KAPSTONE PAPER & PACKAGING CORP
Form 10-K
March 09, 2012

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2011
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 $0.0001)	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 ý 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. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definition of the above in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer o	Accelerated Filer ý	Non-Accelerated Filer o (Do not check if a smaller reporting company)	Smaller Reporting Company o

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

The aggregate market value of the 39,203,571 shares of Common Stock held by non-affiliates of the registrant on June 30, 2011, was $646,603,171. This calculation was made using a price per share of Common Stock of $16.57; the closing price of the Common Stock on the New York Stock Exchange on June 30, 2011 the last day of the registrant's most recently completed second fiscal quarter of 2011. 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 27, 2012, the number of shares of Common Stock outstanding, excluding 40,000 treasury shares, was 46,494,013.

DOCUMENTS INCORPORATED BY REFERENCE:

The registrant's Definitive Proxy Statement for its 2012 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

KapStone Acquisition History

KapStone Paper and Packaging Corporation 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. Unless the context otherwise requires, references to "KapStone," the "Company," "we," "us" and "our" refer to KapStone Paper and Packaging Corporation.

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 $155.0 million, less $7.8 million of working capital adjustments. The KPB assets consisted of an unbleached kraft paper manufacturing facility in Roanoke Rapids, North Carolina, 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 $60.0 million if certain EBITDA targets were achieved. The acquisition was financed by cash on hand and a $95.0 million senior secured credit facility.

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 $485.0 million (net of cash acquired of $10.6 million), less $8.9 million of working capital adjustments. The CKD 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, a lumber mill located in Summerville, South Carolina, trade accounts receivable and inventories. The liabilities assumed consisted of trade accounts payable, accrued expenses and certain long-term liabilities. The acquisition was financed by cash on hand, a new $515.0 million senior secured credit facility and $40.0 million principal amount of seven-year 8.30 percent senior notes. In connection with the transaction the Company paid off the remaining amount due under its then-existing credit facility. There was no contingent earn-out for the CKD acquisition.

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On March 31, 2009, we consummated the sale of our 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 reduce its debt and focus on its core business. The sale of the dunnage bag business accelerated a $4.0 million contingent earn-out payment to IP relating to the KPB acquisition.

On January 4, 2011, we negotiated the early settlement of our final contingent earn-out payment to IP relating to the KPB acquisition. We paid $49.7 million to settle this liability in January 2011, approximately $5.3 million less than the maximum contractual amount which would have been settled when the payment would have been due in April 2012.

On October 31, 2011, we acquired U.S. Corrugated Acquisition Inc. ("USC") pursuant to a merger for $330.0 million in cash plus $1.6 million of working capital adjustments. USC owned, at the time of the merger, a recycled containerboard paper mill in Cowpens, South Carolina and fourteen corrugated packaging plants across the eastern and mid western United States. The acquisition was financed by cash on hand and by a new $525.0 million senior secured credit facility consisting of a $375.0 million LIBOR based five-year term loan and a $150.0 million revolving credit facility. In connection with the transaction the Company paid off the remaining amount due under its then-existing credit facility. See Note 3, "USC Acquisition" and Note 11, "Debt" for more information on the USC acquisition and the new senior secured credit agreement.

In conjunction with the USC acquisition, the Company evaluated its segment reporting requirements and concluded that it operates in one segment, the integrated manufacture and sale of unbleached kraft paper and corrugated products for industrial and consumer markets.

Future 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

KapStone is a producer of unbleached kraft paper products. In terms of production, in 2011 we produced 1,349,000 tons of unbleached kraft paper, of which nearly 65% was sold to third party converters or shipped to our corrugating products manufacturing plants based in the United States and 35% was sold to foreign based customers. With the consummation of the USC acquisition in late 2011 we began manufacturing and selling corrugated products. While under KapStone ownership in 2011, USC produced and sold about 1.0 billion square feet (BSF) of corrugated products in the U.S. Our net sales in 2011 totaled $906.1 million, which was comprised of $847.7 million of unbleached kraft paper and $58.4 million from the USC acquisition.

Our corrugated products manufacturing plants, acquired as part of the 2011 USC acquisition, produce a wide variety of corrugated products, including conventional shipping containers used to protect and transport manufactured goods and multi-color boxes and displays with strong visual appeal that help to merchandise the packaged product in retail locations.

The Company's business is affected by cyclical industry conditions and general economic conditions in the U.S. and in the countries where we export unbleached kraft paper. These conditions affect the prices which we are able to charge for our products. Our export sales may also be affected by fluctuations in currency values, foreign exchange rates and trade policies and relations.

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Unbleached Kraft Paper Industry Overview

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

Containerboard

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

The American Forest and Paper Association's ("AF&PA") estimate of the size of the U.S. containerboard market is as follows:

(In millions)	2011	2010	2009
Total U.S. sales	30.6 tons	30.6 tons	28.6 tons
U.S. production	34.0 tons	33.9 tons	31.5 tons
Imports	0.8 tons	0.8 tons	0.6 tons
Exports	4.2 tons	4.1 tons	3.5 tons
U.S. operating rates	96%	96%	85%

The primary target markets for our containerboard are our corrugated products manufacturing plants and independent corrugated and laminated products customers who focus on specialty niche packaging.

Kraft Paper

The AF&PA's estimate of the size of the U.S. kraft paper market is as follows:

(In millions)	2011	2010	2009
Total U.S. sales	1.39 tons	1.43 tons	1.28 tons
U.S. production	1.32 tons	1.45 tons	1.24 tons
Imports	0.16 tons	0.17 tons	0.20 tons
Exports	0.25 tons	0.21 tons	0.16 tons
U.S. operating rates	78%	79%	76%

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 has a large variety of uses within coating and laminating applications that requires 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.

Over the last two decades, unbleached kraft paper capacity has 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 increased 2.3 percent in 2007 and 4.6 percent in 2008 as the net impact of machines shifting from other grades to kraft paper was realized. Capacity decreased 2.9 percent in 2009 and stayed about even in 2010. According to AF&PA's annual survey kraft paper capacity was 1.6 million tons in 2011 and is expected to hold constant through 2012.

Saturating Kraft

Saturating kraft is used in multiple industries around the world, including construction, electronics manufacturing and furniture manufacturing. The major end-use markets are in those using thin high

pressure laminates (HPL) to create decorative surfaces such as kitchen and bath countertops, home and office furniture and flooring. Within the HPL market there is a growing and distinct HPL segment manufacturing and selling much thicker product called compact laminates used as surfacing products such as exterior cladding, partitions and doors. In Asia, there is significant use of saturating kraft product 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. We are not aware of any published data reporting the size of the saturating kraft market. Barriers to entry for producing high quality saturating kraft are high as it is a technically difficult grade of paper to produce.

Unbleached Folding Carton Board

Unbleached folding carton board is a low density virgin fiber board. Applications are widely spread throughout end uses in the general folding carton segment of the paperboard packaging market. This product can replace the use of more expensive coated recycled board, coated natural kraft board and solid bleached sulfate board which are currently much larger markets. There is no published data reporting the size of the unbleached, uncoated folding carton market.

Corrugated Products

According to the Fibre Box Association, the value of industry shipments of corrugated products was $26.1 billion in 2011.

The primary end-use markets for corrugated products are shown below (as reported in the most recent Fibre Box Association annual report dated April 2011):

Food, beverages and agricultural products	52%
Paper products	16%
Petroleum, plastic, synthetic and rubber products	11%
General retail and wholesale trade	7%
Appliances, vehicles, and metal products	5%
Miscellaneous manufacturing	5%
Textile mill products and apparel, and other	4%

Corrugated products plants tend to be located in close proximity to customers to minimize freight costs. The Fibre Box Association estimates that the U.S. corrugated products industry consists of approximately 575 companies and 1,245 plants.

Manufacturing

We operate three paper mills in the southeastern United States. In 2011, we produced 1,349,000 tons of unbleached kraft paper at our mills in North Charleston, South Carolina, Roanoke Rapids, North Carolina and Cowpens, South Carolina. In 2012 we expect production to increase to approximately 1,550,000 tons reflecting a full year of production from the Cowpens mill. Currently, our mills operate on a 24 hours a day, seven days a week basis and are operating at full capacity. Fiber used to make unbleached kraft paper is produced from a combination of locally sourced roundwood and 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. Old corrugated containers ("OCC") are used to make recycled containerboard in Cowpens. The Company processes pulp using six paper machines at our facilities. 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.

We operate 14 corrugated manufacturing plants, comprised of six box plants, six sheet plants and two sheet feeder plants. Box plants operate as combining operations that manufacture corrugated sheets and finished corrugated products. Sheet feeder plants own a corrugator machine and manufacture corrugated sheets which are shipped to Sheet or Box Plants. Sheet plants have various machines which convert corrugated sheets, purchased either from our operations or third parties, into finished corrugated products. Plants with a corrugating machine have total capacity of approximately nine billion square feet ("BSF").

We have corrugated manufacturing operations in nine states in the U.S., with no manufacturing facilities outside of the continental U.S. Each corrugated plant, for the most part, serves a market radius that typically averages 200 miles. Our sheet plants are generally located in close proximity to our larger corrugated plants, which enables us to offer additional services and converting capabilities such as small volume and quick turnaround items.

We produce a wide variety of products ranging from basic corrugated shipping containers to specialized packaging. We also have multi-color printing capabilities to make high-impact graphics boxes and displays that offer customers such as consumer products companies more attractive packaging.

Distribution

Unbleached kraft paper produced in our mills is shipped by rail or truck to customers in the U.S. and is shipped by truck to nearby ports and then by ocean vessel to our export customers. Domestic rail shipments represent about 51% of the tons shipped and the remaining 49% is shipped by truck.

Our corrugated products are delivered by truck. Most of our plants have their own fleet of trucks as our customers demand timely service.

Sales and Marketing

Our marketing strategy is to sell our products to third party converters and manufacturers of industrial and consumer packaging products. We seek to meet the quality and service needs of the customers of our corrugated operations at the most efficient cost, while balancing those needs against the demands of our containerboard customers. Our corrugated operations focus on supplying both high-volume commodity products and specialized packaging with high value graphics. We sell our products directly to end users and converters, as well as through sales agents.

Our sales groups are responsible for the sale of these products to third party converters in the U.S. Sales to export markets are managed by separate teams of which certain personnel are based in Europe and Asia.

We have dedicated personnel who coordinate and execute all containerboard trade agreements with other containerboard manufacturers. It is industry practice to "trade" among industry participants who are located more closely to converting plants in order to reduce freight costs.

Our corrugated products are sold through an internal sales and marketing organization. We have sales representatives and sales managers who serve local and regional accounts. We also have corporate account managers who serve large national accounts at multiple customer locations.

Customers and Products

KapStone has over 400 U.S.-based and over 200 export customers for unbleached kraft paper.

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The following represents the Company's tons of unbleached kraft paper sold:

	2011		2010	
Product Line:	**Tons**	**% of Total**	**Tons**	**% of Total**
Containerboard	672,933	51.3%	650,224	50.6%
Kraft paper	275,461	21.0%	273,216	21.3%
DuraSorb®	266,571	20.2%	268,852	20.9%
Kraftpak®	96,947	7.5%	92,853	7.2%
Tons of paper sold	1,311,912		1,285,145	

Containerboard is sold to domestic and foreign converters in the corrugated packaging industry and to other converters for a variety of uses including laminated tier sheets and wrapping material, among others. Historically, our focus is on independent converters who do not have their own mill systems or converters who otherwise commonly purchase containerboard in the open market. USC had been a containerboard customer of ours. The USC acquisition provides us with vertical integration opportunities and we expect to increase the amount of KapStone containerboard shipments used in our acquired corrugated manufacturing plants.

Kraft paper is sold primarily to domestic 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.

Our saturating kraft paper, sold under the trade name Durasorb® has a customer base which is split among three geographic regions, the Americas, Europe and Asia. Approximately 77 percent of our sales are exports to customers in Europe, Latin America and Asia where growth opportunities are favorable. KapStone, or its predecessor, has done business with many of these customers for well over 30 years. Some customers have consolidated to form a greater presence in their end-use markets. Customer consolidation is particularly evident in North America and is 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 with our Durasorb® product through knowledge of our markets and understanding the technical needs of our customers' manufacturing processes and the demanding requirements of their products.

