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INSIGHT
TO
THE
INDUSTRY



ABOUT THIS REPORT

In this,
our first annual report, we at
Paragon Trade Brands have provided answers to our
customers' and investors' most frequently asked questions
about the Company and the industry. The information
appears in sections designed to allow
easy access.

“Our private label program is extremely important to us. We value its contribution to our success and the value it represents to Kroger customers. Private label is growing... particularly in diapers. When we buy our private label goods we almost always buy from more than one supplier; an exception is diapers. We buy only from Paragon.”

Terry Cox
Vice President HB&A
Kroger Company

ABOUT THE COMPANY

For over twenty years, Paragon Trade Brands has been the leading supplier of store brand disposable baby diapers in North America. The company manufactures a line of premium-quality diapers known as "Ultra" as well as a line of economy diapers that has fewer features. These products are distributed throughout the United States and Canada, primarily through grocery and food stores, mass merchandisers, warehouse clubs, toy stores and drugstores that market the products under their own store brands. Paragon's success has been driven by a commitment to work with retailers in building their store brand share and category profits. By focusing on continual improvement, Paragon has set the standards for product quality and profitability in store brands for our retail trade partners, while providing significant savings and value to the consumer.

TO OUR STOCKHOLDERS:

Paragon Trade Brands is the leading supplier of store brand disposable diapers in North America. We have achieved that position by adhering to our unwavering mission to provide our customers with the highest quality products and value-added services at the lowest price possible.

In our first year of independent existence, we have far exceeded our performance targets despite price reductions by the national brands. We owe this accomplishment to the energy, dedication, and teamwork of our 1700 Company associates and the solid partnerships that we have formed with our customers and suppliers over the years.

Paragon Trade Brands became a public company on January 26, 1993 through an initial public offering (IPO) of 11.5 million shares of common stock at \$19 per share. The proceeds from the sale of 10 million shares and a bank loan of \$35 million were paid to Weyerhaeuser Company for the acquisition of its Private Label Baby Diaper Business. The proceeds from the remaining 1.5 million shares were used by the Company to reduce its bank debt to \$8.1 million.

Operating Results and Financial Highlights

In fiscal 1993, sales increased by 16% from \$484.8 million to \$562.9 million. Operating earnings on a pro forma basis increased by 60% from \$30.6 million to \$48.9 million. Net income on a pro forma basis, excluding the tax benefit of \$15.6 million due to changes in the tax law, increased by 64% from \$18.3 million to \$30.0 million.

During our first year as a public company our return on average equity, excluding the one-time tax benefit of \$15,588,000, was 21.7% on a book basis and 13.7% on an IPO market capitalization basis.

IPO Business Plan Highlights

During our IPO, we discussed two external factors and four internal factors that contribute to the



**Bobby Abraham, Chairman and Chief Executive Officer,
and David W. Cole, President and Chief Operating Officer**

"We've seen a
lot of growth from our Smiles brand diapers
mostly due to Paragon's quality...they sell as well as our
national brands in our clubs. We really consider Paragon
Trade Brands an important partner in our
long-term growth plans."

Clark Tyndall
Divisional Merchandise Manager
SAM's Club
A Division of Wal-Mart

growth potential of our business and strengthen our leadership position in the value segment of the diaper category.

The external factors identified were: (1) the general shift of the retail trade toward emphasizing quality in store brands to strengthen franchises and improve profits and (2) the general shift in consumer purchase behavior to value over brand image, particularly in frequently purchased items such as diapers.

The internal factors identified were: (1) our partnerships with key retailers; (2) our product quality; (3) our product development strategies and capabilities; and (4) our manufacturing capabilities.

To underscore our commitment to growing the business, we also disclosed plans to invest \$184 million over the period 1993 through 1997, with approximately two-thirds of the spending planned for the years 1993 and 1994. The investments were targeted toward several key areas:

- First, to increase our capacity from 3 billion units in 1992 to 4.1 billion units in 1997. We indicated that the capacity additions for the years 1993 and 1994 would be approximately 10% a year, with much of our growth expected to come from our North American customers.
- Second, to modernize our manufacturing equipment and processes to reduce costs. Our ongoing goal is to share the benefits of this cost reduction with our customers, while at the same time improving our pretax operating margins.
- Third, to stay current with the continual innovation of products in the diaper category by upgrading and maintaining our equipment.

To ensure a strong balance sheet, while funding the aggressive investment program, we indicated both no dividend payments in the early years of this program and a conservative target debt to total capital ratio of under 30%.

Business Plan Update

Our trade customers continue to emphasize the importance of quality and remain committed to growing

their store brand franchises in the face of testing challenges from the national brands. Consumers have reaffirmed their preference for value — quality at a lower price — by buying our customers' store brands despite the narrowing gap in price compared to the national brands. By building on our fundamental internal strengths, we were able to leverage these favorable market trends.


We have strengthened our relationships with our trade customers. We have also emphasized more customer-specific marketing, packaging improvements, and promotional programs to optimize each retailer's unique image and strategy. In addition, we are making significant investments in developing systems for electronic data interchange to efficiently interface with trade customers.

In the area of diaper product quality and development we already enjoy a two-to-one product performance advantage over all value segment competitors. National consumer home use tests of our new Ultra thin diaper product indicate that it is significantly preferred over our current Ultra product and continues to compare favorably to the leading national brand. We believe this continuing trend in our product quality will help offset the narrowing price gap between store brands and national brands.

Paragon has made three significant improvements to its training pant product since its introduction in 1992. These include upgrading the pad, adding a printed backsheet, and introducing an improved elastic waist system. Our training pant production was on allocation during most of 1993. We are doubling our capacity for 1994.

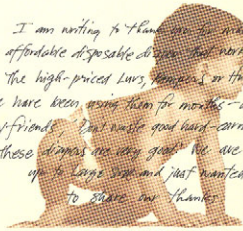
We have also significantly upgraded the economy diaper product and package and expect that this will add to our growth in the lower-price segment of the market.

In the cost arena, both Paragon and its competitors have benefited greatly from the weakness in raw material prices, particularly fluff pulp. More importantly, our modernization program aimed at sustainable cost reduction is on track. The improved processing capabilities of our machines are enabling us to use



Muppet Babies,[™] exclusively on Paragon Trade Brands' Ultra Diaper Waist Panel

TM © 1993 Jim Henson
Productions, Inc.



I am writing to thank you for making
an affordable disposable diaper that works as well as
the high-priced Luvs, Pampers or Huggies.
We have been using them for months - and telling
my friends, 'Don't waste good hard-earned money;
these diapers are very good.' We are now
up to Large Size and just wanted
to share our thanks.

Cindy Johnson
New Hope, Virginia

materials more efficiently and to increase machine speeds. Additionally, in 1993 we restructured our compensation system across the Company. We reduced base wages and increased variable pay tied to performance on volume growth, service to trade customers, and profit targets. Furthermore, by working closely with our supply partners, we reduced our costs by helping them reduce their costs. These actions, combined with continuing emphasis on training, teamwork and problem solving, have enabled us to achieve our goals of controlling costs while improving product quality. Every day, in everything we do, Paragon continues to move forward toward our goal of becoming the lowest-cost manufacturer and the toughest competitor in the category.

In 1993, we increased our capacity faster than we had originally projected. Part of this increase was due to the addition of new machines; however, a significant portion resulted from productivity increases from existing machines.

Capital investment to manufacture our new Ultra thin diaper product will be somewhat higher than expected. In some instances, we reinstalled equipment and modified plants to accommodate changes. These changes should give us sustainable advantages in product performance versus our value segment competitors.

In terms of total capital investment, our current plans for spending are somewhat behind projections as our Ultra thin diaper introduction was delayed from late 1993 to 1994 in favor of cost management priorities. However, we expect our spending to catch up in 1994 and our overall capital expenditures for the five-year period to exceed our original projections somewhat, due to increased capacity and higher than anticipated costs for product innovations.

At year end, our balance sheet was stronger than expected with a cash balance of \$8.8 million and no debt. This position is the result of a strong operating performance and the unexpected benefit of tax deductibility of goodwill amortization. Despite the health of our balance sheet and our higher than expected sales and earnings growth, we intend to

retain our no-dividend policy for the foreseeable future. The basis for this decision is our plan to continue investing in our base business, as well as providing for growth in related businesses in North America and in selected foreign countries.

New Business Opportunities

The most important growth potential for Paragon Trade Brands is in marketing disposable baby diapers to rapidly growing markets outside the United States and Canada. Mexico represents a prime opportunity with its growth potential bolstered by NAFTA. In addition, joint efforts between leading U.S. and Mexican retailers will give Mexican consumers access to more, and cheaper, discretionary products.

Another key area of opportunity is acquisitions of, or joint ventures with, existing manufacturers of baby, feminine and adult absorbent products who are interested in benefiting from our expertise in absorbent technology. Direct entry into the North American store brand segment of feminine hygiene and adult incontinent disposable products is an alternative.

Risks and Uncertainties

While we are cautiously optimistic about our ability to achieve our mid-term business growth plans in North America and are planning for growth beyond our shores, we are keenly aware of the risks and uncertainties that could cause us to reassess our plans. In particular, 1994 will be a major challenge for Paragon Trade Brands as we face continued competitive pressures from the major brands, implement a national roll-out of our Ultra thin diaper product, upgrade our packaging, and add new capacity to meet anticipated growth.

