products sold	139.9	142.0	280.7	278.5
Gross Profit	22.2	26.2	46.8	50.3
Selling expense	5.9	6.1	11.5	12.3
Research expense	1.9	2.5	3.7	5.0
General expense	6.8	6.9	14.5	12.7
Total nonmanufacturing expenses	14.6	15.5	29.7	30.0
Restructuring expense (see Note 4)	3.4		3.9	
Operating Profit	4.2	10.7	13.2	20.3
Interest expense	1.4	1.5	2.8	2.8
Other (expense) income, net	(0.6)	0.9	(0.6)	1.5
Income Before Income Taxes, Minority Interest and Loss from Equity Affiliates	2.2	10.1	9.8	19.0
Provision for income taxes	0.4	2.9	2.4	5.5
Minority interest in earnings of subsidiaries	1.0	1.4	2.0	2.7
Loss from equity affiliates	0.1		0.1	
Net Income	$ 0.7	$ 5.8	$ 5.3	$ 10.8
Net Income Per Share				
Basic	$ 0.04	$ 0.39	$ 0.34	$ 0.72
Diluted	$ 0.04	$ 0.38	$ 0.34	$ 0.70
Cash Dividends Declared Per Share	$ 0.15	$ 0.15	$ 0.30	$ 0.30
Weighted Average Shares Outstanding				
Basic	15,399,600	15,156,200	15,377,100	15,083,600
Diluted	15,528,000	15,499,000	15,529,200	15,501,700

The accompanying notes are an integral part of these consolidated financial statements.

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SCHWEITZER-MAUDUIT INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(dollars in millions, except per share amounts)

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current Assets		
Cash and cash equivalents	$ 2.7	$ 5.1
Accounts receivable	93.1	99.8
Inventories	127.3	123.0
Other current assets	15.2	14.8
Total Current Assets	238.3	242.7
Property, Plant and Equipment, net	418.6	414.0
Other Assets	37.1	34.1
Total Assets	$ 694.0	$ 690.8
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Current debt	$ 27.3	$ 30.0
Accounts payable	54.4	64.3
Accrued expenses	73.7	71.7
Current deferred revenue	6.0	6.0
Total Current Liabilities	161.4	172.0
Long-Term Debt	79.4	83.7
Deferred Income Tax Liabilities	38.8	40.2
Pension and Other Postretirement Benefits	37.4	38.1
Deferred Revenue	26.7	30.0
Other Liabilities	20.9	20.1
Minority Interest	17.1	13.8
Total Liabilities	381.7	397.9
Stockholders Equity		
Preferred stock, $0.10 par value; 10,000,000 shares authorized; none issued or outstanding		
Common stock, $0.10 par value; 100,000,000 shares authorized; 16,078,733 shares issued; 15,441,163 and 15,307,756 shares outstanding at June 30, 2006 and December 31, 2005, respectively	1.6	1.6
Additional paid-in-capital	63.3	63.8
Common stock in treasury, at cost, 637,570 and 770,977 shares at June 30, 2006 and December 31, 2005, respectively	(12.9)	(15.6)
Retained earnings	282.4	281.8
Unearned compensation on restricted stock		(0.3)
Accumulated other comprehensive loss, net of tax	(22.1)	(38.4)
Total Stockholders Equity	312.3	292.9
Total Liabilities and Stockholders Equity	$ 694.0	$ 690.8

The accompanying notes are an integral part of these consolidated financial statements.

SCHWEITZER-MAUDUIT INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS

EQUITY AND COMPREHENSIVE INCOME (LOSS)

(dollars in millions, except per share amounts)

(Unaudited)

	Common Stock Issued		**Additional Paid-In**	**Treasury Stock**		**Retained**	**Unearned**	**Accumulated Other Comprehensive**	
	Shares	**Amount**	**Capital**	**Shares**	**Amount**	**Earnings**	**Compensation**	**Income (Loss)**	**Total**
Balance, December 31, 2004	**16,078,733**	**$ 1.6**	**$ 63.3**	**1,132,083**	**$ (22.3)**	**$ 271.5**	**$ (0.5)**	**$ (21.0)**	**$ 292.6**
Net income for the six months ended June 30, 2005						10.8			10.8
Adjustments to unrealized foreign currency translation								(14.9)	(14.9)
Changes in the fair value of derivative instruments								(0.5)	(0.5)
Comprehensive (loss)									(4.6)
Dividends declared ($0.30 per share)						(4.6)			(4.6)
Purchases of treasury stock				29,270	(1.0)				(1.0)
Restricted stock issuances			0.1	(4,500)	0.1				0.2
Amortization of unearned compensation							0.1		0.1
Stock issued to directors as compensation				(1,596)					
Stock issued to directors from deferred compensation			0.1	(4,511)	0.1				0.2
Excess tax benefits of stock-based awards			0.8						0.8
Issuance of shares for options exercised			(0.4)	(264,270)	5.2				4.8
Balance, June 30, 2005	**16,078,733**	**1.6**	**63.9**	**886,476**	**(17.9)**	**277.7**	**(0.4)**	**(36.4)**	**288.5**
Net income for the six months ended December 31, 2005						8.6			8.6
Adjustments to minimum pension liability								(0.2)	(0.2)
Adjustments to unrealized foreign currency translation								(2.3)	(2.3)
Changes in the fair value of derivative instruments								0.5	0.5
Comprehensive income									6.6

Dividends declared ($0.30 per share)						(4.5)			(4.5)
Restricted stock forfeitures			(0.1)	2,000	(0.1)				(0.2)
Amortization of unearned compensation							0.1		0.1
Stock issued to directors as compensation				(2,068)	0.1				0.1
Excess tax benefits of stock-based awards			0.2						0.2
Issuance of shares for options exercised			(0.2)	(115,431)	2.3				2.1
Balance, December 31, 2005	**16,078,733**	**1.6**	**63.8**	**770,977**	**(15.6)**	**281.8**	**(0.3)**	**(38.4)**	**292.9**
Net income for the six months ended June 30, 2006						5.3			5.3
Adjustments to unrealized foreign currency translation								16.3	16.3
Comprehensive income									21.6
Effect of adoption of new accounting standard			(0.3)				0.3		
Dividends declared ($0.30 per share)						(4.7)			(4.7)
Restricted stock issuances			(0.5)	(27,000)	0.5				
Return of shares.				13					
Restricted stock forfeitures			0.1	3,000	(0.1)				
Stock-based compensation expense			0.2						0.2
Stock issued to directors as compensation				(3,020)	0.1				0.1
Excess tax benefits of stock-based awards			0.4						0.4
Issuance of shares for options exercised			(0.4)	(106,400)	2.2				1.8
Balance, June 30, 2006	**16,078,733**	**$ 1.6**	**$ 63.3**	**637,570**	**$ (12.9)**	**$ 282.4**	**$**	**$ (22.1)**	**$ 312.3**

The accompanying notes are an integral part of these consolidated financial statements.

SCHWEITZER-MAUDUIT INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOW

(dollars in millions)

(Unaudited)

	Six Months Ended June 30, 2006	June 30, 2005
Operations		
Net income	$ 5.3	$ 10.8
Non-cash items included in net income		
Depreciation and amortization	22.3	19.3
Amortization of deferred revenue	(3.3)	(3.9)
Deferred income tax (benefit) provision	(2.9)	0.3
Minority interest in earnings of subsidiaries	2.0	2.7
Other items	1.4	(0.8)
Net changes in operating working capital	(2.6)	(36.4)
Cash Provided by (Used for) Operations	22.2	(8.0)
Investing		
Capital spending	(2.1)	(8.2)
Capitalized software costs	(0.7)	(0.2)
Acquisitions, net of cash acquired		(11.9)
Investment in equity affiliates	(2.5)	
Other	(5.9)	(4.7)
Cash Used for Investing	(11.2)	(25.0)
Financing		
Cash dividends paid to SWM stockholders	(4.7)	(4.6)
Changes in short-term debt	(3.5)	19.2
Proceeds from issuances of long-term debt	21.2	17.2
Payments on long-term debt	(28.6)	(4.9)
Purchases of treasury stock		(1.0)
Proceeds from exercise of stock options	1.8	4.8
Excess tax benefits of stock-based awards	0.4	
Cash (Used for) Provided By Financing	(13.4)	30.7
Effect of Exchange Rate Changes on Cash		
Decrease in Cash and Cash Equivalents	(2.4)	(2.3)
Cash and Cash Equivalents at beginning of period	5.1	4.5
Cash and Cash Equivalents at end of period	$ 2.7	$ 2.2

The accompanying notes are an integral part of these consolidated financial statements.