Our unbleached folding carton board sold under the Kraftpak® trade name has a customer base which consists primarily of integrated and independent converters in the folding carton industry. Our unbleached folding carton board product is a unique, low density virgin fiber board. KapStone believes that the best growth opportunities for Kraftpak® are in consumer brands that are changing their images to promote environmental friendliness and sustainability, where Kraftpak® and similar products replace the use of coated recycled board, coated natural kraft board and solid bleached sulfate board which are currently much larger markets.

As part of the 2011 USC acquisition we have about 1,000 corrugated product customers, most of which are regional and local accounts, which are broadly diversified across industries and geographic locations. In addition, we have a select number of national accounts, or those customers with a national presence. These national customers typically purchase corrugated products from several of our box plants throughout the United States. In 2011 we sold approximately 1.0 billion square feet of corrugated products.

No customer accounts for more than 10% of consolidated net sales. Our business is not dependent upon a single customer or upon a small number of major customers. We do not believe the loss of any one customer would have a material adverse effect on our business.

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Backlog

Demand for our major product lines is relatively constant throughout the year, and seasonal fluctuations in marketing, production, shipments and inventories are not significant. Backlogs are a factor in the industry as it allows paper mills to run more efficiently. Most orders are placed for delivery within 30 days.

Major Raw Materials Used

Fiber is the single largest cost in the manufacture of containerboard and unbleached kraft paper. KapStone consumes both wood fiber and recycled fiber in its paper mills. Our mills in North Charleston and Roanoke Rapids use 100% virgin fiber. Fiber used to make unbleached kraft paper is produced from a combination of locally sourced roundwood and woodchips. We rely on supply agreements and open market purchases to supply these mills with roundwood and wood chips. Fiber resources are generally available within economic proximity to these mills and we have not experienced any significant difficulty in obtaining our mill fiber needs.

Our mill in Cowpens, South Carolina (acquired as part of USC) is a 100% recycled mill, whose fiber consumption consists solely of recycled fiber commonly referred to as OCC. We obtain OCC pursuant to certain supply agreements and in open market purchases from suppliers within economic proximity to the Cowpens Mill. OCC has historically exhibited significant price volatility. We have not experienced any significant difficulty in obtaining our OCC needs for Cowpens.

Our corrugated manufacturing plants consume containerboard from our mills and from third parties. We use third party mills which are closer to our corrugated manufacturing plants to realize freight savings. Containerboard, which includes both linerboard and corrugating medium, is the principal raw material used to manufacture corrugated products. Linerboard is used as the inner and outer facings, or liners, of corrugated products. Corrugating medium is fluted and laminated to linerboard in corrugated plants to produce corrugated sheets. The sheets are subsequently printed, cut, folded and glued into produce corrugated products.

Energy

Energy at the mills is obtained through purchased electricity or through various fuels, which are converted to steam or electricity on-site. Fuel sources include coal, natural gas, oil and bark and by-products of the manufacturing and pulping process, including black liquor. These fuels are burned in boilers to produce steam. Steam turbine generators are used to produce electricity. To reduce our mill energy cost, we have invested in processes and equipment to ensure a high level of purchased fuel flexibility. In recent history, fuel oil has exhibited higher costs per thermal unit and more price volatility than natural gas and coal. During 2011, approximately 58% of our mills' purchased fuel needs were from coal, historically our lowest cost purchased fuel.

We purchase coal under three contracts with fixed pricing through December 31, 2012.

Approximately 80% of the electricity consumed by our North Charleston mill is generated on-site by our cogeneration facility. This facility was constructed in 1999.

KapStone's corrugated product manufacturing plants primarily use boilers that produce steam which are used to power the corrugating machines. The majority of these boilers burn natural gas, although some also have the ability to burn fuel oil. Sheet plants use electricity for their main source of power.

Competition

The markets in which we sell our products are highly competitive and comprised of many participants. We face significant competitors, including large, vertically integrated companies and numerous smaller companies.

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Our principal competitors with respect to sales of our unbleached kraft paper are a number of large, diversified paper companies, including International Paper Company, Georgia-Pacific (owned by Koch Industries, Inc.), Rock-Tenn Corporation and Packaging Corporation of America, all of which have greater financial resources than we do. We also compete with other regional manufacturers of these products. Our unbleached kraft paper products (other than our Durasorb® and Kraftpak® products) are each generally considered a commodity-type product and can be purchased from numerous suppliers and competition is based primarily on price.

According to industry sources corrugated products are produced by about 575 U.S. companies operating approximately 1,245 plants. Most corrugated products are manufactured to the customer's specifications. Corrugated producers generally sell within a 200-mile radius of their plants and compete with other corrugated producers in their local market. In fact, the Fibre Box Association tracks industry data by 47 distinct market regions.

Corrugated products businesses seek to differentiate themselves through pricing, quality, service and product design and innovation. We compete for both local and national account business, and we compete against producers of other types of packaging products. On a national level, our primary competitors include International Paper Company, Georgia-Pacific (owned by Koch Industries, Inc.), Rock-Tenn Corporation and Packaging Corporation of America. However, with our strategic focus on local and regional accounts, we also compete with the smaller, independent converters.

Intellectual Property

The Company owns patents, licenses, trademarks and trade names on products. However, we do not believe that our intellectual property is material to our business and the loss of any or our intellectual property rights would not have a material adverse effect on our operations or financial condition.

Employees

As of December 31, 2011, we have 2,715 employees. Of these, 802 employees are salaried and 1,913 are hourly. Approximately 53% of our hourly employees are represented by unions. The majority of our unionized employees are represented by the United Steel Workers (USW).

Currently, there is a collective bargaining agreement in place with union employees in North Charleston through July 2012 and Roanoke Rapids through August 2013. We expect to begin negotiations to renew the North Charleston union contract soon.

During 2011, we experienced no work stoppages and have experienced no instances of significant work stoppages in the five years prior to 2011. We believe we have good relations with our employees.

Environmental Matters

Compliance with environmental requirements is a significant factor in our business operations. We commit substantial resources to maintaining environmental compliance and managing environmental risk. We are subject to, and must comply with, a variety of federal, state and local environmental laws, particularly those relating to air and water quality and waste disposal. The most significant of these laws affecting us are:

1. Resource Conservation and Recovery Act (RCRA)
2. Clean Water Act (CWA)
3. Clean Air Act (CAA)
4. The Emergency Planning and Community Right-to-Know-Act (EPCRA)

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5. Toxic Substance Control Act (TSCA)

6. Safe Drinking Water Act (SDWA)

We believe that we are currently in material compliance with these and all applicable environmental rules and regulations. Because environmental regulations are constantly evolving, we have incurred, and will continue to incur, costs to maintain compliance with these and other environmental laws and regulations. We work diligently to anticipate and budget for the impact of applicable environmental regulations, and do not currently expect that future environmental compliance obligations will materially affect our business or financial condition. Total capital costs for environmental matters were $0.3 million for 2011. We currently estimate 2012 environmental capital expenditures will be less than $1.0 million.

We do not believe that any ongoing remedial projects are material in nature. As of December 31, 2011, we maintained an environmental reserve of $1.8 million, which includes funds relating to on-site landfill and surface impoundments for our landfill obligations, which are accounted for in accordance with Accounting Standards Codification ("ASC") 410, *Asset Retirement and Environmental Obligations*. We believe these reserves are adequate.

We could also incur environmental liabilities as a result of claims by third parties for civil damages, including liability for personal injury or property damage, arising from releases of hazardous substances or contamination. We are not aware of any material claims of this type currently pending against us.

While legislation regarding the regulation of greenhouse gas emissions has been proposed at the federal level, it is uncertain whether such legislation will be passed and, if so, what the breadth and scope of such legislation will be. The result of the regulation of greenhouse gas emissions could be an increase in our future environmental compliance costs, through caps, taxes or additional capital expenditures to modify facilities, which may be material. However, climate change legislation and the resulting future energy policy could also provide us with opportunities if the use of renewable energy is encouraged. We currently generate a significant portion of our power requirements for our mills using bark, black liquor and biomass as fuel, which are derived from renewable resources. While we believe we are well-positioned to take advantage of any renewable energy incentives, it is uncertain what the ultimate costs and opportunities of any climate change legislation will be and how our business and industry will be affected.

In 2004, the U.S. Environmental Protection Agency (the "EPA") published the Boiler MACT regulations, establishing air emissions standards and certain other requirements for industrial boilers. These regulations were vacated and remanded by the U.S. Court of Appeals for the D.C. Circuit in 2007. The EPA proposed final regulations in March 2011, which would require compliance in 2014. During 2011, the EPA determined that it would reconsider certain provisions of the Boiler MACT regulations and, in December 2011, the EPA published proposed rules containing changes to the March 2011 rules. The EPA may make further changes to the proposed rules. KapStone is currently assessing the impact of these regulations on its operations which could require significant modifications to one boiler. Due to the complexity of these regulations, and the potential for additional future regulatory or judicial modification to these regulations, the timing and amount of expenditures to be made by KapStone are uncertain, but could be significant during the period before compliance is required.

In addition to Boiler MACT and greenhouse gas standards, the EPA has recently finalized a number of other environmental rules, including National Ambient Air Quality Standards for nitrogen oxide (NOx) and sulfur dioxide (SO_2), which may impact the pulp and paper industry. The EPA also is revising existing environmental standards and developing several new rules that may apply to the industry in the future. We cannot currently predict with certainty how any future changes in environmental laws, regulations and/or enforcement practices will affect our business; however, it is possible that our compliance, capital expenditure requirements and operating costs could increase materially.

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Available Information

We make available free of charge our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished as required by Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, through our Internet Website (www.kapstonepaper.com) as soon as is reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Information contained in or incorporated into our Internet Website is not incorporated by reference herein.

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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.

Risks associated with our business

Changes in U.S. and global economic conditions could have an adverse effect on the profitability of some or all of our businesses.

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 few years. 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, 2011, no customer accounted for more than 10 percent of consolidated net sales. However, losses of key customers could significantly impact our business, results of operations, cash flows and financial position.

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We are dependent upon key management executives the loss of 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.

KapStone's indebtedness may adversely affect its financial health.

As of December 31, 2011, we had approximately $355.3 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 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

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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 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 400 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 and North Charleston through August 2013 and July 2012, respectively. 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 35 percent and 38 percent, respectively, of our 2011 and 2010 revenues 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.

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

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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. However, 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.

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 heightened 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 percent 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.

We may be required to pay income taxes related to the Cellulosic biofuel tax credit.

In August 2010, we received approval from the Internal Revenue Service for our registration as producer of cellulosic biofuel for the tax year 2009, which provides for a nonrefundable income tax credit of $1.01 per gallon of qualified cellulosic biofuel for black liquor burned in early 2009 when the Company did not claim the alternative fuel mixture tax credit. We reflected a $21.0 million net tax benefit (net of U.S. Federal and state taxes) related to cellulosic biofuel in the Company's income tax provision for the year ended December 31, 2010. The Company expects to utilize this benefit beginning in 2012 to reduce federal income taxes. However, Congress is now considering changes to U.S. tax laws which may preclude the carry forward of the credit to future years.

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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.

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 shares issued 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, 2011, our executive officers and directors owned 7.1 million shares of our common stock, or approximately 15.3 percent of our total outstanding common stock. Accordingly, our executive officers and directors may have some 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 some influence regarding the outcome of the election.

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 including OCC 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 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 economic, 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 input cost for the paper and packaging industry. Increases in energy prices can be expected to adversely impact businesses. 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 the industry, often contributing to reduced margins and increased earnings volatility. 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.

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.

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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

We may fail to realize the anticipated synergies and cost savings expected from the USC acquisition.

Our success after the USC acquisition will depend, in part, on our ability to realize the anticipated $8.0 million of growth opportunities and synergies, and $8.0 million of cost savings from integrating our business with USC. To realize these anticipated benefits, we must successfully integrate our business with USC in a manner that permits these synergies to be realized. If we are not able to successfully achieve these objectives, such anticipated benefits may not be realized fully, or at all, or may take longer to realize than expected.

