

KAPSTONE PAPER & PACKAGING CORP  
Form 10-Q  
July 27, 2016

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2016

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<br>Incorporation or Organization) | (I.R.S. Employer<br>Identification No.) |

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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 No

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 No

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

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

There were 96,571,405 shares of the Registrant's Common Stock, \$0.0001 par value, outstanding at July 20, 2016.



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,<br>2016<br>(unaudited) | December<br>31,<br>2015 |
|--|---------------------------------|-------------------------|
| Assets   |                                 |                         |
| Current assets:  |                                 |                         |
| Cash and cash equivalents  | \$ 7,890                        | \$ 6,821                |
| Trade accounts receivable (Includes \$381,999 at June 30, 2016, and \$345,372 at December 31, 2015, associated with the receivables credit facility) | 415,131                         | 363,869                 |
| Other receivables  | 12,682                          | 18,732                  |
| Inventories  | 331,642                         | 335,903                 |
| Prepaid expenses and other current assets  | 15,124                          | 28,932                  |
| Total current assets   | 782,469                         | 754,257                 |
| Plant, property and equipment, net   | 1,411,362                       | 1,406,146               |
| Other assets   | 10,792                          | 12,532                  |
| Intangible assets, net   | 327,235                         | 344,583                 |
| Goodwill   | 704,592                         | 704,592                 |
| Total assets   | \$ 3,236,450                    | \$ 3,222,110            |
| Liabilities and Stockholders' Equity   |                                 |                         |
| Current liabilities:   |                                 |                         |
| Short-term borrowings  | \$ 16,000                       | \$ 6,400                |
| Dividend payable   | 9,907                           | 9,862                   |
| Accounts payable   | 182,376                         | 196,491                 |
| Accrued expenses   | 63,864                          | 73,138                  |
| Accrued compensation costs   | 52,215                          | 64,149                  |
| Accrued income taxes   | 2,288                           | 15                      |
| Total current liabilities  | 326,650                         | 350,055                 |
| Other liabilities:   |                                 |                         |
| Long-term debt (Includes \$259,538 at June 30, 2016, and \$265,614 at December 31, 2015, associated with the receivables credit facility)            | 1,537,028                       | 1,543,748               |
| Pension and postretirement benefits  | 37,830                          | 40,510                  |
| Deferred income taxes  | 420,843                         | 418,479                 |
| Other liabilities  | 44,993                          | 24,038                  |
| Total other liabilities  | 2,040,694                       | 2,026,775               |
| Stockholders' equity:  |                                 |                         |
| Preferred stock \$0.0001 par value; 1,000,000 shares authorized; no shares issued and outstanding  | —                               | —                       |
|  | 10                              | 10                      |

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Common stock—\$0.0001 par value; 175,000,000 shares authorized; 96,530,362 shares issued and outstanding (excluding 40,000 treasury shares) at June 30, 2016 and 96,327,506 shares issued and outstanding (excluding 40,000 treasury shares) at December 31, 2015

|  |              |              |
|--|--------------|--------------|
| Additional paid-in-capital                 | 271,530      | 266,220      |
| Retained earnings                          | 659,789      | 642,306      |
| Accumulated other comprehensive loss       | (62,223)     | (63,256)     |
| Total stockholders' equity                 | 869,106      | 845,280      |
| Total liabilities and stockholders' equity | \$ 3,236,450 | \$ 3,222,110 |

See notes to consolidated financial statements.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## Consolidated Statements of Comprehensive Income

(In thousands, except share and per share amounts)

(unaudited)

|   | Three Months Ended June 30, |            | Six Months Ended June 30, |              |
|---|-----------------------------|------------|---------------------------|--------------|
|   | 2016                        | 2015       | 2016                      | 2015         |
| Net sales   | \$ 784,911                  | \$ 671,255 | \$ 1,523,126              | \$ 1,217,544 |
| Cost of sales, excluding depreciation and amortization        | 568,831                     | 470,478    | 1,102,108                 | 852,676      |
| Depreciation and amortization                                 | 46,035                      | 36,996     | 90,574                    | 72,117       |
| Freight and distribution expenses                             | 70,978                      | 53,891     | 136,037                   | 97,318       |
| Selling, general, and administrative expenses                 | 55,554                      | 48,481     | 116,294                   | 86,675       |
| Operating income  | 43,513                      | 61,409     | 78,113                    | 108,758      |
| Foreign exchange loss   | 872                         | 53         | 975                       | 938          |
| Interest expense, net   | 10,006                      | 8,515      | 19,817                    | 14,928       |
| Income before provision for income taxes                      | 32,635                      | 52,841     | 57,321                    | 92,892       |
| Provision for income taxes                                    | 11,913                      | 18,585     | 20,425                    | 32,536       |
| Net income  | \$ 20,722                   | \$ 34,256  | \$ 36,896                 | \$ 60,356    |
| Other comprehensive income, net of tax                        |                             |            |                           |              |
| Pension and postretirement plan reclassification adjustments: |                             |            |                           |              |
| Amortization (accretion) of prior service costs               | (104)                       | 12         | (208)                     | 24           |
| Amortization of net loss                                      | 620                         | 191        | 1,241                     | 382          |
| Other comprehensive income, net of tax                        | 516                         | 203        | 1,033                     | 406          |
| Total comprehensive income                                    | \$ 21,238                   | \$ 34,459  | \$ 37,929                 | \$ 60,762    |
| Weighted average number of shares outstanding:                |                             |            |                           |              |
| Basic   | 96,517,357                  | 96,269,619 | 96,458,354                | 96,196,889   |
| Diluted   | 97,629,786                  | 97,664,781 | 97,561,774                | 97,647,666   |
| Net income per share:   |                             |            |                           |              |
| Basic   | \$ 0.21                     | \$ 0.36    | \$ 0.38                   | \$ 0.63      |
| Diluted   | \$ 0.21                     | \$ 0.35    | \$ 0.38                   | \$ 0.62      |
| Dividends declared per common share                           | \$ 0.10                     | \$ 0.10    | \$ 0.20                   | \$ 0.20      |

See notes to consolidated financial statements.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## Consolidated Statements of Cash Flows

(In thousands)

(unaudited)

|   | Six Months Ended June 30, |           |
|---|---------------------------|-----------|
|   | 2016                      | 2015      |
| Operating activities  |                           |           |
| Net income  | \$ 36,896                 | \$ 60,356 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                           |           |
| Depreciation expense  | 72,701                    | 63,659    |
| Amortization of intangible assets   | 17,873                    | 8,458     |
| Stock-based compensation expense  | 5,362                     | 6,537     |
| Pension and postretirement  | (1,027)                   | (5,416)   |
| Excess tax (deficiency) / benefit from stock-based compensation                             | 150                       | (1,511)   |
| Amortization of debt issuance costs   | 2,375                     | 3,047     |
| (Gain) / loss on disposal of fixed assets   | 653                       | 210       |
| Deferred income taxes   | 704                       | 2,451     |
| Change in fair value of contingent consideration liability                                  | 3,052                     | 553       |
| Changes in assets and liabilities:  |                           |           |
| Trade accounts receivable, net  | (51,262)                  | (59,007)  |
| Other receivables   | 6,137                     | 7,486     |
| Inventories   | 4,261                     | (10,194)  |
| Prepaid expenses and other current assets   | 12,181                    | (5,537)   |
| Other assets  | —                         | 747       |
| Accounts payable  | (6,365)                   | 8,765     |
| Accrued expenses and other liabilities  | (5,295)                   | 3,567     |
| Accrued compensation costs  | (11,934)                  | (8,052)   |
| Accrued income taxes  | 3,163                     | (3,532)   |
| Net cash provided by operating activities   | 89,625                    | 72,587    |
| Investing activities  |                           |           |
| Purchase of intangible assets   | (1,525)                   | —         |
| Victory acquisition, net of cash acquired   | —                         | (616,564) |
| Capital expenditures  | (72,373)                  | (63,711)  |
| Proceeds from the sale of assets  | 4,856                     | —         |
| Other   | (1,250)                   | —         |
| Net cash used in investing activities   | (70,292)                  | (680,275) |
| Financing activities  |                           |           |
| Proceeds from revolving credit facility   | 263,700                   | 266,200   |
| Repayments on revolving credit facility   | (254,100)                 | (251,200) |
| Proceeds from receivables credit facility   | 21,094                    | 103,735   |
| Repayments on receivables credit facility   | (27,170)                  | (4,962)   |
| Proceeds from long-term debt  | —                         | 519,763   |
| Payment of loan amendment fees and debt issuance costs                                      | (2,388)                   | (10,790)  |



