

KAPSTONE PAPER & PACKAGING CORP

Form 10-Q

November 10, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities
Exchange Act of 1934

For the quarterly period ended September 30, 2008

Commission File Number: 001-33494

KapStone Paper and Packaging Corporation

(Exact name of registrant as specified in its charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

20-2699372
(I.R.S. Employer
Identification No.)

KapStone Paper and Packaging Corporation, 1101 Skokie Blvd., Suite 300

Northbrook, IL 60062

(Address of Principal Executive Offices including zip code)

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(847) 239-8800

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

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

There were 28,370,248 shares of the Registrant's Common Stock, \$0.0001 par value, outstanding at October 31, 2008, excluding 40,000 shares held as treasury shares.

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Table of Contents**Part 1. Financial Information****Item 1. Financial Statements****KapStone Paper and Packaging Corporation****Condensed Consolidated Balance Sheets****(In thousands, except share and per share amounts)**

| | September 30, 2008 (Unaudited) | December 31, 2007 |
|--|--------------------------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 41,874 | \$ 56,635 |
| Trade accounts receivable, net | 83,955 | 30,208 |
| Inventories | 74,203 | 19,846 |
| Refundable and prepaid income taxes | 11,416 | |
| Deferred income taxes | 2,599 | 1,263 |
| Prepaid expenses and other current assets | 12,650 | 735 |
| Total current assets | 226,697 | 108,687 |
| Plant, property and equipment, net | 481,987 | 104,858 |
| Other assets | 2,160 | 3,735 |
| Intangible assets, net | 48,972 | 5,875 |
| Goodwill | 8,902 | 2,295 |
| Total assets | \$ 768,718 | \$ 225,450 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Current portion of long-term debt and notes | \$ 35,752 | \$ 19,578 |
| Accounts payable | 37,128 | 11,050 |
| Accrued expenses | 32,963 | 4,867 |
| Accrued compensation costs | 12,839 | 6,625 |
| Accrued income taxes | | 1,477 |
| Total current liabilities | 118,682 | 43,597 |
| Other liabilities: | | |
| Long-term debt and notes | 443,357 | 32,922 |
| Pension and post-retirement benefits | 7,315 | 3,420 |
| Deferred income taxes | 14,222 | 1,047 |
| Other liabilities | 6,853 | 279 |
| Total other liabilities | 471,747 | 37,668 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock \$.0001 par value; 1,000,000 shares authorized; no shares issued and outstanding | 3 | 3 |

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| | | | |
|--|----|---------|------------|
| Common stock \$.0001 par value, 175,000,000 shares authorized; 28,309,377 shares issued and outstanding (40,000 treasury shares outstanding) at September 30, 2008 and 25,280,197 issued and outstanding (40,000 treasury shares outstanding) at December 31, 2007 | | | |
| Additional paid-in capital | | 131,336 | 115,002 |
| Retained earnings | | 46,887 | 29,101 |
| Accumulated other comprehensive income | | 63 | 79 |
| Total stockholders' equity | | 178,289 | 144,185 |
| Total liabilities and stockholders' equity | \$ | 768,718 | \$ 225,450 |

See notes to condensed consolidated financial statements

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KapStone Paper and Packaging Corporation
Condensed Consolidated Statements of Income
(In thousands, except share and per share amounts)

(unaudited)

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|--|----------------------------------|------------|------|------------|---------------------------------|------------|------|------------|
| | 2008 | | 2007 | | 2008 | | 2007 | |
| Net sales | \$ | 207,671 | \$ | 66,188 | \$ | 342,962 | \$ | 191,857 |
| Cost of sales, excluding depreciation and amortization | | 151,064 | | 39,910 | | 233,422 | | 123,704 |
| Freight and distribution | | 19,969 | | 6,116 | | 33,480 | | 17,476 |
| Selling, general and administrative expenses | | 9,757 | | 4,529 | | 19,251 | | 12,552 |
| Depreciation and amortization | | 12,953 | | 3,178 | | 18,381 | | 8,272 |
| Other operating income | | 218 | | 399 | | 589 | | 987 |
| Operating income | | 14,146 | | 12,854 | | 39,017 | | 30,840 |
| Foreign exchange losses | | 607 | | | | 607 | | |
| Interest income | | 51 | | 585 | | 891 | | 1,467 |
| Interest expense | | 8,772 | | 1,044 | | 9,985 | | 3,317 |
| Income before provision for income taxes | | 4,818 | | 12,395 | | 29,316 | | 28,990 |
| Provision for income taxes | | 2,513 | | 4,593 | | 11,530 | | 10,661 |
| Net income | \$ | 2,305 | \$ | 7,802 | \$ | 17,786 | \$ | 18,329 |
| Weighted-average number of shares outstanding: | | | | | | | | |
| Basic | | 26,904,070 | | 24,968,097 | | 25,859,149 | | 24,967,143 |
| Diluted | | 38,012,635 | | 36,674,697 | | 36,429,893 | | 35,723,847 |
| Net income per share: | | | | | | | | |
| Basic | \$ | 0.09 | \$ | 0.31 | \$ | 0.69 | \$ | 0.73 |
| Diluted | \$ | 0.06 | \$ | 0.21 | \$ | 0.49 | \$ | 0.51 |