We may have difficulty integrating our business with the USC business and may incur substantial costs in connection with the integration.

Achieving the anticipated benefits of the transaction will depend on the successful integration of our products, operations, personnel, and facilities with those of USC in a timely and efficient manner.

Although we do not anticipate material difficulties in connection with such integration, the possibility exists that such difficulties could be experienced in connection with the transaction, especially given the relatively large size of the transaction. The time and expense associated with integrating our businesses and USC may exceed our expectations and limit or delay the intended benefits of the transaction. Similarly, the process of integrating sales and marketing forces and administrative functions and coordinating product offerings can take longer, cost more, and provide fewer benefits than initially projected. To the extent any of these events occurs, the benefits of the transaction may be reduced.

Integrating our business with USC will be a complex, time-consuming and expensive process. Before the transaction, KapStone and USC operated independently, each with its own business, products, customers, employees, culture and systems. We may face substantial difficulties, costs and delays in integrating the two businesses. These difficulties, costs and delays may include:

- Costs and delays in implementing common systems and procedures;
- Potential charges to earnings resulting from the application of purchase accounting to the transaction;
- Difficulty comparing financial reports due to differing financial and/or internal reporting systems;
- Diversion of management resources from the business;
- Challenges in retaining and integrating management and other key employees of KapStone and USC;
- Difficulties in coordinating infrastructure operations in an effective and efficient manner; and

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The inability to achieve the synergies anticipated to be realized from the transaction on the timeline presently anticipated, or at all.

We seek to combine certain operations and functions using common information and communication systems, operating procedures, financial controls and human resource practices, including training, professional development and benefit programs. We may be unsuccessful in implementing the integration of these systems and processes in a timely and efficient manner. Any one or all of these factors may cause increased operating costs, worse than anticipated financial performance and/or the loss of customers and employees. Many of these factors are also outside of our control.

We may have difficulty integrating our system of internal control over financial reporting with that of USC.

The failure to integrate our system of internal control over financial reporting with that of USC could affect adversely our ability to exercise effective internal control over financial reporting. A failure to exercise effective internal control over financial reporting could result in a material misstatement in our annual or interim consolidated financial statements.

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.

Item 1B. Unresolved Staff Comments

None.

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Item 2. Properties

The table below provides a summary of our paper mills, the principal products produced and each mill's annual practical maximum capacity based upon all of our paper machines' production capabilities, as reported to the AF&PA:

Location	Products	Capacity (tons)
North Charleston, SC	Unbleached Kraft	870,000
Roanoke Rapids, NC	Unbleached Kraft	440,000
Cowpens, SC	Recycled containerboard	240,000
Total		1,550,000

We have granted mortgages on all of our owned real property, including our paper mills, to secure our obligations under our senior secured credit facility.

We own three of our 14 corrugated manufacturing plants. These plants are located in Georgia, Texas and Massachusetts and total 0.5 million square feet. The remaining 11 plant locations are leased. These plants are located in Georgia, New York, Kentucky, Iowa, Minnesota, Nebraska, North Dakota and Texas and total 2.1 million square feet. The majority of these leases expire in 2032. The equipment in the leased facilities is, in virtually all cases, owned by KapStone, except for forklifts, trailers and other rolling stock which are leased.

We currently lease space for our corporate headquarters in Northbrook, Illinois. The lease for this facility expires in 2020.

We currently believe that our owned and leased space for facilities and properties are sufficient to meet our operating requirements for the foreseeable future.

Item 3. Legal Proceedings

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 employments 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 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.

Item 4. Mine Safety Disclosure

Not applicable.

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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 was traded on the NASDAQ Global Market from May 29, 2007 through January 3, 2010 under the symbol "KPPC". Effective January 4, 2010, the Company's common stock began trading on the New York Stock Exchange ("NYSE") under the "KS" trading symbol. The following table sets forth the high and low bid information for the Company's common stock from January 1, 2010 through December 31, 2011, as reported by the NYSE.

	2011		2010	
Quarter Ended	**Low**	**High**	**Low**	**High**
March 31	$ 15.08	$ 17.80	$ 8.08	$ 12.35
June 30	$ 14.37	$ 17.63	$ 10.00	$ 13.40
September 30	$ 12.66	$ 17.28	$ 10.25	$ 13.13
December 31	$ 13.18	$ 17.88	$ 12.01	$ 15.56

At December 31, 2011, the closing share price on the NYSE was $15.74.

Number of Holders of Common Stock

The number of beneficial holders of record of our common stock on December 31, 2011 was 4,250.

Dividends

There were no cash dividends or other cash distributions made by us during the fiscal years 2011, 2010 or 2009. The Company's senior secured credit facility restricts the declaration or payment of cash dividends. The Company does not currently have plans to pay dividends.

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 December 31, 2006 with a $100 investment in each of the S&P 500 and the S&P Paper and Packaging Index (the Company's peer

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group) also made on December 31, 2006. The graph portrays total return, 2006-2011, assuming reinvestment of dividends.

Comparison of 5 Year Cumulative Total Return
Assumes Initial Investment of $100
December 2011

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, 2011, 2010, 2009, 2008 and 2007.

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 consolidated financial statements included in Item 8.

	Years Ended December 31,				
In thousands, except per share amounts	**2011**	**2010**	**2009**	**2008**	**2007**
Statement of Income Data:					
Net sales(1)	$ 906,119	$ 782,676	$ 632,478	$ 524,549	$ 256,795
Operating income(2)	$ 106,741	$ 68,703	$ 151,362	$ 50,656	$ 44,300
Net income(3)	$ 123,981	$ 65,041	$ 80,280	$ 19,665	$ 26,963
Basic net income per share	$ 2.68	$ 1.42	$ 2.32	$ 0.74	$ 1.08
Diluted net income per share	$ 2.61	$ 1.38	$ 2.29	$ 0.57	$ 0.75
Balance Sheet Data:					
Cash and cash equivalents	$ 8,062	$ 67,358	$ 2,440	$ 4,165	$ 56,635
Total assets	$ 1,124,354	$ 719,727	$ 669,123	$ 727,190	$ 225,450
Long-term liabilities	$ 442,269	$ 185,539	$ 213,637	$ 419,545	$ 37,668
Total stockholders' equity	$ 546,278	$ 418,634	$ 348,790	$ 180,767	$ 144,185

(1) 2011 reflects the USC acquisition on October 31, 2011. 2008 reflects the CKD acquisition from MeadWestvaco on July 1, 2008.

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(2) 2009 includes $164.0 million of alternative fuel mixture credits and $16.4 million from the gain on the sale of the dunnage bag business.

(3) 2011 includes a $63.0 million benefit from the reversal of the tax reserve for alternative fuel mixture credits.

See Note 3 to Notes to Consolidated Financial Statements for USC acquisition information and Note 5 for information on the sale of the dunnage bag business.

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

Executive Summary

We were formed 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.

We have consummated three acquisitions since January 2007, including the USC acquisition consummated on October 31, 2011, as we drive towards our strategic objective of being a $2 billion revenue company by 2015. We continue to evaluate additional acquisition opportunities.

Our operations had a strong year in 2011 producing a record 1.35 million tons of paper compared to 1.27 million tons in 2010. Our operating rate for the year increased to 102.7 percent up from 98.5 percent in 2010. Market driven price increases, occurring as a result of higher demand in 2011, increased our average selling prices by $41 per ton to $627. During 2011, we fully realized our 2010 announced price increase and partially realized our 2011 announced price increases for Kraftpak® and kraft paper.

Some key highlights for 2011 include:

- On January 4, 2011, we negotiated the early settlement of our contingent earn-out with IP relating to the KPB acquisition. We paid $49.7 million to settle this liability in January 2011, approximately $5.3 million less than the maximum contractual amount which would have been settled in April 2012. There is no contingent earn-out for our CKD or USC acquisitions.

- In October 2011, Forbes announced that they ranked KapStone 10th overall on their annual list of the 100 Best Small Companies according to the rankings included in their November 5, 2011 issue. Forbes determined the rankings based upon return on equity, growth of earnings and sales, and the relative stock performance of each company as compared with that of its peers over the past 12 months and over 5 years.

- On October 31, 2011, we consummated the acquisition of U.S. Corrugated ("USC") from its stockholders by merger for $330.0 million in cash plus $1.6 million of working capital adjustments. The assets primarily consisted of a recycled containerboard paper mill in Cowpens, South Carolina and fourteen box and corrugated sheet plants across the eastern and mid western United States. The acquisition was financed by cash on hand and by a new credit facility of $525.0 million consisting of a $375.0 million LIBOR based five-year term loan and a $150.0 million revolving credit facility. In connection with the transaction the Company paid off the remaining amount due under its prior credit facility. Consolidated net sales for the year ended December 31, 2011 include $58.4 million from the acquisition.

- In December 2011, we recognized a $63.0 million tax benefit by reversing tax reserves related to alternative fuel mixture tax credits upon completion of the 2009 IRS examination.

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Results of Operations for the Years Ended December 31, 2011, 2010, and 2009

The following table compares results of operations for the years ended December 31, 2011 and 2010:

($ in thousands)	Year Ended December 31, 2011	Year Ended December 31, 2010	% Change	% of Net Sales 2011	% of Net Sales 2010
Net sales	$ 906,119	$ 782,676	15.8%	100.0%	100.0%
Cost of sales, excluding depreciation and amortization	628,613	565,185	11.2%	69.4	72.2
Depreciation and amortization	51,036	45,245	12.8%	5.6	5.7
Freight and distribution expenses	79,643	73,406	8.5%	8.7	9.4
Selling, general and administrative expenses	41,265	31,129	32.6%	4.6	4.0
Other operating income	1,179	992	18.9%	(0.1)	(0.1)
Operating income	106,741	68,703	55.4%	11.8	8.8
Foreign exchange loss	(319)	(666)	52.1%	(0.0)	(0.1)
Interest expense, net	6,081	5,403	12.5%	0.7	0.7
Income before income taxes	100,341	62,634	60.2%	11.1	8.0
Benefit for income taxes	(23,640)	(2,407)	882.1%	(2.6)	(0.3)
Net income	$ 123,981	$ 65,041	90.6%	13.7%	8.3%

Net sales for the year ended December 31, 2011 were $906.1 million compared to $782.7 million for the year ended December 31, 2010, an increase of $123.4 million or 15.8 percent. Net sales in 2011 included two months (acquisition consummated on October 31, 2011) of USC sales which accounted for $58.4 million of the increase in net sales. Excluding the acquisition, the increase in net sales was driven by $50.5 million of higher average selling prices in 2011 compared to 2010 mainly due to full realization of price increases implemented in 2010 and in the first half of 2011. Average selling price per ton for 2011 was $627 compared to $586 for 2010. Net sales also increased by $11.8 million due to higher unit sales and $1.0 million of more favorable product mix partially offset by $2.2 million of lower lumber sales. Exchange rates positively impacted net sales by $3.9 million.

The following represents the Company's tons of unbleached kraft paper sold:

Product Line (in tons):	Year Ended December 31, 2011	Year Ended December 31, 2010	Increase/ (Decrease)	%
Containerboard	672,933	650,224	22,709	3.5
Kraft paper	275,461	273,216	2,245	0.8
DuraSorb®	266,571	268,852	(2,281)	(0.8)
Kraftpak®	96,947	92,853	4,094	4.4
Tons of paper sold	1,311,912	1,285,145	26,767	2.1

Tons of paper sold in 2011 was 1,311,912 tons compared to 1,285,145 tons in 2010, an increase of 26,767 tons or 2.1 percent. Containerboard sales volume increased 3.5 percent reflecting higher demand for lightweight grades. DuraSorb® sales volume declined (0.8) percent due to a reduction in export shipments, mainly in Asia. Kraftpak® sales volume increased 4.4 percent reflecting higher penetration in folding carton markets.