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SCHWEITZER-MAUDUIT INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. GENERAL

Nature of Business

Schweitzer-Mauduit International, Inc., or the Company, is a multinational diversified producer of premium specialty papers headquartered in the United States of America and is the world s largest supplier of fine papers to the tobacco industry. The Company manufactures and sells paper and reconstituted tobacco products to the tobacco industry as well as specialized paper products for use in other applications. The primary products include cigarette, plug wrap and tipping papers used to wrap various parts of a cigarette, reconstituted tobacco leaf, or RTL, which is used as a blend with virgin tobacco in cigarettes, reconstituted tobacco wrappers and binders for cigars and paper products used in cigarette packaging. These products are sold directly to the major tobacco companies or their designated converters in North and South America, western and eastern Europe, Asia and elsewhere.

The Company is the premier manufacturer of high porosity papers, which are used in manufacturing ventilated cigarettes, and the leading independent producer of RTL used in producing blended cigarettes. The Company conducts business in over 90 countries and currently operates 11 production locations worldwide, with production facilities in the United States, France, the Philippines, Indonesia, Brazil and Canada. The Company has a 50 percent equity interest in a joint venture to manufacture and sell tobacco-related papers in China.

The Company s manufacturing facilities have a long history of producing paper, which dates back to 1545. The Company s domestic mills led the development of the North American tobacco-related papers manufacturing industry, which was originated by Peter J. Schweitzer, Inc. and began as an importer of cigarette papers from France in 1908.

Basis of Presentation

The accompanying unaudited consolidated financial statements and the notes thereto have been prepared in accordance with the instructions of Form 10-Q and Rule 10-01 of Regulation S-X of the Securities and Exchange Commission, or the SEC, and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America, or GAAP. However, such information reflects all adjustments (consisting of normal recurring adjustments) which are, in the opinion of management, necessary for a fair statement of results for the interim periods.

The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year. The unaudited consolidated financial statements included herein should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 as filed with the SEC on March 7, 2006.

Principles of Consolidation

The consolidated financial statements include the accounts of Schweitzer-Mauduit International, Inc. and wholly owned, controlled majority-owned and financially controlled subsidiaries. Minority interest represents minority stockholders proportionate share of the equity in LTRI Industries S.A., or LTRI, and Schweitzer-Mauduit do Brasil S.A., or SWM-B. The Company s share of the net income or loss of its 50 percent owned joint venture in China is included in the consolidated income statement as Loss from equity affiliates. All significant intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. Estimates are used for, but not limited to, inventory valuation, depreciable lives, sales returns, receivables valuation,

pension, postretirement and other benefits, taxes and contingencies. Actual results could differ materially from those estimates.

Reclassifications

Certain prior year amounts in the Consolidated Statements of Cash Flow have been reclassified to conform to the current year financial statement presentation.. Historically, amounts relating to changes in currency translation had been included in changes in operating working capital. These amounts had not been significant when aggregated. However, recent increases in working capital and fluctuations in foreign currency exchange rates have increased the value related to each category of working capital. Such currency translation amounts are now excluded from changes in operating working capital and are reported separately. The net effects of the reclassifications on the Consolidated Statements of Cash Flow were to increase Cash Used for Operations by $0.9 million for the six months ended June 30, 2005, decrease Cash Used for Investing by $0.9 million for the six months ended June 30, 2005, and on a separate line report the Effect of Exchange Rate Changes on Cash, which had no effect for the six months ended June 30, 2005.

Share-Based Incentive Compensation

Accounting Prior to Adoption of SFAS 123R

Prior to the January 1, 2006 adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R, which revised SFAS 123, *Accounting for Stock Based Compensation,* and superseded Accounting Principles Board Opinion No. 25, or APB 25, *Accounting for Stock Issued to Employees*, the Company accounted for stock-based compensation using the intrinsic value method under APB 25 and related Accounting Interpretations thereof as permitted by SFAS 123. SFAS 123 provided entities a choice of recognizing related compensation expense by adopting a fair value based method of accounting for stock compensation, including stock options to employees, or to measure compensation using the intrinsic value method under APB 25. Prior to January 1, 2006, the Company had elected to continue to measure compensation cost for stock compensation based on the intrinsic value method under APB 25. Payments in the form of the Company s shares made to third parties, including outside directors, were and still are recorded at fair value based on the market value of the Company s common stock at the time of payment. Under APB 25, because the exercise price of employee stock options equaled the market price of the underlying stock on the date of grant, no compensation expense was recognized. SFAS 123, as amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, required presentation of pro forma net income and earnings per share as if the Company had accounted for its employee stock compensation under the fair value method of that statement.

For purposes of the pro forma disclosures, the estimated fair value of the stock compensation was amortized to expense over the vesting period. Under the fair value method, the Company s net income and earnings per share would have been the pro forma amounts indicated below (dollars in millions, except per share amounts):

	Three Months Ended, June 30, 2005	Six Months Ended, June 30, 2005
Net Income		
As reported	$ 5.8	$ 10.8
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related income tax effects	0.2	0.5
Pro forma	$ 5.6	$ 10.3
Basic net income per share		
As reported	$ 0.39	$ 0.72
Pro forma	$ 0.37	$ 0.68
Diluted net income per share		
As reported	$ 0.38	$ 0.70
Pro forma	$ 0.36	$ 0.66

Summary of Impact of SFAS 123R

As a result of adopting SFAS 123R on January 1, 2006, the Company s net income for the three and six month periods ended June 30, 2006 were both lower by less than $0.1 million than what would have been reported under APB 25. Excess tax benefits recognized related to stock-based awards for the three and six months ended June 30, 2006 were none and $0.4 million, respectively, and were $0.2 million and $0.8 million, respectively, for the three and six months ended June 30, 2005. Prior to the adoption of SFAS 123R, the Company presented all excess tax benefits resulting from the exercise of stock-based awards as operating cash flows in the Consolidated Statements of Cash Flow. SFAS 123R requires the amounts of cash flow resulting from the tax benefits in excess of the compensation cost recognized (excess tax benefits) to be classified as financing cash flows. Also, in connection with past awards of restricted stock, the unamortized compensation expense previously recognized as a reduction of stockholders equity in accordance with SFAS 123 was eliminated against additional paid-in-capital as of January 1, 2006 in accordance with SFAS 123R.

In prior years, the Company transitioned the primary form of its stock-based compensation from stock options to restricted stock, including the substitution of restricted stock for stock options for the equity component of the Long-Term Incentive Plan, or LTIP, beginning in 2006. Also, on December 9, 2005, the Board of Directors accelerated vesting of certain unvested and out-of-the-money stock options previously awarded to employees and officers that had exercise prices above $30.00 per share. As a result, options to purchase approximately 300,000 shares of the Company s common stock vested immediately, but no underlying shares will be transferable by the Company s officers prior to the original vesting schedule except in the event of an officer s termination of employment. Accelerated stock options held by the Company s officers represented approximately 90 percent of the total accelerated options. As a result of the transition by the Company to the use of restricted stock instead of stock options as the primary form of stock-based compensation and the acceleration of vesting of certain unvested and out-of-the-money stock options in December 2005, the impact of the adoption of SFAS 123R on the Company s financial statements was not material.

Accounting After Adoption of SFAS 123R

Employee Stock Options

The Company s Equity Participation Plan expired in 2005 and was not renewed. Stock options are not expected to be granted after 2005.

