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

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2016

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

For the transition period from to

Commission File Number: 001-33494

KapStone Paper and Packaging Corporation

(Exact Name of Registrant as Specified in its Charter)

Delaware	20-2699372
(State or Other Jurisdiction of 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 including zip code)

Registrant's Telephone Number, including area code (847) 239-8800

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (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 96,571,405 shares of the Registrant's Common Stock, $0.0001 par value, outstanding at July 20, 2016.

KAPSTONE PAPER AND PACKAGING CORPORATION

Index to Form 10-Q

TABLE OF CONTENTS

PART 1. FINANCIAL INFORMATION

ITEM 1. - FINANCIAL STATEMENTS

KAPSTONE PAPER AND PACKAGING CORPORATION

Consolidated Balance Sheets

(In thousands, except share and per share amounts)

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

Common stock—$0.0001 par value; 175,000,000 shares authorized; 96,530,362 shares issued and outstanding (excluding 40,000 treasury shares) at June 30, 2016 and 96,327,506 shares issued and outstanding (excluding 40,000 treasury shares) at December 31, 2015		
Additional paid-in-capital	271,530	266,220
Retained earnings	659,789	642,306
Accumulated other comprehensive loss	(62,223)	(63,256)
Total stockholders’ equity	869,106	845,280
Total liabilities and stockholders’ equity	$ 3,236,450	$ 3,222,110

See notes to consolidated financial statements.

KAPSTONE PAPER AND PACKAGING CORPORATION

Consolidated Statements of Comprehensive Income

(In thousands, except share and per share amounts)

(unaudited)

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

See notes to consolidated financial statements.

KAPSTONE PAPER AND PACKAGING CORPORATION

Consolidated Statements of Cash Flows

(In thousands)

(unaudited)

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

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

See notes to consolidated financial statements.

KAPSTONE PAPER AND PACKAGING CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share amounts)

(unaudited)

1. Financial Statements

The accompanying unaudited consolidated financial statements of KapStone Paper and Packaging Corporation (the "Company," "we," "us," "our" or "KapStone") have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of a normal recurring nature) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. For further information, refer to the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2015.

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

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

2. Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB') issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers". The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The guidance in this update supersedes the revenue recognition requirements in Accounting Standards Codification (“ASC”) Topic 605, “Revenue Recognition”, and most industry-specific guidance throughout the Industry Topics of the Codification. Additionally, this update supersedes some cost guidance included in Subtopic 605-35, “Revenue Recognition—Construction-Type and Production-Type Contracts”. The standard will be effective for public entities for annual reporting periods beginning after December 15, 2017 and interim periods therein. Additionally the FASB approved the option to early adopt up to the original effective date (fiscal years beginning after December 15, 2016). We are currently evaluating the impact that the adoption of ASU 2014-09 will have on our financial position, results of operations and disclosures.

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

In July 2015, the FASB issued ASU 2015-11, “Simplifying the Measurement of Inventory,” which is intended to simplify the subsequent measurement of inventories by replacing the current lower of cost or market test with a lower of cost and net realizable value test. The guidance applies only to inventories for which cost is determined by methods other than last-in first-out and the retail inventory method. Application of the standard, which should be applied prospectively, is required for the annual and interim periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of this standard to have a material impact on its consolidated balance sheets.

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

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

3. Planned Maintenance Outages

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

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

6

4. Inventories

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

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

5. Short-term Borrowings and Long-term Debt

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

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

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

Short-term Borrowings

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

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

Receivables Credit Facility

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

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

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

Debt Covenants

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

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

Fair Value of Debt

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

6. Income Taxes

The Company's effective income tax rate for the three and six months ended June 30, 2016 was 36.5 percent and 35.6 percent, respectively, compared to 35.2 percent and 35.0 percent for the three and six months ended June 30, 2015. Our tax rate is affected by recurring items such as state income taxes, as well as discrete items that may occur in any given period but are not consistent from period to period. In addition to state income taxes, the domestic manufacturing deduction had the most significant impact on the difference between our statutory U.S. federal income tax rate of 35 percent and our effective income tax rate for both periods. The higher effective income tax rate in the three and six months ended June 30, 2016 includes a provision for an unfavorable state examination adjustment.

