KAPSTONE PAPER & PACKAGING CORP
Form 10-K
March 10, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2009

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 No.: 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) (ZIP Code)

Registrant's telephone number, including area code: **(847) 239-8800**

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:

Title of Each Class	Name of Exchange On Which Registered
Common Stock (Par Value $.0001)	New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT: **NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ý

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 ý 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 shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý

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 the definition of the above in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer o Accelerated Filer ý Non-Accelerated Filer o 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 ý

The aggregate market value of the 20,599,751 shares of Common Stock held by non-affiliates of the registrant on June 30, 2009, was $96,612,832. This calculation was made using a price per share of Common Stock of $4.69; the closing price of the Common Stock on the NASDAQ on June 30, 2009 the last day of the registrant's most recently completed second fiscal quarter of 2009. Solely for purposes of this calculation, all shares held by directors and executive officers of the registrant have been excluded. This exclusion should not be deemed an admission that these individuals are affiliates of the registrant.

On February 28, 2010, the number of shares of Common Stock outstanding, excluding 40,000 treasury shares, was 45,418,074.

DOCUMENTS INCORPORATED BY REFERENCE:

The registrant's Definitive Proxy Statement for its 2010 Annual Meeting of Stockholders will be filed with the Securities and Exchange Commission no later than 120 days after the end of the fiscal year covered by this Form 10-K pursuant to General Instruction G(3) of the Form 10-K. Information from such Definitive Proxy Statement will be incorporated by reference into Part III.

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Forward Looking Statements.

This Annual Report on Form 10-K 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, including the risks set forth in Item 1A. Risk Factors below, 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 our other Securities and Exchange Commission filings. All subsequent written and oral forward-looking statements attributable to KapStone or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements in this paragraph. KapStone disclaims any intention or obligation to publicly announce the results of any revisions to any of the forward-looking statements contained herein to reflect future events or developments.

PART I

Item 1. Business

Overview

KapStone Paper and Packaging Corporation, formerly Stone Arcade Acquisition Corporation, ("KapStone" or the "Company") was formed in Delaware as a special purpose acquisition corporation on April 15, 2005 for the purpose of effecting a merger, capital stock exchange, asset acquisition or other similar business combination with an unidentified operating business in the paper, packaging, forest products and related industries.

On August 19, 2005, we consummated our initial public offering of 20,000,000 units with each unit consisting of one share of our common stock and two warrants. Each warrant entitled the holder to purchase one share of our common stock at an exercise price of $5.00 per share. The units sold in our initial public offering were sold at an offering price of $6.00 per unit, generating gross proceeds of $120.0 million.

On January 2, 2007, we consummated the purchase from International Paper Company ("IP") of substantially all of the assets, and the assumption of certain liabilities, of the Kraft Papers Business ("KPB") for $155 million less $7.8 million of closing adjustments. The assets consisted of an unbleached kraft paper manufacturing facility in Roanoke Rapids, North Carolina, and Ride Rite® Converting, an inflatable dunnage bag manufacturer located in Fordyce, Arkansas, trade accounts receivable and inventories. The liabilities assumed consisted of trade accounts payable, accrued expenses and certain long-term liabilities. The purchase price included two contingent earn-out payments of up to $60 million if certain EBITDA targets are achieved. We obtained a $95 million senior secured credit facility from LaSalle Bank National Association, which was used to fund a portion of the KPB purchase price.

On July 1, 2008, we consummated the purchase from MeadWestvaco Corporation ("MWV") of substantially all of the assets and the assumption of certain liabilities of the Charleston Kraft Division ("CKD"), for $485 million less $8.9 million of working capital adjustments. The assets consisted of an unbleached kraft paper manufacturing facility in North Charleston, South Carolina, including a cogeneration facility, chip mills located in Elgin, Hampton, Andrews and Kinards, South Carolina and a lumber mill located in Summerville, South Carolina, trade accounts receivables and inventories. The

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liabilities assumed consisted of trade accounts payable, accrued expenses and certain long-term liabilities.

The CKD acquisition was financed by cash on hand and by a new senior secured credit facility of $515 million consisting of a five-year term loan of $390 million, a seven-year term loan of $25 million and a $100 million revolving credit facility. In addition, $40 million of seven-year 8.30% senior notes were issued. In connection with the transaction the Company paid off the remaining amount due under its prior credit facility.

On March 31, 2009, the Company consummated the sale of its dunnage bag business to Illinois Tool Works Inc. for $36.0 million less $1.1 million of working capital adjustments. The Company considered the sale an opportunity to lower its debt and focus on its core business. The sale of the dunnage bag business accelerated a contingent earn-out payment of $4.0 million. As a result, future contingent earn-out payments total $55.0 million if certain EBITDA targets are achieved.

Acquisitions

In an effort to diversify and/or grow our business we have been, and continue to be, engaged in evaluating a number of potential acquisition opportunities. No assurance can be given that we will consummate additional transactions. The structuring and financing of any future acquisitions may be dependent on the terms and availability of additional financing to us that either replaces or does not conflict with the Company's existing senior secured credit facility.

General

We produce and sell a variety of unbleached kraft paper, linerboard, saturating kraft and unbleached folding carton board.

In 2009, the Company determined, in accordance with Accounting Standards Codification 280, Segment Reporting, to make changes to its reportable segments. All segment disclosures in this Report are presented in conformance with the new presentation. For additional information regarding the change in segments, and the results of our segments, see Note 20 of the Notes to Consolidated Financial Statements.

Industry Overview

We view the unbleached kraft market as including kraft paper, linerboard, saturating kraft and unbleached folding carton board.

The American Forest and Paper Association ("AF&PA") estimation of the size of the U.S. kraft paper market is as follows:

(In millions)	2009	2008	2007
Total U.S. sales	1.29 tons	1.56 tons	1.55 tons
U.S. production	1.25 tons	1.49 tons	1.36 tons
Imports	0.20 tons	0.25 tons	0.36 tons
Exports	0.16 tons	0.18 tons	0.17 tons
U.S. operating rates	73%	93%	94%

The kraft paper market is comprised of three general product types. Multiwall paper is used to produce bags for agricultural products, pet food, baking products, cement and chemicals. Specialty converting paper is used for a large variety of end uses within coating and laminating applications that require a smooth surface. Specialty converting is also used to produce shingle wrap, end caps, roll wrap and dunnage bags. Grocery bag and sack paper is converted into retail shopping bags, grocery sacks and lawn and leaf refuse bags.

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Over the last two decades unbleached kraft paper capacity declined due to a shift in market demand from paper bags to plastic. The multiwall market has contracted due to conversion to plastics in certain end-use markets primarily in the insulation, pet food and lawn and garden markets. After bottoming in 2006, capacity has increased 2.3% in 2007 and 4.6% in 2008 as the net impact of machines shifting from other grades to kraft paper was realized. According to AF&PA's annual survey kraft paper capacity was 1.7 million tons in 2009 and is expected to hold constant through 2011.

Linerboard is primarily used to manufacture corrugated containers for packaging products. U.S. demand for corrugated boxes and linerboard tends to be driven by industrial production of processed foods, nondurable goods and certain durable goods.

The AF&PA estimation of the size of the U.S. linerboard market is as follows:

(In millions)	2009	2008	2007
Total U.S. sales	19.8 tons	21.3 tons	22.6 tons
U.S. production	22.6 tons	24.2 tons	25.2 tons
Imports	0.37 tons	0.56 tons	0.55 tons
Exports	3.18 tons	3.32 tons	3.20 tons
U.S. operating rates	85%	91%	97%

We target our linerboard for specialty independent corrugated and laminated products customers who focus on specialty niche packaging.