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|   |          |           |
|---|----------|-----------|
| Proceeds from other current borrowings                          | —        | 6,615     |
| Repayments on other current borrowings                          | —        | (2,195)   |
| Cash dividends paid   | (19,348) | (19,464)  |
| Payment of withholding taxes on vested stock awards             | (786)    | (2,448)   |
| Proceeds from exercises of stock options                        | 420      | 778       |
| Proceeds from shares issued to ESPP                             | 464      | 415       |
| Excess tax (deficiency) / benefit from stock-based compensation | (150)    | 1,511     |
| Net cash (used in) provided by financing activities             | (18,264) | 607,958   |
| Net increase in cash and cash equivalents                       | 1,069    | 270       |
| Cash and cash equivalents-beginning of period                   | 6,821    | 28,467    |
| Cash and cash equivalents-end of period                         | \$ 7,890 | \$ 28,737 |

See notes to consolidated financial statements.

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 notes 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 six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. For further information, refer to the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2015.

We report our operating results in two reportable segments: Paper and Packaging and Distribution. Our Paper and Packaging segment manufactures and sells a wide variety of containerboard, corrugated products and specialty paper for industrial and consumer markets. The Distribution segment was established June 1, 2015 concurrent with the acquisition of Victory Packaging, L.P. and its subsidiaries (“Victory”). For more information about our segments, see Note 11, Segment Information.

In these consolidated financial statements, certain amounts in prior periods’ consolidated financial statements have been reclassified to conform with the current period presentation. Amortization of intangible assets and the fair value of the contingent consideration liability are now separately identified in the Statement of Cash Flows and 2015 was recast to conform to the current year presentation. These reclassifications did not affect our results of operations, financial position, or cash flows.

2. Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers”. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial

assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The guidance in this update supersedes the revenue recognition requirements in Accounting Standards Codification (“ASC”) Topic 605, “Revenue Recognition”, and most industry-specific guidance throughout the Industry Topics of the Codification. Additionally, this update supersedes some cost guidance included in Subtopic 605-35, “Revenue Recognition—Construction-Type and Production-Type Contracts”. The standard will be effective for public entities for annual reporting periods beginning after December 15, 2017 and interim periods therein. Additionally the FASB approved the option to early adopt up to the original effective date (fiscal years beginning after December 15, 2016). We are currently evaluating the impact that the adoption of ASU 2014-09 will have on our financial position, results of operations and disclosures.

In April 2015, the FASB issued ASU 2015-03, “Simplifying the Presentation of Debt Issuance Costs”, which changes the presentation of debt issuance costs in financial statements. ASU 2015-03 requires an entity to present such costs in the balance sheet as a direct deduction from the related debt liability rather than as an asset. Amortization of the costs will continue to be reported as interest expense. ASU 2015-03 was adopted and it had no material impact on our financial statements.

In July 2015, the FASB issued ASU 2015-11, “Simplifying the Measurement of Inventory,” which is intended to simplify the subsequent measurement of inventories by replacing the current lower of cost or market test with a lower of cost and net realizable value test. The guidance applies only to inventories for which cost is determined by methods

other than last-in first-out and the retail inventory method. Application of the standard, which should be applied prospectively, is required for the annual and interim periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of this standard to have a material impact on its consolidated balance sheets.

In February 2016, the FASB issued ASU 2016-02, "Leases". This guidance revises existing practice related to accounting for leases under Accounting Standards Codification Topic 840 Leases (ASC 840) for both lessees and lessors. The new guidance in ASU 2016-02 requires lessees to recognize a right-of-use asset and a lease liability for virtually all of their leases (other than leases that meet the definition of a short-term lease). The lease liability will be equal to the present value of lease payments and the right-of-use asset will be based on the lease liability, subject to adjustment such as for initial direct costs. For income statement purposes, the new standard retains a dual model similar to ASC 840, requiring leases to be classified as either operating or finance. For lessees, operating leases will result in straight-line expense (similar to current accounting by lessees for operating leases under ASC 840), while finance leases will result in a front-loaded expense pattern (similar to current accounting by lessees for capital leases under ASC 840). While the new standard maintains similar accounting for lessors as under ASC 840, the new standard reflects updates to, among other things, align with certain changes to the lessee model. The guidance is effective for public entities for fiscal years beginning after December 15, 2018, including interim periods within those years. Early adoption is permitted for all entities. We are currently evaluating the impact that the adoption of ASU 2016-02 will have on our financial position, results of operations and disclosures.

In March 2016, the FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting", which will require all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also will allow an employer to repurchase more of an employee's shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election to account for forfeitures as they occur. The guidance is effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the impact that the adoption of ASU 2016-9 will have on our financial position, results of operations and disclosures.

### 3. Planned Maintenance Outages

Planned maintenance outage costs for the three months ended June 30, 2016 and 2015 totaled \$19.0 million and \$11.1 million, respectively, and are included in cost of sales. Outage costs for the three months ended June 30, 2016 and 2015 included an annual planned maintenance outage at the Company's paper mill in Roanoke Rapids, North Carolina. In 2016, the outage lasted approximately 9 days with a cost of approximately \$8.4 million and resulted in an 11,700 reduction in tons produced. In 2015, the outage lasted approximately 8 days with a cost of approximately \$8.0 million and resulted in a 10,400 reduction in tons produced. In addition, the Longview, Washington paper mill incurred \$6.2 million of outage costs for the quarter ended June 30, 2016 compared to \$0.2 million for the quarter ended June 30, 2015 primarily due to timing.

Planned maintenance outage costs for the six months ended June 30, 2016 and 2015 totaled \$25.6 million and \$19.7 million, respectively, and are included in cost of sales.



## 4. Inventories

Inventories consist of the following at June 30, 2016 and December 31, 2015, respectively:

|                                | (unaudited)      |                         |
|--------------------------------|------------------|-------------------------|
|                                | June 30,<br>2016 | December<br>31,<br>2015 |
| Raw materials                  | \$ 92,235        | \$ 101,250              |
| Work in process                | 6,917            | 6,165                   |
| Finished goods                 | 150,756          | 149,774                 |
| Replacement parts and supplies | 82,929           | 79,717                  |
| Inventory at FIFO costs        | 332,837          | 336,906                 |
| LIFO inventory reserves        | (1,195)          | (1,003)                 |
| Inventories                    | \$ 331,642       | \$ 335,903              |

## 5. Short-term Borrowings and Long-term Debt

KapStone and certain of our subsidiaries are parties to a Second Amended and Restated Credit Agreement dated June 1, 2015 (as amended from time to time, the “Credit Agreement”), which provides for a senior secured credit facility (the “Credit Facility”) of \$1.915 billion, consisting of a Term Loan A-1 in the aggregate amount of \$940 million and a Term Loan A-2 in the aggregate amount of \$475 million and a \$500 million revolving credit facility (the “Revolver”). In addition, the Credit Facility also includes an uncommitted accordion feature that allows the Company, subject to certain significant conditions, to request additional commitments from our existing or new lenders under the Credit Facility without further approvals of any existing lenders thereunder. The aggregate amount of such increases in potential commitments (and potential borrowings) is limited to \$600 million, unless the Company would maintain a pro forma total leverage ratio of 2.5 to 1.0 or less after giving effect to the increase in potential commitments (and potential borrowings).

On February 9, 2016, the Company entered into the First Amendment (“First Amendment”) to the Credit Agreement. The First Amendment modified, among other things, the financial covenant in the Credit Agreement related to maintenance of a maximum total leverage ratio by increasing the permitted total leverage ratio for fiscal quarters ending on or prior to June 30, 2018, and it modified certain defined terms used in the calculation of the financial covenants in a manner favorable to the Company. The First Amendment also modified the pricing grid applicable to interest rates and the unused commitment fee under the Credit Agreement in order to provide for an additional pricing level based on the total leverage ratio of the Company.