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Cost of sales, excluding depreciation and amortization expense, for the year ended December 31, 2011 was $628.6 million compared to $565.2 million for the year ended December 31, 2010, an increase of $63.4 million or 11.2 percent. Excluding $44.8 million of cost of sales for the sales of the acquired USC business, the increase in cost of sales was mainly due to a $22.2 million decrease in alternative fuel mixture tax credits (the tax credit expired December 31, 2009), $5.8 million due to inflation of input costs and $5.3 million of higher sales volume. Partially offsetting the increase in cost of sales was $11.9 million from productivity gains and other cost savings and $2.8 million of lower planned maintenance outage costs.

Depreciation and amortization for the year ended December 31, 2011 totaled $51.0 million compared to $45.2 million for the same period in 2010. Excluding $2.2 million for the acquisition, the increase of $3.6 million was primarily due to $38.3 million of capital spending in 2010 and $0.8 million of accelerated depreciation in 2011.

Freight and distribution expenses for the year ended December 31, 2011 totaled $79.6 million compared to $73.4 million for the year ended December 31, 2010, an increase of $6.2 million. Excluding $4.2 million for the addition of two months of USC's results, the increase was primarily due to $1.5 million of inflation on fuel costs and $1.1 million of higher sales volume partially offset by $0.6 million of lower warehousing costs.

Selling, general and administrative expenses for the year ended December 31, 2011 totaled $41.3 million compared to $31.1 million in 2010. Excluding $4.5 million for the addition of two months of USC's results, the increase of $5.7 million reflects $3.3 million of acquisition related expenses, $1.0 million of higher incentive compensation and $1.4 million of other cost increases. As a percentage of net sales, selling, general and administrative expenses increased from 4.0 percent in 2010 to 4.6 percent in 2011.

Foreign exchange losses for the years ended December 31, 2011 and 2010, were $0.3 million and $0.7 million, respectively. The change reflects fluctuations in the U.S. dollar to Euro exchange rate.

Net interest expense for the years ended December 31, 2011 and 2010 was $6.1 million and $5.4 million, respectively. Interest expense reflects interest on the Company's senior credit agreement and amortization of debt issuance costs. Interest expense was $0.7 million higher in 2011 compared to 2010 due to higher term loan balances in the fourth quarter of 2011 as a result of entering into a new credit agreement in conjunction with the USC acquisition on October 31, 2011.

The benefit for income taxes for the years ended December 31, 2011 and 2010 was $23.6 million and $2.4 million, respectively, reflecting an effective tax rate of (23.6) percent in 2011 compared to (3.8) percent in 2010. The higher benefit for income taxes in 2011 mainly reflects $63.0 million for the reversal of tax reserves relating to alternative fuel mixture tax credits upon completion of the 2009 IRS examination in the fourth quarter of 2011. The 2010 benefit for income taxes included a $21.0 million benefit related to the Cellulosic Biofuel credit and a refundable tax credit from the inorganic content of black liquor.

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The following table compares results of operations for the years ended December 31, 2010 and 2009:

($ in thousands)	Year Ended December 31, 2010	Year Ended December 31, 2009	% Change	% of Net Sales 2010	% of Net Sales 2009
Net sales	$ 782,676	$ 632,478	23.7%	100.0%	100.0%
Cost of sales, excluding depreciation and amortization	565,185	355,088	59.2%	72.2	56.1
Depreciation and amortization	45,245	54,667	(17.2)%	5.7	8.6
Freight and distribution expenses	73,406	57,395	27.9%	9.4	9.1
Selling, general and administrative expenses	31,129	31,377	(0.8)%	4.0	5.0
Gain on sale of business		16,417	(100.0)%		(2.6)
Other operating income	992	994	(0.2)%	(0.1)	(0.1)
Operating income	68,703	151,362	(54.6)%	8.8	23.9
Foreign exchange gain (loss)	(666)	219	(404.1)%	(0.1)	
Interest expense, net	5,403	19,164	(71.8)%	0.7	3.0
Income before income taxes	62,634	132,417	(52.7)%	8.0	20.9
Provision (benefit) for income taxes	(2,407)	52,137	(104.6)%	(0.3)	8.2
Net income	$ 65,041	$ 80,280	(19.0)%	8.3%	12.7%

Net sales for the year ended December 31, 2010 were $782.7 million compared to $632.5 million for the year ended December 31, 2009, an increase of 23.7 percent. Net sales in 2010 were higher than in 2009 by $150.2 million, of which $60.8 million was due to higher average selling prices, $82.4 million was due to an 11.8 percent increase in volume due to increased demand from improving economic conditions, and $18.8 million was due to a more favorable product mix due to a lower percentage of export containerboard sales. Partially offsetting the increase in net sales was a decrease of $6.9 million due to the sale of the dunnage bag business in March 2009. Exchange rates negatively impacted net sales by $4.9 million.

The following represents the Company's tons of unbleached kraft paper sold:

Product Line (in tons):	Year Ended December 31, 2010	Year Ended December 31, 2009	Increase/ (Decrease)	%
Containerboard	650,224	535,254	114,970	21.5
Kraft paper	273,216	236,827	36,389	15.4
DuraSorb®	268,852	294,902	(26,050)	(8.8)
Kraftpak®	92,853	82,612	10,241	12.4
Tons of paper sold	1,285,145	1,149,595	135,550	11.8

Tons of paper sold in 2010 was 1,285,145 tons compared to 1,149,595 tons in 2009, an increase of 135,550 tons or 11.8 percent. Containerboard sales volume increased 21.5 percent reflecting higher demand for lightweight grades and a rebound in demand following the recession in 2009. Kraft paper volume increased 15.4 percent due to increased demand. DuraSorb® sales volume declined 8.8 percent due to lower volumes in Europe and Asia. Kraftpak® sales volume increased 12.4 percent reflecting higher penetration in folding carton markets.

Cost of sales, excluding depreciation and amortization expense, for the year ended December 31, 2010 was $565.2 million compared to $355.1 million for the year ended December 31, 2009, an increase of $210.1 million or 59.2 percent. The increase in cost of sales was mainly due to a $141.8 million

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decrease in alternative fuel mixture tax credits (the tax credit expired December 31, 2009), $54.2 million due to volume and mix changes, $6.8 million related to the Charleston mill tri-annual planned maintenance outage, a $5.9 million increase in compensation and benefit costs as the Company reinstated certain benefits in January 2010 and $6.7 million due to inflation on input costs. Partially offsetting the increase in cost of sales was $5.3 million of lower costs due to the sale of the dunnage bag business.

Depreciation and amortization for the year ended December 31, 2010 totaled $45.2 million compared to $54.7 million for the same period in 2009. The decrease of $9.5 million was primarily due to $9.7 million of lower intangible asset amortization. The Company acquired a coal contract with below market prices in conjunction with the CKD acquisition. The contract and related amortization expired on December 31, 2009.

Freight and distribution expenses for the year ended December 31, 2010 totaled $73.4 million, compared to $57.4 million for the year ended December 31, 2009, an increase of $16.0 million. This increase was primarily due to $9.0 million reflecting an 11.8 percent increase in volume, $3.1 million due to inflation and $4.3 million due to a lower percentage of export linerboard shipments in which freight costs are paid by the customer, partially offset by $0.4 million due to the sale of the dunnage bag business.

Selling, general and administrative expenses for the year ended December 31, 2010 totaled $31.1 million compared to $31.4 million in 2009. The decrease of $0.3 million reflects savings of $5.1 million for the termination of transitional services provided by MeadWestvaco in the fourth quarter of 2009, $0.5 million of lower bad debts, $0.5 million of lower audit fees and $0.3 million related to the sale of the dunnage bag business. Partially offsetting these decreases in selling, general and administrative expenses were $5.3 million of higher compensation and benefit expenses as the Company reinstated certain benefits, including management incentives, in January 2010 that were previously suspended as a result of poor economic conditions in early 2009, and $1.2 million of higher stock compensation expense. As a percentage of net sales, selling, general and administrative expenses dropped from 5.0 percent in 2009 to 4.0 percent in 2010.

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, 2010 and 2009 totaled $1.0 million. Other operating income includes commissions the Company receives from marketing bleached paper produced and sold by IP to KapStone customers.

Foreign exchange losses for the year ended December 31, 2010 were $0.7 million compared to a foreign exchange gain of $0.2 million for the year ended December 31, 2009. The change reflects the strengthening of the U.S. dollar in 2010 compared to the Euro.

Net interest expense for the years ended December 31, 2010 and 2009 was $5.4 million and $19.2 million, respectively. Interest expense reflects interest on the Company's senior credit agreement and amortization of debt issuance costs. Interest expense was $13.8 million lower in 2010 compared to 2009 due to lower term loan balances, the extinguishment of senior notes and lower interest rates.

Provision (benefit) for income taxes for the years ended December 31, 2010 and 2009 was $(2.4) million and $52.1 million, respectively, reflecting an effective tax rate of (3.8) percent in 2010 compared to 39.4 percent 2009. The lower provision (benefit) for income taxes in 2010 mainly reflects the combined impact of the $21.0 million net benefit from the cellulosic biofuel producer's tax credit and a $69.8 million reduction in pre-tax income.

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

Operating Segment ($ 000s):	Years Ended December 31, 2010	2009
Consolidated net sales:		
Unbleached kraft	$ 782,676	$ 626,450
Other		6,927
Elimination of intersegment sales		(899)
Total	$ 782,676	$ 632,478
Operating income / (loss):		
Unbleached kraft	$ 89,521	$ 155,904
Other		748
Gain on sale of business		16,417
Corporate	(20,818)	(21,707)
Total	$ 68,703	$ 151,362

Unbleached Kraft

	Years Ended December 31, 2010	2009	Change	%
Net sales	$ 782,676	$ 626,450	$ 156,226	24.9%
Operating income	89,521	155,904	(66,383)	(42.6)%
Operating income % of net sales	11.4%	24.9%	(13.5)%	
Average revenue per ton	$ 586	$ 524	$ 62	11.8%
Tons of paper sold	1,285,145	1,149,595	135,550	11.8%

For the year ended December 31, 2010, unbleached kraft segment net sales increased by $156.2 million, or 24.9 percent, to $782.7 million compared to $626.5 million for the year ended December 31, 2009. The increase in net sales was mainly due to $60.8 million of higher average selling prices, $82.4 million of higher sales volume resulting from an 11.8 percent increase in tons of paper sold, and $18.8 million of a more favorable product mix due to a lower percentage of export containerboard sales. Average revenue per ton for 2010 was $586 per ton, or $62 per ton higher than average revenue per ton in 2009 as market prices for kraft paper and containerboard increased throughout 2010 due to higher overall industry demand. Exchange rates negatively impacted net sales by $4.9 million.

Unbleached kraft segment operating income decreased by $66.4 million, or 42.6 percent, to $89.5 million for the year ended December 31, 2010, compared to $155.9 million for the year ended December 31, 2009. Operating income decreased primarily due to $141.8 million from lower alternate fuel mixture tax credits (the tax credit expired on December 31, 2009), $6.8 million related to the Charleston mill tri-annual planned maintenance outage, $9.8 million of inflation on input and freight costs and $7.7 million of higher compensation and benefit expenses as the Company reinstated certain benefits in January 2010 that were previously suspended in early 2009 and $4.9 million due to foreign exchange rates. The decrease in operating income was partially offset by $60.8 million of higher average selling prices, $19.9 million from higher sales volume, $13.6 million of a more favorable product mix due to a lower percentage of export containerboard sales, $9.7 million of lower amortization expense related to an expired intangible asset and $0.5 million of lower bad debts.

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Operating income for the years ended December 31, 2010, and 2009 includes $21.6 million and $14.5 million, respectively, of expenses relating to the Company's planned maintenance outages. Operating income as a percentage of net sales decreased to 11.4 percent mainly due to lower alternative fuel mixture tax credits, the reinstatement of certain employee benefits and the planned maintenance outages partially offset by higher average selling prices.

Other

Other includes the Company's dunnage bag business which was sold on March 31, 2009 to Illinois Tool Works Inc.

Corporate

Corporate expenses for the year ended December 31, 2010, totaled $20.8 million compared to $21.7 million for the year ended December 31, 2009. The decrease of $0.9 million reflects savings of $5.1 million for the termination of transitional services provided by MeadWestvaco in the fourth quarter of 2009 and $0.5 million of lower audit fees partially offset by $3.5 million of higher compensation and benefit expenses as the Company reinstated the management incentive plan and retirement benefits in 2010 that were temporarily suspended in 2009 as a result of poor economic conditions and $1.2 million of higher stock compensation expense.