Our saturating kraft product line is used in multiple industries including construction, electronics manufacturing and furniture manufacturing around the world. The major end-use markets are in the thin high pressure laminates (HPL) creating decorative surfaces such as kitchen and bath countertops, home and office furniture and flooring. In Europe, there is a growing and distinct HPL segment that involves a much thicker product called compact laminates, which create surfacing products such as exterior cladding, partitions and doors. In Asia, there is significant use of our products for the manufacturing of printed circuit boards (PCB) and copper clad laminates (CCL) and there is also a growing use for thin HPL in decorative surfaces. There is no published data reporting the size of the market. Barriers to entry for producing high quality saturating kraft are high as it is a technically difficult grade of paper to produce.

Our unbleached folding carton board product line, sold under the trade name Kraftpak®, is a unique, low density virgin fiber board. Kraftpak® applications are widely spread throughout end uses in the general folding carton segment of paperboard packaging. KapStone believes that the best growth opportunities for Kraftpak® are in consumer brands that are changing their images to promote environmental friendliness and sustainability, thus taking shares from coated recycled board, coated natural kraft board and solid bleached sulfate board which are much larger markets. There is no published data reporting the size of the market.

Customers

The Company has over 400 customers, many of which are leading world class converters. In 2007, the Company had approximately 100 customers. Upon acquiring CKD in July of 2008, the Company's number of customers increased to approximately 400, of which approximately 100 were based in foreign countries. No customer accounted for more than 10% of consolidated net sales in 2009. Graphic Packaging accounted for 10.7% of consolidated net sales in 2008. Altivity Packaging and Exopack, LLC, accounted for 17.1% and 10.4% of consolidated net sales in 2007, respectively. In 2008, Graphic Packaging acquired Altivity Packaging. KapStone continues to build long-term relationships, most of which were established by KPB and CKD before we acquired them. We believe that the risk of losing customers or business with customers is reduced due to the long-term relationships that have been established.

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Kraft paper is sold to converters who produce multiwall bags for agricultural products, pet food, cement and chemicals, grocery bags and specialty conversion products such as wrapping paper products, dunnage bags and roll wrap. The Company's kraft paper product line accounted for approximately 26% of total unit sales for 2009, 43% for 2008 and 79% for 2007.

Linerboard is sold to domestic and foreign converters in the corrugated box industry and to other converters for a variety of end users including laminated tier sheets and wrapping material, among others. Our focus is on independent producers who do not have their own mill systems or producers who commonly purchase linerboard on the open market. The Company's linerboard product line accounted for approximately 47% of total unit sales for 2009, 32% for 2008 and 21% for 2007.

Our saturating kraft customer base is split among three geographic regions, the Americas, Europe and Asia. Approximately 70% of our sales are exports to customers in Europe, Latin America and Asia where growth opportunities are favorable. KapStone, or its predecessor, have done business with many of these customers for well over 30 years. Some customers have consolidated to form a greater presence in their markets. Customer consolidation is particularly evident for North America and in the early phase in Europe. In Asia, there are numerous players and it is a highly fragmented market making entry difficult for some companies that do not have a presence in the region. KapStone has acquired a leadership position through knowledge of our markets and understanding the technical needs of our customers' manufacturing process and the demanding requirements of their products. The Company's saturating kraft product line accounted for approximately 21% of total unit sales for 2009 and 19% for 2008.

Our Kraftpak® customer base consists primarily of integrated and independent converters in the folding carton industry. The Company's Kraftpak® product line accounted for approximately 6% of total unit sales for 2009 and 6% for 2008.

Sales and Marketing

The sales and marketing team works directly with our technical, manufacturing and product development teams to offer solutions and meet new customer demands and product requirements. We market and sell our products through a national sales force for our domestic sales. Our international sales are supported by sales teams based in Europe and Asia. We sell export linerboard to unaffiliated resellers.

Manufacturing and Distribution

Our manufacturing facilities are based in Roanoke Rapids, North Carolina and North Charleston, South Carolina and include production facilities consisting of integrated pulp and paper mills that produce kraft paper, linerboard, saturating kraft products sold under the DuraSorb® brand and folding carton board sold under the Kraftpak® brand. Our Roanoke Rapids paper mill began operations in 1907 and the North Charleston paper mill began operations in 1937.

The Company's paper mills' annual production capacity is approximately 1.3 million tons. Machinery and equipment is regularly inspected to maintain good working order through planned maintenance outages.

Softwood pulp used to make kraft paper, folding carton board and linerboard is produced from a combination of locally sourced roundwood and pine woodchips. After the wood is debarked and chipped, the chips are loaded into digesters for cooking. Woodchips, chemicals and steam are mixed in the digester to produce softwood pulp. Hardwood pulp is produced in North Charleston in a similar fashion for the production of DuraSorb® saturating kraft. The pulp is screened and washed through a series of washers, and then stored prior to the paper making process. The Company processes softwood pulp using up to five paper machines. Management monitors productivity on a real-time basis with on-line reporting tools that track production values versus targets. Overall equipment efficiency is also monitored daily through production reporting systems.

The majority of our domestic sales are distributed directly to customers by a combination of third parties mainly by truck and rail. Export linerboard and saturating kraft are shipped to customers via ocean vessel.

Transitional Support

We have entered into two transitional services agreements to provide for certain services, including information technology and centralized transaction processing, until we could convert acquisitions to our own Enterprise Resource Planning ("ERP") systems. Our transitional support services from IP ended on April 1, 2008 after a term of 15 months at a cost of $3.2 million. Our transitional service agreement with MWV, which began on July 1, 2008, ended on December 31, 2009, resulting in a term of 18 months at a cost of $8.7 million.

The total cost of transferring services from IP to us was approximately $6.0 million, consisting primarily of the cost of installing a new ERP system which included general ledger, order entry and receivables management, purchasing and payment plus additional modules. The system supports operations in North Carolina and South Carolina as well as the corporate headquarters. We incurred approximately $5.8 million to migrate and upgrade the Charleston operations to our ERP system.

Suppliers

The raw materials needed to process unbleached kraft paper and related products consist primarily of round wood, woodchips and chemicals. In addition, we purchase coal, fuel oil and natural gas to run boilers and our cogeneration facility in South Carolina. We believe that these raw materials are readily available and that there are a number of suppliers from whom the materials can be bought in the open market.

In 2009, approximately 20% of our combined paper mills' fiber supply (round wood and woodchips) was delivered under a long-term supply agreement. Upon acquisition of the CKD business from MWV, we entered into a 15 year fiber supply agreement whereby MWV provides us with up to 25% of our South Carolina fiber requirements with prices tied to a market index. The balance of fiber is purchased from third parties in North Carolina, Virginia, Georgia and South Carolina.

The primary chemical used in our pulp making process is caustic soda which we purchase at market prices. We have fixed-pricing contracts with two long-term suppliers for coal. Fuel oil is purchased from third parties at market prices.

Typical contracts for raw materials range from one to three years in length and are at fixed pricing, driven by market pricing, or tied to a documented moving index for each material. As costs for raw materials, supplies and services increase, we implement price increases to recover these rising material costs from our customers, when possible. We currently do not use futures contracts or enter into hedging arrangements to manage the risk of fluctuations in coal or fuel prices. Thus, if we cannot pass on the rise in energy or other costs to our customers, such rise in costs will have an adverse effect on our gross profit margins.