See notes to condensed consolidated financial statements

Table of Contents**KapStone Paper and Packaging Corporation****Condensed Consolidated Statements of Cash Flows****(In thousands)****(unaudited)**

| | Nine Months Ended September 30, | |
|---|--|-------------|
| | 2008 | 2007 |
| Operating activities | | |
| Net income | \$ 17,786 | \$ 18,329 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 18,381 | 8,272 |
| Stock based compensation expense | 1,189 | 459 |
| Amortization of debt issuance costs | 1,170 | 193 |
| Deferred income taxes | 12,999 | 628 |
| Changes in operating assets and liabilities: | | |
| Trade accounts receivable, net | (17,367) | (5,089) |
| Interest receivable on short-term investments | | (379) |
| Inventories | 438 | 5,280 |
| Refundable and prepaid income taxes | (11,416) | |
| Prepaid expenses and other current assets | (4,937) | (573) |
| Accounts payable | (3,516) | 2,496 |
| Accrued expenses | 13,818 | (881) |
| Accrued compensation costs | 936 | 5,609 |
| Accrued income taxes | (1,477) | 1,927 |
| Net cash provided by operating activities | 28,004 | 36,271 |
| Investing activities | | |
| CKD acquisition (net of cash acquired) | (470,451) | (1,200) |
| KPB acquisition | | (150,303) |
| Capital expenditures | (12,714) | (9,070) |
| Purchase of short-term investments | | (35,000) |
| Net cash (used in) investing activities | (483,165) | (195,573) |
| Financing activities | | |
| Proceeds from long-term debt and notes | 455,000 | 60,000 |
| Borrowings under revolving credit facility | 71,800 | |
| Debt issuance costs paid | (12,593) | (855) |
| Repayment of long-term debt | (88,953) | (3,750) |
| Receipt of cash held in trust | | 115,239 |
| Redemption of shares | | (230) |
| Proceeds from the exercises of common stock warrants | 15,146 | 40 |
| Investment banking fee paid | | (1,200) |
| Net cash provided by financing activities | 440,400 | 169,244 |
| Net increase in cash and cash equivalents | (14,761) | 9,942 |
| Cash and cash equivalents-beginning of period | 56,635 | |
| Cash and cash equivalents-end of period | \$ 41,874 | \$ 9,942 |

See notes to condensed consolidated financial statements

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**KAPSTONE PAPER AND PACKAGING CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(In thousands, except share and per share amounts)

(unaudited)

1. Financial Statements

The accompanying unaudited condensed consolidated financial statements of KapStone Paper and Packaging Corporation (the Company, we, us, our or KapStone) have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of a normal recurring nature) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. For further information, refer to the consolidated financial statements and related footnotes included in our Annual Report on Form 10-K/A for the year ended December 31, 2007.

KapStone Paper and Packaging Corporation (formerly Stone Arcade Acquisition Corporation) or the Company was incorporated in Delaware on April 15, 2005. On May 25, 2006, the Company formed a wholly-owned subsidiary, KapStone Kraft Paper Corporation, or KapStone Kraft. The Company was formed to serve as a vehicle for the acquisition through a merger, capital stock exchange, asset acquisition, or other similar business combination (Business Combination) of an operating business in the paper, packaging, forest products and related industries.

On January 2, 2007, the Company acquired substantially all of the assets and assumed certain liabilities of the Kraft Papers Business (KPB) from International Paper Company (IP). Prior to the acquisition of KPB, the Company had no operations and was considered a development stage company.

On July 1, 2008, the Company consummated an asset purchase agreement with MeadWestvaco Corporation (MWV) to purchase substantially all of the assets and assume certain liabilities of the Charleston Kraft Division (CKD) for \$485 million, subject to certain post-closing adjustments. The accompanying condensed consolidated financial statements include the results of CKD since the date of acquisition.