The exercise price of each of the Company s employee stock option grants was equal to the average of the high and low market price on the date of grant. Under the Company s stock option plan, the stock option s maximum term was 10 years from the date of grant. Awards vested 30 percent, 30 percent and 40 percent over each of the first three years, respectively. Under APB 25, no compensation expense was recorded for stock options. Under SFAS 123R, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. The Company used the fair value of each option grant on the date of grant in the determination of pro forma expense amounts reflected in past disclosures in accordance with SFAS 123. The unamortized balances of those pro forma fair value amounts are being recorded as expense beginning January 1, 2006 in accordance with SFAS 123R.

A summary of the status of stock options outstanding as of June 30, 2006 and changes during the six months then ended is presented below:

	Number of Shares		**Weighted Average Exercise Price Per Share**		**Weighted Average Remaining Contractual Term (in years)**
Options outstanding at January 1, 2006	1,162,592		$	24.48	
Exercised	(106,400	)	16.20		
Canceled					
Options outstanding at June 30, 2006	1,056,192		$	25.31	6.3
Options vested and exercisable June 30, 2006	1,034,192		$	25.30	6.2

As of June 30, 2006, there was $0.1 million of unrecognized compensation cost related to outstanding stock options to be recorded during 2006, 2007 and 2008 in accordance with SFAS 123R.

Restricted Stock

The Company s restricted stock grants generally vest upon completion of a specified period of time. The fair value of each award is equal to the share price of the Company s stock on the date of grant. This cost is recognized over the vesting period of the respective award. As of June 30, 2006, there was $0.6 million of unrecognized compensation cost related to outstanding restricted stock. A summary of outstanding restricted stock awards as of June 30, 2006 and 2005 and changes during the six months ended is summarized below:

	2006		**2005**	
	# of Shares	**Weighted-Average Fair Value at Date of Grant**	**# of Shares**	**Weighted-Average Fair Value at Date of Grant**
Nonvested restricted shares outstanding at January 1	28,500	$ 25.43	54,000	$ 16.45
Granted	27,000	24.51	4,500	33.09
Forfeited	(3,000)	25.97		-
Vested	(13,500)	23.45	(27,000)	22.90
Nonvested restricted shares outstanding at June 30	39,000	25.44	31,500	25.48

Long-Term Incentive Plan Performance Based Shares

The Company s LTIP for key executives includes an equity-based award component. The objectives under the LTIP are established for multiple years at the beginning of a performance cycle and are intended to focus management on longer-term strategic goals. The Compensation Committee of the Board of Directors designates participants in the LTIP and determines the equity-based award opportunity in the form of restricted stock for each performance cycle, which is generally measured on the basis of a 3-year performance period. Performance is measured on a cumulative basis and a portion of each performance cycle s restricted stock award opportunity may be earned annually. The restricted shares are issued and outstanding when the number of shares becomes fixed, after the annual performance is determined, and such awards vest at the end of the performance cycle. The Company recognizes compensation expense over the performance period based on the fair value of the award, with compensation expense being adjusted cumulatively based on the expected level of achievement of performance goals and the Company s stock price. The expected number of restricted shares currently being used to calculate the LTIP equity-based compensation expense for 2006 is 15,590. For the number of common and potential common shares outstanding used in the calculation of diluted net income per common share for the three and six month periods ended June 30, 2006, unamortized compensation expense associated with the equity-based LTIP award opportunity is treated as proceeds used to purchase shares in the treasury stock method of calculating the number of shares, and the net increase in diluted shares for the three and six month periods ended June 30, 2006 was 8,425 and 6,486, respectively.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board, or FASB, issued SFAS 151, *Inventory Costs an amendment of ARB No. 43, Chapter 4 (FAS 151)*, or SFAS 151. SFAS 151 amends the guidance in Accounting Research Bulletin, or ARB, No. 43, Chapter 4, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). SFAS 151 requires that these costs be recognized as current period charges regardless of whether they are abnormal. In addition, SFAS 151 requires that allocation of fixed production overheads to the costs of manufacturing be based on the normal capacity of the production facilities. The Company s adoption of this new accounting standard effective January 1, 2006 had no material impact on the accompanying financial statements.

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections*, which replaces APB 20, *Accounting Changes*, and SFAS 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 applies to all voluntary changes in accounting principles and requires retrospective application (a term defined by the statement) to prior periods financial statements, unless it is impracticable to determine the effect of a change. It also applies to changes required by an accounting pronouncement that does not include specific transition provisions. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company has adopted this new accounting standard effective January 1, 2006. Since

it applies to accounting changes and corrections of errors that occur after January 1, 2006, there was no impact on the Company s consolidated financial position or results of operations.

On July 13, 2006, FASB Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109,* was issued. This Interpretation is effective for years beginning after December 15, 2006. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* FIN 48 also 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 new FASB standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is currently in the process of reviewing this guidance to determine its impact on the Company s consolidated financial position and results of operations.

NOTE 2. NET INCOME PER SHARE

Basic net income per common share is computed based on net income divided by the weighted average number of common shares outstanding. Diluted net income per common share is computed based on net income divided by the weighted average number of common and potential common shares outstanding. Potential common shares during the respective periods are those related to stock options outstanding, restricted stock outstanding, directors accumulated deferred stock compensation, which may be received by the directors in the form of stock or cash, and restricted stock estimated to be earned as part of the LTIP. A reconciliation of the average number of common and potential common shares outstanding used in the calculations of basic and diluted net income per share follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2006	**June 30, 2005**	**June 30, 2006**	**June 30, 2005**
Average number of common shares outstanding	15,399.6	15,156.2	15,377.1	15,083.6
Dilutive effect of:				
• stock options	60.3	293.8	86.5	361.6
• restricted stock	38.9	32.5	39.0	40.3
• directors deferred stock compensation	20.8	16.5	20.1	16.2
• long-term incentive compensation	8.4		6.5	
Average number of common and potential common shares	15,528.0	15,499.0	15,529.2	15,501.7

Certain stock options outstanding during the periods presented were not included in the calculations of diluted net income per share because the exercise prices of the options were greater than the average market prices of the common shares during the respective periods. The average number of share equivalents resulting from these anti-dilutive stock options not included in the computations of diluted net income per share for the three and six month periods ended June 30, 2006 were approximately 600,000 and 489,900, respectively, and for the three and six month periods ended June 30, 2005 were approximately 188,600 and 186,100, respectively.

NOTE 3. INVENTORIES

The following schedule details inventories by major class (dollars in millions):

	June 30, 2006	**December 31, 2005**
Raw materials	$ 37.4	$ 40.9
Work in process	14.7	17.0
Finished goods	53.9	45.1
Supplies and other	21.3	20.0
Total	$ 127.3	$ 123.0

NOTE 2. NET INCOME PER SHARE

NOTE 4. RESTRUCTURING EXPENSE

At the Lee Mills facility in Massachusetts, the Company operates a machine that is owned by Kimberly-Clark Corporation. Ownership of the machine was retained by Kimberly-Clark in the 1995 spin-off of the Company and is operated solely for the purpose of producing a proprietary product used as an in-process material by Kimberly-Clark. Under the contract for its continued operation, the Company essentially invoices Kimberly-Clark the actual costs of operating the machine, including allocations of indirect and fixed overhead costs. While the current term of the contract was scheduled to expire in December 2009, Kimberly-Clark gave notice of early termination in January 2006, which under the contract began an 18 month termination period for the contract now ending in August 2007. While certain of the costs currently invoiced to Kimberly-Clark can be eliminated, the Company may be unable to eliminate a portion of the approximately $2 million of indirect and fixed overhead costs that are currently absorbed by that operation when the Kimberly-Clark contract expires in August 2007. As a result, the Company has begun to evaluate the operational and financial impact that the Kimberly-Clark contract termination, as well as changes in tobacco-related paper customer sales volume forecasts and lack of profitability for certain commercial and industrial paper grades produced at the Lee Mills might have on its operations. While the Company is still evaluating broader restructuring options, it was decided in February 2006 to transfer the production volume from one porous plug wrap paper machine to another currently under-utilized Lee Mills porous plug wrap paper machine and to commence accelerated depreciation on the affected equipment. Additionally, the salaried and hourly Lee Mills workforces were reorganized to be more efficient and cost effective, which will result in the loss of approximately 25 jobs. As a result of these decisions, the Company expects to incur restructuring expenses totaling approximately $1.3 million in 2006 and $1.0 million in each of 2007 and 2008. Of the $1.3 million projected for 2006, $0.3 million and $0.5 million were recorded during the first and second quarters, respectively, of which $0.5 million represented non-cash accelerated depreciation and $0.3 million of cash costs were employee related. The remaining estimated 2006 through 2008 expenses are primarily for non-cash accelerated depreciation.