Competition

We are one of the leading manufacturers of unbleached kraft paper in North America. Other key U.S. market suppliers are Georgia-Pacific, Longview Fibre, Delta Natural, and Smurfit-Stone. A number of other competitors comprise the remainder of North American unbleached kraft paper production. We believe the key parameters on which North American unbleached kraft suppliers compete are supply reliability, delivered price and product quality. We have longstanding relationships with many of our customers and historically have entered into contracts with initial terms of at least two years. We believe our longstanding relationships are based on our ability to provide the best value proposition to our customers through quality products, consistent and reliable service and technical innovation.

The overall U.S. linerboard capacity is in excess of 25 million tons. As such, the combined market share between our two mills is just over two percent. International Paper is the largest producer, followed by Smurfit-Stone, Georgia-Pacific and Temple-Inland Packaging. Our emphasis is on the independent producers of corrugated packaging and other users of linerboard.

In the saturating kraft market, there are three major manufacturers (KapStone, International Paper and Stora Enso). The remainder is supplied by local producers of lower quality material in various regions of the world.

Kraftpak® competes primarily with uncoated recycled board which is produced by Newark, Rock-Tenn, Caraustar and Graphic Packaging, and a variety of smaller producers.

Environmental Regulation

Our operations are subject to environmental regulation by federal, state, and local authorities in the United States, including requirements that regulate discharge into the environment, waste management, and remediation of environmental contamination. Environmental permits are required for the operation of our businesses and are subject to revocation, modification and renewal. Governmental authorities have the power to enforce compliance with environmental requirements and violators are subject to injunctions, civil penalties and criminal fines. Third parties may also have the right to sue to enforce compliance with such regulations.

KapStone is committed to maintaining high environmental quality standards which meet or exceed those established by all relevant environmental laws, regulations and other applicable requirements including Sustainable Forestry Initiatives. KapStone's goal is 100% compliance with all environmental laws and regulations wherever we do business. This is achieved by identifying, understanding and giving priority consideration to the environmental aspects and impacts of KapStone's activities, products and services while integrating continual environmental improvement, pollution prevention and employee diligence into daily operations.

On December 8, 2009, the EPA ("Environmental Protection Agency") announced that for the first time in nearly 40 years, it is proposing to strengthen the nation's sulfur dioxide (SO_2) air quality standard to protect public health. This standard and the impending Industrial Boiler MACT standard will affect fuel combustion sources at our facilities. Our North Carolina mill has completed an application for a Boiler MACT permit under new state regulations with expectation of compliance in 2014. We continue to monitor the process the EPA is undertaking to develop new standards for industrial boilers and process heaters so that we can determine our potential liability regarding any future related regulations.

The EPA is continuing the development of new programs and standards, such as additional wastewater discharge allocations, water intake structure requirements and national ambient air quality standards. We believe that our operations are in compliance in all material respects with all current environmental regulations and we are not aware of any pending regulatory agency compliance actions.

The U.S. Congress is actively considering legislation to reduce emissions of greenhouse gases. In addition, several states have already taken legal measures to require the reduction of emissions of greenhouse gases by companies and public utilities, primarily through the planned development of greenhouse gas emission inventories and/or regional greenhouse gas cap and trade programs. Passage of climate control legislation by Congress or various states of the U.S., or the adoption of regulations by the EPA or analogous state agencies that restrict emissions of greenhouse gases in areas in which we conduct business, may have a material effect on our operations in the United States. We expect that we will not be disproportionately impacted by these measures relative to typical owners of comparable properties in the United States.

Employees

At December 31, 2009, KapStone had approximately 1,600 employees. Of these employees, approximately 1,000 employees were covered by collective bargaining agreements with the United Steelworkers. Currently, there is a collective bargaining agreement in place with union employees in Roanoke Rapids, North Carolina, through August 31, 2010. There are approximately 600 employees at the mill in North Charleston, South Carolina that are represented by one of four unions. Those employees are currently working without a contract. Their respective union contract had expired on June 30, 2009. The union employees represented by three of the four unions have approved the Company's most recent contract offer. The Company is in negotiations with the remaining union. There have not been any slow-downs or work stoppages since the contracts expired on June 30^{th} of last year. We believe that we have a good relationship with our employees and union leadership.

In January 2007, upon consummation of the acquisition of KPB, we began hiring a corporate staff to manage our operations. This included a vice president and chief financial officer, a vice president and general manager to manage KPB and other corporate staff employees. Additional hiring at the corporate headquarters occurred throughout 2007, 2008 and 2009 upon termination of post-acquisition transitional services agreements with IP and MWV.

As part of the CKD acquisition, we acquired 11 employees who are located in Europe and Asia. These employees perform sales and order entry activities in support of the Company's export shipments to customers based in Europe and Asia.

International Sales

For the years ended December 31, 2009, 2008 and 2007, the Company had export shipments from the United States to customers in foreign countries of $239 million, $165 million and $44 million, respectively. No foreign country accounted for more than 10% of our consolidated net sales for any year.

Website Access to Company Reports

The Company's annual reports on Form 10-K, including this Form 10-K, as well as the quarterly reports on Form 10-Q and current reports on Form 8-K, and all amendments to those reports are filed electronically with the Securities and Exchange Commission ("SEC") and are also available free of charge through our website, *www.kapstonepaper.com,* as soon as reasonably practicable after such material is filed electronically with, or furnished to, the SEC. Also, copies of our annual report will be made available, free of charge, upon written request.

Item 1A. Risk Factors

You should carefully consider the following risk factors, together with the other information contained in this annual report on Form 10-K, in evaluating us and our business before making an investment decision regarding our securities. If any of the events or circumstances described in the following risk factors were to actually occur, our business, financial condition or results of operations could be materially and adversely affected. The risks listed below are not the only risks that we face.

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Risks associated with our business

Recent changes in U.S. and global economic conditions could have a continuing adverse effect on the profitability of some or all of our businesses.

Recent concerns over declining consumer and business confidence, the availability and cost of credit, reduced consumer spending and business investment, the volatility and strength of the capital and credit markets, and inflation all affect the business and economic environment and, ultimately, the profitability of our business. In an economic downturn characterized by higher unemployment, lower family income, lower corporate earnings, lower business investment and lower consumer spending, the demand for our products is adversely affected. Adverse changes in the economy could negatively affect earnings and could have a material adverse effect on our business, results of operations, cash flows and financial position. We cannot predict whether or when such circumstances may occur, or what impact, if any such circumstances could have on our business, results of operations, cash flows and financial position.

Conditions in the global capital and credit markets and the economy generally may materially adversely affect our business, results of operations and financial position and we do not expect these conditions to improve in the near future.

Our results of operations and financial position could be materially affected by adverse changes in the global capital and credit markets and the economy generally, including recent declines in consumer and business confidence and spending, both in the U.S. and elsewhere around the world. The capital and credit markets have been experiencing extreme volatility and disruption over the last year. In some cases, these markets have exerted downward pressure on availability of liquidity and credit and increased the costs of credit when such credit is available. Conditions in the capital and credit markets and the effects of the declines in consumer and business confidence and spending may adversely impact the ability of our lenders, suppliers and customers to conduct their business activities. The consequences of such adverse effects could include the interruption of production at the facilities of our customers, the reduction, delay or cancellation of customer orders, delays in or the inability of customers to obtain financing to purchase our products, and bankruptcy of customers or other creditors. Moreover, the current worldwide financial crisis has reduced the availability of liquidity and credit to fund or support the continuation and expansion of business operations worldwide as many lenders and institutional investors have reduced and, in some cases, ceased to provide funding to borrowers.

While we have procedures to monitor and limit exposure to credit risk, there can be no assurance such procedures will effectively limit our credit risk and avoid losses, which could have a material adverse effect on our business, results of operations and cash flows and financial position.

