SCHWEITZER MAUDUIT INTERNATIONAL INC
Form 10-Q
November 07, 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

1-13948
(Commission file number)

SCHWEITZER-MAUDUIT INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**62-1612879** (I.R.S. Employer Identification No.)
100 North Point Center East, Suite 600 **Alpharetta, Georgia** (Address of principal executive offices)	**30022** (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 15,452,287 shares of Common Stock, par value $0.10 per share, of the registrant outstanding as of November 6, 2006.

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EX 32	Section 906 Certification of CEO and CFO*

* 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 September 30, 2006	September 30, 2005	Nine Months Ended September 30, 2006	September 30, 2005
Net Sales	$ 161.5	$ 165.7	$ 489.0	$ 494.5
Cost of products sold	138.8	141.3	419.5	419.8
Gross Profit	22.7	24.4	69.5	74.7
Selling expense	5.0	5.5	16.5	17.8
Research expense	1.7	2.0	5.4	7.0
General expense	6.4	6.2	20.9	18.9
Total nonmanufacturing expenses	13.1	13.7	42.8	43.7
Restructuring expense (see Note 4)	12.4		16.3	
Operating Profit (Loss)	(2.8)	10.7	10.4	31.0
Interest expense	1.5	1.7	4.3	4.5
Other income (expense), net	0.3	0.6	(0.3)	2.1
Income (Loss) Before Income Taxes, Minority Interest and Loss from Equity Affiliates	(4.0)	9.6	5.8	28.6
Provision (benefit) for income taxes (see Note 8)	(3.4)	2.3	(1.0)	7.8
Minority interest in earnings of subsidiaries	1.0	1.5	3.0	4.2
Loss from equity affiliates	0.1		0.2	
Net Income (Loss)	$ (1.7)	$ 5.8	$ 3.6	$ 16.6
Net Income (Loss) Per Share:				
Basic	$ (0.11)	$ 0.38	$ 0.23	$ 1.10
Diluted	$ (0.11)	$ 0.37	$ 0.23	$ 1.07
Cash Dividends Declared Per Share	$ 0.15	$ 0.15	$ 0.45	$ 0.45
Weighted Average Shares Outstanding:				
Basic	15,403,800	15,188,000	15,386,100	15,118,700
Diluted	15,490,300	15,390,100	15,516,300	15,464,900

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)

	September 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current Assets		
Cash and cash equivalents	$ 7.3	$ 5.1
Accounts receivable	88.3	99.8
Inventories	124.3	123.0
Other current assets	18.6	14.8
Total Current Assets	238.5	242.7
Property, Plant and Equipment, net	409.4	414.0
Other Assets	38.9	34.1
Total Assets	$ 686.8	$ 690.8
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Current debt	$ 19.8	$ 30.0
Accounts payable	58.4	64.3
Accrued expenses	86.4	71.7
Current deferred revenue	6.0	6.0
Total Current Liabilities	170.6	172.0
Long-Term Debt	72.6	83.7
Deferred Income Tax Liabilities	39.6	40.2
Pension and Other Postretirement Benefits	35.3	38.1
Deferred Revenue	25.5	30.0
Other Liabilities	21.1	20.1
Minority Interest	14.3	13.8
Total Liabilities	379.0	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; 15,450,339 and 15,307,756 shares outstanding at September 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, 628,394 and 770,977 shares at September 30, 2006 and December 31, 2005, respectively	(12.7)	(15.6)
Retained earnings	278.4	281.8
Unearned compensation on restricted stock		(0.3)
Accumulated other comprehensive loss, net of tax	(22.8)	(38.4)
Total Stockholders Equity	307.8	292.9
Total Liabilities and Stockholders Equity	$ 686.8	$ 690.8

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

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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 nine months ended September 30, 2005						16.6			16.6
Adjustments to unrealized foreign currency translation								(13.8)	(13.8)
Changes in the fair value of derivative instruments								(0.3)	(0.3)
Comprehensive income									2.5
Dividends declared ($0.45 per share)						(6.8)			(6.8)
Purchases of treasury stock				29,270	(1.0)				(1.0)
Restricted stock issuances, net				(2,500)					
Amortization of unearned compensation							0.1		0.1
Stock issued to directors as compensation			0.1	(2,452)	0.1				0.2
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)	(318,501)	6.3				5.9
Balance, September 30, 2005	**16,078,733**	**1.6**	**63.9**	**833,389**	**(16.8)**	**281.3**	**(0.4)**	**(35.1)**	**294.5**
Net income for the three months ended December 31, 2005						2.8			2.8
Adjustments to minimum pension liability								(0.2)	(0.2)
Adjustments to unrealized foreign currency translation								(3.4)	(3.4)
								0.3	0.3