Additionally, on May 26, 2006, the Company announced a decision to cease the production and sale of décor papers made at its mill in Lee. As a result of this decision, the Company ceased operation of a paper machine in July, which will result in 2006 accelerated depreciation and other restructuring related expenses totaling approximately $4.5 million, including cash costs of approximately $0.5 million that are partly related to employee severance expenses. This cessation is resulting in the loss of approximately 15 jobs in total at the Lee Mills and at the Company s U.S. headquarters in Alpharetta, Georgia. Of the $4.5 million of these estimated total restructuring expenses, $2.4 million were recorded in the second quarter of 2006 and the remainder is expected to be incurred during the balance of 2006, primarily in the third quarter. Of the $2.4 million expensed in the current quarter, $2.2 million represented non-cash expenses of accelerated depreciation and inventory write-offs and $0.2 million represented cash costs, including severance benefits.

In France, a downturn in tobacco-related papers demand has resulted from a decrease in consumption of cigarettes in certain countries due to increased taxes and regulation on the cigarette industry. Additionally, new tobacco-related papers capacity began operation in Europe during 2003 and 2004. This has created a very competitive pricing environment during a time of high inflationary cost increases, resulting in some lost sales volumes for tobacco-related papers produced by the French operations. This downturn in demand, as well as the Company s decision to eliminate low margin products, has caused the Company to have excess capacity and machine shutdowns. As a result, the Company recorded $0.2 million of accelerated depreciation in the first quarter of 2006 and $0.5 million of restructuring expenses in the second quarter of 2006 in France, which consisted of accelerated depreciation of $0.3 million and severance and other cash costs of $0.2 million. The Company expects to record an additional $0.3 million in cash restructuring expenses during the third quarter of 2006 based upon decisions made to date.

These restructuring expenses totaled $3.4 million during the second quarter of 2006, of which $0.7 million were cash costs. Restructuring expenses were $3.9 million during the first six months of the year, of which $0.7 million were cash costs.

Restructuring liability reserves related to the cash costs for 2006 were classified in Accrued Expenses as a current liability on the Consolidated Balance Sheet and are summarized as follows (dollars in millions):

Balance at January 1, 2006	$		
Accruals for new committed / announced programs	0.7		
Cash payments	(0.5		)
Balance at June 30, 2006	$	0.2	

NOTE 2. NET INCOME PER SHARE

The Company is continuing to evaluate how to operate its production facilities in France and the United States more effectively. Analyses are ongoing, and the Company has not committed to any actions beyond those identified above. However, additional restructuring expenses in France or the United States may be required based on the outcome of these analyses.

NOTE 2. NET INCOME PER SHARE

NOTE 5. COMMITMENTS AND CONTINGENCIES

Litigation

The Company is involved in various legal proceedings and disputes (see Note 7, Commitments and Contingencies, of the Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2005). There have been no material developments to these matters during 2006.

Environmental Matters

The Company s operations are subject to federal, state and local laws, regulations and ordinances relating to various environmental matters. The nature of the Company s operations exposes it to the risk of claims with respect to environmental matters, and there can be no assurance that material costs or liabilities will not be incurred in connection with such claims. While the Company has incurred in the past several years, and will continue to incur, capital and operating expenditures in order to comply with environmental laws and regulations, the Company believes that its future cost of compliance with environmental laws, regulations and ordinances, and the exposure to liability for environmental claims and its obligation to participate in the remediation and monitoring of certain hazardous waste disposal sites, will not have a material adverse effect on financial condition or results of operations. However, future events, such as changes in existing laws and regulations, or unknown contamination of sites owned, operated or used for waste disposal by the Company (including contamination caused by prior owners and operators of such sites or other waste generators) may give rise to additional costs which could have a material adverse effect on the Company s financial condition or results of operations.

The Company incurs spending necessary to meet legal requirements and otherwise relating to the protection of the environment at its facilities in the United States, France, the Philippines, Indonesia, Brazil and Canada. For these purposes, the Company anticipates that it will incur capital expenditures of approximately $1 million in 2006 and approximately $2 to $3 million in 2007, of which no material amount is the result of environmental fines or settlements. The foregoing capital expenditures are not expected to reduce the Company s ability to invest in other appropriate and necessary capital projects and are not expected to have a material adverse effect on the Company s financial condition or results of operations.

NOTE 6. POSTRETIREMENT AND OTHER BENEFITS

The Company sponsors pension benefits in the United States, France, the Philippines and Canada and postretirement healthcare and life insurance benefits in the United States and Canada. The Company s Canadian and Philippines pension and postretirement benefits are not significant and therefore are not included in the following disclosures.

During May 2006, the Company implemented the terms of its last and final offer following an impasse in negotiations with the United Steelworkers of America on a collective bargaining agreement for the Lee Mills that had been extended since its original expiration date of July 31, 2005. Pursuant to the terms of the offer that was unilaterally implemented by the Company, all affected hourly employees at the Lee Mills were notified that the further accrual of benefits under their defined benefit pension plan would be frozen as of July 17, 2006. Consequently, hourly employees at the Lee Mills do not earn any additional benefits for future service (years or earnings) under the defined benefit plan beginning July 17, 2006. This termination of the accrual of additional benefits for future service qualified this action for curtailment under SFAS No. 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. This action is expected to reduce the Company s future annual pension expense and pension fund contribution requirements. The plan has not been terminated, and benefits accrued as of July 17, 2006 will continue to be paid in accordance with

the plan terms. Allowable contributions and the matching percentage for the defined contribution, or 401(k), plan for the Lee Mills hourly employees are being modified to partially offset the employee pension benefit reduction.

The Lee Mills action necessitated a remeasurement of the Company s accumulated benefit obligation under the U.S. pension plan and resulted in a curtailment gain of $0.1 million during the second quarter. As part of this remeasurement, the Company increased its discount rate assumption from 5.75 percent to 6.50 percent to reflect recent changes in the market interest rates. Other actuarial assumptions (primarily asset returns, wage rate increases, plan population, retirement assumptions, mortality table and cash balance crediting rate) remained consistent with those previously disclosed.

In accordance with SFAS No. 88, the Company calculated its curtailment gain by first remeasuring its plan assets and projected benefit obligation, or PBO, as of the date of the curtailment, excluding the effects of the curtailment, but including the effects of the changes in assumptions. The Company then had the plan assets and the PBO measured using the effects of the curtailment. This enabled it to isolate the effect of the curtailment on the PBO, without affecting the measurement for any change in the actuarial assumptions since the prior measurement date.