We rely on key customers and a loss of one or more of our key customers could adversely affect our business, results of operations, cash flows and financial position.

During the year ended December 31, 2009, no customer accounted for more than 10% of consolidated net sales. However, losses of key customers could significantly impact our business, results of operations, cash flows and financial position.

We are dependent upon key management executives the loss whom may adversely impact our business.

We depend on the expertise, experience and continued services of corporate and mill management. The loss of such management, or an inability to attract or retain other key individuals, could materially adversely affect our business. There can be no assurance that our salaries and incentive compensation plans will allow us to retain the services of these key management executives or hire new key employees.

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KapStone's indebtedness may adversely affect its financial health.

As of December 31, 2009, we had approximately $152 million of outstanding debt. As a result of the indebtedness, our ability to obtain additional financing for working capital, capital expenditures, acquisitions or other general corporate purposes may be impaired in the future. The debt could make us vulnerable to economic downturns and may hinder our ability to adjust to rapidly changing market conditions.

A substantial portion of our cash flow from operations will be needed to meet the payment of principal and interest on our indebtedness. The business may not generate sufficient cash flow from operations to enable it to repay our indebtedness and to fund other liquidity needs, including capital expenditure requirements. The indebtedness incurred by us under our senior secured credit facility bears interest at variable rates, and therefore if interest rates increase, our debt service requirements would increase. In such case, we may need to refinance or restructure all or a portion of our indebtedness on or before maturity. We may not be able to refinance any of our indebtedness, including the senior secured credit facility, on commercially reasonable terms, or at all. If we cannot service or refinance our indebtedness, we may have to take actions such as selling assets, seeking additional equity or reducing or delaying capital expenditures, any of which could have a material adverse effect on our operations and financial condition.

Our senior secured credit facility contains restrictive covenants that limit our liquidity and corporate activities. Our credit facility imposes operating and financial restrictions that limit our ability to:

- incur additional indebtedness;
- create additional liens on our assets;
- make investments;
- engage in mergers or acquisitions;
- pay dividends; and
- sell all or any substantial part of our assets

In addition, the credit facility also imposes other restrictions on us. Therefore, we would need to seek permission from the lenders in order to engage in certain corporate actions. The lenders' interests may be different from ours, and no assurance can be given that we will be able to obtain the lenders' permission when needed. This may prevent us from taking actions that are in our best interest.

The credit facility requires us to maintain certain financial ratios. The failure to maintain the specified ratios could result in an event of default if not cured or waived.

In the event of a default under our senior credit facility, the lenders generally would be able to declare all of such indebtedness, together with accrued interest, to be due and payable. In addition, borrowings under the credit facility are secured by a first priority lien on all of our assets and, in the event of a default under that facility the lenders generally would be entitled to seize the collateral. A default under any debt instrument, unless cured or waived, would likely have a material adverse effect on our business and financial condition.

If we fail to extend or renegotiate the collective bargaining agreements with the United Steelworkers Union as they expire from time to time, or if our unionized employees were to engage in a strike or other work stoppage, our business and operating results could be materially harmed.

Most of our hourly paid employees are represented by trade unions. We are a party to collective bargaining contracts which apply to approximately 600 employees at the North Charleston mill and

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385 employees at the Roanoke Rapids mill. No assurance can be given that we will be able to successfully extend or renegotiate the collective bargaining agreements as they expire from time to time. Currently, there is a collective bargaining agreement in effect with respect to Roanoke Rapids through August 31, 2010. There are approximately 600 union employees at the mill in North Charleston, South Carolina that are represented by one of four unions. Those employees have been working without a contract since June 30, 2009. However, the employees represented by three of the four unions have approved the Company's most recent contract offer. The Company remains in negotiations with the remaining union. If we are unable to extend or negotiate new agreements without work stoppages, it could negatively impact our ability to manufacture our products and adversely affect results of operations.

Our operations are global in nature, and accordingly our business, results of operations, cash flows and financial position could be adversely affected by the political and economic conditions of the countries in which we conduct business, by fluctuations in exchange rates and other factors related to our international operations.

Approximately 38% and 32% of our annual revenues in 2009 and 2008, respectively, were derived from export sales. As our international operations and activities expand, we face increasing exposure to the risks of selling to customers in foreign countries. These factors include:

- Changes in foreign currency exchange rates which could adversely affect selling prices for our products, and therefore our competitive position in a particular market.

- Trade protection measures in favor of local producers of competing products, including government subsidies, tax benefits, trade actions (such as anti-dumping proceedings) and other measures giving local producers a competitive advantage over the company.

- Changes generally in political, regulatory or economic conditions in the countries in which we conduct business.

These risks could affect the cost of selling our products, our pricing, sales volume, and ultimately our financial performance. The likelihood of such occurrences and their potential effect on the company vary from country to country and are unpredictable.

If we fail to maintain effective systems for disclosure controls and internal control over financial reporting, we may be unable to comply with the requirements of Section 404 of the Sarbanes Oxley Act of 2002 in a timely manner.

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to document and test the effectiveness of our internal controls over financial reporting in accordance with an established internal control framework and to report on management's conclusion as to the effectiveness of its internal controls. It also requires an independent registered public accounting firm to test our internal controls over financial reporting and report on the effectiveness of such controls for our fiscal year ending December 31, 2009, and subsequent years. It may cost us more than we expect to comply with these controls and procedure related requirements. If we discover areas of our internal controls that need improvement, we cannot be certain that any remedial measures taken will ensure that we implement and maintain adequate internal controls over financial processes and reporting in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation could harm our operating results or cause us to fail to meet our reporting obligations.

We may be required to record a charge to our earnings if our goodwill becomes impaired.

We test for impairment of goodwill annually at the beginning of the fourth quarter in accordance with generally accepted accounting standards. When events or changes in circumstances indicate that the carrying value for such assets may not be recoverable, however, we review goodwill for impairment on an interim basis. Factors that may be considered a change in circumstances requiring our interim testing include a decline in stock price as compared to our book value per share, future cash flows and slower growth rates. In connection with future annual or interim tests, we may be required to record a non-cash charge to earnings during the period in which any impairment of goodwill is determined, which would adversely impact our results of operations.

See *Note 2. "Summary of Significant Accounting Policies Goodwill and Intangible Assets"* in the Notes to the Consolidated Financial Statements for additional information related to impairment of goodwill.

Our business depends on effective information management systems.

We rely on our enterprise resource planning (ERP) systems to support such critical business operations as processing sales orders and invoicing, inventory control, purchasing and supply chain management, payroll and human resources, and financial reporting. We periodically implement upgrades to such systems or migrate one or more of our affiliates, facilities or operations from one system to another. If we are unable to adequately maintain such systems to support our developing business requirements or effectively manage any upgrade or migration, we could encounter difficulties that could have a material adverse impact on our business, internal controls over financial reporting, financial results, or our ability to timely and accurately report such results.

We may incur business disruptions.

We take measures to minimize the risks of disruptions at our manufacturing facilities. The occurrence of a natural disaster, such as a hurricane, tropical storm, earthquake, tornado, flood, fire or other unanticipated problems such as labor difficulties, equipment failure or unscheduled maintenance could cause operational disruptions and could materially adversely affect our earnings and cash flows. Any losses due to these events may not be covered by our existing insurance policies or may be subject to certain deductibles.

Environmental regulations could materially adversely affect our results of operations and financial position.

We are subject to environmental regulation by federal, state, and local authorities in the United States, including requirements that regulate discharge into the environment, waste management, and remediation of environmental contamination. Maintaining compliance with existing and new environmental laws may require capital expenditures for compliance.