Changes in the fair value of derivative instruments									
Comprehensive loss									(0.5)
Dividends declared ($0.15 per share)						(2.3)			(2.3)
Amortization of unearned compensation							0.1		0.1
Stock issued to directors as compensation			(0.1)	(1,212)					(0.1)
Excess tax benefits of stock-based awards			0.2						0.2
Issuance of shares for options exercised			(0.2)	(61,200)	1.2				1.0
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 nine months ended September 30, 2006						3.6			3.6
Adjustments to unrealized foreign currency translation								15.6	15.6
Comprehensive income									19.2
Effect of adoption of new accounting standard			(0.3)				0.3		
Dividends declared ($0.45 per share)						(7.0)			(7.0)
Restricted stock issuances, net			(0.5)	(31,500)	0.6				0.1
Return of shares				13					
Stock-based compensation expense			0.3						0.3
Stock issued to directors as compensation				(4,696)	0.1				0.1
Excess tax benefits of stock-based awards			0.4						0.4
Issuance of shares for options exercised			(0.4)	(106,400)	2.2				1.8
Balance, September 30, 2006	**16,078,733**	**$ 1.6**	**$ 63.3**	**628,394**	**$ (12.7)**	**$ 278.4**	**$**	**$ (22.8)**	**$ 307.8**

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

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SCHWEITZER-MAUDUIT INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOW

(dollars in millions)

(Unaudited)

	Nine Months Ended September 30, 2006	September 30, 2005
Operations		
Net income	$ 3.6	$ 16.6
Non-cash items included in net income		
Depreciation and amortization	28.8	29.6
Restructuring accelerated depreciation	4.6	
Amortization of deferred revenue	(4.5)	(5.7)
Deferred income tax (benefit) provision	(5.9)	0.9
Minority interest in earnings of subsidiaries	3.0	4.2
Other items	(0.3)	(4.1)
Net changes in operating working capital	21.2	(28.6)
Cash Provided by Operations	50.5	12.9
Investing		
Capital spending	(5.4)	(13.4)
Capitalized software costs	(1.6)	(0.5)
Acquisitions, net of cash acquired		(11.9)
Investment in equity affiliates	(2.5)	
Other	(5.5)	(6.0)
Cash Used for Investing	(15.0)	(31.8)
Financing		
Cash dividends paid to SWM stockholders	(7.0)	(6.8)
Cash dividends paid to minority interest	(3.7)	(3.6)
Changes in short-term debt	(10.9)	8.0
Proceeds from issuances of long-term debt	85.5	23.4
Payments on long-term debt	(99.5)	(5.3)
Purchases of treasury stock		(1.0)
Proceeds from exercise of stock options	1.8	5.9
Excess tax benefits of stock-based awards	0.4	
Cash Provided By (Used for) Financing	(33.4)	20.6
Effect of Exchange Rate Changes on Cash	0.1	
Increase in Cash and Cash Equivalents	2.2	1.7
Cash and Cash Equivalents at beginning of period	5.1	4.5
Cash and Cash Equivalents at end of period	$ 7.3	$ 6.2

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

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 nine months ended September 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 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.

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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 Provided by Operations by $0.6 million for the nine months ended September 30, 2005, increase Cash Used for Investing by $0.6 million for the nine months ended September 30, 2005, and on a separate line report the Effect of Exchange Rate Changes on Cash, which had no effect for the nine months ended September 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 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, September 30, 2005		**Nine Months Ended, September 30, 2005**	
Net Income				
As reported	$	5.8	$	16.6
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related income tax effects	0.3		0.8	
Pro forma	$	5.5	$	15.8
Basic net income per share				
As reported	$	0.38	$	1.10
Pro forma	$	0.37	$	1.05
Diluted net income per share				
As reported	$	0.37	$	1.07
Pro forma	$	0.36	$	1.02

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 nine month periods ended September 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 nine months ended September 30, 2006 were none and $0.4 million, respectively, and were none and $0.8 million, respectively, for the three and nine months ended September 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, $0.3 million of 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 3 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 September 30, 2006 and changes during the nine 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 September 30, 2006	1,056,192	$ 25.31	6.0
Options vested and exercisable September 30, 2006	1,039,192	$ 25.31	6.0

As of September 30, 2006, there was $0.1 million of unrecognized compensation cost related to outstanding stock options to be recorded during the remainder of 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 September 30, 2006, there was $0.7 million of unrecognized compensation cost related to outstanding restricted stock. A summary of outstanding restricted stock awards as of September 30, 2006 and 2005 and changes during the nine 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	$ 23.56
Granted	34,500	23.48	4,500	33.09
Forfeited	(3,000)	25.97	(2,000)	25.97
Vested	(13,500)	23.45	(28,000)	23.01
Nonvested restricted shares outstanding at September 30	46,500	24.52	28,500	25.43

Restricted Stock Plan Performance Based Shares

The Company s LTIP for key executives includes an equity-based award component equal to 50 percent of the total award opportunity that is provided through the Company s Restricted Stock Plan, or RSP. 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 RSP 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. 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 nine month periods ended September 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. As a result, the net increase in the average number of common and potential common shares outstanding for the three and nine month periods ended September 30, 2006 was none and 4,324, respectively.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board, or FASB, issued FASB Statement No. 151, *Inventory Costs an amendment of ARB No. 43, Chapter 4,* or SFAS 151. SFAS 151 amends the guidance in Accounting Research Bulletin No. 43, or ARB 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 Statement No. 154, *Accounting Changes and Error Corrections*, or SFAS 154, which replaces Accounting Principles Board No. 20, *Accounting Changes*, and FASB Statement No. 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.

