KAPSTONE PAPER & PACKAGING CORP
Form 10-Q
August 01, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2012

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

For the transition period from to

Commission File Number: 001-33494

KapStone Paper and Packaging Corporation

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**20-2699372**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

KapStone Paper and Packaging Corporation

1101 Skokie Blvd., Suite 300

Northbrook, IL 60062

(Address of Principal Executive Offices, including zip code)

Registrant s Telephone Number, including area code **(847) 239-8800**

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company 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 46,714,963 shares of the Registrant s Common Stock, $0.0001 par value, outstanding at July 24, 2012, excluding 40,000 shares held as treasury shares.

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KAPSTONE PAPER AND PACKAGING CORPORATION

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PART 1. FINANCIAL INFORMATION

ITEM 1. - FINANCIAL STATEMENTS

KapStone Paper and Packaging Corporation

Consolidated Balance Sheets

(In thousands, except share and per share amounts)

	June 30, 2012 (Unaudited)	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 9,683	$ 8,062
Trade accounts receivable, less allowances of $307 in 2012 and $571 in 2011	114,723	108,320
Other receivables	6,721	11,247
Inventories	109,947	110,054
Prepaid expenses and other current assets	6,979	4,207
Deferred income taxes	11,770	10,048
Total current assets	259,823	251,938
Plant, property and equipment, net	566,151	567,195
Other assets	4,209	4,313
Intangible assets, net	59,282	63,715
Goodwill	235,334	237,193
Total assets	$ 1,124,799	$ 1,124,354
Liabilities and Stockholders Equity		
Current liabilities:		
Current portion of long-term debt	$	$ 6,094
Other current borrowings	1,552	
Accounts payable	84,263	81,051
Accrued expenses	22,579	21,217
Accrued compensation costs	20,136	27,445
Total current liabilities	128,530	135,807
Other liabilities:		
Long-term debt, net of current portion	293,355	335,635
Pension and post-retirement benefits	10,230	10,676
Deferred income taxes	96,687	84,316
Other liabilities	11,157	11,642
Total other liabilities	411,429	442,269
Commitments and contingencies		
Stockholders equity:		

Preferred stock $0.0001 par value; 1,000,000 shares authorized; no shares issued and outstanding				
Common stock $0.0001 par value, 175,000,000 shares authorized; 46,703,892 shares issued and outstanding (40,000 treasury shares outstanding) at June 30, 2012 and 46,449,695 issued and outstanding (40,000 treasury shares outstanding) at December 31, 2011		5		5
Additional paid-in capital		235,123		230,665
Retained earnings		352,035		318,068
Accumulated other comprehensive loss		(2,323)		(2,460)
Total stockholders equity		584,840		546,278
Total liabilities and stockholders equity	$	1,124,799	$	1,124,354

See notes to consolidated financial statements.

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KAPSTONE PAPER AND PACKAGING CORPORATION

Consolidated Statements of Income and Comprehensive Income

(In thousands, except share and per share amounts)

(unaudited)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net sales	$ 306,259	$ 214,786	$ 606,102	$ 421,524
Cost of sales, excluding depreciation and amortization	213,335	143,143	427,409	285,794
Depreciation and amortization	15,327	12,778	30,503	24,569
Freight and distribution expenses	27,936	19,681	53,679	37,510
Selling, general and administrative expenses	17,436	8,866	35,008	18,172
Other operating income	230	290	428	578
Operating income	32,455	30,608	59,931	56,057
Foreign exchange (loss)/gain	(508)	45	(388)	335
Interest expense, net	3,193	1,077	6,472	2,174
Income before provision for income taxes	28,754	29,576	53,071	54,218
Provision for income taxes	10,350	11,417	19,104	20,928
Net income	$ 18,404	$ 18,159	$ 33,967	$ 33,290
Other comprehensive income pension and postretirement plan liability adjustments, net of tax	70	100	137	203
Total comprehensive income	$ 18,474	$ 18,259	$ 34,104	$ 33,493
Weighted-average number of shares outstanding:				
Basic	46,620,354	46,250,362	46,555,990	46,172,108
Diluted	47,744,589	47,416,400	47,792,980	47,435,487
Net income per share:				
Basic	$ 0.39	$ 0.39	$ 0.73	$ 0.72
Diluted	$ 0.39	$ 0.38	$ 0.71	$ 0.70

See notes to consolidated financial statements.

