Mossberg's Investor Digest

July 2016
Issue #97

From the Editor…

Thank you for your subscription to Mossberg's Investor Digest.

Since its founding in 2005 as a Special Purchase Acquisition Vehicle (SPAC), KapStone Paper and Packaging Corporation (NYSE: KS) has been an active consolidator of businesses in the paper, packaging, forest products, and related industries. The Company has made five major acquisitions during that time period, growing the revenue base from $224 million to nearly $3 billion.

The Company operates 4 paper mills that produce 1.7 million tons of containerboard (used to make cardboard boxes) and 1 million tons of specialty paper (used to make grocery bags, bags for cement, pet food, etc.). The company has grown to the fifth largest producer of containerboard and the largest producer of kraft paper in North America. KapStone is partially vertically integrated in that approximately 50% of its 1.7 million tons of containerboard production is used by its 21 finishing plants to make boxes and corrugated sheets. The remaining 50% of its production is sold to third parties. The Company acquired Victory Packaging last year taking another step closer to the end customer and further vertically integrating its business. Victory provides distribution, custom packaging design, fulfillment, kitting and contract packaging services. Victory added a fleet of 220 delivery vehicles and 7 million square feet of warehouse space in 60 warehouses and distribution facilities in the United States (39) Canada(3) and Mexico(18).

As the company has grown, its cost position is improving by gaining efficiencies of scale and operational efficiencies. Cost savings and operating leverage should drive several points of margin improvement over time, and allow the bottom line to grow at a much faster pace than the top line. Our back of the envelope calculation shows 13% growth in EBITDA, which combined with debt reduction, could lead to a share price 2x the current levels over the next two years. Headquartered in Chicago, the company employs 6,400 employees.
As always, I appreciate your feedback.

Dave Mossberg
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July 2016 Issue

Every month we hear ideas suggested from our large network of professional investors. Here are a few of the ideas we heard this month, but have not reviewed in detail…

GSI Technology Inc (Nasdaq: GSIT) - GSI Technology designs, develops and markets a broad range of high performance memory products for networking, military, medical, automotive and other applications. They specialize in memory products featuring very high transaction rates, high density, low latency, high bandwidth, fast clock access times, and low power consumption. They offer unusually long product support life cycles, short lead times, the largest high performance memory product portfolio in the market and complete pre and post-sale support.

RadNet, Inc. (Nasdaq: RDNT) - RadNet, Inc provides outpatient diagnostic imaging services in the US. Its services include magnetic resonance imaging, computed tomography, positron emission tomography, nuclear medicine, mammography, ultrasound, diagnostic radiology (X-ray), fluoroscopy, and other related procedures, as well as multi-modality imaging services. The company also develops and sells computerized systems for the imaging industry, including picture archiving communications systems; and provides teleradiology services for remote interpretation of images on behalf of radiology groups, hospitals, and imaging center customers.

AxoGen, Inc. (Nasdaq: AXGN) – AxoGen is a leading medical technology company dedicated to peripheral nerve repair. AxoGen's portfolio of regenerative medicine products is available in the United States, Canada and several other countries, and includes Avance® Nerve Graft, an off-the-shelf processed human nerve allograft for bridging severed nerves without the comorbidities associated with an additional surgical site, AxoGuard® Nerve Connector, used to repair severed nerves, and AxoGuard® Nerve Protector, a product used to wrap and protect injured peripheral nerves and reinforce the nerve reconstruction while preventing soft tissue attachments.

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Best Idea Profile: **KapStone Paper and Packaging Corporation (NYSE: KS)**

DESCRIPTION:

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KapStone Paper and Packaging Corporation (NYSE: KS)
Investment Data (as of 7/31/16)