In July 2006, the FASB issued Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109.* 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 and will implement FIN 48 in the first quarter of 2007.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, or SAB 108 *Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements*. The purpose of SAB 108 is to provide requirements related to financial statement presentation and financial statement restatement for a discovered prior period misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company does not expect the adoption of SAB 108 to have a material impact on the accompanying financial statements.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*, or SFAS 157, which is effective for financial statements issued for the fiscal year beginning after November 15, 2007. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 also expands disclosure requirements to include: (a) the fair value measurements of assets and liabilities at the reporting date, (b) segregation of assets and liabilities between fair value measurements based on quoted market prices and those based on other methods and (c) information that enables users to assess the method or methods used to estimate fair value when no quoted price exists. SFAS 157 applies to fiscal years and interim periods beginning after November 15, 2007. 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.

In September 2006, the FASB issued Statement No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans An Amendment of FASB Statements No. 87, 88, 106 and 132R*, or SFAS 158, which requires an employer to: (a) recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status, (b) measure a plan s assets and obligations that determine its funded status as of the end of the employer s fiscal year (with limited exceptions) and (c) recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period. The requirement to recognize the funded status of a benefit plan and associated disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006. 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. The Company is currently in the process of reviewing this pronouncement to determine its impact on the Company s consolidated financial position and will implement SFAS 158 effective with its December 31, 2006 financial statements.

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 September 30, 2006	**September 30, 2005**	**Nine Months Ended September 30, 2006**	**September 30, 2005**
Average number of common shares outstanding	15,403.8	15,188.0	15,386.1	15,118.7
Dilutive effect of:				
• stock options	20.4	155.0	64.4	292.8
• restricted stock	44.0	29.9	40.7	36.9
• directors deferred stock compensation	22.1	17.2	20.8	16.5
• long-term incentive compensation			4.3	
Average number of common and potential common shares outstanding	15,490.3	15,390.1	15,516.3	15,464.9

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 nine month periods ended September 30, 2006 were approximately 954,000 and 644,600, respectively, and for the three and nine month periods ended September 30, 2005 were approximately 381,000 and 251,100, respectively.

NOTE 3. INVENTORIES

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

	September 30, 2006	December 31, 2005
Raw materials	$ 35.3	$ 40.9
Work in process	18.2	17.0
Finished goods	50.3	45.1
Supplies and other	20.5	20.0
Total	$ 124.3	$ 123.0

NOTE 4. RESTRUCTURING EXPENSE

The Company initiated restructuring activities during 2006 which are expected to improve its competitiveness and profitability as well as the present imbalance between sales demand and paper production capacity in the United States and France. The following table summarizes the associated cash and non-cash pretax restructuring expense totaling $12.4 million for the third quarter and $16.3 million for the first nine months of 2006 (dollars in millions):

	Three Months Ended September 30, 2006			Nine Months Ended September 30, 2006		
	France	U.S.	Total	France	U.S.	Total
Cash expense						
Severance and other employee related costs	$ 10.3	$ 0.2	$ 10.5	$ 10.4	$ 0.5	$ 10.9
Other	0.1	(0.1)		0.2	0.1	0.3
Total cash expense	10.4	0.1	10.5	10.6	0.6	11.2
Non-cash expense						
Accelerated depreciation	0.2	1.3	1.5	0.7	3.9	4.6
Other		0.4	0.4		0.5	0.5
Total non-cash expense	0.2	1.7	1.9	0.7	4.4	5.1
Total Restructuring Expense	$ 10.6	$ 1.8	$ 12.4	$ 11.3	$ 5.0	$ 16.3

Restructuring liability reserves related to the cash restructuring expense for 2006 not yet paid 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	11.2
Cash payments	(0.9)
Balance at September 30, 2006	$ 10.3

At the Lee Mills facility in Massachusetts, the Company initiated restructuring activities in 2006 to reduce paper machine operations and employment levels. As a result of these decisions, the Company recorded $1.8 million and $5.0 million of restructuring expense for the three and nine months ended September 30, 2006, respectively. Third quarter restructuring expense included $1.7 million for accelerated depreciation and other non-cash costs and $0.1 million for severance and other cash costs. Year-to-date restructuring expense consisted of $4.4 million for accelerated depreciation and other non-cash costs and $0.6 million for severance and other cash costs.