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

7. Net Income per Share

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

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

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

8. Pension Plan and Post-Retirement Benefits

Defined Benefit Plan

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

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

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

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

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

Defined Contribution Plan

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

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

9. Stock-Based Compensation

The Company accounts for stock-based awards in accordance with ASC 718, "Compensation — Stock Compensation," which requires that the cost resulting from all share-based payment transactions be recognized as compensation cost over the vesting period based on the fair value of the instrument on the date of grant.

Total stock-based compensation expense related to the stock option and restricted stock unit grants for the three and six months ended June 30, 2016 and 2015 is as follows:

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

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

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

As of June 30, 2016, total unrecognized compensation cost related to non-vested stock options and restricted stock units is expected to be recognized over a weighted average period of 2.3 years and 2.2 years, respectively.

Stock Options

The following table summarizes stock options amounts and activity:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Intrinsic Value (dollars in thousands)
Outstanding at January 1, 2016	3,265,900	$ 15.45		
Granted	1,237,455	12.72		
Exercised	(69,798)	8.88		
Lapsed (forfeited or cancelled)	(66,287)	23.61		
Outstanding at June 30, 2016		391		
Total		13,813		14,615
Gain on sale of operating real estate assets:				
Wholly-owned real estate assets – discontinued operations		(34,697)		(2,382)
Joint venture real estate assets		-		(432)
Total		(34,697)		(2,814)
FFO available to common shareholders – diluted		**$ 24,335**		**$ 17,591**
Debt extinguishment costs associated with the sale of real estate assets		156		**-**
FFO available to common shareholders, after a supplemental adjustment to exclude debt extinguishment costs associated with the sale of real estate assets – diluted		**$24,491**		**$17,591**
Average common shares outstanding – basic		29,420		28,981
Incremental shares from assumed conversions of:				
Common units		3,959		4,296
Stock options		80		135
Other		20		13
Average common shares outstanding – diluted		33,479		33,425
Reconciliation of FFO available to common shareholders – diluted to FFO available to common shareholders – basic:				
FFO available to common shareholders – diluted		$24,335		$17,591
Less: Minority interest of common unitholders in Operating Partnership		(2,886)		(2,271)
FFO available to common shareholders – basic		**$21,449**		**$15,320**
FFO available to common shareholders, after a supplemental adjustment		$24,491		$17,591

to exclude debt extinguishment costs associated with the sale of real estate assets – diluted		
Less: Minority interest of common unitholders in Operating Partnership	(2,905)	(2,271)
FFO available to common shareholders, after a supplemental adjustment to exclude debt extinguishment costs associated with the sale of real estate assets – basic	**$21,586**	**$15,320**

35

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our capital structure includes the use of fixed-rate and variable rate indebtedness. As such, we are exposed to the impact of changes in interest rates. We periodically seek input from third-party consultants regarding market interest rate and credit risk in order to evaluate our interest rate exposure. In some situations, we may utilize derivative financial instruments in the form of rate caps, rate swaps or rate locks to hedge interest rate exposure by modifying the interest rate characteristics of related balance sheet instruments and prospective financing transactions. We do not utilize such instruments for trading or speculative purposes. We did not have any derivative instruments in place at March 31, 2005 or December 31, 2004.

We typically refinance maturing debt instruments at then-existing market interest rates and terms, which may be more or less favorable than the interest rates and terms on the maturing debt.

Refer to our Annual Report on Form 10-K for the year ended December 31, 2004 for detailed disclosure about quantitative and qualitative disclosures about market risk. Quantitative and qualitative disclosures about market risk have not materially changed since December 31, 2004.

ITEM 4. CONTROLS AND PROCEDURES

We carried out an evaluation under the supervision and with the participation of senior management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness as of March 31, 2005 of the design and operation of our disclosure controls and procedures as defined in Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There was no change in internal control over financial reporting that occurred in the first quarter of 2005 that has materially affected or is reasonably likely to materially affect our internal controls over financial reporting.