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KAPSTONE PAPER AND PACKAGING CORPORATION

Consolidated Statements of Cash Flows

(In thousands)

(unaudited)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Operating activities		
Net income	$ 33,967	$ 33,290
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	30,503	24,569
Stock-based compensation expense	3,577	2,521
Excess tax benefits from stock-based compensation	(1,496)	(758)
Amortization of debt issuance costs	1,803	848
Loss on disposal of fixed assets	591	182
Deferred income taxes	14,728	14,291
Changes in operating assets and liabilities:		
Trade accounts receivable, net	(6,027)	(14,762)
Other receivables	4,526	(247)
Inventories	(237)	(2,160)
Prepaid expenses and other current assets	(2,772)	(675)
Other assets	41	(253)
Accounts payable	3,622	(3,091)
Accrued expenses and other	1,218	(1,505)
Accrued compensation costs	(7,044)	(2,288)
Accrued income taxes		3,130
Net cash provided by operating activities	77,000	53,092
Investing activities		
USC acquisition	(314)	
KPB acquisition earn-out payment		(49,700)
Capital expenditures	(27,454)	(12,914)
Net cash used in investing activities	(27,768)	(62,614)
Financing activities		
Proceeds from revolving credit facility	39,400	7,600
Repayments on revolving credit facility	(39,400)	(7,600)
Repayments of long-term debt	(50,000)	(9,418)
Proceeds from other current borrowings	3,398	2,273
Repayments on other current borrowings	(1,846)	(1,235)
Payment of withholding taxes on vested restricted stock awards	(1,179)	(866)
Proceeds from the exercises of stock options	475	621
Proceeds from issuance of shares to ESPP	90	97
Loan amendment costs	(45)	(244)
Excess tax benefits from stock-based compensation	1,496	758
Net cash used in financing activities	(47,611)	(8,014)
Net increase (decrease) in cash and cash equivalents	1,621	(17,536)

Cash and cash equivalents-beginning of period		8,062		67,358
Cash and cash equivalents-end of period	$	9,683	$	49,822

See notes to consolidated financial statements.

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KAPSTONE PAPER AND PACKAGING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share amounts)

(unaudited)

1. Financial Statements

The accompanying unaudited consolidated financial statements of KapStone Paper and Packaging Corporation (the Company, we, us, our or KapStone) have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of a normal recurring nature) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. For further information, refer to the consolidated financial statements and related footnotes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

2. Recent Accounting Pronouncements

Intangibles Goodwill and Other

In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-08, Intangibles Goodwill and Other. This guidance provides an entity the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit, as described in paragraph 350-20-35-4. This guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company will adopt the provisions of this guidance in conjunction with its annual impairment testing in the fourth quarter of 2012.

Comprehensive Income

In June 2011, the FASB issued ASU 2011-05, Presentation of Comprehensive Income, which revises the manner in which entities should present comprehensive income in their financial statements. The new guidance requires entities to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company adopted the provisions of this guidance in using the continuous statement approach in 2012 on a retrospective basis for all periods presented.

Fair Value Measurements

In May 2011, the FASB issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop converged guidance on how to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP; however, it expands existing disclosure requirements for fair value measurements and makes other amendments, many of which eliminate unnecessary wording differences between U.S. GAAP and IFRS. This ASU is effective for interim and annual periods beginning after December 15, 2011. The application of the requirements of this guidance did not have a material effect on the consolidated financial statements.

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3. USC Acquisition

On October 31, 2011, the Company consummated the acquisition of U.S. Corrugated Inc. (USC) from its stockholders by merger for $330.0 million in cash plus $1.6 million of working capital adjustments. On March 9, 2012, KapStone reached an agreement with USC on the final calculation of Merger Consideration and paid an additional $0.3 million which was allocated to acquisition consideration.