The Company paid approximately \$2.3 million of loan amendment fees associated with the First Amendment, which are being amortized over the term of the Credit Agreement using the effective interest method.

#### Short-term Borrowings

As of June 30, 2016, the Company had \$16.0 million of short-term borrowings outstanding under the Revolver which bear interest at 4.25 percent.

As of June 30, 2016, the Company has available borrowings of \$466.9 million under the Revolver.

#### Receivables Credit Facility

On June 8, 2016, the Company entered into Amendment No. 2 to the Receivables Purchase Agreement (the "Amendment to Receivables Purchase Agreement") amending its Receivables Purchase Agreement dated as of September 26, 2014 (as previously amended, the "Receivables Purchase Agreement"). In addition, the Company, KapStone Receivables, LLC ("KAR"), KapStone Kraft Paper Corporation, KapStone Container Corporation, KapStone Charleston Kraft LLC, Longview Fibre Paper and Packaging, Inc. and Victory Packaging, L.P. (collectively, the "Originators"), entered into Amendment No. 2 to the Receivables Sales Agreement (the "Amendment to Receivables

Sales Agreement” and, together with the Amendment to Receivables Purchase Agreement, the “Amendment”). The Amendment establish the primary terms and conditions of an accounts receivable securitization program (the “Securitization Program”). The Amendment extended the “Facility Termination Date” (as defined in the Receivable Purchase Agreement) from June 8, 2016 to June 6, 2017.

Under our Securitization Program, the Originators sell, on an ongoing basis without recourse, certain trade receivables to KAR, which is considered a wholly-owned, bankruptcy-remote variable interest entity (“VIE”). The Company has the authority to direct the activities of the VIE and, as a result, we have concluded that we maintain control of the VIE, are the primary beneficiary (as defined by accounting guidance) and, therefore, consolidate the account balances of KAR. As of June 30, 2016, \$382.0 million of our trade accounts receivables were sold to KAR. KAR in turn assigns a collateral interest in these receivables to a financial institution under a one-year \$275 million facility (the “Receivables Credit Facility”) for proceeds of \$259.5 million. The assets of KAR are not available to us until all obligations of KAR are satisfied in the event of bankruptcy or insolvency proceedings.

#### Debt Covenants

Our Credit Agreement governing our Credit Facility contains, among other provisions, covenants with which we must comply. The covenants limit our ability to, among other things, incur indebtedness, create additional liens on our assets, make investments, engage in mergers and acquisitions and sell any assets outside the normal course of business.

As of June 30, 2016, the Company was in compliance with all applicable covenants in the Credit Agreement.

#### Fair Value of Debt

As of June 30, 2016, the fair value of the Company’s debt approximates the carrying value of \$1.6 billion as the variable interest rates re-price frequently at current market rates. Our weighted-average cost of borrowings was 2.1 percent and 1.8 percent for the six months ended June 30, 2016 and June 30, 2015, respectively.

#### 6. Income Taxes

The Company’s effective income tax rate for the three and six months ended June 30, 2016 was 36.5 percent and 35.6 percent, respectively, compared to 35.2 percent and 35.0 percent for the three and six months ended June 30, 2015. Our tax rate is affected by recurring items such as state income taxes, as well as discrete items that may occur in any given period but are not consistent from period to period. In addition to state income taxes, the domestic



manufacturing deduction had the most significant impact on the difference between our statutory U.S. federal income tax rate of 35 percent and our effective income tax rate for both periods. The higher effective income tax rate in the three and six months ended June 30, 2016 includes a provision for an unfavorable state examination adjustment.

In the normal course of business, the Company is subject to examination by taxing authorities. The Company's open federal tax years are 2013 and 2014. The Company has open tax years for state income tax filings generally starting in 2012.

## 7. Net Income per Share

The Company's basic and diluted net income per share is calculated as follows:

|   | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|---|-----------------------------|------------|---------------------------|------------|
|   | 2016                        | 2015       | 2016                      | 2015       |
| Net income  | \$ 20,722                   | \$ 34,256  | \$ 36,896                 | \$ 60,356  |
| Weighted-average number of common shares for basic net income per share | 96,517,357                  | 96,269,619 | 96,458,354                | 96,196,889 |
| Incremental effect of dilutive common stock equivalents:                |                             |            |                           |            |
| Unexercised stock options   | 840,386                     | 1,124,212  | 813,369                   | 1,153,586  |
| Unvested restricted stock awards  | 272,043                     | 270,950    | 290,051                   | 297,191    |
| Weighted-average number of shares for diluted net income per share      | 97,629,786                  | 97,664,781 | 97,561,774                | 97,647,666 |
| Net income per share - basic  | \$ 0.21                     | \$ 0.36    | \$ 0.38                   | \$ 0.63    |
| Net income per share - diluted  | \$ 0.21                     | \$ 0.35    | \$ 0.38                   | \$ 0.62    |

Approximately 1,798,000 and 800,000 of unexercised stock options were outstanding at June 30, 2016 and 2015, respectively, but were not included in the computation of diluted earnings per share because the options were anti-dilutive.

## 8. Pension Plan and Post-Retirement Benefits

## Defined Benefit Plan

Net pension cost (benefit) recognized for the three and six months ended June 30, 2016 and 2015 for the Company's defined benefit plan (the "Pension Plan") is as follows:

|   | Three Months Ended |          | Six Months Ended June |          |
|---|--------------------|----------|-----------------------|----------|
|   | June 30,<br>2016   | 2015     | 30,<br>2016           | 2015     |
| Service cost for benefits earned during the quarter | \$ 1,124           | \$ 1,215 | \$ 2,249              | \$ 2,430 |
| Interest cost on projected benefit obligations      | 7,078              | 6,901    | 14,157                | 13,801   |
| Expected return on plan assets                      | (9,340)            | (10,236) | (18,680)              | (20,472) |
| Amortization of net loss                            | 1,157              | 534      | 2,314                 | 1,068    |

|                                    |       |            |       |            |
|------------------------------------|-------|------------|-------|------------|
| Amortization of prior service cost | 24    | 69         | 48    | 138        |
| Net pension cost (benefit)         | \$ 43 | \$ (1,517) | \$ 88 | \$ (3,035) |

The Company currently does not anticipate making any Pension Plan contributions in 2016. This estimate is based on current tax laws, plan asset performance, and liability assumptions, which are subject to change.

The Company provides postretirement health care insurance benefits through an indemnity plan for certain salary and non-salary Longview employees and their dependents. The Company anticipates making contributions to its postretirement plans in 2016 as claims are submitted.

#### Defined Contribution Plan

The Company offers 401(k) Defined Contribution Plans (“Contribution Plans”) to eligible employees. The Company’s monthly contributions are based on the matching of certain employee contributions or based on a union negotiated formula. For the three months ended June 30, 2016 and 2015, the Company recognized expense of \$2.4 million and \$5.0 million, respectively, for the Company contributions to the Contribution Plan. For the six months ended June 30, 2016 and 2015, the Company recognized expense of \$6.0 million and \$10.0 million, respectively, for the Company contributions to the Contribution Plans.

In March 2016, the Company suspended matching contributions to its Contribution Plans for certain employees. As a result, contributions were \$3.1 million lower in the quarter ended June 30, 2016, and \$5.3 million lower for the six months ended June 30, 2016. This was partially offset by an increase attributable to the inclusion of Victory under the Contributions Plans of \$0.5 million for the quarter ended June 30, 2016, and \$1.3 million for the six months ended June 30, 2016.

## 9. Stock-Based Compensation

The Company accounts for stock-based 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, 2016 and 2015 is as follows:

|  | Three Months<br>Ended June 30, |          | Six Months Ended<br>June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2016                           | 2015     | 2016                         | 2015     |
| Stock option compensation expense          | \$ 952                         | \$ 1,272 | \$ 2,741                     | \$ 3,222 |
| Restricted stock unit compensation expense | 989                            | 1,485    | 2,621                        | 3,315    |
| Total stock-based compensation expense     | \$ 1,941                       | \$ 2,757 | \$ 5,362                     | \$ 6,537 |

Total unrecognized stock-based compensation cost related to the stock options and restricted stock units as of June 30, 2016 and December 31, 2015 is as follows:

|   | June 30,<br>2016 | December<br>31,<br>2015 |
|---|------------------|-------------------------|
| Unrecognized stock option compensation expense          | \$ 5,748         | \$ 4,217                |
| Unrecognized restricted stock unit compensation expense | 6,769            | 5,094                   |
| Total unrecognized stock-based compensation expense     | \$ 12,517        | \$ 9,311                |

As of June 30, 2016, 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 2.3 years and 2.2 years, respectively.