We expect that competitive pressure from national brands will continue as they institute product improvements, reduce prices, or increase promotional spending. History shows that we can keep pace with the product improvements more effectively than any other value segment competitor. By continually and

“We carry the

big brand names like Pampers, Luvs and Huggies

because the customer expects to find them when they shop with us.

We also carry our private label diapers like those products we get from Paragon Trade Brands. These are the diapers that bring the high profitability into our diaper department. They're exceptional values to the customer and of high quality. In fact, we will not put our private label name on any product when the quality is not equal to or better than the brands.”

Ron Carlson

Vice President, Private Label

American Stores Company (Lucky, OSCO, ACME Markets)

"Our mission is to provide our customers the highest quality products and value-added services at the lowest price possible."



**Bobby Abraham, Chairman and
Chief Executive Officer, Paragon Trade Brands**

aggressively managing our costs and supporting the retailers' commitment to their store brands, we believe we can offset reasonable increases in promotional spending without significantly eroding our margins.

Beyond the business strategies outlined above, we believe the technical sophistication of our Ultra thin diaper product gives us a genuine performance advantage versus our value segment competitors, thereby creating an added incentive for new customers to switch to us as their supplier.

The operational risks inherent in switching to Ultra thin diaper products and new packaging are formidable. We are however adding resources as needed to ensure a smooth transition for our customers. We are also adding capacity to compensate for productivity slow-downs during learning periods while starting up on the new products.

Despite the relative simplicity of the disposable diaper product, patent infringement is an area that demands constant vigilance. In recent years, we have tried to substantially lower our exposure by obtaining third-party legal opinions stating that our product innovations do not infringe valid patents. In addition, we are developing our own patent portfolio to improve our competitive advantage and to enable negotiation of reasonable settlements in the context of litigation relating to alleged infringement.

Environmental concern regarding diapers and their impact on the waste stream — which captured headlines a few years ago — has declined in the last two years. The decrease in press coverage resulted from growing awareness by the public and legislators of the significant impact cloth diapers have on scarce energy and water resources. Nevertheless, makers of disposable diapers have the continuing responsibility to make their products more environmentally friendly. This is a priority for Paragon and its suppliers. We continue to explore ways to make our products less bulky, to use recycled or more plentiful resources, and to minimize their impact on the waste stream.

Our Most Enduring Strength

As a business entity, Paragon Trade Brands is an organization rich in experienced talent from a wide range of leading consumer companies. We are drawn together by our common values and beliefs, our emphasis on ethics and teamwork, and our commitment to excellence.

While we take pride in our equipment and systems, our people and culture are what truly set Paragon Trade Brands apart. Our commitment to investing in training and development, listening to ideas, and providing resources for solving problems has resulted in a highly creative and energized work force. We speed the resolution of problems, simplify processes, and enhance individual skills across the spectrum of our organization by encouraging teamwork within and across organizational levels.

Variable pay and benefits are a significant component of all our employees' total compensation. By linking that variability to a common set of measures relevant to our customers and stockholders, we have developed a unity of purpose and interest. By recognizing effort and rewarding results, we have created a culture of exceeding the expectations of our customers and stockholders. Our culture, core competencies, and financial strength are focused on our mission of providing our customers the highest quality products at the lowest possible price, and will drive our continued growth.

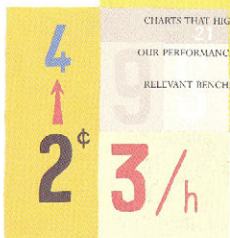
Sincerely,

A handwritten signature in dark ink, reading "Bobby Abraham". The signature is fluid and cursive, with the first name "Bobby" being more prominent and the last name "Abraham" following in a similar style.

Bobby Abraham
Chairman and
Chief Executive Officer

TO HELP YOU VISUALIZE
WHERE THE PERFORMANCE
OF PARAGON TRADE
BRANDS' PRODUCT STANDS,
WE'VE CREATED A SERIES OF

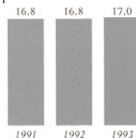
CHARTS THAT HIGHLIGHT
OUR PERFORMANCE VERSUS
RELEVANT BENCHMARKS.



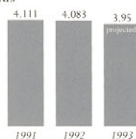
THE MARKET

Birth rates have declined, but the total market has increased because children stay in diapers longer.

Billions of Diapers Sold*

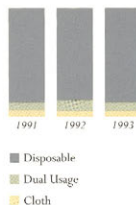


Birthrate Trends**



Despite environmental pressures, disposable diapers are the preferred product.

Household Penetration of Disposable Diapers/Cloth*



■ Disposable
■ Dual Usage
■ Cloth

*Paragon internal estimate

**National Center for Health Statistics

MARKET SHARE TRENDS

The value segment has gained share. Consumers' growing preference for superior value—quality at a lower price—is driving the share.

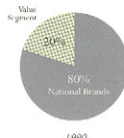
Market Share*



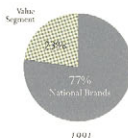
1988



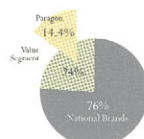
1989



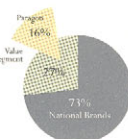
1990



1991



1992



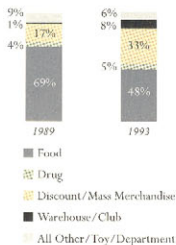
1993

*Paragon internal estimate

WHERE PEOPLE BUY

Consumer buying habits are shifting away from traditional supermarkets and drugstores to mass merchandise and club outlets. We believe mass merchandisers and clubs represent a significant opportunity for growth.

Consumer Purchasing by Outlet Type*

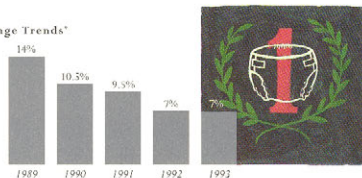


*Nielson Marketing Research

PRODUCT QUALITY BASED ON CONSUMER INPUT

Our commitment to in-home consumer testing emphasizes performance measurement during actual use. The most important diaper attribute to consumers is absorbency/containment. In the last five years our leakage has decreased. Our current performance is comparable to the national brands and is superior to all other value segment suppliers.

Leakage Trends*

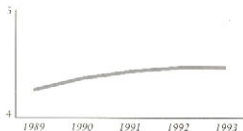


*Paragon Trade Brands survey data

MONITORING CONSUMER ACCEPTANCE VIA REPLY CARDS

Paragon Trade Brands has made a concerted effort to gauge consumer satisfaction through over a million reply cards inserted into our product packages. Paragon Trade Brands' Ultra diaper quality has consistently been rated "high" with a 1993 score of 4.4 out of 5.0.

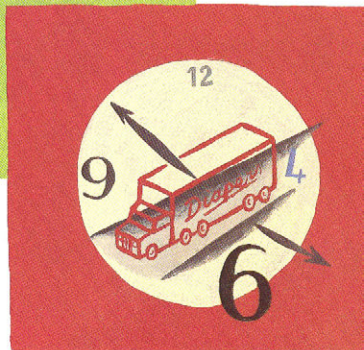
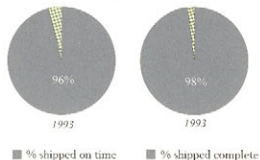
Paragon Quality
Overall Diaper Quality Rating*



SUPERIOR CUSTOMER SERVICE IS A TOP PRIORITY

Hawless customer service is a top priority for our trade customers. By making this our priority and investing in information systems for tracking, we have achieved superior levels of service performance.

Customer Service History

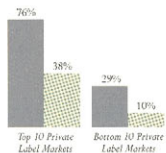


NUMBER 1 IN THE TOP 10 PRIVATE LABEL FOOD MARKETS

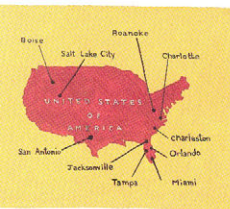
In the ten food (grocery) markets with the highest private label diaper volume shares, Paragon retailers represent 76% of total grocery dollars. These markets average 38% private label share of diaper category sales.

Paragon-supplied retailers in the ten food markets with the lowest shares represent only 29% of total grocery dollars. These markets average only 10% private label share of diaper category sales.

Comparison of Paragon's Market Presence with Private Label Market Share*



■ Average All Commodity Volume Served by Paragon
 ▨ Average Private Label Market Share

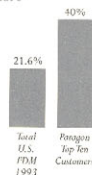


*Information Resources Incorporated. Infoscan, food data only—
 52 weeks through 12/26/93

PARTNERSHIP RESULTS IN SIGNIFICANT SHARE

During 1993, Paragon Trade Brands' top ten customers' private label share of the entire diaper aisle was on a weighted average basis greater than 40%. These results were driven by the quality of our products combined with customized promotions and retailer commitment to their store brands.

Private Label Share*

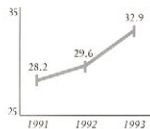


*Paragon internal estimates, customer provided data & IRI Infoscan

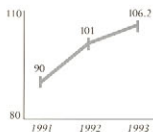
PARAGON'S PRODUCTIVITY

The Company has increased its capacity by adding machines and by increasing the speed of existing machines. As of the end of 1993, the Company had 35 installed diaper machines and one training pant machine. The Company expects to continue to add capacity to meet customer demand.

