KAPSTONE PAPER & PACKAGING CORP
Form 10-Q
May 02, 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 March 31, 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 Exchange Act 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 46,546,808 shares of the Registrant s Common Stock, $0.0001 par value, outstanding at April 26, 2012, excluding 40,000 shares held as treasury shares.

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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)

(unaudited)

	March 31, 2012 (Unaudited)	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 20,066	$ 8,062
Trade accounts receivable, less allowance of $281 in 2012 and $571 in 2011	114,462	108,320
Other receivables	7,176	11,247
Inventories	113,218	110,054
Prepaid expenses and other current assets	7,590	4,207
Deferred income taxes	10,048	10,048
Total current assets	272,560	251,938
Plant, property and equipment, net	563,952	567,195
Other assets	4,515	4,313
Intangible assets, net	61,302	63,715
Goodwill	237,553	237,193
Total assets	$ 1,139,882	$ 1,124,354
Liabilities and Stockholders Equity		
Current liabilities:		
Current portion of long-term debt	$ 13,125	$ 6,094
Other current borrowings	2,477	
Accounts payable	80,096	81,051
Accrued expenses	19,439	21,217
Accrued compensation costs	16,805	27,445
Accrued income taxes	2,275	
Total current liabilities	134,217	135,807
Other liabilities:		
Long-term debt, net of current portion	329,418	335,635
Pension and postretirement benefits	9,939	10,676
Deferred income taxes	89,562	84,316
Other liabilities	11,569	11,642
Total other liabilities	440,488	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; 46,546,808 shares issued and outstanding (40,000 treasury shares outstanding) at March 31, 2012 and 46,449,695 issued and outstanding (40,000 treasury shares outstanding) at December 31, 2011		5		5
Additional paid-in capital		233,934		230,665
Retained earnings		333,631		318,068
Accumulated other comprehensive loss		(2,393)		(2,460)
Total stockholders equity		565,177		546,278
Total liabilities and stockholders equity	$	1,139,882	$	1,124,354

See notes to consolidated financial statements.

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KAPSTONE PAPER AND PACKAGING CORPORATION

Consolidated Statements of Comprehensive Income

(In thousands, except share and per share amounts)

(unaudited)

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Net sales	$ 299,843	$ 206,738
Cost of sales, excluding depreciation and amortization	214,074	142,651
Depreciation and amortization	15,176	11,791
Freight and distribution expenses	25,743	17,829
Selling, general and administrative expenses	17,572	9,306
Other operating income	198	288
Operating income	27,476	25,449
Foreign exchange gain/(loss)	120	290
Interest expense, net	3,279	1,097
Income before provision for income taxes	24,317	24,642
Provision for income taxes	8,754	9,511
Net income	$ 15,563	$ 15,131
Other comprehensive income		
Total comprehensive income	$ 15,563	$ 15,131
Weighted-average number of shares outstanding:		
Basic	46,491,626	46,093,852
Diluted	47,841,371	47,454,574
Net income per share:		
Basic	$ 0.33	$ 0.33
Diluted	$ 0.33	$ 0.32

See notes to consolidated financial statements.

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KAPSTONE PAPER AND PACKAGING CORPORATION

Consolidated Statements of Cash Flows

(In thousands)

(unaudited)

	Three Months Ended March 31, 2012	2011
Operating activities		
Net income	$ 15,563	$ 15,131
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	15,176	11,791
Stock-based compensation expense	2,313	1,758
Excess tax benefit from stock-based compensation expense	(445)	(66)
Amortization of debt issuance costs	906	410
Loss on disposal of fixed assets	68	126
Deferred income taxes	6,202	7,135
Changes in operating assets and liabilities:		
Trade accounts receivable, net	(5,766)	(7,228)
Other receivables	4,071	39
Inventories	(3,208)	(1,115)
Prepaid expenses and other current assets	(3,383)	(2,139)
Other assets	(225)	(31)
Accounts payable	(955)	(678)
Accrued expenses and other	(2,426)	(6,056)
Accrued compensation costs	(10,375)	(7,066)
Accrued income taxes	2,275	443
Net cash provided by operating activities	19,791	12,454
Investing activities		
USC acquisition	(314)	
KPB acquisition earn-out payment		(49,700)
Capital expenditures	(10,905)	(4,678)
Net cash used in investing activities	(11,219)	(54,378)
Financing activities		
Proceeds from revolving credit facility	38,000	7,600
Repayments on revolving credit facility	(38,000)	(7,600)
Repayments of long-term debt		(4,709)
Proceeds from other current borrowings	3,398	2,273
Repayments on other current borrowings	(921)	(617)
Proceeds from the exercises of stock options	420	178
Proceeds from issuance of shares to ESPP	90	97
Loan amendment costs		(244)
Excess tax benefit from stock-based compensation	445	66
Net cash provided by (used in) financing activities	3,432	(2,956)
Net increase (decrease) in cash and cash equivalents	12,004	(44,880)
Cash and cash equivalents-beginning of period	8,062	67,358