2. Reclassification

Certain 2007 balances have been reclassified to conform to 2008 presentation, including freight and distribution from cost of sales, and amortization expense from selling, general and administrative expenses in the statements of income for the three and nine month periods ended September 30, 2007. In addition, deferred income taxes have been reclassified from accrued expenses in the statements of cash flows.

3. Accounting Pronouncements

In April 2008, the Financial Accounting Standards Board (FASB) issued Staff Position (FSP) 142-3, *Determination of the Useful Life of Intangible Assets*, which amends the factors that should be considered in developing renewal or extension assumptions used in determining the useful life of a recognized intangible asset. This FSP is effective for financial statements issued for fiscal years (and interim periods) beginning after December 15, 2008 (calendar year 2009). The Company is currently evaluating the impact of the provisions of this FSP on the consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements but does not change existing guidance as to whether or not an instrument is carried at fair value. In February 2008, the FASB released a FASB Staff Position, which delayed the effective date of SFAS No. 157 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value in the condensed consolidated financial statements on a recurring basis. SFAS No. 157 was first effective for the Company on January 1, 2008.

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The impact of the adoption of SFAS No. 157 on our financial assets and liabilities, which are principally comprised of cash equivalents, did not have a significant impact on their fair value measurements or require expanded disclosures.

4. CKD Acquisition

On July 1, 2008, the Company consummated an asset purchase agreement with MeadWestvaco Corporation (MWV) to purchase substantially all of the assets and assume certain liabilities of MWV 's Charleston Kraft Division (CKD), for \$485 million, subject to certain adjustments. CKD consists of an unbleached kraft paper manufacturing facility in North Charleston, South Carolina, chip mills located in Elgin, Hampton, Andrews and Kinards, South Carolina and a lumber business located in Summerville, South Carolina.

The acquisition was financed by cash on hand and by a new senior secured credit facility of \$515 million consisting of a LIBOR based five-year term loan of \$390 million, a LIBOR based seven-year term loan of \$25 million and a \$100 million revolving credit facility. In addition, \$40 million of seven-year 8.30% senior notes were issued. A portion of the proceeds were used to redeem the Company 's prior credit facility.

The CKD business was deemed an attractive acquisition candidate based upon meeting the Company 's objectives of being a North American-based, profitable company in the paper and packaging industry and for its synergies with the Company 's existing operations.

In connection with the CKD acquisition, the Company entered into a Long Term Fiber Supply Agreement (Supply Agreement) with MWV. Pursuant to the Supply Agreement, the Company will purchase, on a take or pay basis, certain amounts of pine pulpwood and saw timber at market prices for a period of 15 years. The purchases will be accounted for as raw materials.

The CKD acquisition was accounted for in accordance with the provisions of SFAS No. 141, *Business Combinations* and the accompanying condensed consolidated financial statements include the results of CKD since the date of acquisition.

The excess of the purchase price over the aggregate fair value of net assets acquired was allocated to goodwill. The following table summarizes the purchase price (\$000 s):

| | | |
|---|----|---------|
| Purchase price (net of cash acquired of \$10,572) | \$ | 474,428 |
| Preliminary working capital adjustment | | (7,525) |
| Transaction costs | | 4,748 |
| Total purchase price | \$ | 471,651 |

The excess of the purchase price over the aggregate fair value of net assets acquired was allocated to goodwill. Th

The following table summarizes the preliminary estimated fair value of the assets acquired and liabilities assumed at the date of acquisition (\$000 s):

| | | |
|---|----|----------|
| Trade accounts receivable | \$ | 36,380 |
| Inventories | | 54,795 |
| Prepaid expenses and other current assets | | 6,978 |
| Plant, property and equipment | | 378,837 |
| Deferred income taxes | | 1,160 |
| Intangible assets | | 46,520 |
| Goodwill | | 6,607 |
| Accounts payable | | (29,594) |
| Accrued expenses | | (14,878) |
| Accrued compensation costs | | (5,278) |
| Other liabilities | | (6,503) |
| Accrued pension and postretirement benefits | | (3,373) |
| Acquisition consideration | \$ | 471,651 |

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The appraisal process for determining the fair value of the acquired CKD assets, in accordance with SFAS No. 141, *Business Combinations*, included a valuation of the acquired assets with a consideration of the three traditional valuation approaches to fair value: cost, market and income. The preliminary appraisal was based on management's estimates and assumptions. As of September 30, 2008, the preliminary purchase accounting is still subject to final adjustment and could materially change in subsequent periods. The Company's management has not finalized its review of all CKD plant and equipment, intangible assets, deferred income taxes and other liabilities.