The following table summarizes the acquisition consideration:

Purchase price, net of cash acquired	$	330,000
Working capital adjustments		1,946
Total acquisition consideration	$	331,946

The USC acquisition was accounted for in accordance with the provisions of ASC 805, *Business Combinations*, and the accompanying consolidated financial statements include the results of USC since October 31, 2011. The Company estimated the fair value of the assets and liabilities of USC at the time of acquisition and used third-party appraisals to determine the fair market value for tangible and intangible assets. The excess of the purchase price over the aggregate estimated fair value of net assets acquired was allocated to goodwill. The allocation is not final as the review of the fair value of deferred income tax assets and liabilities and certain other acquired assets and liabilities is in process.

The following table summarizes the preliminary allocation of acquisition consideration to the fair value of the assets acquired and the liabilities assumed at the date of acquisition:

Trade accounts receivable	$	38,377
Other receivables		5,745
Inventories		32,859
Prepaid expenses and other current assets		754
Plant, property and equipment		106,082
Other assets		634
Intangible assets		45,000
Goodwill		180,823
Deferred income tax asset		5,126
Accounts payable		(34,116)
Accrued expenses		(3,660)
Accrued compensation costs		(5,526)
Deferred income taxes		(36,045)
Other liabilities		(4,107)
Total acquisition consideration	$	331,946

4. Annual Planned Maintenance Outage

Annual planned maintenance outage costs for the three months ended June 30, 2012 and 2011 totaled $3.8 million and $3.0 million, respectively. In addition, planned maintenance outage costs for the six months ended June 30, 2012 and 2011 totaled $4.6 million and $3.4 million, respectively.

5. Inventories

Inventories consist of the following at June 30, 2012 and December 31, 2011, respectively:

	(Unaudited) June 30, 2012	December 31, 2011
Raw materials	$ 43,504	$ 46,926
Work in process	2,042	1,780
Finished goods	38,730	36,747
Replacement parts and supplies	25,671	24,601
Inventories	$ 109,947	$ 110,054

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6. Debt

Amendment to Credit Agreement

On May 10, 2012, the Company entered into a First Amendment to Credit Agreement (the First Amendment), by and among Kapstone Kraft Paper Corporation, as Borrower (the Borrower), the Company and certain subsidiaries of the Company as Guarantors, the lenders party thereto, and Bank of America N.A., as Administrative Agent, which amends the Credit Agreement, dated as of October 31, 2011 (collectively, the Credit Agreement). The First Amendment, among other things, expands the accordion feature under the Credit Agreement, removes certain mandatory prepayment events, and modifies the calculation methodology of the financial covenants. The accordion feature in the Credit Agreement now permits KapStone, subject to certain terms and conditions, to request an increase in the revolving commitments and/or additional term loans in an aggregate principal amount of up to $450.0 million.

Voluntary Prepayment

On June 29, 2012, the Company made a $50.0 million voluntary prepayment on its term loan under the Credit Agreement using cash generated from operations.

Debt Covenants

The Company s Credit Agreement contains, among other provisions, covenants with which we must comply while the agreement is in force. The covenants limit our ability to, among other things, incur indebtedness, create additional liens on our assets, make investments, engage in mergers and acquisitions, pay dividends and sell any assets outside the normal course of business. As of June 30, 2012, the Company was in compliance with all applicable covenants in the Credit Agreement.

Other Current Borrowings

In 2012 and 2011, the Company entered into financing agreements of $3.4 million and $2.3 million, respectively, at an annual interest rate of 2.00 and 1.75 percent, respectively, for its annual property insurance premiums. The agreements required the Company to pay consecutive monthly payments through the term of each financing agreement ending on December 1st. As of June 30, 2012, there was $1.6 million outstanding under the current agreement which is included in Other current borrowings on the Consolidated Balance Sheets.

Interest Paid

Interest paid was $2.4 million and $0.6 million for the three months ended June 30, 2012 and 2011, respectively. In addition, interest paid was $4.7 million and $1.3 million for the six months ended June 30, 2012 and 2011, respectively. The increase in interest paid reflects a higher term loan balance resulting from the USC acquisition.

Fair Value of Debt

At June 30, 2012 the fair value of the Company s debt approximates the carrying value of $293.4 million as the variable interest rates re-price frequently at current market rates. The debt was valued using Level 2 inputs in the fair value hierarchy which are significant observable inputs including quoted prices for debt of similar terms and maturities.