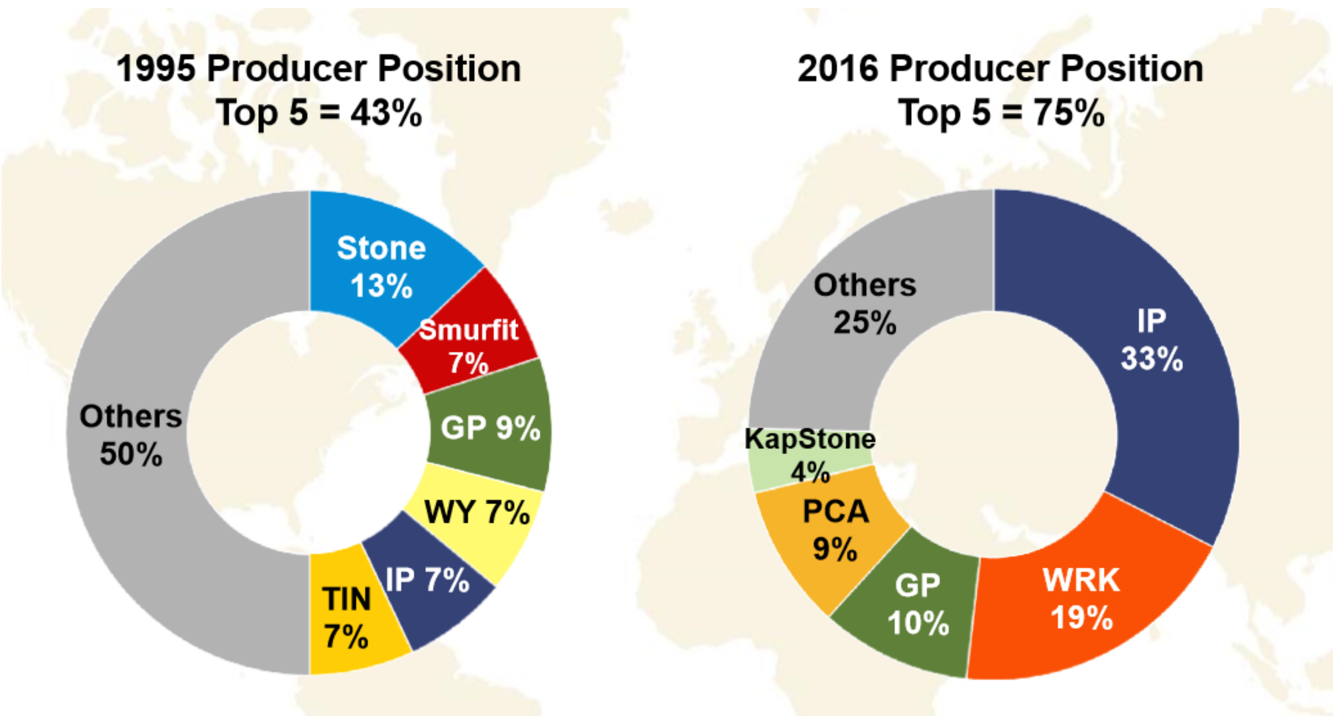
Recent Price	**$14.28**
52-Week Range	$8.95 - $24.91
Fiscal Year End	December
Dividend	0.40
Yield	2.8%
Shares Outstanding	96.5 M
Average Trading Volume (3 mos)	100,000
Market Capitalization	$1.4 B
Cash	$7 M
Long-term Debt	$1.5 B
Enterprise Value (EV)	$2.9 B
Book Value	$8.86
P/ Book	1.6 x
TTM Revenue	$3.0 B
EV/ Revenue	1.0 x
TTM Adjusted EBITDA	$394 M
EV/ EBITDA	7.4x
2016 EPS Consensus Est.	$1.17
P/2016E	12.4x

KEY INVESTMENT CONSIDERATIONS:

Ways to win in a commodity business

1) **Have a disciplined market environment -** The Fibre Box Association estimates that the U.S. corrugated products industry consists of approximately 540 companies and over 1,200 plants. As the figure below shows, in the past 10 years there has been significant industry consolidation, with the largest 5 players now controlling 75 percent of the market, up from 43% in 1995. As the largest players get larger, the competitive nature of the market becomes more disciplined. Without efficiencies of scale, smaller players have a difficult time producing adequate returns and become marginalized. In an undisciplined market, smaller players may price irrationally to generate cash, particularly during the bottom of a cycle. Now that the industry has consolidated, market participants should maintain greater pricing discipline and allow for more consistent returns for the larger players, including KapStone.

