

MOD-PAC Corp.
Third Quarter 2009 Earnings Conference Call
November 4, 2009



Operator: Greetings ladies and gentlemen and welcome to MOD-PAC CORP.'s third quarter 2009 earnings conference call. It is now my pleasure to introduce your host Mr. Craig Mychajluk, Investor Relations for MOD-PAC.

Craig Mychajluk: Thank you, Manny. Thank you, everyone, for joining us today. On the call I have with me Dan Keane, President and CEO of MOD-PAC and Dave Lupp, COO and CFO. They will be reviewing the results of the third quarter and progress on the company's strategies. You should have a copy of the financial results that went out this morning, and if not, you can access it at the Company's website www.modpac.com.

As you are aware, we may make some forward looking statements during the formal discussion as well as during the question and answer session. These statements apply to future events and are subject to risks and uncertainties, as well as other factors that could cause actual results to differ from what is stated here today. These risks and uncertainties and other factors are provided in the earnings release as well as other documents filed by the company with the Securities and Exchange Commission. These documents can be found at the Company's website or at www.sec.gov.

With that, let me turn it over to Dan.

Daniel Keane: Thank you, Craig. Good afternoon, everyone. Thank you for joining us today. We had a strong quarter, as you could see from the release today. The strategic action that we undertook in the second quarter, by exiting the commercial print market enabled us to achieve solid profitability in the third quarter, even though top line sales have remained relatively flat.

We earned \$0.29 per diluted share, or \$1 million, in net income. This was our best quarter since the fourth quarter of 2005. The 14.8% increase in custom folding carton sales was offset by declines in stock packaging and personalized print, and the elimination of sales to the commercial print market due to the rationalization of the Company's specialty print and direct mail product line. Excluding last year's \$1.1 million in specialty print and direct mail sales, total revenue in the third quarter of 2009 grew \$1 million, or 8.8%.

Custom folding carton sales performed well in light of the economic challenges that have impacted our other lines of business. This was due, in part, to our ability to attract new accounts and gain a greater share of our existing customers' business. In addition, many of our custom folding carton customers are in recession-resistant industries, such as private label food and medical markets, and as a result, have actually seen sales increase through this downturn. Custom folding carton sales in this year's third quarter were \$9.4 million, up \$1.2 million, compared with last year. Offsetting some of our gains in the recent quarter was a decrease in waste sales, due to a drop in the recycled paperboard market. We are pursuing a number of new folding carton opportunities and expect to see continued growth in this product line.

As I previously mentioned, economic conditions have impacted our stock packaging and personalized print lines. However, stock packaging sales were down only marginally to \$2.2 million from last year's third quarter. We are hopeful this is an early indication the market may be stabilizing. Personalized print sales declined to \$0.8 million in the third quarter of 2009 compared with \$1 million in the third quarter of 2008. We have targeted, well-defined sales plans for these product lines and have seen some success through our website, www.partybasics.com, as well as our Krepe-Kraft brand.

I will now turn it over to Dave for a more detailed review of our operating and financial performance.



David Lupp: Thanks, Dan, and good afternoon, everyone. As Dan mentioned, we had a solid quarter on relatively flat sales and have measurably improved as a result of our exiting the commercial print market and rationalizing our product lines. Total product sales, excluding rent, was \$12.4 million in the quarter.

Sales of folding cartons, which combine custom folding cartons and stock packaging, were \$11.6 million in the third quarter of 2009, up 11.2% from \$10.5 million in the third quarter of 2008. High custom folding carton sales were slightly offset by marginally lower sales of stock packaging.

Print services sales, which are now solely comprised of personalized print, were down \$1.2 million, or 60.7%, to \$0.8 million in the third quarter of 2009. Last year's third quarter included \$1.1 million in specialty print direct mail revenue.

Gross margin expanded nicely and was 20%, up 440 basis points, when compared with 15.6% in the 2008 third quarter. Gross profit increased \$0.5 million, or 27.4%, to \$2.5 million in the reported quarter. As a result of the product line rationalization, labor costs were down, depreciation was reduced and supply purchases weren't required. We also benefited from reduced freight expense as gas prices were down this year and lower natural gas prices helped as well. Product mix and reduced recycled paperboard waste sales dampened these savings somewhat.

Selling, general and administrative expense was relatively flat for the quarter at \$1.8 million, or 14.6%, of total revenue, compared with \$1.9 million, or 14.7%, of total revenue, in the 2008 third quarter. Lower labor costs from the product line rationalization, along with lower professional service fees, as some of our technology and systems development have been implemented, were partially offset by increased sales commission expense.

Other income of \$0.4 million included a \$104,000 gain on the sale of assets associated with the rationalized specialty print direct mail product line, plus an additional \$263,000 fair value adjustment to increase the balance of assets held for sale associated with the rationalized product line based on bids received in our public auction held in late September 2009.

Adjusted EBITDA, or earnings before interest, asset impairment, fair value adjustment, taxes, depreciation, amortization and non-cash option expense, was \$1.5 million in the third quarter of 2009, a significant improvement when compared with \$1 million in the third quarter of 2008. We believe that adjusted EBITDA, although not a generally accepted accounting principle measure, is a good indicator of our business performance as it reflects our ability to generate cash from our operations.