Liquidity and Capital Resources

Acquisitions

On October 31, 2011, we consummated the acquisition of USC from its stockholders by merger for $330.0 million in cash plus $1.6 million of working capital adjustments. The assets consisted of a recycled containerboard paper mill in Cowpens, South Carolina and fourteen box and corrugated sheet plants across the eastern and mid western United States, trade accounts receivable, inventories and certain long-term assets. The liabilities assumed consisted of trade accounts payable, accrued expenses and certain long-term liabilities. The acquisition was financed by cash on hand and by a new credit facility of $525.0 million consisting of a $375.0 million LIBOR based five-year term loan and a $150.0 million revolving credit facility. In connection with the transaction the Company paid off the remaining amount due under its prior credit facility.

The new credit facility includes an accordion provision which allows the Company, subject to certain terms and conditions, to increase the commitments by up to $300.0 million and would be available for future acquisitions.

Credit Facilities

New Credit Agreement

In connection with the USC acquisition on October 31, 2011, the Company entered into a credit agreement (the "New Credit Agreement") by and among KapStone, Kapstone Kraft Paper Corporation, as Borrower ("Borrower"), KapStone and all subsidiaries of Borrower from time to time party thereto, as Guarantors, the lenders from time to time thereto, and Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer. The New Credit Agreement replaces the Company's existing Credit Agreement dated June 12, 2008, (the "Old Credit Agreement"), which was fully repaid and terminated.

The New Credit Agreement provides for a senior secured credit facility in an initial aggregate principal amount of $525.0 million (the "Credit Facility"), consisting of an initial term loan in an aggregate principal amount of $375.0 million (the "Initial Term Loan") and a revolving credit facility in an initial aggregate principal amount of $150.0 million (including a letter of credit sub-facility) (the

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"Revolver"). The Credit Facility also includes an "accordion" feature which allows Borrower, subject to certain terms and conditions, to increase the commitments under the Credit Facility by up to $300.0 million. The proceeds of the Initial Term Loan were used, together with cash on hand, (i) to finance Borrower's acquisition of USC, (ii) to pay certain transaction fees and expenses of $13.8 million in connection with the acquisition of USC and entering into the New Credit Agreement, (iii) to repay certain existing KapStone indebtedness of $100.8 million and (iv) to provide for ongoing working capital requirements and general corporate purposes. The repayment of borrowings under the Credit Facility is guaranteed by KapStone and Borrower's domestic subsidiaries, and is secured by substantially all of the assets of KapStone, Borrower and such subsidiaries. A portion of the repayment of borrowings under the Credit Facility are guaranteed by Borrower's foreign subsidiaries.

Depending on the type of borrowing by Borrower, the applicable interest rate under the Credit Facility is calculated at a per annum rate equal to (a) LIBOR plus an applicable margin, which is currently 2.00% for Eurodollar loans, or (b) (i) the greatest of (x) the prime rate, (y) the federal funds effective rate plus 0.5% or (z) one-month LIBOR plus 1.00% plus (ii) an applicable margin, which is currently 1.00% for base rate loans. The unused portion of the Revolver will also be subject to an unused fee that will be calculated at a per annum rate (the "Unused Fee Rate"), which is currently 0.40%. Commencing with the delivery of the financial statements for the fiscal quarter ending December 31, 2011, the applicable margin for borrowings under the Credit Facility and the Unused Fee Rate will be determined by reference to a pricing grid based on the Company's total leverage ratio. Under such pricing grid, the applicable margins for the Credit Facility will range from 1.50% to 2.50% for Eurodollar loans and from 0.50% to 1.50% for base rate loans, and the Unused Fee Rate will range from 0.30% to 0.50%.

The Credit Facility has a maturity date of October 31, 2016, but the outstanding amounts there under may be prepaid at any time without premium (except for certain customary break funding payments in connection with Eurodollar loans). Net cash proceeds (in excess of certain minimum threshold amounts) from certain asset dispositions, the sale or issuance of equity securities, and the incurrence or issuance of certain indebtedness are subject to certain mandatory prepayment provisions. The New Credit Agreement contains customary representations and warranties, conditions to borrowing and events of default, the occurrence of which would entitle lenders to accelerate the amounts outstanding.

Voluntary and Mandatory Prepayments

For the year ended December 31, 2011, the Company made a $15.0 million voluntary prepayment. No mandatory prepayments were required under the New Credit Agreement.

Other Borrowing

In 2011 and 2010, the Company entered into financing agreements of $2.3 million and $2.6 million, respectively, at an annual interest rate of 1.75 percent and 1.62 percent, respectively, for the annual property insurance premium. The agreements required the Company to make consecutive monthly repayments through the term of the financing agreement ending on December 1 of each year. As of December 31, 2011, there was no balance outstanding under the current agreement. The Company entered into a similar agreement in 2012 with similar terms and conditions.

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Debt Covenants

Under the financial covenants of the New Credit Agreement, KapStone must comply on a quarterly basis with a maximum permitted leverage ratio. The leverage ratio is calculated by dividing KapStone's debt by its rolling twelve month total earnings before interest expense, taxes, depreciation and amortization and allowable adjustments. The maximum permitted leverage ratio declines over the life of the New Credit Agreement. On December 31, 2011, the maximum permitted leverage ratio was 3.50 to 1.00. On December 31, 2011, KapStone was in compliance with the New Credit Agreement with a leverage ratio of 1.83 to 1.00.

The New Credit Agreement also includes a financial covenant requiring a minimum fixed charge coverage ratio. This ratio is calculated by dividing KapStone's twelve month total earnings before interest expense, taxes, depreciation and amortization and allowable adjustments less cash payments for income taxes and capital expenditures by the sum of our cash interest and required principal payments during the twelve month period. From the closing date of the New Credit Agreement through the quarter ending December 31, 2011 the fixed charge coverage ratio was required to be at least 1.25 to 1.00. On December 31, 2011, KapStone was in compliance with the New Credit Agreement with a fixed charge coverage ratio of 3.66 to 1.00.

As of December 31, 2011, KapStone was in compliance with all applicable covenants in the New Credit Agreement.

Alternative Fuel Mixture Tax Credit

On March 31, 2009, the Company received approval from the Internal Revenue Service for its registration as an alternative fuel mixer, which provides for a refund of $0.50 per gallon of alternate fuel used in the Company's pulp making process. As a result, for the year ended December 31, 2009, the Company received refunds of $165.0 million. The Company received refunds in early 2010 of $14.3 million for amounts generated through December 31, 2009.

Based on a U.S. Internal Revenue Service Advice Memorandum released on March 12, 2010, the Company was eligible to receive an additional $7.9 million tax credit related to inorganic content burned in 2009. The inorganic content, which represented about 4% of the total gallons burned, was excluded from refunds submitted in 2009. The Company recorded this benefit in pre-tax income for the year ended December 31, 2010. The Company received this refund in May 2010.

The alternative fuel mixture tax credit ("AFMTC") expired on December 31, 2009. As a result, no additional refunds were received in 2011. In December 2011, the Company recognized a $63.0 million tax benefit by reversing tax reserves related to alternative fuel mixture tax credits upon completion of the 2009 IRS examination.

Income Taxes

Income taxes paid, net of refunds, were $0.3 million, ($13.2) million and ($11.3) million in 2011, 2010 and 2009, respectively.

The Company expects to pay a higher amount of income taxes in 2012.

Sources and Uses of Cash

Years ended December 31 (dollars in thousands)	**2011**	**2010**	**2009**
Operating activities	$ 136,376	$ 136,076	$ 201,235
Investing activities	(423,863)	(35,180)	256
Financing activities	228,191	(35,978)	(203,216)

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2011

Cash and cash equivalents of $8.1 million at December 31, 2011 decreased by $59.3 million from December 31, 2010, reflecting cash provided by operations of $136.4 million and cash provided by financing activities of $228.2 million offset by cash used in investing activities of $423.9 million.

Net cash provided by operating activities was $136.4 million due to $124.0 million of net income and $98.8 million of non-cash charges. Changes in operating assets and liabilities used $86.5 million of cash. Net cash provided by operating activities increased by $0.3 million during the year ended December 31, 2011 compared to the year ended December 31, 2010 due to a $58.9 million increase in net income and $71.5 million of higher non-cash charges partially offset by a $130.2 million increase in cash used in operating assets and liabilities. Non-cash charges increased by $71.5 million primarily due to $65.8 million of higher deferred income taxes. The $130.2 million increase of cash used in operating assets and liabilities was mainly due to a reversal of a $63.0 million tax reserve for the AFMTC, $13.2 million tax refund received in June 2010, $13.1 million of AFMTC payments received in the first six months of 2010 and $9.7 million of incentive compensation paid in 2011.

Net cash used in investing activities includes $331.6 million for the USC acquisition, $49.7 million reflecting a contingent earn-out payment made to IP and $42.5 million of capital expenditures. Capital expenditures were mainly spent on equipment upgrades and replacements at the paper mills. Net cash used in investing activities increased by $388.7 million during the year ended December, 31 2011 compared to the year ended December 31, 2010 mainly due to the $331.6 million paid for the USC acquisition and $49.7 million contingent earn-out payment.

Net cash provided by financing activities totaled $228.2 million reflecting $375.0 million of loan proceeds from the New Credit Agreement partially offset by the $114.9 million payoff of the Company's prior credit facility, $19.7 million of term loan repayments including a $15.0 million voluntary payment, and $13.8 million of debt issuance costs for the New Credit Agreement. Net cash provided by financing activities changed by $264.2 million during the year ended December 31, 2011 compared to the year ended December 31, 2010 mainly due to the loan proceeds received under the New Credit Agreement partially offset by the payoff of the Company's prior credit facility and payment of debt issuance costs.

2010

Cash and cash equivalents of $67.4 million at December 31, 2010 increased by $64.9 million from December 31, 2009, reflecting cash provided by operations of $136.1 million offset by cash used in investing activities of $35.2 million, and cash used in financing activities of $36.0 million.

Net cash provided by operating activities was $136.1 million due to $65.0 million of net income and $27.3 million of non-cash charges. Changes in operating assets and liabilities also provided $43.7 million. Net cash provided by operating activities decreased by $65.1 million during the year ended December 31, 2010 compared to the year ended December 31, 2009 due to a $15.2 million reduction in net income, a $39.0 million decrease in non-cash charges primarily due to a $43.5 million decrease in deferred income taxes primarily from the benefit of the cellulosic biofuel tax credit, and a $10.9 million decrease in operating assets and liabilities.

Net cash used in investing activities was $35.2 million reflecting $38.3 million of capital expenditures offset by $2.5 million of proceeds from the sale of the dunnage bag business that were released from escrow on September 29, 2010 and $0.6 million received from MeadWestvaco relating to the CKD acquisition. Capital expenditures included $34.6 million for the equipment upgrades and replacements at the paper mills and $3.7 million for information systems projects. Net cash used in investing activities increased by $35.4 million during the year ended December 31, 2010 compared to

the year ended December 31, 2009 mainly due to $34.9 million of proceeds received from the sale of the dunnage bag business in the first quarter of 2009.

Net cash used in financing activities totaled $36.0 million reflecting $30.0 million of term loan repayments including a $12.5 million of prepayments and $7.4 million of net repayments on the revolving credit facility partially offset by $1.3 million of proceeds from exercises of stock options. Net cash used in financing activities decreased by $167.2 million during the year ended December 31, 2010 compared to the year ended December 31, 2009 due to a lower amount of debt repayments in 2010.

2009

Cash and cash equivalents of $2.4 million at December 31, 2009 decreased by $1.7 million from December 31, 2008, reflecting cash provided by operations of $201.2 million and cash provided by investing activities of $0.3 million, offset by cash used in financing activities of $203.2 million.

Net cash provided by operating activities was $201.2 million due to $80.3 million of net income and $83.3 million of non-cash charges offset by the gain on sale of the dunnage bag business of $16.4 million. Changes in operating assets and liabilities provided $54.1 million.