During the third quarter of 2006, as a result of announced restructuring that included planned reductions in paper machine operations and employment levels at the Company s Papeteries de Mauduit S.A.S., or PdM, facility in France, the minimum severance liability mandated by French law was recorded in accordance with FASB Statement No. 112, *Employers Accounting for Postemployment Benefits An Amendment of FASB Statements No. 5 and 15.* The Company plans to record any additional severance liability as a result of negotiations and amortize this incremental severance cost to expense over the affected employees remaining service period in accordance with FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, or SFAS 146. When known, the Company will record incremental severance liability for voluntary retirements in accordance with FASB Statement No. 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Plans and for Termination Benefits* and amortize this incremental cost to expense over the affected employees service period. Third quarter restructuring expense totaled $0.2 million for accelerated depreciation and $10.4 million for severance and other cash costs, including amounts fully expensed for the minimum PdM severance liability mandated by French law. Year-to-date restructuring expense consisted of $0.7 million for accelerated depreciation and $10.6 million for severance and other cash costs.

Events Subsequent to September 30, 2006 Not Reflected in the Accompanying Financial Statements. On October 18, 2006, the first meeting among PdM management, unions and the Work s Council occurred related to the planned restructuring. The negotiations with PdM s unions and Work s Council are proceeding under a mutually agreed upon schedule and protocol. The negotiations are expected to conclude by mid-December 2006. The proposal from the Company calls for the shutdown of 2 paper machines and the reduction of 209 employees, or approximately one-fourth of the PdM workforce. The reductions are proposed to occur in essentially 2 equal phases during the first and fourth quarters of 2007. At this meeting, PdM offered severance payments in excess of the French legal minimum. Approximately $9 million of estimated additional severance liability, which is incremental to that recorded in the third quarter, will be recorded during the fourth quarter. This incremental severance amount will be amortized to restructuring expense over the affected employees remaining service periods during 2006 and 2007 in accordance with SFAS 146. The estimated amount of severance liability could change, dependent upon the results of negotiations and the mix of employees that leave through early retirement or other voluntary means versus involuntary separation.

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, except in the Brazil tax assessment number 2001.001.064544-6, or Assessment 2, concerning Imposto sobre Circulacão de Mercadorias e Servicos, or ICMS.

Superior Tribunal of Justice Judge Denise Arruda previously granted the Company s petition for a preliminary injunction staying execution of the ICMS tax assessment by the State of Rio de Janeiro. On October 20, 2006, following a hearing on whether to make the preliminary injunction permanent pending resolution of the ICMS tax assessment on the merits, Judge Arruda decided that the Superior Tribunal of Justice did not have jurisdiction over the constitutional question presented and that it should be heard by the Supreme Court of Brazil. Consequently, the judge vacated the preliminary injunction. This court decision does not apply to the similar Brazil tax assessment number 2001.001.115144-5, or Assessment 1.

Regarding this recent court decision in Assessment 2, the Company has entered with a request for plenary examination of the injunction by the Superior Tribunal of Justice. The Company expects that it could be up to one year before this matter is heard by the Superior Tribunal of Justice sitting in plenary session. While it is technically possible for the State of Rio de Janeiro to commence execution on Assessment 2, because there is no preliminary injunction in force, the Company does not believe that is likely. If such administrative execution were to be initiated by the State of Rio de Janeiro, SWM-B would be obligated to provide security for payment of the initial litigation amount, plus monetary correction and penalties estimated at September 30, 2006 to equal the Reais equivalent of $6.3 million. This security may be provided in the form of a cash deposit, enrollment of assets or a bond. In conjunction with providing security for the potential liability, the Company would seek a preliminary injunction based on such an administrative deposit. If the fiscal authority does not initiate the administrative execution, the plenary decision of the Superior Tribunal of Justice is a condition precedent to further judicial appeals. In the event that such a judgment is negative to SWM-B, an appeal to the Supreme Court of Brazil will be initiated.

SWM-B continues to vigorously contest these Assessments and believes that these Assessments will ultimately be resolved in its favor. However, since the final resolution involves presentation of these matters to the Supreme Court of Brazil, they are not likely to be finally resolved for several years. No liability has been recorded on the Company s consolidated financial statements for these Assessments based on its evaluation that SWM-B is more likely than not to prevail in its challenge of these Assessments under the facts and law as presently understood.

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 FASB Statement No. 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, or SFAS 88. 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 has been modified to partially offset the employee pension benefit reduction.

The Lee Mills action necessitated a remeasurement of the Company s accumulated benefit obligation of 2006 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 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 July 2005, the decision was made and communicated to all affected U.S. salaried employees that benefits related to the Company s defined benefit pension plan in the United States would be frozen as of December 31, 2005. This

action is expected to reduce the Company s annual pension expense and pension fund contribution requirements. The plan was not terminated and benefits accrued as of December 31, 2005 will continue to be paid in accordance with the plan terms. Allowable contributions and the Company s matching percentage for its defined contribution, or 401(k), plan were modified to partially offset the employee benefit reduction.