The components of net pension and postretirement healthcare and life insurance benefit costs for U.S. employees for the three and six month periods ended June 30, 2006 and 2005 were as follows (dollars in millions):

U.S. Pension Benefits	**Three Months Ended June 30, 2006**	**June 30, 2005**	**Six Months Ended June 30, 2006**	**June 30, 2005**
Service cost	$ 0.3	$ 0.8	$ 0.9	$ 1.5
Interest cost	1.8	1.6	3.3	3.1
Expected return on plan assets	(1.7)	(1.6)	(3.5)	(3.2)
Amortization and other	0.6	0.5	1.3	1.1
Pension curtailment gain	(0.1)		(0.1)	
Net periodic benefit cost	$ 0.9	$ 1.3	$ 1.9	$ 2.5

U.S. Postretirement Healthcare and Life Insurance Benefits	**Three Months Ended June 30, 2006**	**June 30, 2005**	**Six Months Ended June 30, 2006**	**June 30, 2005**
Service cost	$	$	$ 0.1	$ 0.1
Interest cost	0.2	0.2	0.4	0.4
Net periodic benefit cost	$ 0.2	$ 0.2	$ 0.5	$ 0.5

The components of net pension costs in France for the three and six month periods ended June 30, 2006 and 2005 were as follows (dollars in millions):

French Pension Benefits	**Three Months Ended June 30, 2006**	**June 30, 2005**	**Six Months Ended June 30, 2006**	**June 30, 2005**
Service cost	$ 0.4	$ 0.4	$ 0.8	$ 0.8
Interest cost	0.5	0.4	1.0	0.8
Expected return on plan assets	(0.3)	(0.2)	(0.6)	(0.4)
Amortization and other	0.2	0.1	0.4	0.3
Net periodic benefit cost	$ 0.8	$ 0.7	$ 1.6	$ 1.5

NOTE 2. NET INCOME PER SHARE

The Company contributed $2.0 million and $5.0 million to its pension plans through the first six months of 2006 and 2005, respectively, and currently expects to make total pension contributions for the full year of 2006 of approximately $10 to $15 million. The Company also made a total of $1.2 million of payments related to its U.S.

NOTE 2. NET INCOME PER SHARE

postretirement healthcare and life insurance benefits for the six months ended June 30, 2006, and expects to make additional payments during the remainder of 2006 of approximately $1 million.

NOTE 7. SEGMENT INFORMATION

The Company operates and manages its businesses based on the geographical location of the primary manufacturing operations: the United States, France and Brazil. These business segments manufacture and sell cigarette, plug wrap and tipping papers, used to wrap various parts of a cigarette, reconstituted tobacco products and paper products used in cigarette packaging. While the products are similar in each segment, they vary based on customer requirements and the manufacturing capabilities of each location. Sales by a segment into markets primarily served by a different segment occur where specific product needs cannot be cost-effectively met by the manufacturing operations domiciled in that segment.

Tobacco industry products comprised approximately 91 percent of the Company s consolidated net sales in the three and six month periods ended June 30, 2006 and 2005. The non-tobacco industry products are a diverse mix of products, certain of which represent commodity paper grades produced to maximize machine operations.

For purposes of the segment disclosure in the following tables, the term United States includes operations in the United States and Canada. The Canadian operation only produces flax fiber used as raw material in the U.S. operations. The term France includes operations in France, the Philippines, beginning in June 2005, and Indonesia. Since the results of the Philippine and Indonesian operations are not material for segment reporting purposes and their sales are coordinated with sales of the French operations in southeast Asia, they are included in the France segment. Sales of products between segments are made at market prices and elimination of these sales is referred to in the following tables as intersegment sales. Expense amounts not associated with segments are referred to as unallocated expenses.

Net Sales

(dollars in millions)

	Three Months Ended				Six Months Ended			
	June 30, 2006		June 30, 2005		June 30, 2006		June 30, 2005	
France	$ 97.3	60.0 %	$ 104.8	62.3 %	$ 190.0	58.0 %	$ 206.9	62.9 %
United States	55.8	34.4	54.8	32.6	118.2	36.1	106.7	32.5
Brazil	14.7	9.1	14.2	8.4	31.0	9.5	27.7	8.4
Subtotal	167.8	103.5	173.8	103.3	339.2	103.6	341.3	103.8
Intersegment sales by France	(3.7)	(2.3)	(3.5)	(2.1)	(7.1)	(2.2)	(9.0)	(2.7)
United States	(0.2)	(0.1)	(0.5)	(0.3)	(0.4)	(0.1)	(0.8)	(0.3)
Brazil	(1.8)	(1.1)	(1.6)	(0.9)	(4.2)	(1.3)	(2.7)	(0.8)
Subtotal	(5.7)	(3.5)	(5.6)	(3.3)	(11.7)	(3.6)	(12.5)	(3.8)
Consolidated	$ 162.1	100.0 %	$ 168.2	100.0 %	$ 327.5	100.0 %	$ 328.8	100.0 %

Operating Profit

(dollars in millions)

	Three Months Ended				Six Months Ended			
	June 30, 2006		June 30, 2005		June 30, 2006		June 30, 2005	
France	$ 5.5	130.9 %	$ 11.5	107.5 %	$ 13.9	105.3 %	$ 22.3	109.9 %
United States	0.7	16.7			3.2	24.2	(0.4)	(2.0)
Brazil	(0.3)	(7.1)	1.0	9.3	(0.1)	(0.7)	1.3	6.4
Unallocated	(1.7)	(40.5)	(1.8)	(16.8)	(3.8)	(28.8)	(2.9)	(14.3)
Subtotal	$ 4.2	100.0 %	$ 10.7	100.0 %	$ 13.2	100.0 %	$ 20.3	100.0 %

NOTE 8. SUBSEQUENT EVENTS

New Bank Credit Agreement

On July 20, 2006, Schweitzer-Mauduit International, Inc. and Schweitzer-Mauduit France S.A.R.L., a wholly-owned subsidiary of the Company, entered into a new unsecured credit agreement, or the Credit Agreement, with a group of banks led by Natexis Banques Populaires, Société Générale Corporate & Investment Banking and SunTrust Robinson Humphrey, a division of SunTrust Capital Markets, Inc. to refinance its existing bank credit agreement. The Credit Agreement became effective July 31, 2006 and provides for (a) additional borrowing capacity of approximately $60 million, increasing the total facilities to $195 million from $135 million, (b) a reduced number of tranches from 4 to 2, (c) extended terms, with the maturity date of the new facilities being no earlier than 5 years, (d) lower interest rate margins and (e) fewer, less restrictive financial covenant requirements. The Credit Agreement replaces the existing credit facility executed on January 31, 2002 that was scheduled to expire in January 2007. Borrowings outstanding under the credit agreement existing as of June 30, 2006 of $64.2 million were classified as Long-Term Debt in the Consolidated Balance Sheet at June 30, 2006 as a result of the Company having refinanced the debt with a new Credit Agreement effective July 31, 2006.

The Credit Agreement provides for a $95 million U.S. revolving credit facility, or U.S. revolver, and an 80 million revolving credit facility, or Euro revolver, both with 5-year terms, plus 2 one-year extension options, with the extensions at the discretion of the participating banks. The Credit Agreement is guaranteed by the Company and contains representations and warranties which are customary for facilities of this type and covenants and provisions that, among other things, require the Company to maintain (a) a Net Debt to Equity Ratio not to exceed 1.0 and (b) a Net Debt to Adjusted EBITDA Ratio not to exceed 3.0. The increased amount of the facility and its favorable terms will provide greater flexibility to pursue possible restructuring activities in France and the United States and various strategic opportunities. Repayment of amounts drawn under the Credit Agreement may be accelerated in limited circumstances, which include events of default not timely cured and change of control events. Draws have been made to repay borrowings under the existing credit agreement. Expected draws are also anticipated for (a) working capital needs (b) funding the Company s joint venture in China and (c) other general corporate purposes. Borrowings, including repayments of the existing credit agreement, against the Credit Agreement are expected to aggregate the U.S. dollar equivalent of approximately $70 to $100 million during the balance of 2006. Under the Credit Agreement, interest rates are at market rates, based on the London Interbank Offered Rate, or LIBOR, for U.S. dollar borrowings and the Euro Interbank Offered Rate, or EURIBOR, for euro borrowings, plus an applicable margin that varies from 0.35 percent to 0.75 percent per annum depending on the Net Debt to Adjusted EBITDA Ratio, as defined in the Credit Agreement. The Company will incur commitment fees at an annual rate of either 0.30 or 0.35 percent of the applicable margin on the committed amounts not drawn, depending on the Net Debt to Adjusted EBITDA Ratio.