Average Number of Diaper Machines



Diapers per Machine (in millions)



CAPITAL EXPANSION

The Company is committed to increasing its capacity, lowering its manufacturing costs, and continuously offering the latest product enhancements. These objectives, in part, will be met through the Company's capital expenditure program.

The Capacity Expansion category includes facility expansion, additional diaper and training pant machines and productivity improvements. The Machine Modernization category includes equipment expenditures for the modernization of pad forming, and the new Ultra thin diaper. The Product Innovation, Maintenance and Other category includes expenditures for product enhancements, maintenance capital and computer systems. The Company anticipates increasing its capital expenditures in 1994.

Capital Expansion (in thousands)



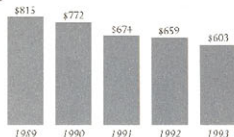
- Capacity Expansion
- Machine Modernization
- Product Innovation, Maintenance and Other

THE IMPACT OF PULP

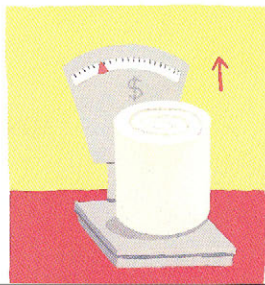
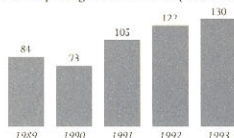
Fluff pulp as a percentage of the cost of goods sold has declined in recent years primarily due to the change in market price and, in some cases, to a decline in usage per diaper. Much of the fluctuation has been caused by the change in market price.

In 1994, the Company will begin shipping its Ultra thin diaper which uses even less pulp. Over time, the Ultra thin diaper should allow the Company to reduce its consumption of pulp by over 40%. Fluff pulp will be replaced by additional quantities of super-absorbent materials, which historically have less price fluctuation.

Average Price/Metric Ton



Estimated Pulp Usage/Metric Tons (in thousands)



DISPOSABLE DIAPERS AND THE ENVIRONMENT

Much attention has been focused on the environmental effects of diapers as local municipalities, states and the nation deal with solid waste management issues. Studies have found that while disposables generate more solid waste, they produce considerably less air and water pollution than cloth diapers. They also use less energy and water than cloth.*

Energy Usage

Disposables use half as much energy as cloth diapers.



Total Solid Waste

Disposables generate four times as much total solid waste as cloth diapers.



Air Pollution

Disposables create half as much air pollution as cloth diapers.



Water Pollution

Disposables create one-seventh as much water pollution as cloth diapers.



Water Usage

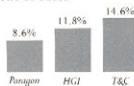
Disposables use one-fourth as much water as cloth diapers.



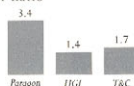
*Energy and Environmental Profile Analysis of Children's Disposable and Cloth Diapers, Franklin Associates, Ltd., 1990.

Paragon continually benchmarks performance against its competitors. Despite somewhat lower operating margins as a percentage of sales, Paragon's return on assets is comparable to Value Line Household Goods Industry Products and Toiletries/Cosmetics groups which are comprised of successful branded companies. The Company's return on equity is lower because of an absence of debt.

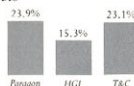
EBIT as a Percent of Sales



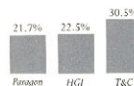
Asset Turnover Ratio



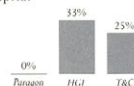
Return on Assets



ROE



Debt/Total Capital



Source for Household Products and Toiletries/Cosmetics data and calculation: Value Line Publishing—October 15 and October 22, 1993 issues. Household Products group includes: Church & Dwight, Clorox, Colgate-Palmolive, Falt Brands Corp., General Household, Kimberly-Clark, Lancaster Colony, Newell Co., Olusda, Procter & Gamble, Rohm and Haas, Sundum-Oster, Toiletries/Cosmetics group includes: Alberto Culver, Avon Products, Bie Corporation, Carter-Wallace, Gillette, Helen of Troy Corp., Helene Curtis, Neutrogena, Tambrands Inc., Windmere Corp.

(a) Uses pro forma EBIT. (b) excludes the deferred tax asset. (c) excludes tax benefit of \$15,588,000.

The Company's compensation philosophy at all levels emphasizes the alignment of customer, stockholder, and employee interest. The key operative elements of this philosophy are:

- 1) All employees* participate in a common bonus plan, the funding of which is dependent on how well the Company services its customers, based on the achievement of volume, service, and operating margin targets.
- 2) All employees* participate in a defined contribution pension plan in which the Company's contribution level is heavily influenced by Company profits.
- 3) In addition, almost all manufacturing employees participate in a continuous improvement plan (gain-sharing), driven by their achieving safety, quality, productivity, cost, and profitability improvements over the prior year.
- 4) Base pay for the CEO and the COO have been set below competitive levels while the performance-driven component of compensation, both long- and short-term, has been given greater importance in total compensation.



Company Totals for

Variable Compensation	
Pension contribution	\$2,019,195
Bonus contribution	\$2,366,705
Total	\$4,385,900
Total as % of base pay	37%

Top Management Compensation

	Abraham,	Cole,
Current	CEO	COO
Base pay	\$230,000	\$194,200
Cash bonus**	\$256,164	\$161,333
Total cash compensation***	\$486,164	\$354,533
Cash compensation as a multiple of		
Avg. employee pay	15	11
Avg. hourly pay	17	12

Long-Term Incentives

IPO ('93) grants of restricted stock	9,775	—
'94 grants of restricted stock	7,500	5,000
IPO ('93) stock options at \$19 strike price	113,000	57,500
'94 stock options at \$31½ strike price	38,330	75,000

*Other than the LaPante hourly work force, which is covered by a specific union contract.
 ** 100% of the cash bonus was used to purchase restricted company stock at a 20% discount.
 *** Estimated total cash compensation for comparable executives at companies similar in size to Paragon in the Value Line Household Products and Toiletries/Cosmetics Toiletries Index was \$819,000 for CEO and \$671,000 for COO. Estimates provided by Hewitt & Associates.

AS THE CHARTS REVEAL,
THE DIAPER CATEGORY
CONTINUES TO EVOLVE AS
CONSUMER PREFERENCES
SHIFT. WITH OUR EMPHASIS
ON EXCEPTIONAL QUALITY
AND TRADE SUPPORT,
PARAGON TRADE BRANDS
IS WELL POSITIONED
TO CAPITALIZE ON
THESE TRENDS.

SELECTED FINANCIAL DATA

(Dollar amounts in millions)

	Fiscal Years				
	1989	1990	1991	1992	1993
Earnings statement data⁽¹⁾					
Sales, net of discounts and allowances	\$292.7	\$286.2	\$396.3	\$484.8	\$562.9
Gross profit	\$ 33.3	\$ 38.3	\$ 73.4	\$ 84.9	\$105.3
Gross margin	11.4%	13.4%	18.5%	17.5%	18.7%
Operating profit (loss)	\$ (9.8)	\$ (4.4)	\$ 33.4	\$ 34.8	\$ 49.3
Operating margin	—	—	8.4%	7.2%	8.8%
Net earnings (loss) ⁽²⁾	\$ (6.1)	\$ (1.8)	\$ 21.0	\$ 21.1	\$ 45.9 ⁽³⁾
Net margin	—	—	5.3%	4.4%	8.2% ⁽¹⁾⁽³⁾
Balance sheet data⁽¹⁾					
Working capital	\$ 22.9	\$ 20.8	\$ 27.6	\$ 31.9	\$ 20.7
Total assets	\$119.3	\$110.4	\$122.4	\$150.6	\$244.2
Stockholders' equity	—	—	—	—	\$167.1
Investment by Weyerhaeuser	\$ 93.0	\$ 80.5	\$ 88.8	\$108.8	—
Other data⁽¹⁾					
Capital spending	\$ 18.9	\$ 13.2	\$ 15.2	\$ 29.0	\$ 55.4 ⁽⁴⁾
Depreciation and amortization	\$ 10.8	\$ 12.4	\$ 13.5	\$ 15.6	\$ 22.5
Units sold (millions)	2,006	1,907	2,535	2,993	3,435

⁽¹⁾ See Note 1 of Notes to Financial Statements.⁽²⁾ For earnings per share information see page 45.⁽³⁾ Reflects the benefit to income of \$15.8 million relating to deferred taxes due to the enactment of the Omnibus Budget Reconciliation Act of 1983 (see Notes 1 and 3 of Notes to Financial Statements). If such tax benefit were excluded, net earnings would be \$30.3 and net margin would be 5.4%.⁽⁴⁾ Includes \$1.7 million for computer software and development.