Due to past history of industrial operations at the Roanoke Rapids and North Charleston mills, the possibility of onsite and offsite environmental impact to the soil and groundwater may present a heighted risk of contamination. If we are required to make significant expenditures for remediation, the costs of such efforts may have a significant negative impact on our results of operations and financial condition.

MWV retained responsibility for certain offsite environmental conditions resulting from the operations at the North Charleston mill existing prior to the closing of the CKD acquisition. The overall indemnification by MWV for certain losses includes assumed environmental liabilities, subject to an $8.5 million threshold and a cap equal to 15% of the purchase price of $485 million, MWV's obligation to indemnify us for any historical onsite liability or breach of certain environmental representations and warranties terminates on December 31, 2013. MWV's indemnification for certain offsite historical liabilities survive indefinitely. Because we are unable to presently make a determination as to whether the environmental impact, if any, would be widespread or significant, the negotiated cap and survival period may not be sufficient to cover future losses.

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We may be required to pay income taxes related to the Alternative Fuel Mixture Tax Credit.

On March 31, 2009, we received approval from the Internal Revenue Service for our registration as an alternative fuel mixer, which provides for a refund of $0.50 per gallon of alternate fuel used in our pulp making process. For the year ended December 31, 2009, we received refunds of $165 million. We have taken the position that the tax credit is similar to a federal excise tax refund, and as a result, is not taxable. To date, the Internal Revenue Service has issued no guidance concerning this issue.

As of December 31, 2009 we have recorded a $63 million liability for an unrecognized tax benefit relating to the taxability of alternative fuel mixture tax credits.

Risks Associated with KapStone's Common Stock

The market price for our common stock may be highly volatile.

The market price of our common stock may be volatile due to certain factors, including, but not limited to; quarterly fluctuations in our financial and operating results; general conditions in the paper and packaging industries; or changes in earnings estimates.

Shares available for future issuance, conversion and exercise could have an adverse effect on the earnings per share and the market price of our common stock.

Any future issuance of equity securities, including upon exercise of outstanding stock options, could dilute the interests of our existing stockholders and could substantially decrease the trading price of our common stock.

Our executive officers and directors control a substantial percentage of our common stock and thus may influence certain actions requiring a stockholder vote.

At December 31, 2009, our executive officers and directors owned 7.8 million shares of our common stock, or approximately 17.3% of our total issued and outstanding common stock. Accordingly, our executive officers and directors may have considerable influence over the outcome of all matters requiring approval by our stockholders, including future acquisitions and the election of directors. In addition, our board of directors is divided into three classes, each of which will generally serve for a term of three years with only one class of directors being elected in each year. At the annual meeting, as a consequence of our "staggered" board of directors, only a minority of the board of directors will be considered for election and our officers and directors, because of their ownership position, will have considerable influence regarding the outcome of the election.

Some of our executive officers and directors may in the future become affiliated with entities engaged in business activities similar to those intended to be conducted by us and, accordingly, may have conflicts of interest in determining to which entity a particular business opportunity should be presented.

Some of our executive officers and directors have, or may in the future, become affiliated with entities, including "blank check" companies, engaged in business activities similar to those conducted by us. Additionally, our executive officers and directors may become aware of business opportunities which may be appropriate for presentation to us as well as the other entities to which they have an affiliation. Accordingly, they may have conflicts as to questions pertaining to which entity a particular business opportunity should be presented.

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Risks associated with the paper, packaging, forest products and related industries

The paper, packaging, forest products and related industries are highly cyclical. Fluctuations in the prices of and the demand for products could result in smaller profit margins and lower sales volumes.

Historically, economic and market shifts, fluctuations in capacity and changes in foreign currency exchange rates have created cyclical changes in prices, sales volume and margins for products in the paper, packaging, forest products and related industries. The length and magnitude of industry cycles have varied over time and by product, but generally reflect changes in macroeconomic conditions and levels of industry capacity. Most paper products and many wood products used in the packaging industry are commodities that are widely available from many producers. Because commodity products have few distinguishing qualities from producer to producer, competition for these products is based primarily on price, which is determined by supply relative to demand. The overall levels of demand for these commodity products reflect fluctuations in levels of end-user demand, which depend in large part on general macroeconomic conditions in North America and regional economic conditions in our markets, as well as foreign currency exchange rates. The foregoing factors could materially and adversely impact sales and profitability of our company.

Difficulty obtaining wood fiber at favorable prices, or at all, may negatively impact companies in the paper and packaging industry.

Wood fiber is the principal raw material in many parts of the paper and packaging industry. Wood fiber is a commodity, and prices historically have been cyclical. Environmental litigation and regulatory developments have caused, and may cause in the future, significant reductions in the amount of timber available for commercial harvest in the United States. These reductions have caused the closure of plywood and lumber operations in some of the geographic areas in which a target company might operate. In addition, future domestic or foreign legislation and litigation concerning the use of timberlands, the protection of endangered species, the promotion of forest health and the response to and prevention of catastrophic wildfires could also affect timber supplies. Availability of harvested timber may further be limited by fire, insect infestation, disease, ice storms, wind storms, flooding and other natural and manmade causes, thereby reducing supply and increasing prices.

Industry supply of commodity paper and wood products is also subject to fluctuation, as changing industry conditions can influence producers to idle or permanently close individual machines or entire mills. In addition, to avoid substantial cash costs in connection with idling or closing a mill, some producers will choose to continue to operate at a loss, sometimes even a cash loss, which could prolong weak pricing environments due to oversupply. Oversupply in these markets can also result from producers introducing new capacity in response to favorable short-term pricing trends. Industry supply of commodity papers and wood products is also influenced by overseas production capacity, which has grown in recent years and is expected to continue to grow. Wood fiber pricing is subject to regional market influences, and the cost of wood fiber may increase in particular regions due to market shifts in those regions. In addition, the ability to obtain wood fiber from foreign countries may be impacted by legal and political conditions in those countries as well as transportation difficulties.

An increase in the cost of purchased energy and raw materials would lead to higher manufacturing costs, thereby reducing margins which would have an adverse effect on our results of operations.

Energy is a significant raw material in the paper and packaging industry. Energy prices, particularly for electricity, coal and fuel oil, have been volatile in recent years and currently coal and electricity exceed historical averages. These fluctuations have historically impacted manufacturing costs of companies in these industries, often contributing to reduced margins and increased earnings volatility. Recent significant increases in energy prices can be expected to adversely impact businesses in these industries. In addition, we could be materially adversely impacted by supply disruptions or the inability to pass on cost increases to our customers.

Paper and packaging companies face strong competition.

The paper and packaging industry is highly fragmented, and we face competition from numerous competitors, domestic as well as foreign. Some of our competitors will be large, vertically integrated companies that have greater financial and other resources, greater manufacturing economies of scale, greater energy self-sufficiency and/or lower operating costs.

Certain paper and wood products are vulnerable to long-term declines in demand due to competing technologies or materials.

Companies in the paper and packaging industry are subject to possible declines in demand for their products as the use of alternative materials and technologies grows and the prices of such alternatives become more competitive. Any substantial shift in demand from wood and paper products to competing technologies or materials could result in a material decrease in sales of our products and could adversely affect our results of operations. We cannot ensure that any efforts we might undertake to adapt our product offerings to such changes would be successful or sufficient.

Paper and packaging companies are subject to significant environmental regulation and environmental compliance expenditures, as well as other potential environmental liabilities.