Changes in Executive Officers

On July 10, 2006, the Company issued a press release announcing that effective August 1, 2006, Paul C. Roberts,, current Chief Financial Officer and Treasurer , or CFO, would be assuming the newly created position of Vice President Strategic Planning and Implementation, reporting to Wayne H. Deitrich, Chairman and Chief Executive Officer. Mr. Roberts has served as CFO since August 1995. In this new role, Mr. Roberts will be responsible for corporate projects including potential investment opportunities and strategic initiatives, while continuing to serve as Vice-Chairman of the Board of China Tobacco Mauduit (Jiangmen) Paper Industry Company Ltd., the Company s tobacco-related papers joint venture in China.

Succeeding Mr. Roberts as CFO is Peter J. Thompson, President U.S. Operations since November 1998. Mr. Thompson joined the Company in January 1997 as Marketing Manager U.S. Previously, he was CFO and then Marketing Director for Tape, Inc. from May 1995 to January 1997. Also, prior to May 1995, he held several key financial positions with Kimberly-Clark where he was involved in financial and business analysis, acquisitions and divestitures.

Coincident with the above changes, Otto R. Herbst, President Brazilian Operations, became President the Americas, with profit responsibility for the Brazilian and U.S. Business Units, reporting to Frédéric P. Villoutreix, Chief Operating Officer. This change will result in the consolidation of the positions of President Brazilian Operations and President U.S. Operations. Mr. Herbst served as President of the Brazilian operations since 1999. Prior to 1999, Mr. Herbst served as General Manager for New Business and Services from 1997 through 1999 for Interprint, a manufacturer of security documents, telephone cards, and business forms. From 1990 through 1997,

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NOTE 2. NET INCOME PER SHARE

Mr. Herbst served as Director for Agaprint, a manufacturer of packaged materials, business forms, commercial printing papers, personalized documents and envelopes.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our results of operations and current financial position. This discussion should be read in conjunction with our unaudited consolidated financial statements and related notes included elsewhere in this report and the audited consolidated financial statements and related notes and the selected financial data included in Item 6 of our Annual Report on Form 10-K for the year ended December 31, 2005. Our discussion of our results of operations and financial position includes various forward-looking statements about our markets, the demand for our products and our future results. These statements are based on certain assumptions that we consider reasonable. For information about risks and exposures relating to our business and our company, you should read the section entitled Factors That May Effect Future Results included in our Annual Report on Form 10-K for the year ended December 31, 2005.

The accompanying unaudited consolidated financial statements set forth certain information with respect to our financial position, results of operations and cash flows which should be read in conjunction with the following discussion and analysis. Unless the context indicates otherwise, references to *we*, *us*, *our*, *SWM*, *Schweitzer-Mauduit* or similar terms include Schweitzer-Mauduit International, Inc. and our consolidated subsidiaries.

Introduction

This management s discussion and analysis of financial condition and results of operations is intended to provide you with an understanding of our recent performance, our financial condition and our prospects. The following will be discussed and analyzed:

- Executive Summary
- Recent Developments
- Results of Operations
- Liquidity and Capital Resources
- Other Factors Affecting Liquidity and Capital Resources
- Outlook
- Forward-Looking Statements

Executive Summary

(dollars in millions, except per share amounts)

	Three Months Ended June 30, 2006				June 30, 2005				Six Months Ended June 30, 2006				June 30, 2005			
Net sales	$	162. 1	100.0	%	$	168. 2	100.0	%	$	327. 5	100.0	%	$	328. 8	100.0	%
Gross profit	22.	2	13.7		26.	2	15.6		46.	8	14.3		50.	3	15.3	
Restructuring expense	3.	4	2.1						3.	9	1.2					
Operating profit	4.	2	2.6		10.	7	6.4		13.	2	4.0		20.	3	6.2	
Net income	$ 0.	7	0.4	%	$ 5.	8	3.4	%	$ 5.	3	1.6	%	$ 10.	8	3.3	%
Diluted earnings per share	$ 0.	04			$ 0.	38			$ 0.	34			$ 0.	70		
Capital spending	$ 0.	5			$ 4.	7			$ 2.	1			$ 8.	2		

The decline in earnings compared with the second quarter of 2005 was the result of our inability to fully offset unabsorbed fixed costs, inflationary cost increases and restructuring expenses through improved mill operations or higher selling prices. Unabsorbed fixed costs increased operating expenses by $5.4 million and inflationary cost increases unfavorably impacted operating results by $3.7 million during the quarter. Restructuring expenses of $3.4 million were also recognized in the quarter.

Recent Developments

Operational Changes   United States and France

At the Lee Mills facility in Massachusetts, we operate a machine that is owned by Kimberly-Clark Corporation. Ownership of the machine was retained by Kimberly-Clark in our 1995 spin-off and is operated solely for the purpose of producing a proprietary product used as an in-process material by Kimberly-Clark. Under the contract

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for its continued operation, we essentially invoice Kimberly-Clark the actual costs of operating the machine, including allocations of indirect and fixed overhead costs. While the current term of the contract was scheduled to expire in December 2009, Kimberly-Clark gave notice of early termination in January 2006, which under the contract began an 18 month termination period for the contract now ending in August 2007. While certain of the costs currently invoiced to Kimberly-Clark can be eliminated, we may be unable to eliminate a portion of the approximately $2 million of indirect and fixed overhead costs that are currently absorbed by that operation when the Kimberly-Clark contract expires in August 2007. As a result, we have begun to evaluate the operational and financial impact that the Kimberly-Clark contract termination, as well as changes in tobacco-related paper customer sales volume forecasts and lack of profitability for certain commercial and industrial paper grades produced at the Lee Mills might have on its operations. While we are still evaluating broader restructuring options, we decided in February 2006 to transfer the production volume from one porous plug wrap paper machine to another currently under-utilized Lee Mills porous plug wrap paper machine and to commence accelerated depreciation on the affected equipment. Additionally, the salaried and hourly Lee Mills workforces were reorganized to be more efficient and cost effective, which will result in the loss of approximately 25 jobs. As a result of these decisions, we expect to incur restructuring expenses totaling approximately $1.3 million in 2006 and $1.0 million in each of 2007 and 2008. Of the $1.3 million projected for 2006, $0.3 million and $0.5 million were recorded during the first and second quarters, respectively, of which $0.5 million represented non-cash accelerated depreciation and $0.3 million of cash costs were employee related. The remaining estimated 2006 through 2008 expenses are primarily for non-cash accelerated depreciation.

Additionally, on May 26, 2006, we announced a decision to cease the production and sale of décor papers made at our mill in Lee. As a result of this decision, we ceased operation of a paper machine in July, which will result in 2006 accelerated depreciation and other restructuring related expenses totaling approximately $4.5 million, including cash costs of approximately $0.5 million that are partly related to employee severance expenses. This cessation is resulting in the loss of approximately 15 jobs in total at the Lee Mills and at our U.S. headquarters in Alpharetta, Georgia. Of the $4.5 million of these estimated total restructuring expenses, $2.4 million were recorded in the second quarter of 2006 and the remainder is expected to be incurred during the balance of 2006, primarily in the third quarter. Of the $2.4 million expensed in the current quarter, $2.2 million represented non-cash expenses of accelerated depreciation and inventory write-offs and $0.2 million represented cash costs, including severance benefits.

In France, a downturn in tobacco-related papers demand has resulted from a decrease in consumption of cigarettes in certain countries due to increased taxes and regulation on the cigarette industry. Additionally, new tobacco-related papers capacity began operation in Europe during 2003 and 2004. This has created a very competitive pricing environment during a time of high inflationary cost increases, resulting in some lost sales volumes for tobacco-related papers produced by our French operations. This downturn in demand, as well as our decision to eliminate low margin products, has caused us to have excess capacity and machine shutdowns. As a result, we recorded $0.2 million of accelerated depreciation in the first quarter of 2006 and $0.5 million of restructuring expenses in the second quarter of 2006 in France, which consisted of accelerated depreciation of $0.3 million and severance and other cash costs of $0.2 million. We expect to record an additional $0.3 million in cash restructuring expenses during the third quarter of 2006 based upon decisions made to date.