Net cash provided by investing activities was $0.3 million reflecting proceeds from the sale of the dunnage bag business of $34.9 million and $1.0 million received as a working capital adjustment related to the CKD acquisition offset by $29.2 million of capital expenditures, $4.0 million paid for the KPB earn-out related to the sale of the dunnage bag business and $2.5 million of proceeds from the sale of the dunnage bag business held in escrow. Capital expenditures included $21.1 million for the unbleached kraft segment for equipment upgrades and replacements at the paper mills. In addition, $8.1 million was spent on upgrading information systems and migrating CKD to our systems.

Net cash used in financing activities totaled $203.2 million reflecting $283.1 million of repayments on term loans, $85.0 million of payments on the revolving credit facility and $0.3 million of debt issuance costs, offset by borrowings under the revolving credit facility of $80.0 million and $85.2 million of proceeds from exercised common stock warrants.

Future Cash Needs

We expect that cash on hand at December 31, 2011 and cash generated from operating activities in 2012 and, if needed, the ability to draw from our $150.0 million revolving credit facility and our $300.0 million accordion provision will be sufficient to meet anticipated cash needs, which primarily consist of $15.2 million of debt service and interest, approximately $60.0 million of expected capital expenditures, $5.6 million of pension plan funding and any additional working capital or acquisition needs. At December 31, 2011, the Company did not utilize any borrowings under the revolving credit facility. The Company's remaining availability under the revolving credit facility was $142.0 million at December 31, 2011.

On a long term basis, we expect that cash generated from operating activities and, if needed, the ability to draw from our revolving credit facility and accordion provision will be sufficient to meet long term obligations, which primarily consist of $377.5 million of debt service and interest which includes a $201.6 million final payment on our term loan in October 2016, capital expenditures of $55.0 to $60.0 million annually, annual defined benefit pension plan contributions, working capital needs and acquisitions.

Off-Balance Sheet Arrangements

We have not entered into any off-balance sheet arrangements and have not established any special purpose entities. We have not guaranteed any debt or commitments of other non-related entities or entered into any options on non-financial assets.

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Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of expenses during the reporting period. Actual results could differ from those estimates. KapStone believes our critical accounting policies are those described below. The Company's audit committee has reviewed the policies listed below. For a detailed discussion of these and other accounting policies, see Note 2 of the Notes to the Consolidated Financial Statements.

Revenue Recognition The Company recognizes revenue in accordance with Accounting Standards Codification ("ASC") 605*Revenue Recognition*. Revenue is recognized when the customer takes title and assumes the risks and rewards of ownership. Sales with terms designated f.o.b. (free on board) shipping point are recognized at the time of shipment. For sales transactions with terms f.o.b. destination, revenue is recorded when the product is delivered to the customer's site and when title and risk of loss are transferred. Sales on consignment are recognized in revenue at the earlier of the month that the goods are consumed or after a period of time subsequent to receipt by the customer as specified by contract terms. Incentive rebates are typically paid in cash and are netted against revenue on an accrual basis as qualifying purchases are made by the customer to earn and thereby retain the rebate.

The Company recognizes revenue from the sale of shaft horsepower, generated by its cogeneration facility, on a gross basis and within net sales.

Freight charged to customers is recognized in net sales.

Goodwill and Intangible Assets Goodwill is the excess of cost over the fair value of the net assets of businesses acquired. On an annual basis and in accordance with ASC 350, *Intangibles Goodwill and Other*, the Company tests for goodwill impairment using a two-step process, unless there is a triggering event, in which case a test would be performed at the time that such triggering event occurs. The first step is to identify a potential impairment by comparing the fair value of a reporting unit with its carrying amount. For all periods presented, the Company's reporting units are consistent with its operating segments. The estimates of fair value of a reporting unit are determined based on a market approach as well as an income approach using a discounted cash flow analysis. A discounted cash flow analysis requires the Company to make various judgmental assumptions, including assumptions about future cash flows, growth rates and discount rates. The assumptions about future cash flows and growth rates are based on the forecast and long-term business plans of the Company's operating segment. Discount rate assumptions are based on an assessment of the risk inherent in the future cash flows of the respective reporting units. If necessary, the second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination.

Pension and Postretirement Benefits KapStone provides pension and postretirement benefits to certain employees and accounts for these benefits in accordance with ASC 715, *Compensation Retirement Benefits*. For financial reporting purposes, long-term assumptions are developed through consultations with actuaries. Such assumptions include the expected long-term rate of return on plan assets, discount rates, health care trend rates and mortality rates. The discount rate for the current year is based on long-term high quality bond rates.

Income Taxes The Company accounts for income taxes under the liability method in accordance with ASC 740*Income Taxes*. Accordingly, deferred income taxes are provided for the future tax consequences attributable to differences between the carrying amounts of assets and liabilities for financial reporting and income tax purposes. Deferred tax assets and liabilities are measured using tax

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rates in effect for the year in which those temporary differences are expected to be recovered or settled. A valuation allowance is established when necessary to reduce deferred tax assets to the amount that is more likely than not to be realized. The Company recognizes the benefit of tax positions when it is more likely than not to be sustained on its technical merits.

Stock Based Compensation Costs The Company accounts for stock compensation expense in accordance with ASC 718, *Compensation Stock Compensation*. The compensation expense for stock options is recorded on an accelerated basis over the awards' vesting periods. The compensation expense for restricted stock is recorded on a straight-line basis over the awards' vesting periods. Forfeitures are estimated on the date of grant and revised if actual or expected forfeiture activity differs materially from the original estimate.

Recent Accounting Pronouncements

See Note 2 in the Notes to Consolidated Financial Statements for a discussion of recent accounting pronouncements.

Contractual Obligations

The following table summarizes our contractual obligations as of December 31, 2011, ($000s):

	Payments Due by Period						
Contractual Obligations	**Total**	**1 Year**	**2 Years**	**3 Years**	**4 Years**	**5 Years**	**Thereafter**
Long-term debt(1)	$ 355,313	$ 6,094	$ 30,469	$ 39,844	$ 49,219	$ 229,687	$
Interest on long-term debt(2)	37,375	9,099	8,676	7,877	6,854	4,869	
Operating lease obligations(3)	121,373	10,976	9,392	8,226	7,567	7,254	77,958
Purchase obligations(4)	252,786	29,689	29,048	27,765	27,123	25,521	113,640
Minimum pension plan funding(5)	5,621	5,621					
Total	$ 772,468	$ 61,479	$ 77,585	$ 83,712	$ 90,763	$ 267,331	$ 191,598

(1) These obligations are reflected on our Consolidated Balance Sheet at December 31, 2011, in current portion of long-term debt and long-term debt net of current portion, as appropriate. See Note 11 of Notes to Consolidated Financial Statements.

(2) Assumes debt is carried to full term. Debt bears interest at variable rates and the amounts above assume future interest will be incurred at the rates in effect on December 31, 2011. These obligations are not reflected on our Consolidated Balance Sheet at December 31, 2011.

(3) These obligations are not reflected on our Consolidated Balance Sheet at December 31, 2011.

(4) Purchase obligations are agreements to purchase goods that are enforceable and legally binding on us and that specify all significant terms, including: fixed or minimum quantities to be purchased. These obligations are not reflected on our Consolidated Balance Sheet at December 31, 2011. See Note 16 of Notes to Consolidated Financial Statements regarding the Company's purchase obligation relating to the Long Term Fiber Supply with MWV.

(5) The Company's pension and postretirement liabilities total $10.8 million as of December 31, 2011. This minimum pension plan funding represents the Company's expected 2012 contributions and was determined in consultation with our actuary in accordance with IRS guidelines. See Note 12 of Notes to Consolidated Financial Statements.

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Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the sensitivity of income to changes in interest rates, commodity prices and foreign currency changes. The Company is exposed to the following types of market risk: interest rates, commodity prices and foreign currency.

Interest Rates

Under KapStone Kraft's New Credit Agreement, at December 31, 2011, we have an outstanding credit facility consisting of a term loan and revolving credit facility totaling $505.3 million. The initial term loan and the revolving credit facility have a maturity date of October 31, 2016. 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, which is currently 2.00% for Eurodollar loans, or (b) (i) the greatest of (x) the prime rate, (y) the federal funds effective rate plus 0.5% or (z) one-month LIBOR plus 1.00% plus (ii) an applicable margin, which is currently 1.00% for base rate loans. The unused portion of the Revolver will also be subject to an unused fee that will be calculated at a per annum rate (the "Unused Fee Rate"), which is currently 0.40%. Commencing with the delivery of the financial statements for the fiscal quarter ending December 31, 2011, the applicable margin for borrowings under the Credit Facility and the Unused Fee Rate will be determined by reference to a pricing grid based on the Company's total leverage ratio. Under such pricing grid, the applicable margins for the Credit Facility will range from 1.50% to 2.50% for Eurodollar loans and from 0.50% to 1.50% for base rate loans, and the Unused Fee Rate will range from 0.30% to 0.50%.

Changes in market rates may impact the base or LIBOR rate in our New Credit Agreement. For instance, if the bank's LIBOR rate was to increase or decrease by one percentage point (1.0%), our annual interest expense would change by approximately $3.6 million based upon our expected future monthly loan balances per our existing repayment schedule.

Commodity Prices

We are exposed to price fluctuations of certain commodities used in production. Key materials and energy used in the production process include roundwood and woodchips, recycled fiber, containerboard, fuel oil, natural gas, electricity and caustic soda. We purchase these materials and energy 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 three contracts to purchase coal at fixed prices through December 31, 2012.

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.

Foreign Currency

We are exposed to currency fluctuations as we invoice certain European customers in Euros. The Company used foreign currency forward contracts and foreign exchange forward contracts to manage some of the foreign currency exchange risks associated with foreign sales of its U.S. operations during 2010. Using such foreign currency forward contracts, the Company received or paid the difference between the contracted forward rate and the exchange rate at the settlement date. These contracts were used to hedge the variability of exchange rates on the Company's cash flows. No such contracts were outstanding at December 31, 2011 and 2010.

Item 8. Financial Statements and Supplementary Data

Financial statements are attached hereto beginning on Page F-1.

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures.

An evaluation of the effectiveness of our disclosure controls and procedures as of December 31, 2011 was made by our Chief Executive Officer and Chief Financial Officer. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Internal Control over Financial Reporting.

Management Annual Report on Internal Control over Financial Reporting. Our management's report on internal control over financial reporting is set forth on page F-2 of this report.

Our management has excluded USC from its assessment of internal control over financial reporting as of December 31, 2011 as it was acquired by us in a stock purchase business combination on October 31, 2011. USC is a wholly-owned subsidiary whose total assets and total revenues represent 36.6% and 6.5%, respectively, of our consolidated financial statement amounts as of, and, for the year ended December 31, 2011. Under guidelines established by the Securities and Exchange Commission, companies are allowed to excluded acquisitions from their assessment of internal control over financial reporting during the first year of an acquisition.

Changes in Internal Control over Financial Reporting. There were no changes in our internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item is incorporated by reference from our definitive proxy statement to be filed on or about April 15, 2012 with the Securities and Exchange Commission ("SEC").

Additional information required by this Item (i) with respect to members of our Board of Directors will be contained in the Company's Proxy Statement to be filed with the SEC on or about April 15, 2012 under the caption "Election of Directors," (ii) with respect to our audit committee will be contained in the Company's Proxy Statement under the caption "Election of Directors What Committees has the Board of Directors Established?," (iii) with respect to compliance under Section 16(a) of the Securities Exchange Act of 1934 will be contained in Company's Proxy Statement under the caption "Section 16(a) Beneficial Ownership Reporting Compliance," and (iv) with respect to our code of ethics will be contained in the Company's Proxy Statement under the caption "Code of Ethics," and is incorporated herein by this reference.