Goodwill is allocated amongst reporting units in proportion to the fair value of their net assets acquired at July 1, 2008. Goodwill of \$6.6 million was allocated to the unbleached kraft segment as a result of the CKD acquisition. See footnote 14 for additional discussion regarding the Company's segments.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized, but instead is tested annually for impairment, or more frequently, if circumstances indicate a possible impairment may exist. The impairment test will be conducted in the fourth quarter.

The following table summarizes the acquired intangible assets and their estimated fair value (\$000's):

| | Estimated Fair Value | Average Remaining Useful Life In Years |
|--|----------------------------|---|
| Trademarks and knowledge | \$ 27,700 | 8 |
| Coal supply contract with below-market terms | 13,700 | 1.5 |
| Engineering documents | 2,181 | 12 |
| Customer relationships | 1,989 | 20 |
| Transportation lease | 500 | 5 |
| Land lease | 290 | 99 |
| Customer backlog | 100 | 1 |
| Emission credits | 60 | 1 |
| Total fair value of intangible assets | \$ 46,520 | |

The fair value of the intangible assets will be amortized on a straight-line basis over the remaining useful lives. Estimated amortization expense for the next five years is as follows (\$000's):

| | |
|--------------------------------------|-----------|
| 2008 (third and fourth quarter only) | \$ 6,570 |
| 2009 | 13,060 |
| 2010 | 3,847 |
| 2011 | 3,847 |
| 2012 | 3,847 |
| 2013 | 3,797 |
| Thereafter | 11,552 |
| Total amortization | \$ 46,520 |

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The following unaudited pro forma consolidated results of operations assume that the acquisition of CKD occurred as of the beginning of the periods presented. This pro forma data is based on historical information and does not necessarily reflect the actual results that would have occurred, nor is it indicative of future results of operations (\$000 s).

| | Three months ended September 30, | | Nine months ended September 30, | |
|------------------------------|-------------------------------------|------------|------------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| Net sales | \$ 207,671 | \$ 190,540 | \$ 596,268 | \$ 568,414 |
| Net income | \$ 2,305 | \$ 8,144 | \$ 6,020 | \$ 13,135 |
| Net income per share basic | \$ 0.09 | \$ 0.33 | \$ 0.23 | \$ 0.53 |
| Net income per share diluted | \$ 0.06 | \$ 0.22 | \$ 0.17 | \$ 0.37 |

Certain corporate services were performed and allocated or charged by MWV to the historical CKD business. For the three and nine months ended September 30, 2007, and the nine months ended September 30, 2008, amounts allocated or charged by MWV to CKD were \$5,304, \$15,911 and \$14,775, respectively, and are included in net pro forma income.

5. Inventories

Inventories consist of the following at September 30, 2008, and December 31, 2007, respectively (\$000 s):

| | September 30, 2008 (Unaudited) | December 31, 2007 |
|--------------------------------|--------------------------------------|----------------------|
| Raw materials | \$ 20,964 | \$ 5,351 |
| Work in process | 1,573 | 655 |
| Finished goods | 33,449 | 9,851 |
| Replacement parts and supplies | 18,217 | 3,989 |
| Total inventories | \$ 74,203 | \$ 19,846 |

6. Accrued expenses

Accrued expenses consist of the following at September 30, 2008, and December 31, 2007, respectively (\$000 s):

| September 30, 2008 (Unaudited) | December 31, 2007 |
|--------------------------------------|----------------------|
|--------------------------------------|----------------------|

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| | | | | |
|---------------------------------|----|--------|----|-------|
| Accrued interest | \$ | 7,124 | \$ | 65 |
| Accrued taxes other than income | | 5,428 | | 1,835 |
| Accrued maintenance cost | | 3,956 | | 402 |
| Accrued liability with MWV | | 3,822 | | |
| Accrued energy | | 3,396 | | |
| Accrued workers compensation | | 1,920 | | 5 |
| Accrued freight | | 1,839 | | 569 |
| Other accruals | | 5,478 | | 1,991 |
| Total accrued expenses | \$ | 32,963 | \$ | 4,867 |

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7. Long-Term Debt and Credit Facility

Senior Credit Agreement

On June 12, 2008, the Company entered into a Credit Agreement, effective with the consummation of the acquisition of CKD, (the Senior Credit Agreement) which provides for an aggregate of up to \$515 million in senior secured credit facilities (the Senior Credit Facilities), consisting of a \$390 million term A loan facility, a \$25 million term B loan facility and a \$100 million revolving credit facility (including a letter of credit sub-facility). The Senior Credit Agreement replaces the prior senior secured credit facility due on December 31, 2011. The Senior Credit Facilities are guaranteed by the Company and its domestic subsidiaries and are secured by substantially all of the Company s assets.