These restructuring expenses totaled $3.4 million during the second quarter of 2006, of which $0.7 million were cash costs. Restructuring expenses were $3.9 million during the first six months of the year, of which $0.7 million were cash costs.

We are continuing to evaluate how to operate our production facilities in France and the United States more effectively. Analyses are ongoing, and we have not committed to any actions beyond those identified above. However, additional restructuring expenses in France or the United States may be required based on the outcome of these analyses.

Lower Ignition Propensity Cigarettes

During 2005, Canada implemented a requirement for lower cigarette ignition propensity properties for all cigarettes manufactured or imported into Canada on or after October 1, 2005. Accordingly, a full year of sales of these products in Canada is expected during 2006. During the fourth quarter of 2005, the State of California enacted legislation that requires all cigarettes sold in California as of January 2007 to have lower ignition propensity properties. California joins the State of New York, which already requires lower ignition propensity properties, and the State of Vermont, which requires cigarettes to have these properties as of May 2006. An additional 3 U.S. states have regulations that become effective between October 2007 and January 2008, with the states of Illinois, New Hampshire and Massachusetts having recently passed lower ignition propensity cigarette legislation. These 6 U.S.

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states with lower ignition propensity legislation are estimated to comprise approximately 16 percent of U.S. cigarette consumption and, with Canada, are estimated to comprise approximately 23 percent of combined U.S. and Canadian cigarette consumption. Legislation could also be enacted in Australia this year which would reportedly require compliance beginning in 2008.

Pension Plan Curtailment at Lee Mills

During May 2006, we implemented the terms of our last and final offer following an impasse in negotiations with the United Steelworkers of America on a collective bargaining agreement for the Lee Mills. Pursuant to the terms of the offer that was unilaterally implemented by us, all affected hourly employees at the Lee Mills were notified that the further accrual of benefits under their defined benefit pension plan would be frozen as of July 17, 2006. Consequently, hourly employees at the Lee Mills do not earn any additional benefits for future service (years or earnings) under the defined benefit plan beginning July 17, 2006. This action is expected to reduce our future annual pension expense and pension fund contribution requirements. The plan has not been terminated, and benefits accrued as of July 17, 2006 will continue to be paid in accordance with the plan terms. Allowable contributions and the matching percentage for the defined contribution, or 401(k), plan for the Lee Mills hourly employees are being modified to partially offset the employee pension benefit reduction.

New Energy Contracts in Brazil

During May 2006, SWM-B entered into the first of a series of agreements for purchased electricity supply and the transmission and distribution of electricity to the mill.

The contract for the electrical energy supply is for the period May 1, 2006 through December 31, 2010 to cover 100 percent of the mill s consumption of electrical energy. The absolute value of the electric energy to be provided under this contract is estimated at approximately $4.5 to $5.0 million annually. Under our former contract, we expected electrical energy costs to be significantly higher than the prior year due to a general increase in energy costs. However, we expect this contract to provide approximately $1 million in annual savings versus the previously expected increased cost for electrical energy, which will bring current year electrical costs to slightly higher than the prior year.

The agreements for transmission and distribution are revolving annual contracts and are estimated at approximately $3 million annually.

China Joint Venture

In July 2005, we announced execution of an agreement to form a joint venture to produce tobacco-related papers in China. The joint venture is building a new state-of-the-art paper mill, with 2 paper machines that will produce cigarette paper and porous plug wrap in partnership with the China National Tobacco Corporation, or CNTC, which is the principal operating company under China s State Tobacco Monopoly Administration. CNTC and Schweitzer-Mauduit International China, Limited each own 50 percent of the joint venture. We are accounting for this joint venture under the equity method of accounting.

The new mill will have an annual capacity of approximately 18,000 metric tons and is located in Jiangmen, in the Guangdong province. Project spending, including capital expenditures and working capital requirements, is expected to total approximately $100 million. Papeteries de Mauduit S.A.S., or PdM, one of our wholly owned indirect French subsidiaries, is providing technical support and project management. In late 2005, governmental approval for the joint venture was obtained and the joint venture legal entity was incorporated. Various governmental licenses and permits have now been obtained, the management team for the joint venture is now in place, administrative procedures and controls are being implemented and detailed engineering and long-lead item procurement are in process. Construction of the new mill should take approximately 2 years, with mill operations expected to commence in early 2008. We made our initial equity injection in the joint venture of $2.5 million during the second quarter of 2006 and we expect to make an additional equity investment of less than $1 million during the remainder of 2006.

Philippines Acquisition

On June 30, 2005, we acquired the tobacco-related paper manufacturing assets of KCPI, a Philippines company, and associated land and water rights. The acquired assets included buildings, production equipment and related utilities, support assets and inventories. The total acquisition cost was $11.9 million, funded through existing bank lines of

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credit. The impact on the results of our operations and accompanying consolidated financial statements was not material.

New Bank Credit Agreement

We entered into a new bank Credit Agreement effective July 31, 2006 which provides for (a) additional borrowing capacity of approximately $60 million, increasing the total facilities to approximately $195 million from approximately $135 million, (b) a reduced number of tranches from 4 to 2, (c) extended terms, with the maturity date of the new facilities being no earlier than 5 years, (d) lower interest rate margins and (e) fewer, less restrictive financial covenant requirements. The Credit Agreement replaces the prior existing credit facility executed on January 31, 2002 that was scheduled to expire in January 2007.

The increased amount of the facility and its favorable terms will provide greater flexibility to pursue possible restructuring activities in France and the United States and various strategic opportunities. Draws have been made to repay borrowings under the prior existing credit agreement. Expected draws are also anticipated for (a) working capital needs (b) funding of our joint venture in China and (c) other general corporate purposes. Borrowings, including repayment of the prior existing credit agreement, against the Credit Agreement are expected to aggregate the U.S. dollar equivalent of approximately $70 to $100 million during the balance of 2006.

Results of Operations

This section presents a discussion and analysis of our second quarter and year-to-date 2006 net sales, operating profit and other information relevant to an understanding of the results of operations. The following table represents the unaudited consolidated statements of operations for the periods indicated (dollars in millions, except per share amounts):

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Net Sales	$ 162.1	$ 168.2	$ 327.5	$ 328.8
Cost of products sold	139.9	142.0	280.7	278.5
Gross Profit	22.2	26.2	46.8	50.3
Selling expense	5.9	6.1	11.5	12.3
Research expense	1.9	2.5	3.7	5.0
General expense	6.8	6.9	14.5	12.7
Total nonmanufacturing expenses	14.6	15.5	29.7	30.0
Restructuring expense	3.4		3.9	
Operating Profit	4.2	10.7	13.2	20.3
Interest expense	1.4	1.5	2.8	2.8
Other (expense) income, net	(0.6)	0.9	(0.6)	1.5
Income Before Income Taxes, Minority Interest and Loss from Equity Affiliates	2.2	10.1	9.8	19.0
Provision for income taxes	0.4	2.9	2.4	5.5
Minority interest in earnings of subsidiaries	1.0	1.4	2.0	2.7
Loss from equity affiliates	0.1		0.1	
Net Income	$ 0.7	$ 5.8	$ 5.3	$ 10.8
Net Income Per Share				
Basic	$ 0.04	$ 0.39	$ 0.34	$ 0.72
Diluted	$ 0.04	$ 0.38	$ 0.34	$ 0.70

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Three Months Ended June 30, 2006 Compared with the Three Months Ended June 30, 2005

Net Sales

(dollars in millions)

	Three Months Ended June 30, 2006	June 30, 2005	Percent Change	Consolidated Sales Volume Change
France	$ 97.3	$ 104.8	(7.2)%	3.4 %
United States	55.8	54.8	1.8	(17.2)
Brazil	14.7	14.2	3.5	0.3
Subtotal	167.8	173.8		
Intersegment	(5.7)	(5.6)		
Total	$ 162.1	$ 168.2	(3.6)%	(2.1)%

We reported net sales of $162.1 million in the quarter compared with $168.2 million in the same period a year ago. The decrease of $6.1 million, or 3.6 percent, consisted of the following (dollars in millions):

	Amount	Percent
Changes in selling prices and product mix	$ 2.4	1.4 %
Changes in sales volumes (acquisition)	1.6	1.0
Changes in sales volumes (internal growth)	(8.8)	(5.2)
Changes in currency exchange rates	(1.3)	(0.8)
Total	$ (6.1)	(3.6)%

Net sales decreased by $6.1 million, or 3.6 percent, as a result of decreased sales volumes and unfavorable currency exchange rate changes, partially offset by higher average selling prices and an improved mix of products sold.