Companies in the paper and packaging industry are subject to a wide range of general and industry-specific environmental laws and regulations, particularly with respect to air emissions, wastewater discharges, solid and hazardous waste management, site remediation, forestry operations and endangered species habitats. We may incur substantial expenditures to maintain compliance with applicable environmental laws and regulations, which could adversely affect our results of operations. Failure to comply with applicable environmental laws and regulations could expose us to civil or criminal fines or penalties or enforcement actions, including orders limiting operations or requiring corrective measures, installation of pollution control equipment or other remedial actions.

Risks Associated with Acquisitions

Future acquisitions of businesses by us would subject us to additional business, operating and industry risks, the impact of which cannot presently be evaluated, and could adversely impact our capital structure.

We intend to pursue other acquisition opportunities in an effort to diversify our investments and/or grow our business. Any business acquired by us may cause us to be affected by numerous risks inherent in the acquired business' operations. If we acquire a business in an industry characterized by a high level of risk, we may be adversely affected by the currently unascertainable risks of that industry. We cannot ensure that we would be able to properly ascertain or assess all of the significant risk factors with any such acquisitions.

In addition, the financing of any acquisition completed by us could adversely impact our capital structure as any such financing would likely include the issuance of additional equity securities and/or the borrowing of additional funds. The issuance of additional equity securities may significantly reduce the equity interest of our stockholders and/or adversely affect prevailing market prices for our common stock. Increasing our indebtedness could increase the risk of a default that would entitle the holder to declare all of such indebtedness due and payable and/or to seize any collateral securing the indebtedness. In addition, default under one debt instrument could in turn permit lenders under other debt instruments to declare borrowings outstanding under those other instruments to be due and payable pursuant to cross default clauses. Accordingly, the financing of future acquisitions could adversely impact our capital structure and the value of your equity interest in us.

Except as required by law or the rules of any securities exchange on which our securities might be listed at the time we seek to consummate a subsequent acquisition, stockholders will not be asked to vote on any such proposed acquisition and no redemption rights in connection with any such acquisition will exist.

Our operations are dependent upon certain operating agreements for fiber.

We rely on certain supply arrangements to provide us roundwood and woodchips. If one of these suppliers suffered a setback, KapStone's supply of roundwood and woodchips may not be adequate to cover customer needs.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We believe that our properties are well-maintained, in good operating condition and adequate for our present needs. The following table sets forth our principal properties, as of December 31, 2009:

Location	Segment	Owned/Leased
North Charleston, South Carolina	Unbleached kraft paper	Owned
Roanoke Rapids, North Carolina	Unbleached kraft paper	Owned
Northbrook, Illinois	Corporate	Leased

The lease for our corporate headquarters expires in 2015.

Item 3. Legal Proceedings

We are party to various legal proceedings arising from our operations. We establish reserves for claims and proceedings when it is probable that liabilities exist and where reasonable estimates can be made. While it is not possible to predict the outcome of any these matters, based on our assessment of the facts and circumstances now known, we do not believe that any these matters, individually or in the aggregate, are material. However, actual outcomes may be different from those expected and could have a material effect on our results of operations or cash flows in a particular period.

Disclosure of Certain Tax Penalties

The Company has no tax penalties owing to the Internal Revenue Service.

Item 4. Reserved

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PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company's common stock and warrants were traded on the NASDAQ Global Market from May 29, 2007 through January 3, 2010 under the symbols "KPPC" and "KPPCW," respectively. Effective January 4, 2010, the Company's common stock began trading on the New York Stock Exchange under the "KS" trading symbol. Previously, KapStone's common stock and warrants were traded on the Over-the-Counter Bulletin Board under the symbols "SCDE" and "SCDEW," respectively, since September 14, 2005. The following table sets forth the high and low bid information for the Company's securities from January 1, 2008 through December 31, 2009, as reported by the various exchanges where its securities are traded. The quotations reflect inter-dealer prices, are without retail markup, markdowns or commissions, and may not represent actual transactions.

		2009		2008	
	Quarter	**Low**	**High**	**Low**	**High**
Common Stock	1st	$ 1.05	$ 3.07	$ 6.31	$ 6.98
	2nd	$ 2.14	$ 5.01	$ 6.41	$ 7.18
	3rd	$ 4.50	$ 8.80	$ 6.10	$ 7.97
	4th	$ 6.48	$ 9.90	$ 2.06	$ 6.07
Warrants	1st			$ 1.45	$ 2.00
	2nd			$ 1.46	$ 2.17
	3rd			$ 1.31	$ 2.87
	4th			$ 0.05	$ 1.25

Effective August 17, 2009, the Company's warrants expired. Prior to expiration, approximately 20.5 million warrants were exercised. Data for 2009 closing share prices for warrants are not available.

Number of Holders of Common Stock

The number of beneficial holders of record of our common stock on December 31, 2009 was 3,686.

Dividends

There were no cash dividends or other cash distributions made by us during the fiscal years 2009, 2008 or 2007. The Company's senior secured credit facility restricts the declaration or payment of cash dividends. The Company does not expect to pay dividends in the foreseeable future.

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Stock Performance Graph

The performance graph shall not be deemed to be "soliciting material" or to be "filed" with the commission or subject to Regulation 14A or 14C, or to the liabilities of Section 18 of the Securities Exchange Act of 1934 as amended.

The following graph compares a $100 investment in Company stock on August 31, 2005 with a $100 investment in each of the S&P 500 and the S&P Paper and Packaging Index (the Company's peer group) also made on August 31, 2005. The graph portrays total return, 2005-2009, assuming reinvestment of dividends.

Comparison of 4 Year Cumulative Total Return
Assumes Initial Investment of $100
December 2009

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Item 6. Selected Financial Data

The following table sets forth KapStone's selected financial information derived from its audited consolidated financial statements as of, and for the years ended, December 31, 2009, 2008, 2007 and 2006 as well as KPB Predecessor's audited financial statements as of, and for the years ended December 31, 2006, and 2005.

The selected financial data presented below summarizes certain financial data which has been derived from and should be read in conjunction with Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and KapStone's audited financial statements included in Item 7.

	Years Ended December 31,				Predecessor KPB Years Ended December 31,	
In thousands, except per share amounts	**2009**	**2008**	**2007**	**2006**	**2006**	**2005**
Statement of Income Data:						
Net sales	$ 632,478	$ 524,549	$ 256,795	$	$ 246,161	$ 221,972
Operating income / (loss)	$ 151,362	$ 50,656	$ 44,300	$ (1,976)	$ 33,951	$ 9,478
Net income	$ 80,280	$ 19,665	$ 26,963	$ 2,196	$ 19,967	$ 4,933
Basic net income per share	$ 2.32	$ 0.74	$ 1.08	$ 0.09	$ n/a	$ n/a
Diluted net income per share	$ 2.29	$ 0.57	$ 0.75	$ 0.07	$ n/a	$ n/a
Balance Sheet Data:						
Cash and cash equivalents	$ 2,440	$ 4,165	$ 56,635	$	$ 1	$ 1
Total assets	$ 669,123	$ 727,190	$ 225,450	$ 119,257	$ 257,382	$ 269,328
Long-term liabilities	$ 213,637	$ 419,545	$ 37,668	$	$ 22,622	$ 24,064
Total stockholders' equity	$ 348,790	$ 180,767	$ 144,185	$ 116,045	$ 219,685	$ 228,557

For the year ended December 31, 2006, net income allocable to holders of nonredeemable common stock was $1.5 million.

See Notes 4 and 5 to Notes to Consolidated Financial Statements for acquisition information.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Executive Summary

We were a special purpose acquisition corporation formed on April 15, 2005 for the purpose of effecting a merger, capital stock exchange, asset acquisition or other similar business combination with an unidentified operating business in the paper, packaging, forest products and related industries.

We have consummated two acquisitions since January 2007, as we drive towards our five year strategic objective of being a $2 billion revenue company.