## Stock Options

The following table summarizes stock options amounts and activity:

|                                 | Options   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Life (Years) | Intrinsic<br>Value<br>(dollars in<br>thousands) |
|---------------------------------|-----------|--|--|---|
| Outstanding at January 1, 2016  | 3,265,900 | \$ 15.45                                 |  |   |
| Granted                         | 1,237,455 | 12.72                                    |  |   |
| Exercised                       | (69,798)  | 8.88                                     |  |   |
| Lapsed (forfeited or cancelled) | (66,287)  | 23.61                                    |  |   |
| Outstanding at June 30, 2016    | 4,367,270 | \$ 14.65                                 |  |   |
| Exercisable at June 30, 2016    | 2,316,810 | \$ 10.04                                 | 5.0  | \$ 11,339                                       |

For the three and six months ended June 30, 2016, cash proceeds from the exercise of stock options totaled \$0.2 million and \$0.4 million, respectively. For the three and six months ended June 30, 2015, cash proceeds from the exercise of stock options totaled \$0.3 million and \$0.8 million, respectively.

## Restricted Stock

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

|                                | Units     | Weighted<br>Average<br>Grant<br>Price |
|--------------------------------|-----------|---------------------------------------|
| Outstanding at January 1, 2016 | 550,009   | \$ 24.60                              |
| Granted                        | 384,572   | 12.72                                 |
| Vested                         | (188,934) | 14.06                                 |
| Forfeited                      | (24,162)  | 24.47                                 |
| Outstanding at June 30, 2016   | 721,485   | \$ 21.03                              |

## 10. Commitments and Contingencies

## Legal Claims

We are from time to time subject to various administrative and legal investigations, claims and proceedings incidental to our business, including environmental and safety matters, labor and employment matters, personal injury claims, contractual disputes and taxes. We establish reserves for claims and proceedings when it is probable that liabilities exist and where reasonable estimates can be made. We also maintain insurance that may limit our financial exposure for defense costs, as well as liability, if any, for claims covered by the insurance (subject also to deductibles and self-insurance amounts). While any investigation, claim or proceeding has an element of uncertainty, and we cannot predict or assure the outcome of any claim or proceeding involving the Company, we believe the outcome of any pending or threatened claim or proceeding (other than those that cannot be assessed due to their preliminary nature), or all of them combined, will not have a material adverse effect on our results of operations, cash flows or financial condition.

The Company's subsidiary, Longview Fibre Paper and Packaging, Inc. ("Longview"), is a potentially responsible party under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") with respect to the Lower Duwamish Waterway Superfund Site in the State of Washington (the "Site"). The U.S. Environmental Protection Agency ("EPA") asserts that the Site is contaminated as a result of discharges from various businesses and government entities located along the Lower Duwamish Waterway, including a corrugated converting plant owned and operated by Longview. In November 2014, the EPA issued a Record of Decision ("ROD") for the Site. The ROD includes a selected remedy for the Site. In the ROD, EPA states that the total estimated net present value costs (discounted at 2.3%) for the selected remedy are \$342 million. Neither the Company nor Longview has received a

specific monetary demand regarding its potential liability for the Site. In addition, Longview is a participant in a non-judicial allocation process with respect to the Site. Pursuant to the non-judicial allocation process, Longview and other participating parties will seek to allocate certain costs, including but not limited to the costs necessary to perform the work under the ROD. The non-judicial allocation process is not scheduled to be completed until 2019. Based upon the information available to the Company at this time, the Company cannot reasonably estimate its potential liability for this Site.

There have been no material changes in any of our legal proceedings for the six months ended June 30, 2016.

#### Contingent Consideration

The Company's contingent consideration obligation relates to the Victory acquisition that was consummated on June 1, 2015 and is considered a Level 3 liability. The fair value of the obligation as of June 30, 2016 and December 31, 2015 was \$16.4 million and \$13.3 million, respectively. The fair value of the contingent consideration is driven by the probability of reaching the performance measures through December 1, 2017 required by the purchase agreement and the associated discount rate. The probability is estimated by reviewing financial forecasts and assessing the likelihood of reaching the required performance measures based on factors specific to the acquisition. The discount rate is determined by applying a risk premium to a risk-free interest rate. The total potential payout under this obligation is \$25.0 million.

## 11. Segment Information

**Paper and Packaging:** This segment manufactures and sells a wide variety of container board, corrugated products and specialty paper for industrial and consumer markets.

**Distribution:** Through Victory, a North American distributor of packaging materials, with its more than 60 distribution centers located in the United States, Mexico and Canada, the Company provides packaging materials and related products to a wide variety of customers.

Each segment's profits and losses are measured on operating profits before foreign exchange gains / (losses), net interest expense and income taxes.

| Three Months Ended June 30, 2016                          | Net Sales  |               |            | Depreciation            |                  |                      |              |
|---|------------|---------------|------------|-------------------------|------------------|----------------------|--------------|
|   | Trade      | Inter-segment | Total      | Operating Income (Loss) | and Amortization | Capital Expenditures | Assets (a)   |
| Paper and Packaging: Containerboard / Corrugated products | \$ 336,300 | \$ 20,524     | \$ 356,824 |                         |                  |                      |              |
| Specialty paper   | 174,209    | —             | 174,209    |                         |                  |                      |              |
| Other   | 22,062     | —             | 22,062     |                         |                  |                      |              |
| Paper and Packaging Distribution                          | \$ 532,571 | \$ 20,524     | \$ 553,095 | \$ 41,082               | \$ 38,163        | \$ 34,265            | \$ 2,507,161 |
| Corporate   | 252,340    | —             | 252,340    | 12,336                  | 5,702            | 932                  | 686,997      |
| Intersegment eliminations                                 | —          | —             | —          | (9,905)                 | 2,170            | 1,013                | 42,292       |
|   | —          | (20,524)      | (20,524)   | —                       | —                | —                    | —            |
|   | \$ 784,911 | \$ —          | \$ 784,911 | \$ 43,513               | \$ 46,035        | \$ 36,210            | \$ 3,236,450 |



| Three Months Ended June 30, 2015                          | Net Sales  |               |            | Operating Income (Loss) | Depreciation and Capital Expenditures Assets (a) |              |              |
|---|------------|---------------|------------|-------------------------|--|--------------|--------------|
|   | Trade      | Inter-segment | Total      |                         | Amortization                                     | Expenditures | Assets (a)   |
| Paper and Packaging: Containerboard / Corrugated products | \$ 365,790 | \$ 788        | \$ 366,578 |                         |  |              |              |
| Specialty paper   | 189,504    | —             | 189,504    |                         |  |              |              |
| Other   | 22,563     | —             | 22,563     |                         |  |              |              |
| Paper and Packaging Distribution                          | \$ 577,857 | \$ 788        | \$ 578,645 | \$ 71,844               | \$ 34,187  | \$ 30,256    | \$ 2,553,708 |
| Corporate   | 93,398     | —             | 93,398     | 1,720                   | 1,945  | 243          | 527,704      |
| Intersegment eliminations                                 | —          | —             | —          | (12,155)                | 864  | 4,450        | 223,792      |
|   | —          | (788)         | (788)      | —                       | —  | —            | —            |
|   | \$ 671,255 | \$ —          | \$ 671,255 | \$ 61,409               | \$ 36,996  | \$ 34,949    | \$ 3,305,204 |