• Unit sales volumes decreased 2.1 percent compared with last year, having a $7.2 million, or 4.2 percent, impact on the net sales comparison.

- Sales volumes in the United States decreased by 17.2 percent reflecting a reduction of commercial and industrial paper sales, as a result of paper machine rationalization, as well as lower sales of conventional tobacco-related papers. Sales volumes of cigarette paper for lower ignition propensity cigarettes increased.

- Sales volumes of the French segment increased by 3.4 percent. Sales volumes increased for reconstituted tobacco leaf products and for tobacco-related papers in both the Indonesian and Philippines operations. Sales volumes were lower for tobacco-related papers in France.

- Brazil experienced increased sales volumes of 0.3 percent, compared with the second quarter of 2005.

- Changes in currency exchange rates unfavorably impacted the net sales comparison by $1.3 million. The euro was approximately 1.5 percent weaker against the U.S. dollar during the quarter, averaging 1.25 dollars per euro in the second quarter of 2006 versus 1.27 in the second quarter of 2005. The Brazilian real was approximately 14 percent stronger against the U.S. dollar in the second quarter of 2006, partially offsetting the impact of the weaker euro.

- Higher average selling prices had a favorable impact on net sales of $2.4 million, or 1.4 percent. Higher average selling prices in the United States were partially offset by lower average selling prices in our French and Brazilian operations. The increase in average selling prices in the United States was primarily attributed to a change in the mix of products sold.

Sales of tobacco-related products accounted for approximately 91 percent of net sales for the quarters ended June 30, 2006 and 2005.

French segment net sales of $97.3 million declined $7.5 million, or 7.2 percent, compared with $104.8 million in 2005. The decline was a result of the decline in tobacco-related paper sales volumes in France, lower average selling prices in France and unfavorable changes in currency exchange rates, These unfavorable effects were partially offset by increased sales of RTL, increased sales in Indonesia and the added net sales of the Philippines business.

The U.S. segment net sales of $55.8 million represented an increase of $1.0 million, or 1.8 percent, compared with 2005 net sales of $54.8 million. Net sales of the U.S. segment increased as a result of higher average selling prices, primarily due to the mix of products sold, partially offset by decreased sales volume.

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The Brazil segment net sales of $14.7 million increased $0.5 million, or 3.5 percent, compared with 2005 net sales of $14.2 million. The Brazilian segment s net sales increase was primarily due to the stronger Brazilian real.

Operating Expenses

(dollars in millions)

	Three Months Ended					
	June 30, 2006	June 30, 2005	Change	Percent Change	Percent of Net Sales 2006	2005
Net Sales	$ 162.1	$ 168.2	$ (6.1)	(3.6)%		
Cost of products sold	139.9	142.0	(2.1)	(1.5)	86.3 %	84.4 %
Gross Profit	$ 22.2	$ 26.2	$ (4.0)	(15.3)%	13.7 %	15.6 %

Gross profit was $22.2 million in the second quarter of the current year versus $26.2 million in the second quarter of 2005. The gross profit margin was 13.7 percent, declining from 15.6 percent in the second quarter of 2005. The decline in gross profit was the result of the inability to fully offset unabsorbed fixed costs, caused by lower production volumes, and inflationary cost increases through improved mill operations or higher selling prices. Reduced paper machine operating schedules and lower production volumes were experienced, primarily in our French and U.S. operations. This resulted in unfavorable fixed cost absorption impacts that increased operating expenses by $5.4 million. Inflationary cost increases unfavorably impacted operating results by $3.7 million in the quarter compared with the prior year quarter.

Purchased energy costs increased by $3.0 million compared with the second quarter of 2005, with higher energy costs experienced in all business units, related to higher electricity, natural gas and fuel oil costs. Higher labor rates increased manufacturing expenses by $0.5 million during the quarter. Changes in the per ton costs of wood pulp increased our operating expenses by $0.5 million in the current quarter comparison with the prior year. The U.S. list price of northern bleached softwood kraft pulp, a bell-weather pulp grade, averaged $705 per metric ton during the second quarter of 2006, an 8 percent increase compared with an average market list price of $655 per metric ton in the second quarter of 2005. Decreases in prices for purchased materials other than wood pulp had a favorable impact on the operating results of $0.3 million.

These unfavorable factors were partially offset by improved mill operations. Significant operational improvements were achieved in each of our business units through increased productivity and reduced waste.

Nonmanufacturing Expenses

(dollars in millions)

	Three Months Ended					
	June 30, 2006	June 30, 2005	Change	Percent Change	Percent of Net Sales 2006	2005
Selling expense	$ 5.9	$ 6.1	$ (0.2)	(3.3)%	3.6 %	3.6 %
Research expense	1.9	2.5	(0.6)	(24.0)	1.2	1.5
General expense	6.8	6.9	(0.1)	(1.4)	4.2	4.1
Nonmanufacturing expenses	$ 14.6	$ 15.5	$ (0.9)	(5.8)%	9.0 %	9.2 %

Nonmanufacturing expenses were $14.6 million in the second quarter of 2006, a decrease of $0.9 million, or 5.8 percent, less than the prior year of $15.5 million. Selling, research and general expenses were all lower, reflecting cost reduction efforts in these areas. Nonmanufacturing expenses were 9.0 percent of net sales in the second quarter of 2006, slightly below the prior-year period.

Restructuring Expense

We decided in February 2006 to transfer the production volume from one Lee Mills porous plug wrap paper machine to another currently under-utilized Lee Mills porous plug wrap paper machine and to commence accelerated depreciation on the affected equipment. Additionally, the salaried and hourly Lee Mills workforce was reorganized to be more efficient and cost effective. As a result of these decisions, we incurred restructuring expenses of $0.5 million during the second quarter, of which $0.2 million represented non-cash accelerated depreciation and $0.3 million of cash costs were employee related.

Additionally, during May 2006, we announced a decision to cease the production and sale of décor papers made at our mill in Lee. As a result of this decision, we ceased operation of a paper machine in July, which resulted in

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accelerated depreciation and other restructuring related expenses totaling $2.4 million during the second quarter, of which $2.2 million represented non-cash expenses of accelerated depreciation and inventory write-offs and $0.2 million represented cash costs, including severance benefits.

In France, a downturn in demand for tobacco-related papers has resulted from a decrease in consumption of cigarettes in certain countries due to increased taxes and regulation on the cigarette industry. Additionally, new tobacco-related papers capacity began operation in Europe during 2003 and 2004. This has created a very competitive pricing environment during a time of high inflationary cost increases resulting in some lost sales volumes for tobacco-related papers produced by our French operations. This downturn in demand, as well as our decision to eliminate low margin products, has caused us to have excess capacity and machine shutdowns. As a result, we recorded restructuring expense of $0.5 million in the second quarter of 2006, which consisted of accelerated depreciation of $0.3 million and severance and other cash restructuring charges of $0.2 million.

Total restructuring expenses of $3.4 million were recorded during the second quarter of 2006.

Operating Profit

(dollars in millions)

	Three Months Ended				
	June 30, 2006	June 30, 2005	Percent Change	Return on Net Sales 2006	2005
France	$ 5.5	$ 11.5	(52.2)%	5.7 %	11.0 %
United States	0.7		N.M.	1.3	N.M.
Brazil	(0.3)	1.0	N.M.	(2.0)	7.0
Subtotal	5.9	12.5			
Unallocated expenses	(1.7)	(1.8)			
Total	$ 4.2	$ 10.7			