KapStone's operating results in 2008 benefited from the July 1, 2008 acquisition of the CKD business from MeadWestvaco. We financed the acquisition with a new $515 million senior secured credit facility, which includes up to a $100 million revolving credit line to provide flexibility during these uncertain economic times, and the issuance of $40 million of seven year 8.3% senior notes and cash.

Our operating results for 2008 reflect six months of operations for CKD. The acquisition accounted for $254.1 million of net sales and $16.3 million of operating income. In addition, we successfully increased selling prices throughout 2008 to offset the tremendous amount of inflation experienced by our industry. We experienced double digit increases in fiber and certain key chemical costs, energy and transportation. Overall, our operations had a strong 2008, producing approximately 830,000 tons of paper and related products with minimal unplanned outages.

In January 2009, we announced compensation and benefit reductions for all salaried employees to reduce costs by approximately $1 million a month, effective February 1, 2009. These reductions included temporary salary reductions, and the suspension of management and sales force incentives and 401k matching contributions. On November 30, 2009, the Company lifted certain curtailments and reimbursed employees for lost salaries and wages and accrued $1.9 million for certain retirement benefits. Effective January 1, 2010, the management and sales incentives plans and Company 401k match benefits were reinstated.

On March 31, 2009, the Company consummated the sale of its dunnage bag business for $36.0 million less certain working capital adjustments to Illinois Tool Works Inc. ("ITW"). The results of operations for the dunnage bag business were included in the dunnage bags segment until the date of the sale. In conjunction with the sale, the Company signed a long-term supply agreement with ITW, pursuant to which the Company sells kraft paper to ITW.

Our operating results for 2009 include $164 million of alternative fuel mixture tax credits which significantly improved earnings. In addition, the cash generated from this tax credit and other sources was used to make over $280 million of repayments on our long-term debt. At December 31, 2009, we have recorded a $63 million reserve relating to alternative fuel mixture tax credits as it meets the requirements of Financial Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified primarily in Accounting Standards Codification No. 740, *Income Taxes*). Our position is that these tax credits are not taxable for federal income purposes. However, the Internal Revenue Service has not issued any specific guidance.

After a sluggish start to 2009 following the economic decline that started in late 2008, the Company's operations returned to historical production and sales volumes. After falling as low as 71% in early 2009, our operating rate reached approximately 97% by the end of the year. Overall, our operations had a strong year producing approximately 1.14 million tons of paper and related products with minimal unplanned outages. Market driven price reductions, occurring as a result of lower demand in the first two quarters of 2009, reduced our average selling prices by $118 per ton. To offset some of the volume loss, the Company sold a higher percentage of linerboard to export customers at a lower price. In December 2009, a $20 per ton price increase for kraft paper was implemented followed by an

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additional $20 per ton in January 2010. In January 2010, a $50 per ton price increase was announced for certain linerboard grades and is expected to be fully implemented by the end of the first quarter of 2010.

In August 2009, approximately 17 million of our common stock warrants were exercised, generating over $85 million of cash for the Company. In accordance with our Senior Credit Agreement and Note Purchase Agreement, the warrant proceeds were used to make mandatory debt repayments. The exercises increased the number of common stock outstanding from approximately 28.4 million shares in early 2009 to 45.4 million shares at December 31, 2009.

We continue to invest in our infrastructure. In 2009, we spent $8 million on a new and upgraded enterprise resource planning ("ERP") system, allowing us to migrate our CKD operations from an ERP system hosted by MWV to our own ERP system, which will save us approximately $3 million, of pre-tax income annually. Our transition from the IP hosted ERP system occurred in April 2008.

Results of Operations for the Years Ended December 31, 2009, 2008, and 2007

The following table compares results of operations for the years ended December 31, 2009 and 2008:

	Year Ended December 31,		%	% of Net Sales	
($ in thousands)	**2009**	**2008**	**Change**	**2009**	**2008**
Net sales	$ 632,478	$ 524,549	20.6%	100.0%	100.0%
Cost of sales excluding depreciation and amortization	355,088	362,462	(2.0)%	56.1	69.1
Freight and distribution expenses	57,395	50,154	14.4%	9.1	9.6
Selling, general and administrative expenses	31,377	30,411	3.2%	5.0	5.8
Depreciation and amortization	54,667	31,683	72.5%	8.6	6.0
Gain on sale of business	16,417		%	(2.6)	
Other operating income	994	817	21.7%	(0.1)	(0.2)
Operating income	151,362	50,656	198.8%	23.9	9.7
Foreign exchange gain (loss)	219	(987)	(122.2)%		(0.2)
Interest income	12	927	(98.7)%		0.1
Interest expense	19,176	18,449	3.9%	3.0	3.5
Income before income taxes	132,417	32,147	311.9%	20.9	6.1
Provision for income taxes	52,137	12,482	(317.7)%	8.2	2.4
Net income	$ 80,280	$ 19,665	308.2%	12.7%	3.7%

Net sales for the year ended December 31, 2009 were $632.5 million compared to $524.5 million for the year ended December 31, 2008, an increase of 20.6%. The full year of sales for CKD in 2009, compared to six months in 2008 (acquisition consummated on July 1, 2008), accounted for $188.2 million of the increase in net sales. Excluding the additional six months of CKD's sales and $26.1 million of lower sales due to the sale of the dunnage bag business on March 31, 2009, net sales in 2009 were lower than in 2008 by $54.1 million, of which $61.0 million was due to lower selling prices and $27.4 million was due to a less favorable product mix, as the Company had a higher percentage of linerboard sales, which has a lower average selling price than other products. This was partially offset by $34.3 million of higher volume in the second half of 2009.

Cost of sales for the year ended December 31, 2009 was $355.1 million compared to $362.5 million for the year ended December 31, 2008, a decrease of $7.4 million or 2.0%. Excluding $130.7 million for the additional six months of CKD's results and $18.6 million of lower cost of sales due to the sale of the dunnage bag business on March 31, 2009, cost of sales decreased by $119.5 million, of which $129.8 million was due to alternative fuel mixture tax credits and $9.3 million was due to deflation on energy and raw material costs. This was offset by $15.6 million of additional costs due to higher sales volume and $4.0 million of unplanned downtime.

The total amount of alternative fuel mixture tax credits recorded as a reduction in cost of sales for the year ended December 31, 2009 was $164.0 million, of which $34.2 million was included in the additional six months of CKD's results.

Freight and distribution expenses for the year ended December 31, 2009 totaled $57.4 million, compared to $50.2 million for the year ended December 31, 2008, an increase of $7.2 million. Excluding $15.9 million for the additional six months of CKD's results less $1.4 million for the sale of the dunnage bag business, freight and distribution expenses were $7.3 million lower in 2009 than in 2008. This decrease was due to a $5.6 million increase in customer-billed freight shipments and $6.6 million of lower fuel oil surcharges and lower costs due to favorable freight contract negotiations, partially offset by $4.9 million due to higher sales volume.

Selling, general and administrative expenses for the year ended December 31, 2009 totaled $31.4 million compared to $30.4 million for the same period in 2008. The increase of $1.0 million reflects $4.2 million for the additional six months of CKD's results, $3.1 million of higher professional fees and information technology expenses and $1.5 million of transitional services provided by MWV reflecting twelve months of charges in 2009 compared to only six months in 2008. These increases were partially offset by $2.3 million of lower compensation and benefit expenses as the Company suspended the management incentive plan, sales incentive plan and 401k matching contributions as a result of economic conditions, $2.4 million of lower start-up expenses related to the CKD acquisition, $1.8 million of lower bad debt expenses (three customer bankruptcies in 2008 compared to one in 2009) and $1.3 million due to the sale of the dunnage bag business. As a percentage of net sales, selling, general and administrative expenses dropped from 5.8% in 2008 to 5.0% in 2009.