CONSOLIDATED AND COMBINED BALANCE SHEET

(Dollar amounts in thousands)	December 26, 1993	December 27, 1992
(Note 1)		
Assets		
Cash and short-term investments	\$ 8,785	\$ 58
Receivables (Note 5)	46,498	43,076
Inventories (Note 6)	35,571	24,286
Current portion of deferred income taxes (Note 3)	5,704	4,575
Prepaid expenses	1,243	309
Total current assets	97,801	72,304
Property and equipment (Note 7)	78,310	56,697
Construction in progress	28,841	18,252
Patents and trademarks (Note 1)	1,739	2,195
Deferred income taxes (Note 3)	34,742	—
Other assets	2,735	1,176
Total assets	\$ 244,168	\$ 150,624
Liabilities and Investment by Weyerhaeuser Co./Stockholders' Equity		
Checks issued but not cleared (Notes 1 and 10)	\$ 10,711	\$ 9,350
Accounts payable	41,117	18,614
Accrued liabilities (Note 8)	25,266	12,411
Total current liabilities	77,094	40,375
Deferred income taxes (Note 3)	—	1,415
Commitments (Note 12)		
Total liabilities	77,094	41,790
Investment by Weyerhaeuser Co.	—	108,834
Stockholders' equity (Notes 1 and 3):		
Preferred stock: authorized 10,000,000 shares, no shares issued, \$.01 par value	—	—
Common stock: authorized 25,000,000 shares, issued 11,500,000, \$.01 par value	115	—
Capital surplus	125,733	—
Foreign currency translation adjustment	(436)	—
Retained earnings	41,662	—
Total stockholders' equity	167,074	—
Total liabilities and investment by Weyerhaeuser Co./stockholders' equity	\$ 244,168	\$ 150,624

See accompanying Notes to Financial Statements.

CONSOLIDATED AND COMBINED EARNINGS STATEMENT

(Dollar amounts in thousands)

	Year Ended		
	December 26, 1993	December 27, 1992	December 29, 1991
(Note 1)			
Sales, net of discounts and allowances	\$ 562,949	\$ 484,776	\$ 396,323
Cost of sales, including purchases by the Private Label Diaper Business of raw materials from Weyerhaeuser Co. totaling \$9,681, \$88,048 and \$73,007, respectively (Note 10)	457,613	399,919	322,884
Gross profit	105,336	84,857	73,439
Selling, general and administrative expense, including costs allocated to the Private Label Diaper Business from Weyerhaeuser Co. totaling \$292, \$3,480 and \$3,830, respectively (Note 10)	50,026	43,472	34,357
Research and development expense	6,015	8,627	5,704
Operating profit	49,295	34,758	33,378
Other income (expense), net (Note 2)	(911)	(741)	175
Earnings before income taxes	48,384	34,017	33,553
Provision for (benefit from) income taxes (Note 3):			
Effect of change in tax law	(15,588)	—	—
Other current and deferred taxes	18,044	12,914	12,585
Net tax provision	2,456	12,914	12,585
Net earnings	\$ 45,928	\$ 21,103	\$ 20,968

See accompanying Notes to Financial Statements.

CONSOLIDATED AND COMBINED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(Dollar amounts in thousands)

	Investment by Weyerhaeuser Co.	Common Stock	Capital Surplus	Foreign Currency Translation	Retained Earnings
(Note 1)					
Balance, December 30, 1990	\$ 80,500	\$ —	\$ —	\$ —	\$ —
Net earnings	20,968	—	—	—	—
Net return to Weyerhaeuser Co.	(12,623)	—	—	—	—
Balance, December 29, 1991	88,845	—	—	—	—
Net earnings	21,103	—	—	—	—
Net return to Weyerhaeuser Co.	(1,114)	—	—	—	—
Balance, December 27, 1992	108,834	—	—	—	—
Net earnings	4,266	—	—	—	41,662
Net return to Weyerhaeuser Co.	(6,188)	—	—	—	—
Acquire net assets of Private Label Diaper Business of Weyerhaeuser Co.	(106,912)	100	88,883	—	—
Sale of common stock	—	15	26,850	—	—
Translation adjustment	—	—	—	(436)	—
Balance, December 26, 1993	\$ —	\$ 115	\$ 125,733	\$ (436)	\$ 41,662

See accompanying Notes to Financial Statements.

CONSOLIDATED AND COMBINED STATEMENT OF CASH FLOWS

(Dollar amounts in thousands)

	Year Ended		
	December 26, 1993	December 27, 1992	December 28, 1991
(Note 1)			
Cash flows from operating activities:			
Net earnings	\$ 45,928	\$ 21,103	\$ 20,968
Noncash charges to earnings:			
Depreciation and amortization	22,510	15,618	13,545
Deferred income taxes	(17,831)	(2,656)	1,806
Changes in working capital:			
Receivables	(3,422)	(9,806)	(6,502)
Inventories and prepaid expenses	(12,219)	(3,376)	(4,807)
Accounts payable	22,503	5,440	1,968
Accrued liabilities	10,658	338	1,874
Other	(490)	(516)	(43)
Net cash provided by operating activities	67,637	26,145	28,809
Cash flows from investing activities:			
Expenditures for property and equipment	(53,660)	(29,023)	(15,235)
Proceeds from sale of property and equipment	96	759	341
Acquire net assets - Private Label Diaper Business of Weyerhaeuser Co.	(35,000)	-	-
Other	(2,300)	(945)	(297)
Net cash used in investing activities	(90,864)	(29,209)	(15,191)
Cash flows from financing activities:			
Net return to Weyerhaeuser Co.	(6,188)	(1,114)	(12,623)
Deferred taxes credited (charged) to investment by Weyerhaeuser Co.	-	243	(676)
Proceeds from bank credit facility	43,300	-	-
Repayments of bank credit facility	(43,300)	-	-
Sale of common stock	26,885	-	-
Checks issued but not cleared	11,277	3,987	(352)
Net cash provided by (used in) financing activities	31,954	3,116	(13,651)
Net increase (decrease) in cash	8,727	52	(33)
Cash at beginning of period	58	6	39
Cash at end of period	\$ 8,785	\$ 58	\$ 6
Cash paid during the year for:			
Interest	\$ 357	\$ -	\$ -
Income taxes (Notes 1 and 3)	\$ 16,047	\$ 15,570	\$ 10,779

See accompanying Notes to Financial Statements.

NOTES TO FINANCIAL STATEMENTS

(Dollar amounts in thousands, except per share data)

Note 1: Basis of Presentation and Summary of Significant Accounting and Reporting Policies

BASIS OF PRESENTATION AND RELATED INFORMATION

On February 2, 1993, pursuant to an agreement between Weyerhaeuser Company (Weyerhaeuser) and Paragon Trade Brands, Inc. (Paragon or the Company), Weyerhaeuser transferred substantially all the net assets of its Private Label Diaper Business (the Business) to Paragon in exchange for 9,999,900 shares of Paragon's \$.01 par value common stock and the payment of \$35,000. The book value of the net assets acquired from Weyerhaeuser in this transaction was \$106,912. As a result, the financial statements reflect the results of Paragon from February 2 to December 26, 1993. The results from December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991 reflect the results of the Business.

On February 2, 1993, Paragon issued 1,500,000 shares of its \$.01 par value common stock to Weyerhaeuser in exchange for \$26,865. The entire net proceeds of this issuance were used to reduce the borrowings under the bank credit facility described in Note 9.

The consolidated financial statements include the accounts of Paragon and its wholly owned subsidiary, Paragon Trade Brands (Canada) Inc. All significant intercompany transactions and accounts are eliminated. The combined financial statements include the accounts of the Business.

CASH AND SHORT-TERM INVESTMENTS

For purposes of cash flow reporting, short-term investments with original maturities of 90 days or less are considered as cash equivalents. Short-term investments are stated at cost, which approximates fair value. The obligation for outstanding checks is reflected as checks issued, but not cleared.

INVENTORIES

Inventories are stated at the lower of cost or market. Cost includes labor, materials and production overhead. The last-in, first-out (LIFO) method is used to cost domestic pulp and finished goods inventories. The first-in, first-out (FIFO) method is used to cost all other inventories. Had the FIFO method been used to cost the domestic pulp and finished goods inventories, the amounts at which they are stated would have been \$2,421 and \$3,326 greater at December 26, 1993 and December 27, 1992, respectively.

PROPERTY AND EQUIPMENT

Paragon's property accounts are maintained on an individual asset basis. Betterments and replacements of major units are capitalized. Maintenance, repairs and minor replacements are expensed. Depreciation is provided on the straight-line method at rates based upon estimated useful lives as follows:

Buildings	20 to 40 years
Building improvements	10 years
Machinery, equipment, furniture and fixtures	3 to 10 years

The cost and related depreciation of property sold or retired is removed from the property and allowance for depreciation accounts and the gain or loss is recorded.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

PATENTS AND TRADEMARKS

Purchased patents and trademarks are amortized on a straight-line basis over a five-to-ten-year life. Amortization expense was \$456 for the year ended December 26, 1993. For each of the two years ended December 27, 1992 and December 29, 1991, amortization expense was \$549 and \$576, respectively. Accumulated amortization was \$3,434 and \$2,978 at December 26, 1993 and December 27, 1992, respectively.

SIGNIFICANT SALES

The following table presents the percentage of net sales distributed through one broker and the percentage of net sales to an individual customer whose sales represent in excess of 10% of net sales.

	Year Ended		
	December 26, 1993	December 27, 1992	December 29, 1991
Net sales to:			
Broker	—	30%	50%
Customer	15%	14%	11%

INCOME TAXES

Paragon implemented Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes," giving effect to the accounting treatment prescribed by SFAS No. 109 from its inception. SFAS No. 109 requires accounting for income taxes based on the liability method and, accordingly, deferred income taxes are provided to reflect temporary differences between financial and tax reporting. Deferred tax assets and liabilities are measured based on enacted tax laws and rates without anticipation of future changes. Effects on deferred taxes of enacted changes in tax laws are recognized in income for financial statement purposes in the period of enactment. The effect of the change in the tax laws from enactment of the Omnibus Budget Reconciliation Act of 1993 was a benefit to income of \$15,588 in the 1993 consolidated statement of earnings.