Item 11. Executive Compensation

The information required by this Item will be contained in the Company's Proxy Statement to be filed with the SEC on or about April 15, 2012 under the captions "Executive Compensation,"

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"Compensation Discussion and Analysis," "Report of the Compensation Committee of the Board of Directors," "Compensation Committee Interlocks and Insider Participation," "Summary Compensation Table," "2011 Grants of Plan-Based Awards," "Outstanding Equity Awards at Fiscal Year End 2011," "Potential Payments upon Termination or Change-in-Control," and "2011 Director Compensation" and is incorporated herein by this reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item will be contained in the Company's Proxy Statement to be filed with the SEC on or about April 15, 2012 under the captions "Securities Authorized for Issuance Under Equity Compensation Plan", "Security Ownership of Management" and "Security Ownership of Certain Beneficial Stockholders" and is incorporated herein by this reference.

Item 13. Certain Relationships and Related Persons Transactions and Director Independence

The information required by this Item will be contained in the Company's Proxy Statement to be filed with the SEC on or about April 15, 2012 under the captions "Certain Relationships and Related Person Transactions," and "Governance Structure" is incorporated herein by this reference.

Item 14. Principal Accountant Fees and Services

The information required by this Item will be contained in the Company's Proxy Statement to be filed with the SEC on or about April 15, 2012 under the caption "Independent Registered Public Accounting Firm" and is incorporated herein by this reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a)(1) ***Financial Statements***

An index to Consolidated Financial Statements appears on page F-1.

(a)(2) ***Financial Statement Schedule***

Certain financial statement schedules have been omitted because they are not applicable or the required information is shown in the financial statements or the notes thereto.

(b) ***Exhibits*.**

The following Exhibits are filed as part of this report:

Exhibit No.	Description
2.1	Purchase Agreement, dated June 23, 2006, by and among International Paper Company, the Registrant, and KapStone Kraft Paper Corporation. Incorporated by reference to Annex A of the Registrant's Definitive Proxy Statement (DEFM 14A) filed on December 15, 2006.
2.2	Letter Amendment dated December 15, 2006 to Purchase Agreement, dated June 23, 2006, by and among International Paper Company, the Registrant, and KapStone Kraft Paper Corporation. Incorporated by reference to the Registrant's Current Report on Form 8-K filed on January 4, 2007.

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Exhibit No.	Description
2.3	Letter Amendment dated January 4, 2011 to Purchase Agreement, dated June 23, 2006, by and among International Paper Company, the Registrant, and KapStone Kraft Paper Corporation. Incorporated by reference to the Registrant's Current Report on Form 8-K filed on January 4, 2011.
2.4	Asset Purchase Agreement dated April 4, 2008, among MeadWestvaco South Carolina LLC, MeadWestvaco Corporation, KapStone Paper and Packaging Corporation and Oak Acquisition, LLC. Incorporated by reference to the Registrant's Current Report on Form 8-K filed in April 7, 2008.
2.5	Agreement and Plan of Merger, dated as of September 22, 2011, by and among KapStone Kraft Paper Corporation, U.S. Corrugated Acquisition Inc., Pine Merger Corp., Dennis Dorian Mehiel, for purposes of Section 10.3, and Dennis Mehiel, for purposes of Section 10.3 and as the Representative. Incorporated by reference to the Registrant's Current Report on Form 8-K filed on September 22, 2011.
3.1	Restated Certificate of Incorporation of KapStone Paper and Packaging Corporation (as amended through January 2, 2007). Incorporated by reference to the Registrant's Annual Report on Form 10-K for the period ended December 31, 2009, filed on March 10, 2010.
3.2	Amended and Restated By-laws. Incorporated by reference to the Registrant's Current Report on Form 8-K filed on October 5, 2009.
4.1	Specimen Common Stock Certificate. Incorporated by reference to the Registrant's Registration Statement on Form S-1/A (File No. 333-124601) filed on June 14, 2005.
10.1	Form of Letter Agreement among the Registrant, Morgan Joseph & Co. Inc. and each of the Initial Stockholders. Incorporated by reference to the Registrant's Registration Statement on Form S-1/A (File No. 333-124601) filed on June 14, 2005.
10.2*	Amended and Restated 2006 Incentive Plan. Incorporated by reference to Appendix B of the Registrant's Definitive Proxy Statement filed on April 15, 2010.
10.3*	Performance Incentive Plan of KapStone Paper and Packaging Corporation. Incorporated by reference to the Registrant's Current Report on Form 8-K filed on April 14, 2008.
10.4*	Form of Restricted Stock Unit Agreement. Incorporated by reference to the Registrant's Current Report on Form 8-K filed on April 14, 2008.
10.5	Long-Term Fiber Supply Agreement, dated July 1, 2008, by and among MeadWestvaco Forestry LLC and KapStone Charleston Kraft LLC (with certain confidential information deleted there from). Incorporated by reference to the Registrant's Current Report on Form 8-K filed on July 2, 2008.
10.6	Credit Agreement, dated as of October 31, 2011, by and among KapStone Paper and Packaging Corporation, KapStone Kraft Paper Corporation, as Borrower, the subsidiaries of Borrower named therein, as Guarantors, the lenders named therein, Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer, Barclays Bank PLC, as Syndication Agent, and Fifth Third Bank and TD Bank, as co-Documentation Agents. Incorporated by reference to the Registrant's Current Report on Form 8-K filed on October 31, 2011.
10.10*	2009 Employee Stock Purchase Plan. Incorporated by reference to the Registrant's Form S-8 filed on December 11, 2009.
14.0	Code of Ethics.

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Exhibit No.	Description
21.1	Subsidiaries.
23.1	Consent of Ernst & Young LLP.
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.
31.2	Certification of the Principal Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.
32.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Principal Financial Officer pursuant to 18 U.S.C. 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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SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the Registrant had duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KAPSTONE PAPER AND PACKAGING CORPORATION

March 9, 2012 By: /s/ ROGER W. STONE

Roger W. Stone,
Chairman of the Board,
Chief Executive Officer and Director

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

March 9, 2012 By: /s/ ROGER W. STONE

Roger W. Stone,
Chairman of the Board, Chief Executive Officer and Director
(Principal Executive Officer)

March 9, 2012 By: /s/ ANDREA K. TARBOX

Andrea K. Tarbox,
Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)

March 9, 2012 By: /s/ MATTHEW KAPLAN

Matthew Kaplan,
President, Chief Operating Officer and Director

March 9, 2012 By: /s/ JOHN M. CHAPMAN

John M. Chapman,
Director

March 9, 2012 By: /s/ JONATHAN R. FURER

Jonathan R. Furer,
Director

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March 9, 2012	By:	/s/ BRIAN R. GAMACHE
		Brian R. Gamache, *Director*
March 9, 2012	By:	/s/ RONALD J. GIDWITZ
		Ronald J. Gidwitz, *Director*
March 9, 2012	By:	/s/ MATTHEW H. PAULL
		Matthew H. Paull, *Director*
March 9, 2012	By:	/s/ S. JAY STEWART
		S. Jay Stewart, *Director*
March 9, 2012	By:	/s/ DAVID P. STORCH
		David P. Storch, *Director*

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KapStone Paper and Packaging Corporation

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MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 3a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2011. Management based this assessment on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *"Internal Control Integrated Framework."*

Our management has excluded U.S. Corrugated Acquisition Inc. (USC) from its assessment of internal control over financial reporting as of December 31, 2011 as it was acquired by us in a stock purchase business combination on October 31, 2011. USC is a wholly-owned subsidiary whose total assets and total revenues represent 36.6% and 6.5%, respectively, of our consolidated financial statement amounts as of, and, for the year ended December 31, 2011. Under guidelines established by the Securities and Exchange Commission, companies are allowed to exclude acquisitions from their assessment of internal control over financial reporting during the first year of an acquisition.

Based on this assessment, management concluded that, as of December 31, 2011, our internal control over financial reporting is effective.

Ernst & Young LLP, an independent registered public accounting firm, has audited the consolidated financial statements of the Company and the Company's internal control over financial reporting and has included their reports herein.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
KapStone Paper and Packaging Corporation

We have audited KapStone Paper and Packaging Corporation's internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). KapStone Paper and Packaging Corporation's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As indicated in the accompanying Management's Annual Report on Internal Control over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of U.S. Corrugated Acquisition Inc., which is included in the 2011 consolidated financial statements of KapStone Paper and Packaging Corporation and constituted $411.7 million and $339.8 million of total and net assets, respectively, as of December 31, 2011 and $58.4 million and $1.5 million of revenues and net income, respectively, for the year then ended. Our audit of internal control over financial reporting of KapStone Paper and Packaging Corporation also did not include evaluation of the internal control over financial reporting of U.S. Corrugated Acquisition Inc.

In our opinion, KapStone Paper and Packaging Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the COSO criteria.

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We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets of KapStone Paper and Packaging Corporation as of December 31, 2011 and 2010, and the related statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2011, and our report dated March 9, 2012, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Chicago, Illinois
March 9, 2012

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
KapStone Paper and Packaging Corporation

We have audited the accompanying consolidated balance sheets of KapStone Paper and Packaging Corporation as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2011. Our audits also included the financial statement schedule listed in the Index at Item 15(a)(2). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of KapStone Paper and Packaging Corporation as of December 31, 2011 and 2010, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Oversight Board (United States), the effectiveness of KapStone Paper and Packaging Corporation's internal controls over financial reporting as of December 31, 2011, based on criteria establish in *Internal Control Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 9, 2012 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Chicago, Illinois
March 9, 2012

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KapStone Paper and Packaging Corporation

Consolidated Balance Sheets

(In thousands, except share and per share amounts)

	December 31, 2011	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 8,062	$ 67,358
Trade accounts receivable, less allowance of $571 in 2011 and $1,205 in 2010	108,320	66,640
Other receivables	11,247	2,780
Inventories	110,054	73,324
Prepaid expenses and other current assets	4,207	2,751
Deferred income taxes	10,048	9,394
Total current assets	251,938	222,247
Plant, property and equipment, net	567,195	466,019
Other assets	4,313	3,996
Intangible assets, net	63,715	22,654
Goodwill	237,193	4,811
Total assets	$ 1,124,354	$ 719,727
Liabilities and Stockholders' Equity		
Current liabilities:		
Current portion of long-term debt	$ 6,094	$ 18,835
Accounts payable	81,051	55,504
Accrued expenses	21,217	22,986
Accrued compensation costs	27,445	18,229
Total current liabilities	135,807	115,554
Other liabilities:		
Long-term debt, net of current portion	335,635	92,857
Pension and postretirement benefits	10,676	6,454
Deferred income taxes	84,316	17,917
Other liabilities	11,642	68,311
Total other liabilities	442,269	185,539
Commitments and contingencies		
Stockholders' equity:		
Preferred stock $0.0001 par value; 1,000,000 shares authorized; no shares issued and outstanding		
Common stock $0.0001 par value, 175,000,000 shares authorized; 46,449,695 shares issued and outstanding (40,000 treasury shares outstanding) at December 31, 2011 and 46,081,712 issued and outstanding at December 31, 2010 (40,000 treasury shares outstanding)	5	5
Additional paid-in capital	230,665	224,844
Retained earnings	318,068	194,087
Accumulated other comprehensive loss	(2,460)	(302)
Total stockholders' equity	546,278	418,634

Total liabilities and stockholders' equity	$ 1,124,354	$ 719,727

See notes to consolidated financial statements.

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KapStone Paper and Packaging Corporation

Consolidated Statements of Income

(In thousands, except share and per share amounts)

	Years Ended December 31,		
	2011	2010	2009
Net sales	$ 906,119	$ 782,676	$ 632,478
Cost of sales, excluding depreciation and amortization	628,613	565,185	355,088
Depreciation and amortization	51,036	45,245	54,667
Freight and distribution expenses	79,643	73,406	57,395
Selling, general and administrative expenses	41,265	31,129	31,377
Gain on sale of business			16,417
Other operating income	1,179	992	994
Operating income	106,741	68,703	151,362
Foreign exchange gains/(losses)	(319)	(666)	219
Interest expense, net	6,081	5,403	19,164
Income before provision (benefit) for income taxes	100,341	62,634	132,417
Provision (benefit) for income taxes	(23,640)	(2,407)	52,137
Net income	$ 123,981	$ 65,041	$ 80,280
Weighted average number of shares outstanding:			
Basic	46,287,183	45,854,237	34,675,804
Diluted	47,487,623	46,979,060	35,067,923
Net income per share:			
Basic	$ 2.68	$ 1.42	$ 2.32
Diluted	$ 2.61	$ 1.38	$ 2.29

See notes to consolidated financial statements.