Part II – Other Information

Item 1: Legal Proceedings

We have been named as a party in a class action lawsuit filed in the Florida State Circuit Court alleging that fees charged when residents terminate their leases prior to the end of term or terminate without sufficient notice are not in compliance with state law. We have appealed the Court's December 2004 Order certifying the class. In the first quarter of 2005, we recorded $1.8 million of expected costs associated with a preliminary agreement to settle the class action lawsuit. The preliminary agreement to settle the class action lawsuit is subject to court approval once finalized between the parties and published to the class. The charge of $1.8 million represents an estimate and is comprised of two components: (1) expected plaintiffs' attorneys fees and other costs of the settlement of approximately $1.2 million, payable upon court approval of the settlement, and (2) an estimate of $0.6 million for the amount of contested fees we expect to be substantiated by eligible class members who elect to make a claim, payable if and when proven according to procedures included in the settlement. The proposed settlement caps contested fees at $3.0 million, with no minimum and requires that $350,000 be initially placed into an escrow account controlled by us to pre-fund the payment of expected claims. There can be no assurance that the settlement of the class action lawsuit will be finalized as currently proposed or that actual contested fees will not ultimately exceed our current estimate.

Item 2: Unregistered Sales of Equity Securities and Use of Proceeds

As of March 31, 2005, the Operating Partnership had 79 holders of common units (one general partner and 78 limited partners). On January 4, 2005, we issued 2,750 common shares valued at approximately $94,298 at the time of issuance, to a limited partner of the Operating Partnership in exchange for 2,750 common units. On January 21, 2005, we issued 75,000 common shares valued at approximately $2,580,000 at the time of issuance, to a limited partner of the Operating Partnership in exchange for 75,000 common units. Such shares were issued in reliance on an exemption from registration under Section 4(2) of the Securities Act of 1933, as amended, and the rules and regulations promulgated thereunder, as these were transactions by an issuer not involving a public offering. In light of the information obtained by us from the limited partners in connection with these transactions, we believe we may rely on this exemption.

The following table summarizes repurchases of our common shares and common units during the three months ended March 31, 2005 (in thousands, except per share and per unit amounts):

Period	**Total Number of Securities Purchased (a)**		**Average Price Paid per Security (b)**		**Total Number of Shares and Units Purchased as Part of Publicly Announced Plans or Programs (c)**	**Dollar Value of Shares and Units that May Yet be Purchased Under the Plans or Programs**
	Shares	**Units**	**Shares**	**Units**		
January 1-31	-	-	$ -	$ -	-	$ 83,975,544
February 1-28	223,900	30,000	34.83	34.39	253,900	75,145,375
March 1-31	87,600	223,619	34.54	34.96	311,219	64,301,668
Total	311,500	253,619	$34.75	$34.89	565,119	$ 64,301,668

(a) Common units redeemed from limited partners of the Operating Partnership in exchange for common shares are not considered a repurchase and are excluded from the table above. We are obligated to redeem each common unit held by a limited partner of the Operating Partnership, other than us, at the request of the holder for an amount equal to the fair market value of a share of our common shares at the time of such redemption, provided that we, at our option, may elect to acquire each common unit presented for redemption for one common share or cash.

(b) Includes commissions for the common shares repurchased on the open market.

(c) In November 2002, our board of trustees implemented a common equity repurchase program pursuant to which we are authorized to repurchase in open market or privately-negotiated transactions up to $200 million of our outstanding common shares or units, depending on market prices and other prevailing conditions and using proceeds from sales of selected assets.

Item	3:		Defaults Upon Senior Securities
			None
Item	4:		Submission of Matters to a Vote of Security Holders
			None
Item	5:		Other Information
			None
Item	6:		Exhibits
		* 31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer)
		* 31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer)
		** 32.1	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith
** Furnished herewith

38

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	GABLES RESIDENTIAL TRUST
Date: May 10, 2005	/s/ Marvin R. Banks, Jr.
	Marvin R. Banks, Jr. Senior Vice President and Chief Financial Officer (Authorized Officer of the Registrant and Principal Financial Officer)
Date: May 10, 2005	/s/ Dawn H. Severt
	Dawn H. Severt Senior Vice President and Chief Accounting Officer (Principal Accounting Officer)