For the period December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991, federal and state income taxes related to the U.S. operations of the Business were included in the consolidated tax returns of Weyerhaeuser. For foreign income tax purposes during the same period, the Canadian operations of the Business were included in the tax returns of Weyerhaeuser Canada Ltd. Income taxes in the accompanying financial statements were computed assuming that the Business was a stand-alone entity. Cash paid for income taxes as shown in the accompanying statement of cash flows for the year ended December 26, 1993 represents actual taxes paid by Paragon. For the years ended December 27, 1992 and December 29, 1991, the amounts shown represent the current portion of the Business' income tax provision reflected in the investment by Weyerhaeuser.

Undistributed earnings of the Company's Canadian subsidiary totaled \$1,331 for the period from February 2, 1993 to December 26, 1993, which, under existing law, will not be subject to U.S. tax until distributed as dividends. Since the

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

earnings have been or are intended to be indefinitely reinvested in Canadian operations, no provision has been made for any U.S. taxes that may be applicable if distributed. Furthermore, any taxes paid to the Canadian Government on these earnings may be used, in whole or in part, as credits against the U.S. tax on any dividends distributed from such earnings. It is not practicable to estimate the amount of unrecognized deferred U.S. taxes on these undistributed earnings. Deferred foreign income tax benefits for the periods ended December 27, 1992 and December 29, 1991, were utilized by Weyerhaeuser Canada Ltd. and are therefore included in investment by Weyerhaeuser as of December 27, 1992 and December 29, 1991.

Liabilities for workers' compensation claims that were incurred prior to the transfer of the Business' assets and liabilities by Weyerhaeuser to Paragon (see above) will be paid by Weyerhaeuser. Therefore, the liability for these claims, and the related deferred tax benefit, is reflected in investment by Weyerhaeuser.

Income taxes have been provided for all items included in the consolidated and combined earnings statement, regardless of the period when such items will be deductible for tax purposes. The principal temporary differences between financial and tax reporting arise from tax-basis goodwill, depreciation and reserves not currently deductible.

INVESTMENT BY WEYERHAEUSER

Investment by Weyerhaeuser represents the net, non-interest-bearing assets invested in the Business by Weyerhaeuser.

FOREIGN CURRENCY

Non-U.S. assets and liabilities are translated into U.S. dollars using period-end exchange rates. Revenues and expenses are translated at average rates during the period. The net translation gains and losses charged to investment by Weyerhaeuser for the period December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991, are not material to the financial statements presented.

PENSION AND PROFIT SHARING PLANS

With the exception of assuming sponsorship for the pension plan of one plant, Paragon, as a new corporate entity, no longer participates in Weyerhaeuser's pension plans. Pension obligations for Paragon's employees through February 1, 1993 were retained by Weyerhaeuser. Effective February 2, 1993, Paragon adopted both a defined contribution profit sharing plan and a 401(k) savings plan covering most of its employees. On October 1, 1993, the two plans were merged, amended and restated into one plan, the Paragon Trade Brands, Inc. Profit Sharing and Savings Plan. The plan provides for both employer-matching contributions based on voluntary salary deferrals of employees and discretionary employer contributions. Plan participants are fully vested after five years of service. Contributions to the plan are based on various levels of employee participation. Plan expense for the period February 2, 1993 to December 26, 1993 was \$2,884.

For the period December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991, the Business, under Weyerhaeuser,

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

participated in pension plans covering most of its employees. The U.S. plan covering salaried employees provided pension benefits based on the employees' highest monthly earnings for five consecutive years during the final 10 years before retirement. Plans covering hourly employees generally provided benefits of stated amounts for each year of service. The Business received an allocated charge from Weyerhaeuser for its share of pension costs for those employees who participated in Weyerhaeuser's pension plans. Contributions by Weyerhaeuser to its U.S. plans were based on funding standards established by the Employee Retirement Income Security Act of 1974 (ERISA).

POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

Paragon, as a new corporate entity (see above), does not provide postretirement health-care or life insurance benefits to employees. The Business, separate from Weyerhaeuser, did not implement SFAS No. 106, "Employer's Accounting for Postretirement Benefits Other Than Pensions," which requires accounting for these benefits on an accrual basis beginning in fiscal 1993.

The cash payments made, and expense recorded, for postretirement benefits other than pensions was \$268 and \$233 in 1992 and 1991, respectively.

POSTEMPLOYMENT BENEFITS

In November 1992, the Financial Accounting Standards Board issued SFAS No. 112, "Employer's Accounting for Postemployment Benefits," to be effective for fiscal years beginning after December 15, 1993. Management believes that the future adoption of this pronouncement will not have a significant impact on Paragon's financial position or results of operations.

Note 2: Other Income (Expense), Net

No individual income or expense item is significant in relationship to net earnings.

Note 3: Income Taxes

Provisions for (benefits from) income taxes include the following:

	December 26, 1993	December 27, 1992	December 29, 1991
Effect of change in tax law	\$ (15,588)	\$ —	\$ —
Other current and deferred taxes:			
Federal:			
Current	\$ 16,380	\$ 13,124	\$ 9,007
Deferred	(1,890)	(2,268)	1,033
	14,490	10,856	10,040
State:			
Current	3,269	2,446	1,772
Deferred	(353)	(229)	89
	2,916	2,217	1,861
Foreign:			
Current	638	—	—
Deferred	—	(159)	684
	638	(159)	684
Net tax provision	\$ 2,456	\$ 12,914	\$ 12,585

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

A reconciliation between the federal statutory rate and the effective tax rate follows:

	December 26, 1993	December 27, 1992	December 29, 1991
Expected provision at the statutory rate	\$ 16,934	\$ 11,566	\$ 11,408
Effect of change in tax law	(15,588)	—	—
State income taxes, net of federal tax benefit	1,895	1,385	1,259
Research and experimental credit	(300)	(75)	(230)
All other, net	(485)	38	148
Net tax provision	\$ 2,456	\$ 12,914	\$ 12,585

Net deferred tax assets at December 26, 1993 were \$40,446, net of a valuation allowance of \$593. The amounts recorded primarily reflect the following: (1) the tax effects of a step up in the tax basis of the assets of Paragon as a result of the February 2, 1993 transfer to Paragon of substantially all the assets and liabilities of the Business and (2) an increase in the deferred tax asset due to the enactment of the Omnibus Budget Reconciliation Act of 1993, which replaced the prior law for amortization of intangibles, including goodwill. Net deferred income taxes are attributable to the following temporary differences:

	December 26, 1993	December 27, 1992
Depreciation/amortization	\$ 17,853	\$ (2,528)
Goodwill	14,059	—
Reserves not currently deductible	5,608	4,374
Package design costs	1,271	1,009
Land	1,650	—
All other, net	600	305
Valuation allowance	(593)	—
Net deferred asset	\$ 40,446	\$ 3,160

Net deferred tax asset (liability) attributable to:

Current assets and liabilities	\$ 5,704	\$ 4,575
Long-term assets and liabilities	34,742	(1,415)
Net deferred tax asset	\$ 40,446	\$ 3,160

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Note 4: Pension, Profit Sharing and Stock Option Plans

With the exception of assuming sponsorship of a defined benefit retirement plan for hourly employees at its California plant, Paragon, as a new corporate entity (see Note 1), no longer participates in Weyerhaeuser's pension plans. The Company's actuarial cost method used in determining pension expense for the sponsored plan is the projected unit credit method. The funding policy is to contribute annually amounts sufficient to meet the minimum requirements established by ERISA. A participant's vested percentage is 100% upon the completion of five years of vesting service. Prior to the completion of five years of vesting service, a participant's vested percentage is zero. The pension benefit payable at retirement is based on a specified benefit amount multiplied by the participant's years of benefit service. Net pension expense for the year ended December 26, 1993 was \$199.

An interest rate of 7.5% was assumed with respect to both the rate of return on plan assets and the discount rate for determining the net present value of the projected benefit obligation. At December 26, 1993, the actuarial present value of the vested and nonvested accumulated plan benefits exceeded the fair value of plan assets by \$557.

For the period December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991, the Business participated in Weyerhaeuser pension plans and recognized as its net pension cost amounts allocated to it by Weyerhaeuser. The assets of Weyerhaeuser's pension plans were included in a master trust and not segregated or otherwise restricted for benefits of the Business, with the exception of the sponsored plan described above. The annual pension expense allocated to the Business was approximately \$34, \$531 and \$444 for the period December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991, respectively.