Cash and cash equivalents-end of period	$	20,066	$	22,478

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 months ended March 31, 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 year ended December 31, 2011.

2. Recent Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, which amends current comprehensive income presentation guidance. The objective of this Update is to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. generally accepted accounting principles and International Financial Reporting Standards, the FASB decided to eliminate the option to present components of other comprehensive income as part of the statement of changes in stockholders equity, among other amendments in this Update. The amendments require that all non-owner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted, because compliance with the amendments is already permitted. The amendments do not require any transition disclosures. As a result of the implementation of this standard, the Company has adopted this provision in fiscal 2012 and modified the presentation of the Consolidated Statements of Comprehensive Income.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurements (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, which amends Accounting Standards Codification (ASC) 820, *Fair Value Measurement* . The amended guidance clarifies the application of existing fair value measurement requirements and expands the disclosures for fair value measurements that use significant unobservable (Level 3) inputs. In addition to expanding the disclosures for Level 3 measurements, the guidance requires new disclosures for any not just significant transfers between quoted prices (Level 1) inputs and significant observable (Level 2) inputs of the fair value hierarchy and the hierarchy classification for assets and liabilities whose fair value is disclosed only in the footnotes, such as loans carried at amortized cost whose fair values are required to be disclosed as well. The guidance is effective for annual and interim reporting periods beginning on or after December 15, 2011. As a result of the implementation of this standard, the Company has adopted this provision in fiscal 2012; however, there was no material impact on the consolidated financial statements.

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.

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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		33,159
Prepaid expenses and other current assets		754
Plant, property and equipment		106,082
Other assets		634
Intangible assets		45,000
Goodwill		183,042
Deferred income tax asset		3,404
Accounts payable		(34,526)
Accrued expenses		(3,660)
Accrued compensation costs		(5,526)
Deferred income taxes		(36,432)
Other liabilities		(4,107)
Total acquisition consideration	$	331,946

4. Inventories

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

		(Unaudited) March 31, 2012		**December 31, 2011**
Raw materials	$	49,106	$	46,926
Work in process		1,815		1,780
Finished goods		36,810		36,747
Replacement parts and supplies		25,487		24,601

Inventories	$ 113,218	$ 110,054

5. Debt

Debt Covenants

The Company s New 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 March 31, 2012, the Company was in compliance with all applicable covenants in the New Credit Agreement.

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Fair Value of Debt

At March 31, 2012 the fair value of the Company s debt approximates the carrying value of $342.5 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.

Other Borrowing

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 March 31, 2012, there was $2.5 million outstanding under the current agreement which is included in Other current borrowings on the Consolidated Balance Sheets.

6. Income Taxes

The Company s effective tax rate for the three months ended March 31, 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 quarters ended March 31, 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 March 31, 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.

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

7. Net Income per Share

Basic and diluted net income per share is calculated as follows ($000 s except for share and per share data):

	Three Months Ended March 31, 2012	2011
Net income as reported	$ 15,563	$ 15,131

Weighted-average number of common shares for basic net income per share		46,491,626		46,093,852
Incremental effect of dilutive common stock equivalents:				
Unexercised stock options		947,121		927,451
Unvested restricted stock awards		402,624		433,271
Weighted-average number of shares for diluted net income per share		47,841,371		47,454,574
Net income per share basic	$	0.33	$	0.33
Net income per share diluted	$	0.33	$	0.32

Unexercised stock options to purchase a total of 0.1 million shares were outstanding during the three month period ended March 31, 2012, but were not included in the computation of diluted earnings per share because the options were antidilutive.