The 2005 action included suspending the defined benefit pension plan so U.S. salaried employees do not earn additional benefits for future service (years or earnings) beginning January 1, 2006. This suspension of additional benefits for future service qualified this action for curtailment under SFAS 88. This action necessitated a remeasurement of the Company s accumulated benefit obligation under the Company s U.S. pension plan and resulted in a curtailment gain in the third quarter of 2005 of $0.8 million ($0.5 million after tax). As part of the Company s remeasurement, it decreased its discount rate assumption from 5.75 percent to 5.25 percent to reflect changes in the market interest rates. Turnover and retirement assumptions were modified to reflect a demographic assumption study of the Company. Additionally, the mortality table assumption was also reviewed and updated to a more current mortality table. Annual rate of return and wage rate increase assumptions remained consistent with those previously disclosed.

In accordance with SFAS 88, the Company calculated its curtailment gains by first remeasuring its plan assets and projected benefit obligation, or PBO, as of the date of each of the curtailments, excluding the effects of the curtailments, but including the effects of the changes in assumptions. The Company then had the respective plan assets and PBOs measured using the effects of the curtailments. This enabled the effects of the curtailments on the respective PBO to be isolated, 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 nine month periods ended September 30, 2006 and 2005 were as follows (dollars in millions):

U.S. Pension Benefits	**Three Months Ended September 30, 2006**	**September 30, 2005**	**Nine Months Ended September 30, 2006**	**September 30, 2005**
Service cost	$ 0.3	$ 0.6	$ 1.2	$ 2.1
Interest cost	1.7	1.7	5.0	4.8
Expected return on plan assets	(1.8)	(1.7)	(5.3)	(4.9)
Amortization and other	0.3	1.0	1.6	2.1
Pension curtailment gain		(0.8)	(0.1)	(0.8)
Net periodic benefit cost	$ 0.5	$ 0.8	$ 2.4	$ 3.3

U.S. Postretirement Healthcare and Life Insurance Benefits	**Three Months Ended September 30, 2006**	**September 30, 2005**	**Nine Months Ended September 30, 2006**	**September 30, 2005**
Service cost	$ 0.1	$ 0.1	$ 0.2	$ 0.2
Interest cost	0.1	0.2	0.5	0.6
Amortization and other		(0.1)		(0.1)
Net periodic benefit cost	$ 0.2	$ 0.2	$ 0.7	$ 0.7

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

French Pension Benefits	**Three Months Ended September 30, 2006**	**September 30, 2005**	**Nine Months Ended September 30, 2006**	**September 30, 2005**
Service cost	$ 0.4	$ 0.4	$ 1.2	$ 1.2
Interest cost	0.3	0.4	1.3	1.2
Expected return on plan assets	(0.4)	(0.2)	(1.0)	(0.6)
Amortization and other	0.2	0.4	0.6	0.7
Net periodic benefit cost	$ 0.5	$ 1.0	$ 2.1	$ 2.5

NOTE 2. NET INCOME PER SHARE

The Company contributed $5.0 million and $9.4 million to its pension plans through the first nine months of 2006 and 2005, respectively. The timing of pension contributions, if any, for the remainder of 2006 has not yet been

determined, as no 2006 pension contributions are legally required. The Company expects total pension contributions to be in the range of $7 to $15 million from October 2006 to the end of 2007. The Company also made a total of $1.5 million of payments related to its U.S. postretirement healthcare and life insurance benefits for the nine months ended September 30, 2006, and expects to make additional payments of less than $1 million during the remainder of 2006.

NOTE 7. DEBT

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 replaced the existing credit facility executed on January 31, 2002 that was scheduled to expire in January 2007. Borrowings outstanding under the Credit Agreement of $57.7 million were classified as Long-Term Debt in the Consolidated Balance Sheet at September 30, 2006 under the terms of the new Credit Agreement and management s current intent not to repay these amounts within the next year.

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 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 provide greater flexibility to pursue 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 were 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 against the Credit Agreement are expected to aggregate the U.S. dollar equivalent of approximately $10 to $30 million during the fourth quarter 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 incurs 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.

NOTE 8. INCOME TAXES

Income (loss) before income taxes totaled a loss of $4.0 million and income of $5.8 million for the three and nine months ended September 30, 2006, respectively, and income of $9.6 million and $28.6 million for the three and nine months ended September 30, 2005, respectively.

A reconciliation of income taxes computed at the U.S. federal statutory income tax rate to the provision (benefit) for income taxes is as follows (dollars in millions):

	Three Months Ended September 30, 2006		September 30, 2005		Nine Months Ended September 30, 2006		September 30, 2005	
Tax at U.S. statutory rate	$ (1.4)	35.0 %	$ 3.4	35.0 %	$ 2.0	35.0 %	$ 10.0	35.0 %
Tax benefit of foreign legal structure	(1.9)	47.5	(1.2)	(12.5)	(3.2)	(55.2)	(2.3)	(8.0)
Other, net	(0.1)	2.5	0.1	1.5	0.2	3.0	0.1	0.3
Provision (benefit) for income taxes	$ (3.4)	85.0 %	$ 2.3	24.0 %	$ (1.0)	(17.2)%	$ 7.8	27.3 %

Tax benefits of foreign legal structure result from net foreign tax deductions from the restructuring of the Company s foreign operations in 2003. As a result of reduced earnings in 2006, the proportionate effect of this item on the overall effective income tax rate is greater than in 2005.