7. Income Taxes

The Company s effective tax rate for the six months ended June 30, 2012 and 2011 was 36.0 percent and 38.6 percent, respectively. The effective tax rate decreased in 2012 due to a higher expected benefit from the domestic manufacturing deduction. The differences between the effective tax rate and the federal statutory tax rate for the periods ended June 30, 2012 and 2011 are due to the impact of state tax, net of the federal benefit and the domestic manufacturing deduction.

The gross unrecognized tax benefits, including interest, as of June 30, 2012 is $5.0 million and is unchanged from December 31, 2011. Unrecognized tax benefits of $5.0 million are included in Other liabilities on the Consolidated Balance Sheets.

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In the normal course of business, the Company is subject to examination by taxing authorities. The Company s open tax year is 2010.

Income taxes paid net of refunds were $4.0 million and $0.1 million for the three months ended June 30, 2012 and 2011, respectively. In addition, income taxes paid net of refunds were $4.3 million and $0.3 million for the six months ended June 30, 2012 and 2011, respectively.

8. Net Income Per Share

Basic and diluted net income per share is calculated as follows:

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net income as reported	$ 18,404	$ 18,159	$ 33,967	$ 33,290
Weighted-average number of common shares for basic net income per share	46,620,354	46,250,362	46,555,990	46,172,108
Incremental effect of dilutive common stock equivalents:				
Unexercised stock options	899,480	889,370	923,301	908,410
Unvested restricted stock awards	224,755	276,668	313,689	354,969
Weighted-average number of shares for diluted net income per share	47,744,589	47,416,400	47,792,980	47,435,487
Net income per share basic	$ 0.39	$ 0.39	$ 0.73	$ 0.72
Net income per share diluted	$ 0.39	$ 0.38	$ 0.71	$ 0.70

Unexercised stock options to purchase a total of 0.3 million shares were outstanding during both the three months ended June 30, 2012 and 2011, but were not included in the computation of diluted earnings per share because the options were anti-dilutive.

9. Pension Plan and Post Retirement Benefits

Defined Benefit Pension Plan

The KapStone Paper and Packaging Corporation Defined Benefit Pension Plan (the Pension Plan) provides benefits for approximately 1,000 union employees.

Net pension cost recognized for the three and six months ended June 30, 2012 and 2011 for the Pension Plan is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Service cost for benefits earned during the period	$ 1,023	$ 844	$ 2,047	$ 1,688
Interest cost on projected benefit obligation	251	203	503	406
Expected return on plan assets	(233)	(185)	(467)	(370)
Amortization of net loss	54		108	
Amortization of prior service cost	92	141	184	282
Net pension cost other multi-employer plan	17		34	
Total net pension cost	$ 1,204	$ 1,003	$ 2,409	$ 2,006

KapStone funds the Pension Plan according to IRS funding requirements. Based on those requirements, KapStone funded $2.6 million for the six months ended June 30, 2012 and expects to fund an additional $3.0 million to the Pension Plan in 2012.

Defined Contribution Plan

The KapStone Defined Contribution Plan (the Contribution Plan) covers all eligible employees. The Company s monthly contributions to the Contribution Plan are based on the matching of employee contributions. For the three months ended June 30, 2012 and 2011, the Company recognized expense of $2.6 million and $1.6 million, respectively. In addition, for the six months ended June 30, 2012 and 2011, the

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Company recognized expense of $5.4 million and $3.6 million, respectively. Effective October 31, 2011, employees who joined the Company as part of the USC acquisition are included in the Contribution Plan.

10. Stock-Based Compensation

On March 7, 2012, the Compensation Committee of the board of directors approved stock awards to executive officers, certain employees and directors. The 2012 awards included 310,847 stock option grants and 124,341 restricted stock units.

The Company accounts for stock awards in accordance with ASC 718, *Compensation Stock Compensation*, which requires that the cost resulting from all share-based payment transactions be recognized as compensation cost over the vesting period based on the fair value of the instrument on the date of grant.

Total stock-based compensation expense related to the stock option and restricted stock unit grants for the three and six months ended June 30, 2012 and 2011 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	**2011**	**2012**	**2011**
Stock option compensation expense	$ 717	$ 448	$ 2,025	