With regard to stock options granted to key management and directors during the period February 2, 1993 to December 26, 1993, the following is provided:

During the period:	
Options granted	401,500
Options exercised	-
At end of period:	
Options outstanding	401,500
Options exercisable	-
Average price per share:	
Options granted	\$ 20.12
Options outstanding	\$ 20.12

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Note 5: Receivables

Receivables consist of the following:

	December 26, 1993	December 27, 1992
Accounts receivable — trade	\$ 49,698	\$ 45,726
Other receivables	2,157	686
	51,855	46,410
Less: Allowance for doubtful accounts	(5,357)	(3,334)
Net receivables	\$ 46,498	\$ 43,076

Note 6: Inventories

Inventories consist of the following:

	December 26, 1993	December 27, 1992
LIFO:		
Raw materials — pulp	\$ 4,428	\$ 897
Finished goods	13,757	5,627
FIFO:		
Raw materials — other	6,270	6,438
Materials and supplies	15,592	14,321
	40,047	27,283
Reserve for excess and obsolete items	(4,476)	(2,997)
Net inventories	\$ 35,571	\$ 24,286

Note 7: Property and Equipment

Property and equipment, at cost, are as follows:

	December 26, 1993	December 27, 1992
Land	\$ 2,758	\$ 1,352
Buildings and improvements	27,561	22,603
Machinery and equipment	142,432	116,333
	172,751	140,288
Less: Allowance for depreciation	(94,441)	(83,591)
Net property and equipment	\$ 78,310	\$ 56,697

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Note 8: Accrued Liabilities

Accrued liabilities are as follows:

	December 26, 1993	December 27, 1992
Payroll—wages and salaries, incentive awards, retirement, vacation and severance pay	\$ 12,537	\$ 6,248
Coupons outstanding	2,543	1,972
Income taxes payable—current	2,078	—
Other	8,108	4,191
Total	\$ 25,266	\$ 12,411

Note 9: Bank Credit Facility

On January 25, 1993, Paragon entered into an agreement with a group of lenders to provide a five-year \$70,000 revolving credit facility. On November 5, 1993, the credit facility was amended. In general, the amendment shortened the term of the agreement from five years to three years, lowered the credit facility from \$70,000 to \$50,000, removed the banks' security interests, adjusted certain covenants, lowered interest rates charged on borrowings, and gave the Company more flexibility in purchasing and financing business acquisitions. An additional Cdn\$3,000 credit facility, guaranteed by Paragon, is available to Paragon Trade Brands (Canada) Inc. with terms reflecting those of the U.S. credit facility. A commitment fee of .5% is payable quarterly on the unused portion of both facilities. At December 26, 1993, there were no amounts outstanding under the revolving credit facilities.

Borrowings under the bank credit facilities bear interest at either (i) the Alternative Base Rate, plus .375% per annum or (ii) the reserve-adjusted LIBOR (as determined by the agent bank), plus 1.375% per annum, at Paragon's option. The "Alternative Base Rate" will mean the highest of (a) the agent bank's prime rate, (b) the weekly average of the 90-day Federal Reserve reported certificate of deposit rate, as adjusted for reserves and assessments, plus 1% per annum, and (c) the Federal Funds effective rate, plus .5% per annum.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Note 10: Related-Party Transactions

CASH MANAGEMENT ACCOUNT

For the period December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991, Weyerhaeuser managed a centralized cash account for disbursements made by the Business. The obligation for outstanding checks is reflected as checks issued but not cleared; it was Weyerhaeuser's policy to fund these checks when they cleared the bank. Weyerhaeuser also managed collection of the accounts receivable of the Business; cash collections were deposited in a Weyerhaeuser account. No interest charge or credit was made by Weyerhaeuser to the Business.

PURCHASES

For the period December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991, the Business purchased materials used in the production and packaging process from Weyerhaeuser at prices approximating market value. These purchases included the following:

	February 1, 1993	December 27, 1992	December 29, 1991
Pulp	\$ 8,591	\$ 78,739	\$ 66,584
Corrugated shipping containers and other	1,080	9,308	6,423
Total	\$ 9,681	\$ 88,048	\$ 73,007

ALLOCATED CHARGES

Weyerhaeuser incurred and allocated certain direct and indirect expenses for the benefit and support of the Business for the period December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991. These services included treasury, legal, finance, accounting, insurance, occupancy and other administrative costs. Management believes that these expenses were allocated on a reasonable basis. The total of these expenses included in selling, general and administrative expense in the accompanying consolidated and combined earnings statement amounted to \$292, \$3,480 and \$3,830 for each of the three years in the period ended December 26, 1993, respectively.

Pursuant to the transaction described in Note 1, Weyerhaeuser and Paragon entered into a corporate services agreement under which Weyerhaeuser continues to provide, for the compensation set forth in the agreement, certain of the services referred to above. The agreement became effective as of the closing date of the transaction described in Note 1 for a stated initial term, the length of which depends on the type of services provided. The agreement may be terminated, in whole or in part, by Paragon at any time. The cost of such services for the period February 2, 1993 to December 26, 1993 was not significant in relation to total selling, general and administrative expense.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

INVESTMENT BY WEYERHAEUSER

The following is an analysis of the investment by Weyerhaeuser:

	December 26, 1993	December 27, 1992	December 29, 1991
Cash collected by Weyerhaeuser from the Business' operations	\$ (57,275)	\$(474,469)	\$(389,480)
Cash provided by Weyerhaeuser to fund the Business' operations	38,826	331,423	268,011
Purchases of raw materials from Weyerhaeuser	9,681	88,048	73,007
Costs allocated to the Business by Weyerhaeuser	292	3,480	3,830
Research and development expense incurred by Weyerhaeuser and charged to the Business	77	6,627	5,704
Income taxes (see Note 1)	(497)	15,327	11,455
Assets purchased for or transferred to the Business by Weyerhaeuser	2,708	29,209	15,191
Proceeds from sales of property and equipment	—	(759)	(341)
Net return to Weyerhaeuser	(6,188)	(1,114)	(12,623)
Net earnings	4,266	21,103	20,968
Net assets of the Business acquired by Paragon	(106,912)	—	—
Net change in investment by Weyerhaeuser	(108,834)	19,989	8,345
Investment by Weyerhaeuser at beginning of period	108,834	88,845	80,500
Investment by Weyerhaeuser at end of period	\$ —	\$ 108,834	\$ 88,845
Average balance during the period	\$ 9,542	\$ 97,188	\$ 86,893

OTHER ACTIVITIES

For the period December 28, 1992 to February 1, 1993 and the years ended December 27, 1992 and December 29, 1991, the Business, as described in Note 1, was conducted by the Personal Care Products Division of Weyerhaeuser (PCP). The financial statements of the Business do not include information relating to other businesses conducted by PCP, including the adult incontinent products and branded disposable diaper businesses of Weyerhaeuser. In management's opinion, the combined financial statements of the Business reflect the Business' share of the revenues and costs, and assets and liabilities attributable to the activities in which it was engaged during the periods presented.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Note 11: Legal Proceedings

Procter & Gamble Company (Procter & Gamble) filed a claim in the District Court for the District of Delaware that the Company's products infringe two of Procter & Gamble's inner-leg patents. The Company believes, based upon the advice of its patent counsel, that neither of the two Procter & Gamble patents can be validly construed to cover the Company's products.

The Company has also had discussions with Kimberly-Clark Corporation (Kimberly-Clark) concerning the inner-leg gusher feature on the Company's products. Kimberly-Clark has offered the Company a license, upon payment of a royalty, for rights under Kimberly-Clark's patent(s) relating to the inner-leg gusher feature. The Company has taken the position, based on the advice of its patent counsel, that the patent coverage claimed by Kimberly-Clark is not applicable to the Company's products and is of questionable validity. The Company has been notified that revised patent claims in favor of Kimberly-Clark will be issued shortly from the U.S. Patent and Trademark office, although the Company does not know the nature of those revised claims.

While it is difficult to estimate the potential effects on the Company, if any, of the matters discussed in the preceding paragraphs, management believes that any outcome with respect to these matters will not have a material adverse effect on the Company's financial position or results of operations.

The Company is also a party to other legal proceedings generally incidental to its activities. Although the final outcome of any legal proceeding is subject to a great many variables and cannot be predicted with any degree of certainty, management presently believes that any ultimate liability resulting from any such legal proceedings, or all of them combined, would not have a material adverse effect on the Company's financial position or results of operations.

Note 12: Commitments

Paragon has operating lease agreements for certain facilities that expire during the three years 1994 through 1996. Future minimum lease payments required under these noncancelable operating leases are:

1994	\$	804
1995	\$	624
1996	\$	44

Rental expense for facilities and equipment, excluding allocated floor space charges from Weyerhaeuser (see Note 10), was \$1,922, \$178 and \$278 for each of the three years in the period ended December 26, 1993, respectively.

The Company has commitments to pay royalties for certain product features. Future minimum royalty payments required under these royalty agreements are:

1994	\$	1,095
1995	\$	565

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Commitments for capital expenditures as of December 26, 1993 are as follows:

1994	\$ 21,265
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Other Company commitments include purchase commitments for raw materials from Weyerhaeuser and other third-party vendors at prevailing market rates. In addition, Paragon, as a part of its normal operations, has a collective bargaining agreement at one production facility that expires in 1994.

PURCHASE COMMITMENTS

Paragon entered into a wood pulp supply contract with Weyerhaeuser under which Paragon will purchase its requirements of bleached chemical wood pulp through 1997 at prices as favorable as those Weyerhaeuser charges other U.S. or Canadian diaper customers for a similar grade pulp. Either party may elect, on specified notice, to reduce the quantity of pulp purchased under the contract to no less than 80% of Paragon's requirements.