| Six Months Ended June 30, 2016                            | Net Sales    |               |              | Operating Income (Loss) | Depreciation and Amortization | Capital Expenditures |
|---|--------------|---------------|--------------|-------------------------|-------------------------------|----------------------|
|   | Trade        | Inter-segment | Total        |                         |                               |                      |
| Paper and Packaging: Containerboard / Corrugated products | \$ 660,590   | \$ 36,993     | \$ 697,583   |                         |                               |                      |
| Specialty paper   | 348,647      | —             | 348,647      |                         |                               |                      |
| Other   | 43,374       | —             | 43,374       |                         |                               |                      |
| Paper and Packaging Distribution                          | \$ 1,052,611 | \$ 36,993     | \$ 1,089,604 | \$ 87,323               | \$ 75,299                     | \$ 66,620            |
| Corporate   | 470,515      | —             | 470,515      | 13,717                  | 11,363                        | 2,998                |
| Intersegment eliminations                                 | —            | —             | —            | (22,927)                | 3,912                         | 2,755                |
|   | —            | (36,993)      | (36,993)     | —                       | —                             | —                    |
|   | \$ 1,523,126 | \$ —          | \$ 1,523,126 | \$ 78,113               | 90,574                        | \$ 72,373            |

| Six Months Ended June<br>30, 2015                               | Net Sales    |                   |              | Operating<br>Income (Loss) | Depreciation<br>and<br>Amortization | Capital<br>Expenditures |
|---|--------------|-------------------|--------------|----------------------------|-------------------------------------|-------------------------|
|   | Trade        | Inter-<br>segment | Total        |                            |                                     |                         |
| Paper and Packaging:<br>Containerboard /<br>Corrugated products | \$ 710,098   | \$ 788            | \$ 710,886   |                            |                                     |                         |
| Specialty paper   | 368,707      | —                 | 368,707      |                            |                                     |                         |
| Other   | 45,341       | —                 | 45,341       |                            |                                     |                         |
| Paper and Packaging   | \$ 1,124,146 | \$ 788            | \$ 1,124,934 | \$ 130,136                 | \$ 68,664                           | \$ 56,506               |
| Distribution  | 93,398       | —                 | 93,398       | 1,720                      | 1,945                               | 243                     |
| Corporate   | —            | —                 | —            | (23,098)                   | 1,508                               | 6,962                   |
| Intersegment<br>eliminations                                    | —            | (788)             | (788)        | —                          | —                                   | —                       |
|   | \$ 1,217,544 | \$ —              | \$ 1,217,544 | \$ 108,758                 | \$ 72,117                           | \$ 63,711               |

- (a) The goodwill associated with the Victory acquisition was included in the Corporate segment for the quarter ended June 30, 2015 and was allocated to the Distribution segment as of September 30, 2015.

## 12. Subsequent Event

On July 1, 2016, the Company acquired Central Florida Box Corporation (“CFB”) with operations located in Lake Mary, Florida for approximately \$15.4 million, net of cash acquired. The acquisition was funded from borrowings on the Company’s Revolver. CFB operates a 191,000 square foot facility, accommodating office, warehouse and manufacturing space. CFB provides design, graphics, manufacturing, assembly, fulfillment, warehousing and distribution services to over 400 customers ranging from small, family-owned companies to large, national corporations.

This acquisition further strengthens the goal of increasing mill integration by up to 20,000 tons. Acquisition expenses incurred in the second quarter of 2016 totaled approximately \$0.2 million.

The purchase price allocation has not been completed due to the timing of the close of the acquisition.



## ITEM 2.

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

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about us that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as “may,” “should,” “could,” “would,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “continue,” or the negative of such terms or other similar expressions. Factors that might cause or contribute to such a discrepancy include, but are not limited to, those described in Part I Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 and in our other Securities and Exchange Commission filings. The information contained in this Form 10-Q represents our best judgment at the date of this report based on information currently available. In providing forward-looking statements, KapStone does not intend, and does not undertake any duty or obligation, to update its statements as a result of new information, future events or otherwise.

The following discussion should be read in conjunction with our Consolidated Financial Statements and related Notes thereto included elsewhere in this report.

## Comparison of Results of Operations for the Three Months Ended June 30, 2016 and 2015

(In thousands)

|  | Three Months Ended |            | Increase/<br>(Decrease) | % of Net Sales |         |
|--|--------------------|------------|-------------------------|----------------|---------|
|  | June 30,<br>2016   | 2015       |                         | 2016           | 2015    |
| Paper and packaging                                    | \$ 553,095         | \$ 578,645 | \$ (25,550)             | 70.5 %         | 86.2 %  |
| Distribution   | 252,340            | 93,398     | 158,942                 | 32.1 %         | 13.9 %  |
| Intersegment Eliminations                              | (20,524)           | (788)      | (19,736)                | (2.6) %        | (0.1) % |
| Net sales  | \$ 784,911         | \$ 671,255 | \$ 113,656              | 100.0 %        | 100.0 % |
| Cost of sales, excluding depreciation and amortization | 568,831            | 470,478    | 98,353                  | 72.5 %         | 70.1 %  |
| Depreciation and amortization                          | 46,035             | 36,996     | 9,039                   | 5.9 %          | 5.5 %   |
| Freight and distribution expenses                      | 70,978             | 53,891     | 17,087                  | 9.0 %          | 8.0 %   |
| Selling, general, and administrative expenses          | 55,554             | 48,481     | 7,073                   | 7.1 %          | 7.2 %   |
| Operating income                                       | \$ 43,513          | \$ 61,409  | \$ (17,896)             | 5.5 %          | 9.2 %   |
| Foreign exchange loss                                  | 872                | 53         | 819                     | 0.1 %          | — %     |

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|  |           |           |             |     |   |     |   |
|--|-----------|-----------|-------------|-----|---|-----|---|
| Interest expense, net                    | 10,006    | 8,515     | 1,491       | 1.3 | % | 1.3 | % |
| Income before provision for income taxes | 32,635    | 52,841    | (20,206)    | 4.1 | % | 7.9 | % |
| Provision for income taxes               | 11,913    | 18,585    | (6,672)     | 1.5 | % | 2.8 | % |
| Net income                               | \$ 20,722 | \$ 34,256 | \$ (13,534) | 2.6 | % | 5.1 | % |

Consolidated net sales for the quarter ended June 30, 2016 were \$784.9 million compared to \$671.3 million for the second quarter of 2015, an increase of \$113.6 million, or 16.9 percent. The increase in net sales was driven by the benefit of a full quarter of owning Victory in 2016 as compared to a partial quarter in 2015. Victory accounted for approximately \$158.9 million of the net sales increase which was partially offset by the Paper and Packaging segment's decrease in net sales for the quarter ended June 30, 2016.

Paper and Packaging segment net sales decreased by \$25.6 million to \$553.1 million for the quarter ended June 30, 2016, due to \$24.0 million of lower prices and less favorable product mix and \$21.0 million of lower domestic volume, partially offset by \$19.7 million of increased intersegment sales to Victory and higher export volumes. Average mill selling price per ton for the quarter ended June 30, 2016 was \$624 compared to \$667 for the prior year's quarter, reflecting lower containerboard and kraft paper prices and a less favorable product mix.

Paper and Packaging segment sales to customers by product line were as follows:

| Product Line Revenue:                   | Three Months Ended June 30, |            |                         |        | Tons Sold |         | Increase/  |        |
|---|-----------------------------|------------|-------------------------|--------|-----------|---------|------------|--------|
|   | 2016                        | 2015       | Increase/<br>(Decrease) | %      | 2016      | 2015    | (Decrease) | %      |
| Containerboard /<br>Corrugated products | \$ 356,824                  | \$ 366,578 | \$ (9,754)              | (2.7)% | 446,691   | 442,746 | 3,945      | 0.9 %  |
| Specialty paper                         | 174,209                     | 189,504    | (15,295)                | (8.1)% | 256,758   | 266,911 | (10,153)   | (3.8)% |
| Other                                   | 22,062                      | 22,563     | (501)                   | (2.2)% | —         | —       | —          | —      |
| Product sold                            | \$ 553,095                  | \$ 578,645 | \$ (25,550)             | (4.4)% | 703,449   | 709,657 | (6,208)    | (0.9)% |

Tons of product sold for the Paper and Packaging segment for the quarter ended June 30, 2016 was 703,449 tons compared to 709,657 tons for the quarter ended June 30, 2015, a decrease of 6,208 tons, or 0.9 percent, as follows:

- Containerboard sales increased by 3,945 tons to 446,691 tons, primarily due to corrugated products sales volume which increased by 4,949 tons primarily due to higher shipments to Victory.
- Specialty paper sales volume decreased by 10,153 tons to 256,758 tons, primarily due to lower DuraSorb® export shipments of 10,648 tons and lower pulp shipments of 5,646 tons partially offset by higher kraft paper shipments of 6,573 tons.