Depreciation and amortization for the year ended December 31, 2009 totaled $54.7 million compared to $31.7 million for the same period in 2008. The increase of $23.0 million was mainly due to the additional six months of CKD's results, which added $14.4 million of depreciation and $6.7 million of amortization of intangibles, including $4.9 million of amortization for an intangible asset related to an acquired coal contract with below market prices at July 1, 2008. The acquired coal contract expired on December 31, 2009, and therefore, the related intangible asset was fully amortized as of year-end. Excluding the additional six months of CKD results, depreciation and amortization increased by $1.9 million primarily due to an upgrade to the Company's ERP system, the migration of the CKD acquisition to the Company's ERP system and other capital expenditures.

The $16.4 million gain on sale of business reflects the sale of the dunnage bag business to Illinois Tool Works Inc. on March 31, 2009.

Other operating income for the years ended December 31, 2009 and 2008 totaled $1.0 million and $0.8 million, respectively. Other operating income includes commissions the Company receives from marketing bleached paper produced and sold by IP to KapStone customers.

Foreign exchange gains for the year ended December 31, 2009 were $0.2 million compared to a foreign exchange loss of $1.0 million for the year ended December 31, 2008. The change reflects the weakening of the U.S. dollar in 2009 compared to the euro. As a result of the CKD acquisition on July 1, 2008, the Company acquired certain European customers who are invoiced in euros.

Interest income for the year ended December 31, 2009 decreased by $0.9 million compared to the same period in 2008. Due to lower interest rates in 2009, the Company used its excess cash to pay down principal balances on its long-term debt.

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Interest expense for the years ended December 31, 2009 and 2008 was $19.2 million and $18.4 million, respectively. Interest expense reflects interest on the Company's long-term debt and amortization of debt issuance costs. Interest expense was $0.8 million higher in the year ended December 31, 2009 due to $3.0 million of accelerated amortization of debt issuance costs related to $283.1 million of mandatory and voluntary debt prepayments, partially offset by lower expenses due to lower debt balances and interest rates. Amortization of debt issuance costs for the period ended December 31, 2009 was $6.0 million compared to $2.0 million for the same period in 2008.

Provision for income taxes for the years ended December 31, 2009 and 2008 was $52.1 million and $12.5 million, respectively, reflecting an effective tax rate of 39.4% compared to 38.8% for the same period in 2008. The $39.6 million increase in provision for income taxes is a result of $100.3 million of higher pre-tax income and a slightly higher effective tax rate due to a return to provision adjustment for state income taxes.

The following table presents a reconciliation of consolidated net sales and operating income to amounts reported by operating segment:

	Years Ended December 31,	
Operating Segment ($ 000s):	**2009**	**2008**
Consolidated net sales:		
Unbleached kraft	$ 626,450	$ 495,864
Other	6,927	33,041
Elimination of intersegment sales	(899)	(4,356)
Total	$ 632,478	$ 524,549
Operating income / (loss):		
Unbleached kraft	$ 155,904	$ 66,871
Other	748	5,248
Gain on sale of business	16,417	
Corporate	(21,707)	(21,463)
Total	$ 151,362	$ 50,656

Unbleached Kraft

	Years Ended December 31,			
	2009	**2008**	**Change**	**%**
Net sales	$ 626,450	$ 495,864	$ 130,586	26.3%
Operating income	155,904	66,871	89,033	133.1%
Operating income % of net sales	24.9%	13.5%	11.4%	
Average revenue per ton	$ 524	$ 603	$ (79)	(13.1)%
Tons of paper sold	1,149,595	805,605	343,990	42.7%

For the year ended December 31, 2009, unbleached kraft segment net sales increased by $130.6 million, or 26.3%, to $626.5 million compared to $495.9 million for the year ended December 31, 2008. The increase in net sales was due to a full year of sales in 2009 for CKD compared to six months for the same period in 2008, as the acquisition occurred on July 1, 2008, which increased sales by $188.2 million. Excluding the additional six months of CKD's results, net sales were lower by $57.6 million in 2009 compared to the same period in 2008, mainly due to $61.0 million of lower average revenue per ton and $27.4 million of a less favorable product mix, as the Company had a higher percentage of linerboard sales. Average revenue per ton for 2009 was $524 per ton, or $79 per

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ton lower than average revenue per ton in the same period of 2008 as market prices for paper were reduced in the first two quarters of 2009 due to lower overall industry demand.

Unbleached kraft segment operating income increased by $89.0 million, or 133.1%, to $155.9 million for the year ended December 31, 2009, compared to $66.9 million for the year ended December 31, 2008. Operating income increased by $16.3 million due to the additional six months of CKD's results, $129.8 million due to alternative fuel mixture tax credits, $16.0 million of deflation on energy, raw materials and freight costs, $8.4 million of increased sales volume and $1.7 million due to lower bad debts, partially offset by $61.0 million of lower average revenue per ton, $21.9 million of a less favorable product mix and $4.0 million due to unplanned outages. Included in operating income for 2009 and 2008 is $9.7 million and $4.3 million, respectively, of amortization expense for an intangible asset, acquired as part of the CKD acquisition, consisting of a coal contract with favorable prices. The coal contract expired on December 31, 2009 and was fully amortized by year-end.

The total amount of the alternative fuel mixture tax credits recorded in operating income for 2009 was $164.0 million of which $34.2 million is included in the additional six months of CKD's results.

Operating income for the year ended December 31, 2008, was negatively impacted by non-cash purchase accounting charges of $0.7 million, adjusting acquired finished goods inventories to fair value.

Operating income for the years ended December 31, 2009, and 2008 includes $6.0 million of expenses relating to the Company's annual planned maintenance outage. Operating income as a percentage of net sales increased to 24.9% mainly due to the alternative fuel mixture tax credits offset by lower prices and mix.

Other

Other includes the Company's dunnage bag business which was sold on March 31, 2009 to Illinois Tool Works, Inc. For the year ended December 31, 2009, net sales of $6.9 million and operating income of $0.7 million decreased by $26.1 million and $4.5 million, respectively, due to the sale of the business.

Corporate

Corporate expenses for the year ended December 31, 2009, totaled $21.7 million compared to $21.5 million for the year ended December 31, 2008. The increase of $0.2 million is primarily due to a $1.5 million increase in transitional services provided by MWV for twelve months in 2009 compared to six months in 2008, $2.3 million of higher professional services and other costs and $0.8 million of higher depreciation and amortization expenses relating to ERP investments partially offset by $2.3 million of lower CKD acquisition start up costs, $2.1 million of lower compensation and benefit expenses as the Company temporarily suspended management and sales incentive plans and the 401k match as a result of economic conditions.

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The following table compares results of operations for the years ended December 31, 2008 and 2007:

	Year Ended December 31,		%	% of Net Sales	
($ in thousands)	**2008**	**2007**	**Change**	**2008**	**2007**
Net sales	$ 524,549	$ 256,795	104.3%	100.0%	100.0%
Cost of sales excluding depreciation and amortization	362,462	162,429	123.2%	69.1	63.3
Freight and distribution expenses	50,154	23,581	112.7%	9.6	9.2
Selling, general and administrative expenses	30,411	16,482	84.5%	5.8	6.4
Depreciation and amortization	31,683	11,327	179.7%	6.0	4.4
Other operating income	817	1,324	(38.3)%	(0.2)	(0.6)
Operating income	50,656	44,300	14.3		