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NOTE 9. 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 90 percent of the Company s consolidated net sales in the three and nine month periods ended September 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				Nine Months Ended			
	September 30, 2006		September 30, 2005		September 30, 2006		September 30, 2005	
France	$ 95.6	59.2 %	$ 102.0	61.6 %	$ 285.6	58.4 %	$ 308.9	62.5 %
United States	51.5	31.9	54.1	32.7	169.7	34.7	160.8	32.5
Brazil	18.5	11.4	15.3	9.2	49.5	10.1	43.0	8.7
Subtotal	165.6	102.5	171.4	103.5	504.8	103.2	512.7	103.7
Intersegment sales by								
France	(1.7)	(1.1)	(3.3)	(2.0)	(8.8)	(1.8)	(12.3)	(2.5)
United States	(0.4)	(0.2)	(0.3)	(0.2)	(0.8)	(0.2)	(1.1)	(0.2)
Brazil	(2.0)	(1.2)	(2.1)	(1.3)	(6.2)	(1.2)	(4.8)	(1.0)
Subtotal	(4.1)	(2.5)	(5.7)	(3.5)	(15.8)	(3.2)	(18.2)	(3.7)
Consolidated	$ 161.5	100.0 %	$ 165.7	100.0 %	$ 489.0	100.0 %	$ 494.5	100.0 %

Operating Profit (Loss)

(dollars in millions)

	Three Months Ended				Nine Months Ended			
	September 30, 2006		September 30, 2005		September 30, 2006		September 30, 2005	
France	$ (1.1)	39.3 %	$ 11.7	109.4 %	$ 12.8	123.1 %	$ 34.0	109.7 %
United States	0.1	(3.6)	0.8	7.5	3.3	31.7	0.4	1.3
Brazil	(0.1)	3.6	(0.2)	(1.9)	(0.2)	(1.9)	1.1	3.5
Unallocated	(1.7)	60.7	(1.6)	(15.0)	(5.5)	(52.9)	(4.5)	(14.5)
Consolidated	$ (2.8)	100.0 %	$ 10.7	100.0 %	$ 10.4	100.0 %	$ 31.0	100.0 %

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				Nine Months Ended			
	September 30, 2006		September 30, 2005		September 30, 2006		September 30, 2005	
Net sales	$ 161.5	100.0 %	$ 165.7	100.0 %	$ 489.0	100.0 %	$ 494.5	100.0 %
Gross profit	22.7	14.1	24.4	14.7	69.5	14.2	74.7	15.1
Restructuring expense	12.4	7.7			16.3	3.3		
Operating profit(loss)	(2.8)	(1.7)	10.7	6.5	10.4	2.1	31.0	6.3
Net income (loss)	$ (1.7)	(1.1)%	$ 5.8	3.5 %	$ 3.6	0.7 %	$ 16.6	3.4 %
Diluted earnings (loss) per share	$ (0.11)		$ 0.37		$ 0.23		$ 1.07	
Capital spending	$ 3.3		$ 5.2		$ 5.4		$ 13.4	

The decline in earnings compared with the third quarter of 2005 was primarily the result of $12.4 million of pre-tax restructuring expense recorded in the quarter. Absent the restructuring expense, our improved mill operations and benefits of cost reduction activities largely offset the unfavorable effects of inflationary cost increases and lower sales and production volumes. Inflationary cost increases unfavorably impacted operating results by $3.8 million and unabsorbed fixed costs increased operating expenses by $3.5 million during the quarter.

Recent Developments

Operational Changes   United States and France

We initiated restructuring activities during 2006 which are expected to improve our competitiveness and profitability as well as the present imbalance between sales demand and paper production capacity in the United States and France. The following table summarizes the associated cash and non-cash pretax restructuring expense totaling $12.4 million for the third quarter and $16.3 million for the first nine months of 2006 (dollars in millions):

	Three Months Ended September 30, 2006			Nine Months Ended September 30, 2006		
	France	U.S.	Total	France	U.S.	Total
Cash expense						
Severance and other employee related costs	$ 10.3	$ 0.2	$ 10.5	$ 10.4	$ 0.5	$ 10.9
Other	0.1	(0.1)		0.2	0.1	0.3
Total cash expense	10.4	0.1	10.5	10.6	0.6	11.2
Non-cash expense						
Accelerated depreciation	$ 0.2	$ 1.3	$ 1.5	$ 0.7	$ 3.9	$ 4.6
Other		0.4	0.4		0.5	0.5
Total non-cash expense	0.2	1.7	1.9	0.7	4.4	5.1
Total Restructuring Expense	$ 10.6	$ 1.8	$ 12.4	$ 11.3	$ 5.0	$ 16.3