SUBLICENSE AGREEMENT

Weyerhaeuser and Paragon entered into an agreement providing, among other things, for the sublicense by Weyerhaeuser to Paragon of certain intellectual property rights that related to the Business. In exchange for these rights, Paragon will pay Weyerhaeuser the following amount:

1994	\$ 400
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Note 13: Net Pro Forma Earnings Per Common Share (Unaudited)

Net pro forma earnings per common share are based on the average number of common and common equivalent shares outstanding and assume that the shares were issued and outstanding for the entire year ended December 26, 1993.

	December 26, 1993 (Unaudited)
Primary	
Net pro forma earnings (Note 14)	\$ 45,627
Average common and common equivalent shares outstanding (000's)	11,500
Net pro forma earnings per common share	\$ 3.97
Fully Diluted	
Net pro forma earnings (Note 14)	\$ 45,627
Average common and common equivalent shares outstanding (000's)	11,573
Net pro forma earnings per common share (fully diluted)	\$ 3.94

This calculation is submitted in accordance with Regulation S-K item 601(b)(11), although not required by footnote 2 to paragraph 14 of APB Opinion No. 15 because it results in dilution of less than 3%.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Note 14: Unaudited Pro Forma Consolidated Earnings Statement

	Fiscal Year 1993		
	Historical	Adjustments	Pro Forma
		(Unaudited)	
Sales, net of discounts and allowances	\$ 562,949	\$ —	\$ 562,949
Cost of sales	457,613	—	457,613
Gross profit	105,336	—	105,336
Selling, general and administrative expense	50,026	108 ⁽¹⁾ 316 ⁽²⁾	50,450
Research and development expense	6,015	—	6,015
Operating profit	49,295	(424)	48,871
Interest expense	288	53 ⁽³⁾	341
Other income (expense), net	(623)	—	(623)
Earnings before income taxes	48,384	(477)	47,907
Provision for (benefit from) income taxes:			
Effect of change in tax law	(15,588)	—	(15,588)
Other current and deferred taxes	18,044	(176) ⁽⁴⁾	17,868
	2,456	(176)	2,280
Net earnings	\$ 45,928	\$ (301)	\$ 45,627
Net earnings per common share ⁽⁵⁾			\$ 3.97

(1) To reflect expected insurance and other costs to Paragon in excess of the historical charges by Weyerhaeuser to the Business for the period December 28, 1992 to February 1, 1993.

(2) To reflect the expected costs of corporate, administrative and public financial reporting activities not previously undertaken by the Business and the costs of implementing Paragon's employee retirement benefits program for the period December 28, 1992 to February 1, 1993.

(3) To reflect (i) amortization of deferred financing costs related to the bank credit facility, (ii) interest expense, at an assumed rate equal to the average LIBOR rate for the relevant period plus 1.75%, (iii) commitment fees of .5% per annum on the unused portion of the bank credit facility, and (iv) interest income at an assumed rate equal to the average LIBOR rate for the period.

(4) To provide for the federal and state tax effects of the pro forma adjustments described in Notes (1), (2) and (3) above.

(5) Net earnings per common share are computed assuming 11,500,000 shares of common stock are outstanding for the entire period presented. Paragon has granted options to purchase 401,500 shares of common stock to certain key management and directors.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Note 15: Quarterly Results of Operations (Unaudited)

	Year Ended December 26, 1993			
	First	Second	Third	Fourth
Net sales	\$ 141,864	\$ 138,452	\$ 144,855	\$ 137,778
Gross profit	25,004	25,420	29,871	25,041
Net earnings	7,530	6,625	24,632	7,141
Net pro forma earnings (Note 14)	7,229	6,625	24,632 ⁽¹⁾	7,141
Net pro forma earnings per share (Note 14)	\$.63	\$.58	\$ 2.14	\$.62

(1) Reflects the benefit to income of \$15,988 relating to deferred taxes due to enactment of the Omnibus Budget Reconciliation Act of 1993 (see Notes 1 and 3).

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Stockholders of Paragon Trade Brands, Inc.:

We have audited the accompanying consolidated balance sheet of Paragon Trade Brands, Inc. (Paragon) and Subsidiary, formerly the Private Label Diaper Business of Weyerhaeuser Company (the Business), as of December 26, 1993, and the related consolidated statements of earnings, changes in stockholders' equity, and cash flows for the year then ended (see Note 1 of Notes to Financial Statements), and the combined balance sheet of the Business as of December 27, 1992, and the related combined statements of earnings, changes in investment by Weyerhaeuser Company, and cash flows for each of the two years in the period ended December 27, 1992. These financial statements are the responsibility of Paragon's and the Business' management, respectively. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Paragon Trade Brands, Inc. and subsidiary as of December 26, 1993, and the results of their operations and their cash flows for the year then ended, and the financial position of the Private Label Diaper Business of Weyerhaeuser Company as of December 27, 1992, and the results of its operations and its cash flows for each of the two years in the period ended December 27, 1992, in conformity with generally accepted accounting principles.

Arthur Andersen & Co.

Seattle, Washington
February 4, 1994

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Year Ended December 26, 1993 Vs. Year Ended December 27, 1992

Results of Operations

Net earnings increased to \$45.9 million in 1993 compared to \$21.1 million in 1992. Earnings, however, were favorably impacted by a \$15.6 million increase in the deferred tax asset as required by SFAS No. 109, "Accounting for Income Taxes." The increase primarily recognizes amortization of acquired intangibles, including goodwill, as a result of the Omnibus Budget Reconciliation Act of 1993. See Note 3 of Notes to Financial Statements. Earnings, excluding the effect of the tax asset increase, were \$30.3 million in 1993 compared to \$21.1 million in 1992, a 44% increase.

The improved earnings were partially attributable to higher sales due to volume increases. Earnings were also favorably impacted by a decrease in cost of sales as a percentage of net sales, partially offset by an absolute increase in selling, general and administrative expense.

Paragon Trade Brands, Inc. Unaudited Pro Forma Earnings Statements

(Dollar amounts in thousands, except per share data)

	Fifty-Two Weeks Ended	
	December 26, 1993	December 27, 1992
Net sales	\$ 562,949	\$ 484,776
Cost of sales	457,613	399,919
Gross profit	105,336	84,857
Selling, general and administrative expense	50,450	47,842
Research and development expense	6,015	6,827
Operating profit	48,871	30,588
Interest expense	341	274
Other income (expense), net	(623)	(741)
Earnings before income taxes	47,907	29,573
Provision for income taxes	17,868	11,227
Impact of tax law change (benefit)	(15,588)	—
Net earnings — pro forma	\$ 45,627	\$ 18,346
Net earnings per common share	\$3.97	\$1.60

Net pro forma earnings increased 64% to \$30.0 million in 1993, after adjusting for the tax asset increase of \$15.6 million as discussed earlier, compared to \$18.3 million in 1992. Pro forma earnings per share increased 63% to \$2.61 per share in 1993, after adjusting for the tax asset increase discussed above, compared to \$1.60 per share in 1992. Pro forma adjustments reflect costs in excess of historical charges by Weyerhaeuser and the additional costs of being an independent public company.

Net Sales

Net sales were \$562.9 million in 1993, a 16% increase from the \$484.8 million reported in 1992. Unit sales increased 15%, to 3,435 million diapers, in 1993 from 2,993 million diapers in 1992. Revenues increased at a slightly higher rate than volume because of shipments of a higher-priced mix of products, including training pants introduced in the third quarter of 1992, and a slight overall price increase due to shipments of reduced-count products. These improvements were offset by increased promotional discounts and allowances in response to the 1992 and 1993 price reductions instituted by the national branded manufacturers and diaper-price decreases in the latter part of the year due to diaper-price reductions announced by Procter & Gamble in April 1993.

Net sales in Canada increased significantly in 1993 compared to 1992. The Canadian increase primarily represents an increase in unit volume as price increases in Canada have been offset by the devaluation of the Canadian dollar in relationship to the U.S. dollar in 1993.

Cost of Sales

Cost of sales in 1993 was \$457.6 million compared to \$399.9 million in 1992, a 14% increase. As a percentage of net sales, cost of sales was 81.3% in 1993 compared to 82.5% in 1992. The lower costs in 1993 were principally caused by lower raw material prices compared to 1992 offset by increased labor, thin-pad start-up and depreciation costs. Pulp prices dropped approximately 19% in 1993. Other raw material prices were also at slightly lower levels in 1993 when compared to 1992. The decrease in cost of sales in 1993 also reflects some improvement in costs in the second half of 1993 due to cost reduction and pad modernization efforts.

Manufacturing efficiencies improved in 1993, but were offset by additional labor costs of the training pant operations and thin-pad start-up costs incurred late in 1993. Labor costs increased 8% in 1993 compared to 1992. Depreciation costs increased over \$6 million in 1993 due to additional diaper-making capacity, pad improvement capital and training pant operations added during late 1992 and 1993. Depreciation costs also included the acceleration of depreciation due to obsolescence of equipment as a result of pad modernization. These costs are expected to continue throughout 1994.