Distribution segment net sales of \$252.3 million reflect sales for Victory, which the Company acquired on June 1, 2015.

Cost of sales, excluding depreciation and amortization expense, for the quarter ended June 30, 2016 was \$568.8 million compared to \$470.5 million for the second quarter of 2015, an increase of \$98.3 million, or 20.9 percent. Cost of sales increased primarily due to the full quarter of owning Victory in 2016, as compared to a partial quarter in 2015. Victory accounted for approximately \$108.8 million for cost of sales in the quarter. Excluding the Victory acquisition, cost of sales decreased by \$10.5 million, or 2.2 percent, due to \$10.2 million of lower sales volume, \$4.0 million of deflation for material costs, \$3.0 million of productivity gains and \$2.2 million due to the suspension of certain employee benefits. These cost decreases were partially offset by \$7.9 million of higher planned maintenance outage costs and \$1.0 million of severance expense. Planned maintenance outage costs of approximately \$19.0 million and \$11.1 million are included in cost of sales for the quarters ended June 30, 2016 and 2015, respectively.

Depreciation and amortization expense for the quarter ended June 30, 2016 totaled \$46.0 million compared to \$37.0 million for the quarter ended June 30, 2015. The increase of \$9.0 million was primarily due to \$5.2 million from higher capital spending and \$3.8 million for the full quarter of owning Victory in 2016, as compared to a partial quarter in 2015, including \$3.1 million of amortization expense for acquired intangible assets attributable to the Victory acquisition.

Freight and distribution expenses for the quarter ended June 30, 2016 totaled \$71.0 million compared to \$53.9 million for the quarter ended June 30, 2015. The increase of \$17.1 million was primarily due to \$16.1 million for the full quarter of owning Victory in 2016, as compared to a partial quarter in 2015.

Selling, general and administrative expenses for the quarter ended June 30, 2016 totaled \$55.6 million compared to \$48.5 million for the quarter ended June 30, 2015. The increase of \$7.1 million, or 14.6 percent, was primarily due to Victory's direct selling and administrative expenses of \$19.1 million. Excluding the Victory acquisition, selling, general and administrative expenses decreased by \$12.0 million, or 24.7 percent. The decrease in selling, general and administrative expenses was mainly due to \$4.1 million due to the suspension of certain employee benefits (which includes \$2.2 million of lower management incentives due to lower earnings), \$2.9 million lower salary and benefit related expenses, \$2.0 million of Victory acquisition related expenses not incurred in 2016, \$0.9 million of lower stock compensation expense, \$0.9 million of other items and \$0.7 million of lower integration expenses. These decreases in expense were partially offset by \$1.0 million for the change in fair value of the contingent consideration liability related to the Victory acquisition and \$0.2 million of CFB acquisition related expenses. For the quarter ended

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June 30, 2016, selling, general and administrative expenses as a percentage of net sales decreased to 7.1 percent from 7.2 percent in the quarter ended June 30, 2015.

Net interest expense for the quarters ended June 30, 2016 and 2015 was \$10.0 million and \$8.5 million, respectively. Interest expense reflects interest on the outstanding borrowings under the Credit Facility and the Receivables Credit Facility and amortization of debt issuance costs. Interest expense was \$1.5 million higher in the quarter ended June 30, 2016, primarily due to higher term loan balances associated with the Victory acquisition.

Provision for income taxes for the quarters ended June 30, 2016 and 2015 was \$11.9 million and \$18.6 million, respectively, reflecting an effective income tax rate of 36.5 percent for the quarter ended June 30, 2016, compared to 35.2 percent for the similar period in 2015. The lower provision for income taxes in 2016 primarily reflects lower pre-tax income of \$20.2 million. The higher tax rate in the second quarter of 2016 included a provision for an unfavorable state tax examination adjustment.

The following discussion should be read in conjunction with our Consolidated Financial Statements and related Notes thereto included elsewhere in this report.

Comparison of Results of Operations for the Six Months Ended June 30, 2016 and 2015

(In thousands)

|  | Six Months Ended June 30, |              | Increase/<br>(Decrease) | % of Net Sales |         |  |  |
|--|---------------------------|--------------|-------------------------|----------------|---------|--|--|
|  | 2016                      | 2015         |                         | 2016           | 2015    |  |  |
| Paper and packaging                                    | \$ 1,089,604              | \$ 1,124,934 | \$ (35,330)             | 71.5 %         | 92.4 %  |  |  |
| Distribution   | 470,515                   | 93,398       | 377,117                 | 30.9 %         | 7.7 %   |  |  |
| Intersegment Eliminations                              | (36,993)                  | (788)        | (36,205)                | (2.4) %        | (0.1) % |  |  |
| Net sales  | \$ 1,523,126              | \$ 1,217,544 | \$ 305,582              | 100.0 %        | 100.0 % |  |  |
| Cost of sales, excluding depreciation and amortization | 1,102,108                 | 852,676      | 249,432                 | 72.4 %         | 70.0 %  |  |  |
| Depreciation and amortization                          | 90,574                    | 72,117       | 18,457                  | 5.9 %          | 5.9 %   |  |  |
| Freight and distribution expenses                      | 136,037                   | 97,318       | 38,719                  | 8.9 %          | 8.0 %   |  |  |
| Selling, general and administrative expenses           | 116,294                   | 86,675       | 29,619                  | 7.6 %          | 7.1 %   |  |  |
| Operating income                                       | \$ 78,113                 | \$ 108,758   | \$ (30,645)             | 5.2 %          | 9.0 %   |  |  |
| Foreign exchange loss                                  | 975                       | 938          | 37                      | 0.1 %          | 0.1 %   |  |  |
| Interest expense, net                                  | 19,817                    | 14,928       | 4,889                   | 1.3 %          | 1.2 %   |  |  |
| Income before provision for income taxes               | 57,321                    | 92,892       | (35,571)                | 3.8 %          | 7.7 %   |  |  |
| Provision for income taxes                             | 20,425                    | 32,536       | (12,111)                | 1.3 %          | 2.7 %   |  |  |
| Net income   | \$ 36,896                 | \$ 60,356    | \$ (23,460)             | 2.5 %          | 5.0 %   |  |  |



Consolidated net sales for the six months ended June 30, 2016 were \$1,523.1 million compared to \$1,217.5 million for the six months of 2015, an increase of \$305.6 million, or 25.1 percent. The increase in net sales was driven by the Victory acquisition. Victory accounted for approximately \$377.1 million of the net sales increase which was partially offset by the Paper and Packaging segment's decrease in net sales for the six months ended June 30, 2016.

Paper and Packaging segment net sales decreased by \$35.3 million to \$1,089.6 million for the six months ended June 30, 2016, due to \$51.9 million of lower prices and less favorable product mix and \$21.0 million of lower domestic sales volumes, partially offset by \$36.2 million of increased intersegment sales to Victory and higher export volumes. Average mill selling price per ton for the six months ended June 30, 2016 was \$624 compared to \$675 for the prior year's period, reflecting lower containerboard and kraft paper prices and a less favorable product mix.