At the Lee Mills facility in Massachusetts, restructuring activities were initiated in 2006 that have become part of an overall effort to sustain profitable operations at this location. As previously disclosed to the SEC on Form 10-Q for the first and second quarters of 2006, actions at the Lee Mills were prompted in part by a notification from Kimberly-Clark Corporation in January 2006 to terminate in later 2007 an agreement for the operation of a paper machine at this site. While certain of the costs associated with operation of this machine that are currently invoiced to Kimberly-Clark can be eliminated, we may be unable to eliminate a portion of the approximately $2 million of annual indirect and fixed overhead costs that are currently absorbed by that operation when the Kimberly-Clark contract expires. As a result of the Kimberly-Clark notice, 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, we decided in February 2006 to transfer production volume from one porous plug wrap paper machine to another 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 resulted in the loss of approximately 25 jobs. Additionally, during May 2006, we announced a decision to cease the production and sale of décor papers made at the Lee Mills. As a result of this decision, we ceased operation of a paper machine in July, which resulted in accelerated depreciation and other restructuring expense. This cessation resulted in the loss of approximately 15 jobs in total at the Lee Mills and at our U.S. headquarters in Alpharetta, Georgia. As a result of these decisions, we recorded $1.8 million and $5.0 million of restructuring expense in the United States for the three and nine months ended September 30, 2006, respectively.

In France, a decrease in the consumption of cigarettes, primarily caused by increased consumer taxes and regulations on the cigarette industry, impacted the demand for some of our tobacco-related products in western Europe and elsewhere. Also, new tobacco-related papers manufacturing capacity was added in 2003 and 2004 by competitors in Europe that increased competition in a period of reduced demand. The reduced demand for our products has caused us to have continuing excess capacity and increased machine downtime in France.

As a result of evaluations of how to operate our production facilities in France more effectively, on September 19, 2006, we announced plans to invest approximately $23 million to improve the cost and quality competitiveness in our paper operations at PdM, as well as initiation of negotiations with the unions and the Work s Council to consider restructuring operations at that facility, including employee layoffs and the shutdown of production equipment. On October 18, 2006, the first meeting among PdM management, unions and the Work s Council occurred. At this meeting, further detail information was provided regarding the costs, timing and benefits of the strategy to become the most cost and quality competitive cigarette and long fiber paper manufacturer in Western Europe. The elements of this strategy at PdM include i) improvement of cigarette paper manufacturing by investing in state-of-the-art, more automated capabilities while removing older, higher cost production equipment; ii) reduction in general mill operating costs; iii) development of an improved commercial policy intended to grow market share;

iv) renewed efforts to further develop the long fiber paper business using PdM s existing papermaking capacity; and v) the restructuring of work practices to enhance the productivity and organizational effectiveness of PdM s human resources.

Meetings with the unions and the Work s Council must be completed before the amount of the restructuring expense, timing and ongoing benefits of the targeted changes can be definitely known. The negotiations are proceeding under a mutually agreed upon schedule and protocol, and are expected to conclude by mid-December 2006. Third quarter restructuring expense in France totaled $0.2 million for accelerated depreciation and $10.4 million for severance and other cash costs, including amounts expensed for the minimum PdM severance liability mandated by French law. Year-to-date restructuring expense consisted of $0.7 million for accelerated depreciation and $10.6 million for severance and other cash costs.

At the October 18th meeting, PdM offered severance payments in excess of the French legal minimum. Approximately $9 million of additional severance liability will be recorded during the fourth quarter. This incremental amount will be amortized to restructuring expense over the affected employees remaining service periods during 2006 and 2007 in accordance with SFAS 146. The amount of these severance expenses could change, dependent upon the results of negotiations and the mix of employees that leave through early retirement or other voluntary means versus involuntary separation.

We continue to evaluate how to operate our worldwide production facilities more effectively. Analyses are ongoing and we have not committed to any actions beyond those identified above. However, additional restructuring expense may be incurred based on the outcome of these analyses.

New Energy Contracts

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 of May 1, 2006 through December 31, 2010 to cover 100 percent of the mill s consumption of electrical energy. The value of the electric energy to be provided under this contract is estimated at approximately $5 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.

During October 2006, PdM entered into an agreement for the supply of 100 percent of its requirements for natural gas supply and associated distribution to service its paper mill located in Quimperlè, France. The contract is with ENI S.p.A., an international energy supplier acting in approximately 70 countries. The contract is for the period April 1, 2007 to April 1, 2008. The value of the natural gas and distribution to be provided under this contract is estimated at approximately $9 to $10 million annually. The contract provides for a fixed price amount per month plus a variable price for each unit of energy used up to a maximum daily volume. The contract may be renewed with all terms and conditions remaining in force with the exception of volumes and contract prices, which are subject to negotiation.

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. 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 required 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. 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 which would reportedly require compliance 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 was not 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 were modified to partially offset the employee pension benefit reduction.