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KapStone Paper and Packaging Corporation

Consolidated Statements of Changes in Stockholders' Equity

(In thousands, except share amounts)

	Common Stock, net of Treasury Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount				
Balance December 31, 2008	28,370,248	$ 3	$ 132,206	$ 48,766	$ (208)	$ 180,767
Stock-based compensation expense			2,377			2,377
Exercises of warrants into common stock	17,043,376	2	85,215			85,217
Exercise of stock options	4,450		30			30
Comprehensive Income:						
Net income				80,280		80,280
Pension and postretirement plan liability adjustments, net of tax of $(80)					119	119
Total Comprehensive Income						80,399
Balance December 31, 2009	45,418,074	$ 5	$ 219,828	$ 129,046	$ (89)	$ 348,790
Stock-based compensation expense			3,592			3,592
Restricted stock awards and payment of withholding taxes	122,433		(624)			(624)
Exercise of purchase option	348,393					
Exercise of stock options	186,171		1,282			1,282
Excess tax benefit from stock-based compensation			585			585
Employee Stock Purchase Plan	6,641		70			70
Other			111			111
Comprehensive Income:						
Net income				65,041		65,041
Pension and postretirement plan liability adjustments, net of tax of $111					(213)	(213)
Total Comprehensive Income						64,828
Balance December 31, 2010	46,081,712	$ 5	$ 224,844	$ 194,087	$ (302)	$ 418,634
Stock-based compensation expense			3,985			3,985
Restricted stock awards and payment of withholding taxes	133,365		(952)			(952)
Exercise of stock options	221,973		1,264			1,264
Excess tax benefit from stock-based compensation			1,332			1,332
Employee Stock Purchase Plan	12,645		192			192
Comprehensive Income:						
Net income				123,981		123,981
Pension and postretirement plan liability adjustments, net of tax of $1,183					(2,158)	(2,158)
Total Comprehensive Income						121,823
Balance December 31, 2011	46,449,695	$ 5	$ 230,665	$ 318,068	$ (2,460)	$ 546,278

See notes to consolidated financial statements.

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KapStone Paper and Packaging Corporation

Consolidated Statements of Cash Flows

(In thousands)

	Years Ended December 31,		
	2011	**2010**	**2009**
Operating activities			
Net income	$ 123,981	$ 65,041	$ 80,280
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	51,036	45,245	54,667
Stock-based compensation expense	3,985	3,592	2,377
Excess tax benefit from stock-based compensation expense	(1,332)	(585)	
Amortization of debt issuance costs	2,482	2,237	5,980
Loss on disposal of fixed assets	910	876	800
Deferred income taxes	41,766	(24,062)	19,459
Gain on sale of business			(16,417)
Changes in operating assets and liabilities:			
Trade accounts receivable, net	(3,679)	(8,232)	10,288
Other receivables	(2,722)	13,707	(13,398)
Inventories	(3,528)	(11,947)	23,465
Prepaid expenses and other current assets	(239)	12,696	446
Other assets	(639)	(624)	(1,031)
Accounts payable	(8,979)	3,357	10,641
Accrued expenses	(5,651)	2,186	(11,506)
Accrued compensation costs	3,424	10,510	(5,967)
Other liabilities	(64,439)	22,079	41,151
Net cash provided by operating activities	136,376	136,076	201,235
Investing activities			
USC acquisition (net of cash acquired)	(331,632)		
CKD acquisition		638	1,000
KPB acquisition earn-out payment	(49,700)		(3,977)
Proceeds from sale of business			34,898
Capital expenditures	(42,531)	(38,318)	(29,165)
Restricted cash		2,500	(2,500)
Net cash provided by (used in) investing activities	(423,863)	(35,180)	256
Financing activities			
Proceeds from revolving credit facility	7,600	76,700	80,000
Repayments on revolving credit facility	(7,600)	(84,100)	(85,000)
Proceeds from long-term debt	375,000		
Repayments of long-term debt and notes	(134,582)	(30,002)	(283,093)
Debt issuance costs paid	(13,819)		(370)
Proceeds from other current borrowings	2,273	2,564	
Repayments on other current borrowings	(2,273)	(2,564)	
Payment of withholding taxes on vested restricted stock awards	(952)	(624)	
Proceeds from exercises of warrants into common stock			85,217
Proceeds from exercise of stock options	1,264	1,282	30
Excess tax benefits from stock-based compensation	1,332	585	
Proceeds from issuance of shares to ESPP	192	70	
Other	(244)	111	

Net cash provided by (used in) financing activities	228,191	(35,978)	(203,216)
Net increase (decrease) in cash and cash equivalents	(59,296)	64,918	(1,725)
Cash and cash equivalents beginning of year	67,358	2,440	4,165
Cash and cash equivalents end of year	$ 8,062	$ 67,358	$ 2,440

See notes to consolidated financial statements.

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KAPSTONE PAPER AND PACKAGING CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share amounts)

1. Formation, Basis of Presentation and Description of Business

KapStone Paper and Packaging Corporation, or the "Company", produces and sells a variety of unbleached kraft paper in the United States and globally. The Company was incorporated on April 15, 2005 in Delaware.

On October 31, 2011, the Company consummated the acquisition of U.S. Corrugated Acquisition Inc. ("USC") from its stockholders by merger. The accompanying consolidated financial statements include the results of USC since the date of acquisition (see Note 3).

On March 31, 2009, the Company consummated the sale of its dunnage bag business to Illinois Tool Works Inc. The accompanying consolidated financial statements include the results of the dunnage bag business through the date of sale (see Note 5).

As a result of these transactions, the accompanying 2011 consolidated financial statements are not comparative to 2010 and 2009.

Certain amounts have been reclassified to conform to current presentation.

Principles of Consolidation The consolidated statements have been prepared on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated. In the opinion of management, all adjustments (consisting of a normal recurring nature) considered necessary for a fair presentation have been included.

Use of Estimates The preparation of financial statements and related disclosures requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Although these estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future, actual results may be different from the estimates.

2. Significant Accounting Policies

Revenue Recognition Revenue is recognized when the customer takes title and assumes the risks and rewards of ownership. Sales with terms f.o.b. (free on board) shipping point are recognized at the time of shipment. For sales transactions with terms f.o.b. destination, revenue is recorded when the product is delivered to the customer's site and when title and risk of loss are transferred. Sales on consignment are recognized in revenue at the earlier of the month that the goods are consumed or after a period of time subsequent to receipt by the customer as specified by contract terms, provided all other revenue recognition criteria is met. Incentive rebates are typically paid in cash and are netted against revenue on an accrual basis as qualifying purchases are made by the customer to earn and thereby retain the rebate.

The Company recognizes revenue from the sale of shaft horsepower, generated by our cogeneration facility, on a gross basis presented in net sales.

Freight charged to customers is recognized in net sales.

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KAPSTONE PAPER AND PACKAGING CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

2. Significant Accounting Policies (Continued)

Cost of Sales Cost of sales is determined on a first-in first-out basis and includes material, labor and overhead costs but excludes depreciation and amortization. Proceeds received from the sale of by-products generated from the paper and packaging manufacturing process are reflected as a reduction to cost of sales. Income from sales of by-products is derived primarily from the sale of tall oil, hardwood, turpentine and waste bales to third parties. During 2011, 2010 and 2009, cost of sales was reduced by $16.0 million, $15.5 million and $11.5 million, respectively.

Freight and distribution expenses Freight and distribution include shipping and handling costs for product sold to customers and is excluded from cost of sales.

Alternative Fuel Mixture Tax Credit The Company has elected to take the alternative fuel mixture tax credit as an excise tax credit and not as a reduction of federal income taxes payable; and accordingly, credits earned are reflected in operating income versus income tax expense. The amount of alternative fuel mixture tax credit earned is based on the volume of black liquor burned in the Company's production process. Black liquor is a raw material used in the production process and is recognized on the consolidated balance sheet within inventory. The Company's accounting policy for alternative fuel mixture tax credits earned was determined by the fuel tax credits' direct link to the manufacturing process. Accordingly, credits earned during the reporting period are reflected as a reduction of the cost basis of inventory and therefore capitalized at the end of the period for inventory on hand. As products are sold, the credits are included in the income statement as a reduction to cost of goods sold. The tax credit expired on December 31, 2009 (see Note 6).

Planned Maintenance Outage Costs The Company recognizes the cost of major maintenance activities in the period in which they occur under the direct expense method in accordance with ASC 360, *Property, Plant and Equipment*. Other maintenance costs are expensed as incurred. The Company performs annual planned maintenance outages at its Roanoke Rapids and Cowpens mills. The Charleston mill has a tri-annual planned maintenance outage which occurred during the year ended December 31, 2010. Costs of approximately $18.8 million, $21.6 million and $14.5 million related to planned maintenance outages are included in cost of sales for the years ended December 31, 2011, December 31, 2010 and December 31, 2009, respectively.

Net Income per Common Share Basic net income per share is based on the weighted average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution assuming common shares were issued for the exercise of outstanding in-the-money warrants and stock options and unvested restricted stock awards and assuming the proceeds thereof were used to purchase common shares at the average market price during the period such awards were outstanding and inclusion of such shares is dilutive to net income per share.

Concentrations of Risk Financial instruments that potentially expose the Company to concentrations of credit and market risk consist primarily of cash and cash equivalents and trade accounts receivable from sales of product to third parties. When excess cash and cash equivalents are invested they are placed in investment grade commercial paper.

No customer accounted for more than 10 percent of consolidated net sales in 2011, 2010 and 2009. In order to mitigate credit risk, the Company obtains letters of credit for certain export customers.

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KAPSTONE PAPER AND PACKAGING CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

2. Significant Accounting Policies (Continued)

The Company establishes its allowance for doubtful accounts based upon factors mainly surrounding the credit risks of specific customers and other related information. Once an account is deemed uncollectible, it is written off. At December 31, 2011, and 2010 the allowance for doubtful accounts totaled $0.6 million and $1.2 million, respectively. For the years ended December 31, 2011, 2010 and 2009, the Company had bad debt expenses of less than $0.1 million, $0.1 million and $0.6 million, respectively. For the year ended December 31, 2011, the Company wrote off $1.2 million of uncollectible accounts.

Foreign Currency Transactions The Company invoices certain European customers in Euros. Balance sheet accounts for such transactions are translated into U.S. dollars at the year-end rate of exchange and statements of income items are translated at the weighted average exchange rates for the period. Gains and losses arising from these transactions are included foreign exchange gains / (losses) within the Consolidated Statements of Income.

Cash and Cash Equivalents Cash equivalents include all highly liquid investments with maturities of three months or less when purchased.

Fair value of Financial Instruments The Company's cash and cash equivalents, trade accounts receivables and accounts payables are financial assets and liabilities with carrying values that approximate fair value. The Company's variable rate term loan is a financial liability with a fair value that approximates its carrying value of $355.3 million (see Note 11).

Inventories Inventories are valued at the lower of cost or market; whereby, cost includes all direct and indirect materials, labor, and manufacturing overhead, less by-product recoveries. Costs of raw materials, work-in-process, and finished goods are determined using the first-in, first-out method. Replacement parts and other supplies are stated using the average cost method. Purchases and sales of inventory with the same counterparty that are entered into in contemplation of one another are combined and recorded as exchanges of inventory measured at the book value of the item exchanged.

Plant, Property, and Equipment, net Plant and equipment is stated at cost less accumulated depreciation. Property, plant and equipment acquired in acquisitions were recorded at fair value on the date of acquisition. Depreciation is computed using the straight-line method over the assets' estimated useful lives. The range of estimated useful lives is as follows:

	Years
Land Improvements	3 - 25
Buildings	11 - 40
Machinery and equipment	3 - 30
Furniture and office equipment	5 - 10
Computer hardware and software	3 - 5

The Company accounts for costs incurred for the development of software for internal use in accordance with the ASC 350 *Intangibles Goodwill and Other*. This standard requires the capitalization of certain costs incurred in connection with developing or obtaining internal use software.

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KAPSTONE PAPER AND PACKAGING CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share an