The Senior Credit Facilities are required to be repaid in consecutive quarterly installments with final payments of all outstanding principal and interest on the maturity date. The maturity date is the earlier of: (a) June 12, 2013 with respect to the term A loan facility and the revolving credit facility, and June 12, 2015 with respect to the term B loan facility, and (b) the date which is 90 days prior to the date on which any earn-out obligations to International Paper Company will become (or are reasonably expected to become) due (January 2, 2011); provided that the maturity date will not be so accelerated if, among other things, the total leverage ratio as of the end of the then most recent fiscal quarter is less than 2.0 to 1.0.

Outstanding principal under the term A loan facility and the revolving credit facility initially bears interest at a rate equal to, at the Company s option, either (1) the base rate plus a margin of 1.50%, or (2) the reserve adjusted one, two, three or six-month LIBOR rate plus a margin of 3.00%. Commencing six months after the closing of the Senior Credit Facilities, pricing under the term A loan facility and the revolving credit facility and the unused line fee for the revolving credit facility will be determined by reference to a pricing grid based on our total leverage ratio. Under the pricing grid, the applicable margins for the term A loan facility and the revolving credit facility will range from 0.0% to 1.5% for base rate loans and from 1.50% to 3.00% for Eurodollar loans, and the unused line fee for the revolving credit facility will range from 0.375% to 0.50%. At September 30, 2008, the revolving credit facility was a base rate loan at a rate of 6.5% and term loan A was a LIBOR loan with a 6.1225% rate. The unused line fee for the revolving credit facility was 0.50% at September 30, 2008.

Outstanding principal under the term B loan facility bears interest at a rate equal to, at the Company s option, either (1) the base rate plus a margin of 2.00% or (2) the reserved adjusted one, two, three or six-month Eurodollar rate plus a margin of 3.50%. At September 30, 2008, the term B loan was a LIBOR loan with a 6.6225% rate.

The term loan facilities and the revolving credit facility may be prepaid at any time without premium penalties. The Senior Credit Facilities are subject to mandatory prepayment with specified percentages of the net cash proceeds of certain asset dispositions, casualty events, exercise of outstanding warrants, debt and equity issuances, and with excess cash flow, in each case subject to certain conditions. During the three months ended September 30, 2008, an \$11.9 million mandatory prepayment was made reflecting proceeds from the exercises of common stock warrants.

Borrowings under the revolving credit facility may be used for working capital and other general corporate purposes.

Note Purchase Agreement

Pursuant to the Note Purchase Agreement dated July 1, 2008 (the Note Purchase Agreement) the Company issued senior secured promissory notes (the Senior Notes) with an aggregate principal amount of \$40 million. The Senior Notes are guaranteed by the Company and secured by substantially all of the Company s assets.

The Senior Notes are required to be repaid in annual installments until the maturity date of July 1, 2015 and bear interest at the rate of 8.30%.

The Senior Notes may be prepaid at any time with the payment of an applicable yield-maintenance amount. In the event that a mandatory prepayment event occurs under the Senior Credit Agreement (certain asset dispositions, casualty events, exercises of outstanding warrants, debt and equity issuances and excess cash flow, in each case subject to certain conditions), then the Company is required to offer to repay, without premium, a pro rata portion of

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the Senior Notes held by each holder who accepts the Company's prepayment offer (such portion based on the product of (a) the net cash proceeds from the mandatory prepayment event required to be prepaid pursuant to the Senior Credit Agreement multiplied by (b) a fraction, the numerator of which is the aggregate outstanding principal amount of the Senior Notes held by such holder and the denominator of which is the sum of (x) the aggregate outstanding principal amount under the Senior Credit Agreement and (y) the aggregate outstanding principal amount under all Senior Notes.)

Long-term debt and notes at September 30, 2008 and December 31, 2007, is summarized as follows (\$000 s):

| | September 30, 2008 (Unaudited) | December 31, 2007 |
|--|---|------------------------------|
| Term A loan with interest payable quarterly at LIBOR plus 3.0% | \$ 371,719 | \$ |
| Term B loan with interest payable quarterly at LIBOR plus 3.5% | 23,828 | |
| Senior Notes with interest payable quarterly at 8.3% | 40,000 | |
| Revolving credit facility (6.5% at September 30, 2008) | 54,800 | |
| Term loan (6.3% at December 31, 2007) | | 52,500 |
| Less current portion of long-term debt and notes | (35,752) | (19,578) |
| Less unamortized debt issuance costs | (11,238) | |
| Total | \$ 443,357 | \$ 32,922 |

The Company recorded approximately \$12.6 million of debt issuance costs a