Paper and Packaging segment sales to customers by product line were as follows:

| Product Line Revenue:                   | Six Months Ended June 30, |              |                         |        | Tons Sold |           | Increase/<br>(Decrease) |
|---|---------------------------|--------------|-------------------------|--------|-----------|-----------|-------------------------|
|   | Net Sales (in thousands)  |              | Increase/<br>(Decrease) | %      | 2016      | 2015      |                         |
|   | 2016                      | 2015         |                         |        | 2016      | 2015      |                         |
| Containerboard /<br>Corrugated products | \$ 697,583                | \$ 710,886   | \$ (13,303)             | (1.9)% | 880,692   | 856,074   | 24,618                  |
| Specialty paper                         | 348,647                   | 368,707      | (20,060)                | (5.4)% | 515,237   | 514,637   | 600                     |
| Other                                   | 43,374                    | 45,341       | (1,967)                 | (4.3)% | —         | —         | —                       |
| Product sold                            | \$ 1,089,604              | \$ 1,124,934 | \$ (35,330)             | (3.1)% | 1,395,929 | 1,370,711 | 25,218                  |

Tons of product sold for the Paper and Packaging segment for the six months ended June 30, 2016 was 1,395,929 tons compared to 1,370,711 tons for the six months ended June 30, 2015, an increase of 25,218 tons, or 1.8 percent, as follows:

- Containerboard sales increased by 24,618 tons to 880,692 tons, primarily due to higher export containerboard shipments of 33,403 tons and higher corrugated products sales volume of 8,252 tons. This was partially offset by lower domestic containerboard shipments of 17,037 tons.
- Specialty paper sales volume increased by 600 tons to 515,237 tons, primarily due to higher kraft paper shipments of 13,866 tons, pulp shipments of 8,193 tons, and Kraftpak® paper shipments of 2,584 tons. This was partially offset by lower DuraSorb® shipments of 24,043 tons.

Distribution segment net sales of \$470.5 million reflect sales for Victory, which the Company acquired on June 1, 2015.

Cost of sales, excluding depreciation and amortization expense, for the six months ended June 30, 2016 was \$1,102.1 million compared to \$852.7 million for the six months ended of 2015, an increase of \$249.4 million, or 29.2 percent. The increase in cost of sales was mainly due to the \$270.1 million attributable to Victory. Excluding the Victory acquisition, cost of sales decreased by \$20.7 million, or 2.4 percent, due to \$12.5 million of productivity gains, \$10.2 million of lower sales volume, \$3.0 million of deflation for material costs and \$4.4 million due to the suspension of certain employee benefits. These cost decreases were partially offset by \$5.9 million of higher planned maintenance outage costs, \$2.5 million of severance expense and \$0.9 million of other cost increases. Planned maintenance outage costs of approximately \$25.6 million and \$19.7 million are included in cost of sales for the six months ended June 30, 2016 and 2015, respectively.

Depreciation and amortization expense for the six months ended June 30, 2016 totaled \$90.6 million compared to \$72.1 million for the six months ended June 30, 2015. The increase of \$18.5 million was primarily due to \$9.0 million from higher capital spending and \$9.4 million attributable to Victory, including \$7.9 million of amortization expense for acquired intangible assets.

Freight and distribution expenses for the six months ended June 30, 2016 totaled \$136.0 million compared to \$97.3 million for the six months ended June, 2015. The increase of \$38.7 million was primarily due to \$39.0 million attributable to Victory.

Selling, general and administrative expenses for the six months ended June 30, 2016 totaled \$116.3 million compared to \$86.7 million for the six months ended June 30, 2015. The increase of \$29.6 million, or 34.1 percent, was primarily due to Victory's direct selling and administrative expenses of \$46.0 million. Excluding the Victory acquisition, selling, general and administrative expenses decreased by \$16.4 million, or 18.9 percent. The decrease in selling, general and administrative expenses was mainly due to \$8.9 million due to the suspension of certain employee benefits (which includes \$4.2 million of lower management incentives due to lower earnings), \$2.9 million lower salary and benefit related expenses, \$2.0 million of Victory acquisition related expenses not incurred in 2016, \$1.3 million of lower stock compensation expense, \$0.9 million of other items and \$0.7 million of lower integration expenses. These decreases in expense were partially offset by \$2.6 million for the change in fair value of the contingent consideration liability related to the Victory acquisition, \$0.6 million severance expense and \$0.2 million of CFB acquisition related

expenses. For the six months ended June 30, 2016, selling, general and administrative expenses as a percentage of net sales increased to 7.6 percent from 7.1 percent in the six months ended June 30, 2015.

Net interest expense for the six months ended June 30, 2016 and 2015 was \$19.8 million and \$14.9 million, respectively. Interest expense reflects interest on the outstanding borrowings under the Credit Facility and the Receivables Credit Facility and amortization of debt issuance costs. Interest expense was \$4.9 million higher in the six months ended June 30, 2016, primarily due to higher term loan balances associated with the Victory acquisition.

Provision for income taxes for the six months ended June 30, 2016 and 2015 was \$20.4 million and \$32.5 million, respectively, reflecting an effective income tax rate of 35.6 percent for the six months ended June 30, 2016, compared to 35.0 percent for the similar period in 2015. The lower provision for income taxes in 2016 primarily reflects lower pre-tax income of \$35.6 million.

## Liquidity and Capital Resources

### Credit Facility

The Company had \$466.9 million available under the Revolver at June 30, 2016. In addition, the Credit Facility also includes an uncommitted accordion feature that allows the Company, subject to certain significant conditions, to request additional commitments from our existing or new lenders under the Credit Facility without further approvals of any existing lenders thereunder. The aggregate amount of such increases in potential commitments (and potential borrowings) is limited to \$600 million, unless the Company would maintain a pro forma total leverage ratio of 2.5 to 1.0 or less after giving effect to the increase in potential commitments (and potential borrowings).

### Receivables Credit Facility

On June 8, 2016, the Company entered into Amendment No. 2 to the Receivables Purchase Agreement (the "Amendment to Receivables Purchase Agreement") amending its Receivables Purchase Agreement dated as of September 26, 2014 (as previously amended, the "Receivables Purchase Agreement"). In addition, the Company, KapStone Receivables, LLC ("KAR"), KapStone Kraft Paper Corporation, KapStone Container Corporation, KapStone Charleston Kraft LLC, Longview Fibre Paper and Packaging, Inc. and Victory (collectively, the "Originators"), entered into Amendment No. 2 to the Receivables Sales Agreement (the "Amendment to Receivables Sales Agreement" and together with the Amendment to Receivables Purchase Agreement, the "Amendment"). The Amendment establish the primary terms and conditions of an accounts receivable securitization program (the "Securitization Program"). The Amendment extended the "Facility Termination Date" (as defined in the Receivable Purchase Agreement) from June 8, 2016 to June 6, 2017.

As of June 30, 2016, the Company had \$259.5 million of outstanding borrowings under its \$275.0 million Receivables Credit Facility with an interest rate of 1.2 percent.

#### Debt Covenants

As of June 30, 2016, under the financial covenants of the Credit Agreement, the Company must comply on a quarterly basis with a maximum permitted leverage ratio as of the end of each such quarter. The leverage ratio is calculated by dividing the Company's debt net of available cash up to \$150 million by its rolling twelve month total earnings before interest expense, taxes, depreciation and amortization after accounting for allowable adjustments. The maximum permitted leverage ratio declines over the life of the Credit Agreement. On June 30, 2016, the maximum permitted leverage ratio was 4.50 to 1.00. On June 30, 2016, the Company was in compliance with a leverage ratio of 3.98 to 1.00.

The Credit Agreement also includes a financial covenant requiring a minimum interest coverage ratio. This ratio is calculated by dividing the Company's trailing twelve month total earnings before interest expense, taxes, depreciation and amortization after accounting for allowable adjustments by the sum of our net cash interest payments during the twelve month period. For the quarter ended June 30, 2016, the interest coverage ratio was required to be at

least 3.00 to 1.00. On June 30, 2016, the Company was in compliance with the Credit Agreement with an interest coverage ratio of 11.71 to 1.00.

As of June 30, 2016, KapStone was also in compliance with all other covenants in the Credit Agreement.

#### Income taxes

The Company's effective income tax rate, excluding discrete items for 2016, is projected to be 34.4 percent. The cash tax rate for 2016 is projected to be 26 percent.

#### Sources and Uses of Cash

| Six months ended June 30 (\$ in thousands) | 2016      | 2015      | Incr / (Dcr) |
|--|-----------|-----------|--------------|
| Operating activities                       | \$ 89,625 | \$ 72,587 | \$ 17,038    |
| Investing activities                       | (70,292)  | (680,275) | 609,983      |
| Financing activities                       | (18,264)  | 607,958   | (626,222)    |
| Total change in cash and cash equivalents  | \$ 1,069  | \$ 270    | \$ 799       |

Cash and cash equivalents increased by \$1.1 million from December 31, 2015, reflecting \$89.6 million of net cash provided by operating activities, \$70.3 million of net cash used in investing activities and \$18.3 million of net cash used in financing activities in the first six months of 2016.