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. PdM 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 additional equity investments of $0.3 million during the fourth quarter of 2006 and approximately $12 million and $2 million in 2007 and 2008, respectively.

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 credit. The impact of this acquisition 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 replaced 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 provide greater flexibility to pursue 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, against the Credit Agreement are expected to aggregate the U.S. dollar equivalent of approximately $10 to $30 million during the fourth quarter.

Results of Operations

This section presents a discussion and analysis of our third 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 September 30, 2006	September 30, 2005	Nine Months Ended September 30, 2006	September 30, 2005
Net Sales	$ 161.5	$ 165.7	$ 489.0	$ 494.5
Cost of products sold	138.8	141.3	419.5	419.8
Gross Profit	22.7	24.4	69.5	74.7
Nonmanufacturing expenses	13.1	13.7	42.8	43.7
Restructuring expense	12.4		16.3	
Operating Profit (Loss)	(2.8)	10.7	10.4	31.0
Interest expense	1.5	1.7	4.3	4.5
Other income (expense), net	0.3	0.6	(0.3)	2.1
Income (Loss) Before Income Taxes Minority Interest and Loss from Equity Affiliates	(4.0)	9.6	5.8	28.6
Provision (benefit) for income taxes	(3.4)	2.3	(1.0)	7.8
Minority interest in earnings of subsidiaries	1.0	1.5	3.0	4.2
Loss from equity affiliates	0.1		0.2	
Net Income (Loss)	$ (1.7)	$ 5.8	$ 3.6	$ 16.6
Diluted Net Income (Loss) Per Share	$ (0.11)	$ 0.37	$ 0.23	$ 1.07

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

Net Sales

(dollars in millions)

	Three Months Ended September 30, 2006	September 30, 2005	Percent Change	Consolidated Sales Volume Change
France	$ 95.6	$ 102.0	(6.3)%	(14.6)%
United States	51.5	54.1	(4.8)	(15.7)
Brazil	18.5	15.3	20.9	24.1
Subtotal	165.6	171.4		
Intersegment	(4.1)	(5.7)		
Total	$ 161.5	$ 165.7	(2.5)%	(8.6)%

We reported net sales of $161.5 million in the quarter compared with $165.7 million in the same period a year ago. The decrease of $4.2 million, or 2.5 percent, consisted of the following (dollars in millions):

	Amount	Percent
Changes in sales volumes	$ (13.2)	(7.9)%
Changes in selling prices and product mix	5.3	3.2
Changes in currency exchange rates	3.7	2.2
Total	$ (4.2)	(2.5)%

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Net sales decreased as a result of decreased sales volumes partially offset by higher average selling prices and favorable currency impacts.

- Unit sales volumes decreased 8.6 percent compared with last year, having a $13.2 million, or 7.9 percent, unfavorable impact on the net sales comparison.

- Sales volumes in the United States decreased by 15.7 percent reflecting a reduction of commercial and industrial paper sales as a result of the décor paper exit and consolidation of paper production on fewer machines, as well as lower sales of tobacco-related papers. Sales volumes of cigarette paper for lower propensity ignition cigarettes increased.

- Sales volumes of the French segment decreased by 14.6 percent as a result of lower sales of reconstituted tobacco leaf products, due to a non-recurring tender order during the prior-year quarter, and tobacco-related papers.

- Brazil experienced increased sales volumes of 24.1 percent due to increased commercial and industrial paper sales as well as higher export sales of tobacco-related papers, in part reflecting our strategy to shift production of certain grades from the United States to Brazil.

- Higher average selling prices had a favorable impact on net sales of $5.3 million, or 3.2 percent. Higher average selling prices were realized in France and the United States, which was largely attributable to a change in the mix of products sold.

- Changes in currency exchange rates favorably impacted the net sales comparison by $3.7 million. Both the euro and Brazilian real were stronger versus the U.S. dollar, by 5 and 7 percent, respectively, accounting for the positive impact.

Sales of tobacco-related products accounted for approximately 90 percent of net sales for the three months ended September 30, 2006 and 2005.

French segment net sales of $95.6 million declined $6.4 million, or 6.3 percent, compared with $102.0 million in 2005. The decline was a result of lower sales volumes of reconstituted tobacco leaf products and tobacco-related papers, partially offset by higher average selling prices and favorable currency impacts.

The U.S. segment net sales of $51.5 million represented a decrease of $2.6 million, or 4.8 percent, compared with 2005 net sales of $54.1 million. Net sales of the U.S. segment decreased as a result of lower sales volumes, partially offset by higher average selling prices.

The Brazil segment net sales of $18.5 million increased $3.2 million, or 20.9 percent, compared with 2005 net sales of $15.3 million. The Brazilian segment s net sales increase was primarily due to higher sales volumes and a favorable currency impact, partially offset by lower average selling prices.

Operating Expenses

(dollars in millions)

Three Months Ended					
September 30,	September 30,		Percent	Percent of Net Sales	
2006	2005	Change	Change	2006	2005