North American Container Board Market Share



Source: International Paper

Ways to win in a commodity business (continued)

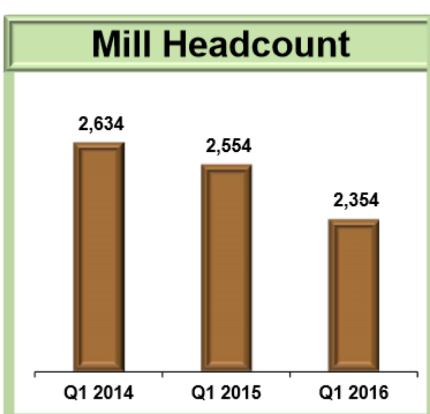
2) Be a low cost Provider

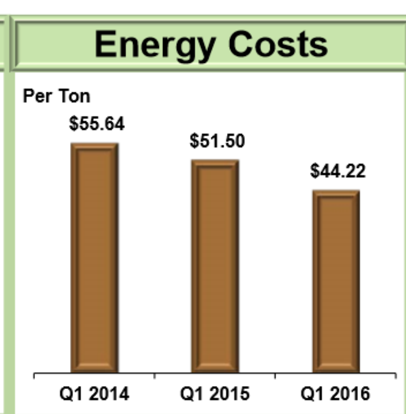
- **Gaining efficiencies of scale -** KapSone has made 5 major acquisitions since 2007 and continues to actively look for acquisition opportunities. KapStone has grown to the 5th largest player in the market with 4% market share.
- **Vertical integration removes the costs of the middle man –** The Company is becoming increasingly vertically integrated from the manufacturing of containerboard and paper, to providing design, custom packaging and distribution services to the end customer.
- **Victory Acquisition to improve utilization of mills and converting plants –** Recently acquired Victory Packaging has historically purchased more than 370,000 tons of corrugated products, only 6,200 tons of which was sourced from KapStone. At the time of the acquisition, management set a goal having 115,000 tons of Victory's purchases sourced from KapStone, which will drive improved asset utilization of the mills as well as the converting plants. Management plans to drive further integration of the two businesses.
- **Improve integration Rate –** Currently the Company's mills produce 1.7 million tons of container board, but only converts 900,000 tons of boxes/packaging. This yields an integration ratio of 55%, which is far below the 90% rate of its peers. Over time, with the integration of Victory and other acquisitions, the company plans to come in line with peers, which should significantly improve margin and return levels.

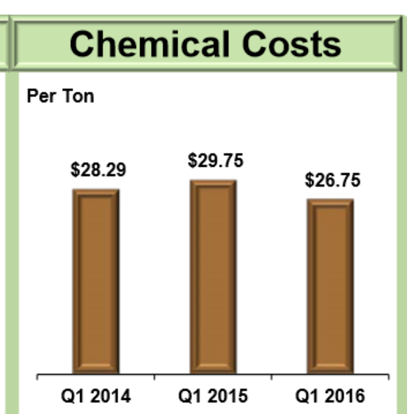
3) Improve efficiencies

The company has been working to improve efficiencies of its operations through a combination of investment in new, more efficient equipment, cutting staff levels and process improvement. The charts below illustrate cost improvements relative to the first quarter of Q1.

- **Lower energy costs -** It is important to note that more than two thirds of the energy cost savings are due to reduced consumption versus lower prices. Total cost per ton has declined further to $41.54/ ton during the second quarter, or roughly 25% since Q1 2014. This translates into 30 basis points of improvement in the Company's overall margin.
- **Chemical Costs** – Likewise, more efficient operations have resulted in $3/ ton decline in chemical costs, which translates into another 30 basis points of overall margin improvement.
- **Mill Headcount –** Mill headcount was 2,265 at the end of Q2. With an average savings per person of $95,000, that equates to $35 million in annual savings and translates into 120 basis points of improvement in overall margin levels.







Valuation

(in $millions)		TTM 2Q16	TTM 2Q17	TTM 2Q18
Revenue		**3,100**	**3,255**	**3,418**
Growth Assumption	5%			
EBITDA Margin		12.7%	13.7%	14.7%
TTM EBITDA		**394**	**446**	**502**
EBITDA Growth			13%	13%
Enterprise Value		2,900	3,396	3,952
EBITDA Multiple		**7.4**	**7.6**	**7.9**
Cash		7	7	7
Operating Cash Flow		324	376	433
Capex			150	150
Dividend			40	40
Free Cash Flow			**186**	**243**
Acquisitions			75	75
Debt Reduction			111	168
Debt		1500	1389	1221
Market Cap		1,400	2,007	2,731
Shares Outstanding		96.5	96.5	96.5
Price Per share		**$14.28**	**$20.80**	**$28.30**

In our back of the envelop calculation above we make the following assumptions for growth and improvement in profitability:

- **Revenue Growth –** Over the next two years, we assume revenue will grow at approximately 5% through a combination of internal growth initiatives and acquisitions.
- **EBITDA Margin –** We assume one percentage point of improvement in EBITDA margin during each of the next two years, reaching nearly 15% margin by mid-2018. Given that larger peers, IP, PCA and Westrock, are consistently producing EBITDA margin percent in the high teens/ low 20, improvement to mid-teens by KapStone seems very reasonable and leaves plenty of room for additional margin expansion.
- **Acquisitions -** We assume acquisition-related revenue will represent half of overall growth and assume acquisition prices that are roughly 1x revenue.
- **Multiple Expansion –** As the company continues to prove out its ability to improve operational profitability and gain efficiencies of scale, investors should be willing to assign an EV/EBITDA multiple more in line with larger peers. We assume multiple expansion of ½ a turn over the next two years to 8x EV/EBITDA.

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Mossberg's Investor Digest Idea Performance

The table below shows the relative change in the value of the ideas published since March 2015 and the Russell 2000. **Performance data quoted represents past performance and does not guarantee future results.** Current performance of ideas may be lower or higher than the performance quoted.

Company	Pub. Date	Original Price	Recent Price	Change	Russell 2000 Change Since Pub.	Relative Perf. vs. Russell 2000
M/A-Com Technology Solutions Holdings, Inc. (NASDAQ:MTSI)	28-Mar-15	$35.81	$39.56	10.5%	-1.9%	12.4%
Kimball International, Inc. (NASDAQ:KBAL)	30-Apr-15	$9.97	$11.52	15.5%	-0.3%	15.8%
Ironclad Performance Wear Corp. (OTC:ICPW)	30-May-15	$0.27	$0.24	-11.1%	-2.4%	-8.7%
Customers Bancorp, Inc. (NYSE: CUBI)	30-Jun-15	$26.87	$25.87	-3.7%	-3.0%	-0.8%
Potbelly Corporation (NASDAQ: PBPB)	30-Jul-15	$13.43	$12.96	-3.5%	-1.2%	-2.3%
Cosi Inc. (NASDAQ:COSI)	31-Aug-15	$1.17	$0.19	-84.2%	5.0%	-89.1%
Calloway Golf Company (NYSE: ELY).	30-Sep-15	$8.39	$10.43	24.3%	10.6%	13.8%
New Gold (NYSE: NGD).	31-Oct-15	$2.47	$4.77	93.1%	4.7%	88.4%
Townsquare Media (NYSE: TSQ)	30-Nov-15	$11.43	$8.56	-25.1%	1.6%	-26.7%
Build-A-Bear Workshop (NYSE: BBW)	31-Dec-15	$11.72	$13.94	18.9%	7.1%	11.8%
Dycom Industries, Inc (NYSE: DY)	31-Jan-16	$62.18	$95.83	54.1%	17.5%	36.6%
Rackspace Hosting, Inc. (NYSE: RAX)	29-Feb-16	$21.54	$23.24	7.9%	17.7%	-9.8%
Kopin Corporation (Nasdaq:KOPN)	31-Mar-16	$1.66	$2.50	50.6%	9.2%	41.4%
PAR Technology Group (NYSE: PAR)	30-Apr-16	$6.39	$5.04	-21.1%	7.6%	-28.7%
Full House Resorts Inc. (Nasdaq: FLL)	30-May-16	$1.60	$1.85	15.6%	5.8%	9.9%
Control4 Corporation (Nasdaq: CTRL)	30-Jun-16	$7.99	$8.58	7.4%	5.6%	1.7%
			Average	**9.3%**	**5.2%**	**4.1%**

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The value proposition of the digest is essentially an "Idea Generator". During the course of my 18-year career in capital markets, I've had the chance to meet and work closely with some very smart professional investors who have consistent track records of outperforming the market indexes. Some of these investors, which include mutual fund managers, hedge fund managers, and other professional investors, are kind enough to share their best ideas with me. I conduct my own analysis of their ideas and publish summaries of those ideas I think represent timely investment opportunities. Over time, I trust the majority of these ideas will pan out and help subscribers generate index-beating returns.

The goal of the Best Idea Profiles in this newsletter is to briefly describe the most relevant investment merits and risks of a company. It is not intended to be an exhaustive report including every detail. With limited space available, I am forced to include only those data points that I feel are most important for subscribers to know before they begin their own due diligence. Thank you for your interest in Mossberg's Investor Digest.

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