8. Pension Plan and Post Retirement Benefits

Defined Benefit Plan

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

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Net pension cost recognized for the three months ended March 31, 2012 and 2011 for the Pension Plan is as follows:

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Service cost for benefits earned during the quarter	$ 1,024	$ 844
Interest cost on projected benefit obligations	252	203
Expected return on plan assets	(234)	(185)
Amortization of net (gain)/loss	54	
Amortization of prior service cost	92	141
Net pension cost Company plan	1,188	1,003
Net pension cost multi-employer plan	17	
Total net pension cost	$ 1,205	$ 1,003

KapStone funds the Pension Plan according to IRS funding requirements. Based on those limitations, KapStone funded $1.8 million for the three months ended March 31, 2012 and expects to fund an additional $2.3 million to the Pension Plan in 2012.

Defined Contribution Plan

The KapStone Defined Contribution Plan (Contribution Plan) covers all eligible employees. Company monthly contributions to the Contribution Plan are based on the matching of employee contributions. For the three months ended March 31, 2012 and 2011, the Company recognized expense of $2.8 million and $2.0 million, respectively. Effective October 31, 2011, former USC employees are included in the Contribution Plan.

9. 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 months ended March 31, 2012 and 2011 is as follows:

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Stock option compensation expense	$ 1,308	$ 951
Restricted stock unit compensation expense	1,005	807
Total stock-based compensation expense	$ 2,313	$ 1,758

Total unrecognized stock-based compensation cost related to the stock option grants and restricted stock units as of March 31, 2012 and December 31, 2011 is as follows:

	March 31, 2012	December 31, 2011
Unrecognized stock option compensation cost	$ 3,489	$ 1,648
Unrecognized restricted stock compensation cost	3,070	1,687
Total stock-based compensation cost	$ 6,559	$ 3,335

As of March 31, 2012, total unrecognized compensation cost related to non-vested stock options and restricted stock units is expected to be recognized over a weighted average period of 2.0 years and 1.6 years, respectively.

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Stock Options

Stock option awards vest as follows: 50% after two years and the remaining 50% after three years or upon the retirement of a grantee of such stock options who has reached the age 65. The stock options awarded in 2012 have a contractual term of ten years and are subject to forfeiture should the recipient terminate his or her employment with the Company for certain reasons prior to vesting in his or her awards, or the occurrence of certain other events such as termination with cause. The exercise price of these stock options is based on the closing market price of our common stock on the date of grant ($19.75 for the 2012 awards described above) and compensation expense is recorded on an accelerated basis over the awards vesting periods.

The weighted average fair value of the KapStone stock options granted in March 2012 was $10.38. The fair value was calculated using the Black-Scholes option-pricing model based on the market price at the grant date and the weighted average assumptions specific to the underlying options. The Company uses the simplified method , defined in SEC Staff Accounting Bulletin (SAB) No. 107, to determine the expected life assumption for all of its options. The Company uses the simplified method , as permitted by SAB No. 110, as it does not have sufficient historical exercise data to provide a reasonable basis upon which to estimate expected life due to the limited time its equity shares have been publicly traded. The expected volatility assumption is based on the volatility of KapStone stock from the same time period as the expected term of the stock options. The risk-free interest rate was selected based upon yields of U.S. Treasury issues with a term similar to the expected life of the stock options.

The assumptions utilized for calculating the fair value of stock options during the period are as follows:

	Three Months Ended March 31, 2012	2011
KapStone Stock Options Black-Scholes assumptions (weighted average):		
Expected volatility	56.52%	45.24%
Expected life (years)	5.98	5.94
Risk-free interest rate	1.10%	2.47%
Expected dividend yield	%	%

The following table summarizes stock options amounts and activity:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Intrinsic Value (dollars in Thousands)
Outstanding at January 1, 2012	2,473,874	$ 7.86	6.7	$ 19,742
Granted	310,847	19.75	9.9	
Exercised	(91,104)	4.61		
Forfeited				
Outstanding at March 31, 2012	2,693,617	$ 9.34	6.8	$ 27,916
Exercisable at March 31, 2012	1,269,037	$ 6.18	5.1	$ 17,160

For the three months ended March 31, 2012, cash proceeds from the exercise of stock options totaled $0.4 million.

Restricted Stock

Restricted stock units are restricted as to transferability until they vest three years from the grant date or upon the retirement of the grantee who has reached the age 65. These restricted stock units are subject to forfeiture should these employees terminate their employment with the Company for certain reasons prior to vesting in their awards, or the occurrence of certain other events. The value of these restricted stock units is based on the closing market price of our common stock on the date of grant and compensation expense is recorded on a straight-line basis over the awards vesting periods.

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The following table summarizes unvested restricted stock units amounts and activity:

	Units		Weighted Average Grant Price
Outstanding at January 1, 2012	496,395	$	9.22