Selling, General and Administrative Expense

Selling, general and administrative ("SG&A") expense increased to \$50.0 million in 1993 compared to \$43.5 million in 1992. As a percentage of net sales, however, this expense decreased to 8.9% in 1993 compared to 9.0% in 1992. The increase of \$6.5 million represents the following: additional

cost of accruals for performance-based compensation programs such as incentive bonuses and profit sharing; additional costs of being an independent public company; and increased promotional expenses. The promotional expenses were in response to branded pricing and promotional pressures in 1993. These increased expenses were partially offset by savings generated by the termination of the Company's relationship with its largest sales broker in the latter part of 1992. Outside brokerage costs fell dramatically during the first three quarters of 1993 but have been partially offset by the additional costs of an internal sales force. It is anticipated that SG&A expense will increase as a percentage of net sales in 1994 to reflect higher promotional expenses, product introduction and information services expenditures.

Pro forma SG&A expense rose to \$50.5 million in 1993 compared to \$47.6 million in 1992. As a percentage of net sales, this expense represented 9.0% in 1993 compared to 8.8% in 1992. Pro forma adjustments reflect costs in excess of historical charges by Weyerhaeuser and the additional costs of being an independent public company.

Research and Development Expense

Research and development expense decreased to \$6.0 million in 1993 from \$6.6 million in 1992. This expense is lower due to the discontinuation of an alternative pad technology. It is anticipated that research and development expense will increase in 1994 to reflect higher expenditures relating to new diaper technologies.

Year Ended December 27, 1992 Vs. Year Ended December 29, 1991

Net earnings remained flat in 1992 compared to 1991 with \$21.1 million in 1992 compared to \$21.0 million in 1991. Volume and price increases in the second half of 1991 were offset by increased pricing pressures, higher-cost product features, additional labor costs of seven-day operations, and higher SG&A expense.

Revenues

Net sales increased 22% to \$484.8 million in 1992 compared to \$396.3 million in 1991. Volume increased 18% to 2,993 million diapers in 1992 compared to 2,535 million diapers in 1991, principally as a result of increased sales to existing trade customers. The increase in net sales also reflected an increase of approximately 7% in average unit sales prices instituted during the second half of 1992.

Cost of Sales

Cost of sales in 1992 was \$399.9 million compared to \$322.9 million in 1991, a 24% increase. As a percentage of net sales, cost of sales was 82.5% in 1992 compared to 81.5% in 1991. The higher costs were primarily caused by higher raw material usage with the introduction of new diaper features such as inner-leg gathers and wider tapes in the second half of 1991. Labor cost also increased primarily due to the increased use of seven-day operating schedules on diaper machines. These increased costs were partially offset by average lower pulp prices in 1992 compared to 1991. Start-up costs were also incurred throughout 1992 in introducing the training pant product.

Selling, General and Administrative Expense

SG&A expense was \$43.5 million in 1992 compared to \$34.4 million in 1991. As a percentage of net sales, the expense was 9.0% in 1992 compared to 8.7% in 1991. The \$9.1 million increase was primarily attributable to increased packaging expense as a result of the introduction of the stages diapers and the roll-out of the training pant product, increased trade cooperative merchandising expenses, increased broker commissions due to volume increases, royalties for the inner-leg gather and Muppet Babies artwork, and increased direct sales staff in anticipation of the termination of the relationship with the Company's largest sales broker in the latter part of 1992.

Research and Development Expense

Research and development expense increased to \$6.6 million in 1992 from \$5.7 million in 1991. The increase was primarily related to research on new super-absorbent pad technologies, development of the new training pant line, development of feature enhancements for existing product lines and improvements in the manufacturing process.

Liquidity and Capital Resources

In 1993, net cash flow from operations was \$67.6 million compared to \$26.1 million in 1992. Approximately \$16.5 million of the improvement was due to improved operating results in 1993. A significant portion of the cash flow improvement was generated in the first quarter of 1993 by changes in working capital items that reflected the one-time impact of the spinoff from Weyerhaeuser. The \$22.5 million increase in accounts payable partially reflects pulp and corrugated purchases from Weyerhaeuser, which were previously cleared monthly through intercompany transactions but are now reflected as a third-party payable. Payable activity also increased due to increased spending levels to support the capital improvement plan and the late 1993 increase in pulp inventories. The \$10.7 million increase in accrued liabilities reflects accruals for income taxes that were previously on Weyerhaeuser's corporate books and increases in payroll-related accruals. Inventories increased by \$12 million in late 1993 due to increases in finished goods and pulp inventories. The finished goods increase reflects a buildup in inventories to support customer service during the thin-pad conversion in 1994. These inventories should decline late in 1994 after the conversion is complete. Pulp inventories increased due to a special purchase of pulp. These inventories will decrease during the first quarter of 1994.

The cash produced from operations supported capital expenditures of \$53.7 million in 1993 compared to \$29.0 million in 1992. An additional \$1.7 million was spent on computer software in 1993 compared to \$.2 million in 1992. Capital expenditures will increase during 1994 to support plans to build capacity, make pad improvements, improve manufacturing efficiencies and construct a corporate headquarters building. Cash was also used to pay \$9.1 million of the \$36 million debt incurred in connection with the transfer of the Private Label Diaper Business from Weyerhaeuser. The remaining \$26.9 million debt was repaid with net proceeds from the public offering. As of the end of 1993, the Company had \$8.8 million in cash and short-term investments.

The Company has access to a bank credit facility of \$50 million. In November 1993, the bank agreement in place at the time of the public offering was amended. Generally, the amendment shortened the term of the agreement from five years to three years, lowered the credit facility from \$70 million to \$50 million, removed the banks' security interests, adjusted certain covenants, lowered interest rates charged on borrowings, and gave the Company more flexibility in purchasing and financing business acquisitions. As of the end of 1993, there was no debt outstanding against the credit facility.

The Company expects to borrow money against the credit facility during the first quarter of 1994 due to the anticipated increased 1994 capital spending levels.

Future Realization of Deferred Tax Asset

The Company implemented SFAS No. 109, "Accounting for Income Taxes," at its inception. SFAS No. 109 requires accounting for income taxes based on the liability method and, accordingly, deferred income taxes are provided to reflect temporary differences between financial and tax reporting. The Company currently has a net deferred tax asset of \$40.4 million. Significant components of net deferred income taxes include temporary differences due to depreciation/amortization (\$17.8 million), goodwill (\$14.1 million) and reserves not currently deductible (\$5.6 million). To realize the full benefit of the deferred tax asset, the Company needs to generate approximately \$104 million in future taxable income. Management believes that the Company will generate sufficient future taxable income for full realization. Based on the nature of the various components of deferred income taxes, the Company expects to realize approximately 65% of the deferred tax asset within five years. The remaining 35% is expected to be realized in 6 to 14 years.

New Accounting Standards

In November 1982, the Financial Accounting Standards Board issued SFAS No. 112, "Employer's Accounting for Postemployment Benefits," to be effective for fiscal years beginning after December 15, 1983. Management believes that the future adoption of this statement will not have a significant impact on the Company's financial position or results of operations.

Inflation

Inflation has not been a significant factor in the Company's results of operations in recent years due to the modest rate of price increases in the United States and Canada.

CORPORATE INFORMATION

Paragon Trade Brands, Inc.

Board of Directors

Bobby V. Abraham
Chairman and Chief Executive Officer
Paragon Trade Brands, Inc.

Thomas B. Boklund
Director
Chief Executive Officer
Oregon Steel Mills

Gene D. Hoffman
Director
President and Chief Executive Officer
Corporate Strategies International

William I. Savel
Director
Consultant

Robert L. Schuyler
Director
President
Nisqually Partners

Paragon Trade Brands, Inc. Officers

David W. Cole
President and Chief Operating Officer

Cliff O. Bickell
Vice President, Chief Financial Officer
and Treasurer

Susan Barley
Vice President, General Counsel
and Secretary

Stockholder Information

CORPORATE HEADQUARTERS
Paragon Trade Brands, Inc.
505 South 336th Street
Federal Way, Washington 98003
Phone: 206-924-4509

ANNUAL MEETING OF STOCKHOLDERS

The Annual Meeting of Stockholders will be held at 9:30 a.m., Tuesday, May 3, 1994, at the Washington Athletic Club, Noble Auditorium, 1326 Sixth Avenue, Seattle, Washington.

Detailed information regarding the meeting is contained in the Notice of Annual Meeting and Proxy Statement to be sent to each stockholder of record as of the close of business on March 7, 1994.

FORM 10-K

A COPY OF THE COMPANY'S FORM 10-K FILED WITH THE SECURITIES AND EXCHANGE COMMISSION AND OTHER REPORTS MAY BE OBTAINED UPON REQUEST AT THE COMPANY'S HEADQUARTERS, ATTENTION: SHAREHOLDER RELATIONS.

TRANSFER AGENT

Chemical Bank
P.O. Box 24935
Church Street Station
New York, New York 10249
1-800-647-4273

STOCK LISTING

Paragon Trade Brands, Inc. Common Stock is traded on the New York Stock Exchange. Symbol: PTB

Stock Information

Quarter Ended	Price Range	
	High	Low
January 26 to March 28, 1993	\$ 29.75	\$ 20.50
June 27, 1993	31.00	15.00
September 28, 1993	24.00	16.25
December 26, 1993	31.38	23.25

As of February 16, 1994, there were 228 holders of record of the Company's common stock. The Company has not paid dividends on its common stock. The Board of Directors will determine future dividend policy based upon the Company's results of operation, financial condition, capital requirements and other circumstances. The Company's credit facility prohibits the Company from paying dividends.