Net cash provided by operating activities was \$89.6 million, comprised primarily of net income for the first six months of \$36.9 million and non-cash charges of \$101.8 million. Changes in operating assets and liabilities used \$49.1 million of cash. Net cash provided by operating activities increased by \$17.0 million in the six months ended June 30, 2016, compared to the six months ended June 30, 2015, mainly due to a \$16.6 million decrease in cash used for working capital and higher non-cash charges of \$23.9 million, partially offset by \$23.5 million of lower net income. The decrease in cash used for working capital in the six months ended June 30, 2016 compared to 2015 is primarily due to lower inventory and trade accounts receivables partially offset by lower trade accounts payable.

Net cash used in investing activities includes \$72.4 million for capital expenditures and \$2.8 million of other investing activities, partially offset by \$4.9 million of proceeds from asset sales. Net cash used by investing activities decreased by \$610.0 million in the six months ended June 30, 2016, compared to the six months ended June 30, 2015, mainly due to the acquisition of Victory in 2015.

Net cash used in financing activities was \$18.3 million and reflects \$6.1 million of net repayments under the Receivables Credit Facility, \$19.3 million of quarterly dividend payments and \$2.4 million of loan amendment fees, partially offset by \$9.6 million of net short-term borrowings under the Revolver. Net cash provided by financing activities decreased by \$626.2 million in the six months ended June 30, 2016, compared to the six months ended June 30, 2015, primarily due to higher net borrowings in 2015 as a result of the Victory acquisition.

#### Future Cash Needs

The Company expects that cash generated from operating activities will be sufficient to meet its remaining 2016 cash needs. The cash needs consist of approximately \$19.0 million for additional dividend payments, which are subject to board approval, and any additional working capital needs. In addition, capital expenditures for the full year are estimated at \$125.0 million.

Should the need arise, we have the ability to draw from our \$500.0 million Revolver. In addition, if available and subject to specified significant conditions, we may have the ability to request additional commitments from our existing or new lenders and borrow up to \$600.0 million under the accordion provision of our Credit Facility without further approvals of any existing lenders thereunder. As of June 30, 2016, the Company had \$16.0 million of borrowings under the Revolver and \$466.9 million of remaining Revolver availability, net of outstanding letters of credit.

### Off-Balance Sheet Arrangements

We have not entered into any off-balance sheet financing arrangements. The Company established KAR, a special purpose entity, in connection with the Receivables Credit Facility, which is consolidated as part of our financial statements. We have not guaranteed any debt or commitments of other entities or entered into any options on non-financial assets.

### ITEM 3.

#### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the sensitivity of income to changes in interest rates, commodity prices, equity prices and other market-driven rates or prices.

Under our Credit Agreement, at June 30, 2016 we have a Credit Facility consisting of two term loans totaling approximately \$1.3 billion outstanding and the Revolver that provides for borrowing of up to \$500 million. Depending on the type of borrowing, the applicable interest rate under the Credit Facility is calculated at a per annum rate equal to (a) LIBOR plus an applicable margin or (b) the base rate that is calculated as (i) the greatest of (x) the prime rate, (y) the federal funds effective rate plus 0.50% or (z) a daily rate equal to one month LIBOR plus 1% plus (ii) an applicable margin. The unused portion of the Revolver is also subject to an unused fee that is calculated at a per annum rate (the "Unused Fee Rate").

The applicable margin for borrowings under the Credit Facility and the Unused Fee Rate is determined by reference to the pricing grid based on the Company's total leverage ratio. Under such pricing grid, the applicable margins for Term Loan A-1 and Revolver ranges from 1.00% to 2.00% for Eurodollar loans and from 0.0% to 1.00% for base rate loans and the Unused Fee Rate ranges from 0.20% to 0.325%. The applicable margins for Term Loan A-2 ranges from 1.125% to 2.125% for Eurodollar loans and from 0.125% to 1.125% for base rate loans. At June 30, 2016 the weighted average interest rate of the term loans was 2.3 percent.

Under our Receivables Credit Facility, at June 30, 2016 we have \$259.5 million of outstanding borrowings. The outstanding capital of each investment in the receivable interests accrues yield for each day at a rate per annum equal to the sum of (a) for any day, the one-month Eurodollar rate for U.S. dollar deposits plus (b) the applicable margin. At June 30, 2016 the interest rate on outstanding amounts under the Receivables Credit Facility was 1.2 percent.



Changes in market rates may impact the base or LIBOR rate under all borrowings. For instance, if the LIBOR rate was to increase or decrease by one percentage point (1.0%), our annual interest expense would change by approximately \$15.8 million based upon our expected future monthly term loan balances per our existing repayment schedule and the Receivables Credit Facility.

We are exposed to price fluctuations of certain commodities used in production and distribution. Key materials and energy used in the production process include roundwood and woodchips, recycled fiber (OCC), containerboard, electricity, coal, natural gas and caustic soda. Diesel fuel prices have a direct impact on our Distribution segment. We generally purchase these commodities in each of our segments at market prices and do not use forward contracts or other financial instruments to hedge our exposure to price risk related to these commodities. We have one contract to purchase coal at fixed prices through December 31, 2016 and contracts to purchase natural gas through December 2018.

We are exposed to price fluctuations in the price of our finished goods. The prices we charge for our products are primarily based on market conditions.

We are exposed to currency fluctuations as we invoice certain European customers in Euros and Mexican customers in Pesos. The Company did not use forward contracts to reduce the impact of currency fluctuations during the quarter ended June 30, 2016. No such contracts were outstanding at June 30, 2016.

ITEM 4.

CONTROLS AND PROCEDURES

As of the end of the period covered by this report, our Chief Executive Officer and our Chief Financial Officer carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as required by Rule 13a-15(b) under the Securities Exchange Act of 1934. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of June 30, 2016.

There were no changes in our internal control over financial reporting during the six months ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. — OTHER INFORMATION

ITEM 1.

LEGAL PROCEEDINGS

There have been no material changes in the legal proceedings described in our Form 10-K for the year ended December 31, 2015.

ITEM 1A.

RISK FACTORS

There have been no material changes from the Risk Factors described in our Form 10-K for the year ended December 31, 2015.

ITEM 2.

UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3.

DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4.

MINE SAFETY DISCLOSURES

None.

ITEM 5.

OTHER INFORMATION

None.

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ITEM 6.

EXHIBITS

The following Exhibits are filed as part of this report.

| Exhibit No. | Description   |
|-------------|---|
| 10.14       | Amendment No. 2 to Receivables Purchase Agreement, dated as of June 8, 2016, by and among the Company, as the Servicer, KapStone Receivables, LLC, as Seller, the financial institutions from time to time party thereto, as Purchasers, and Wells Fargo Bank, N.A. as Administrative Agent. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on June 8, 2016.   |
| 10.15       | Amendment No. 2 to Receivables Sale Agreement, dated as of June 8, 2016, by and among the Company, as Servicer, KapStone Receivables, LLC, as Buyer, and KapStone Kraft Paper Corporation, KapStone Container Corporation, KapStone Charleston Kraft LLC, Longview Fibre Paper and Packaging, Inc., and Victory Packaging, L.P., as originators. Incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on June 8, 2016. |
| 10.16*      | 2016 Incentive Plan. Incorporated by reference to Annex A to Registrant's Definitive Proxy Statement filed on March 28, 2016.   |
| 31.1        | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2        | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1        | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |
| 32.2        | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |
| 101.INS     | XBRL Instance Document.   |
| 101.SCH     | XBRL Taxonomy Extension Schema.   |
| 101.CAL     | XBRL Taxonomy Extension Calculation Linkbase.   |
| 101.DEF     | XBRL Taxonomy Extension Definition Linkbase.  |
| 101.LAB     | XBRL Taxonomy Extension Label Linkbase.   |
| 101.PRE     | XBRL Extension Presentation Linkbase.   |

\* Management compensatory plan or arrangement.

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SIGNATURE

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KAPSTONE PAPER AND PACKAGING CORPORATION

July 27, 2016 By: /s/ Andrea K. Tarbox  
Andrea K. Tarbox  
Vice President and Chief Financial Officer

(duly authorized officer and principal financial officer)