We have recorded a full valuation allowance on our net deferred tax asset due to the uncertainty with respect to utilizing it in the future based on a past trend of operating losses in the second quarter of this year. As a result, the effective tax rate for the third quarter of 2009 was 0% compared with last year's effective tax rate of 74.1%.

We had positive net income of \$1 million, or \$0.29 per diluted share, in the third quarter of 2009 compared with \$14,000, or basically break even, in the third quarter of 2008 on about the same level of sales.

As you all know, cash is king, and we are pleased with what we were able to do this quarter to pay down our debt and increase our cash balance. Cash and cash equivalents were \$315,000 at quarter-end, up from the \$166,000 we had at the end of the second quarter and improved over the \$200,000 at the end of last year.

During the third quarter 2009, we generated \$1 million in cash from our operations primarily due to higher net income and non-cash depreciation and amortization expense, partially offset by



increased working capital requirements. Other sources of cash this quarter included surrendering life insurance policies that had a combined cash surrender value of \$857,000 and the sale of specialty print and direct mail assets for \$212,000. Those proceeds were used to pay down our debt and increase our cash on hand.

Borrowings on our \$5 million line of credit were \$600,000 at the end of the quarter, down \$1.7 million from the end of the second quarter. We are in discussions with our current lender and several others to renew or replace our existing line of credit which expires in March 2010.

During October 2009, we signed an agreement to sell the building that previously housed the personalized print operations. The sale is subject to various terms and conditions, and there is no assurance that the facility will be sold. The net proceeds from the sale are expected to approximate the carrying value of the property at the end of the third quarter of 2009. If all goes according to plan, we hope to close by the end of 2009.

Capital expenditures were \$841,000 in the first nine months of 2009 compared with \$1.6 million in the first nine months of 2008. Cap Ex spending in 2009 has been for productivity enhancements as well as new equipment. We expect capital expenditures of approximately \$1 million for the full year.

Depreciation and amortization expense was down \$319,000 to \$2.5 million for the first nine months of 2009, primarily due to a reduced asset base resulting from our second quarter 2009 write-down of assets for the specialty print and direct mail product line.

We currently have authorization to purchase up to 75,885 additional common shares. Our book value at the end of the third quarter was \$6.41.

I will now just briefly review the first nine months of this year.

Product sales were up 2.3%, or \$35.7 million, compared with \$34.9 million in the same period last year. Included in last year's figures was \$3.2 million in specialty print and direct mail sales compared with \$1.5 million in the first half of this year. Excluding this product line from both years, total sales increased 7.8% to \$34.2 million for the nine-month period in 2009 compared with \$31.7 million for the same period last year.

Gross margin was down slightly to 12.2% for the 2009 year-to-date period when compared with 13% last year. The decline was the result of a generally weaker sales mix, decreased recycled paperboard waste sales, and increased labor and repairs expense, partially offset by lower depreciation expense.

SG&A expense decreased 3.3% to \$5.8 million, or 16.1% of total revenue, in the first nine months this year compared with \$6 million, or 17% of total revenue, in the first nine months of 2008. Primarily lower professional service costs drove the decrease. We also had a \$2.2 million charge to SG&A that was associated with the write-down of impaired assets in the second quarter this year due to the Company's rationalization of the specialty print and direct mail product line. For the nine-month period, adjusted EBITDA was \$1.5 million in 2009 compared with \$1.8 million in 2008.

Maintaining cost discipline will continue to be a priority for us as well as growing our revenue in our core product lines. We will be challenged, of course, as we face the prospects of continued inflation especially with health insurance costs and the continually changing paperboard markets. Nonetheless, we believe that with the changes we have made to the organization, we can better focus our resources on our core products, ensure that we have valid value propositions that enable us to be leaders in the markets we serve, and operate a flexible business model that can



withstand the effects of economic cycles while having the capacity to expand and generate operating leverage.

Finally, I would like to note that our ability to make the considerable changes that we have made over the last several months and to achieve the success in this quarter that we have, would not have been possible were it not for the creativity, hard work and dedication of all of our MOD-PAC employees.

That concludes my remarks, and I will now turn the call back to Dan.

Daniel Keane: Thank you, Dave. Operator, I would like to now open the call for questions.

Operator: Our first question is from the line of John Lewis with Osmium Partners.

John Lewis: Good afternoon. Nice job. I have just a couple of quick questions. First, you announced in early October that you had an agreement, in principle, to sell your real estate. Your balance sheet shows assets held for sales at \$2.1 million. How much of that is the real estate for sale?

Daniel Keane: Less than \$1.4 million, net of all selling expenses.

John Lewis: In your prepared comments you talk about seeing stronger sales in your capturing “a greater percentage of business and adding new accounts.” Can you talk about any new account wins and give any more color on that remark?

Daniel Keane: Our sales have held up well. We’ve been pleased with the uncertainty of the last year in the general economy. We do serve the non-durable consumer goods markets, and it has held up nicely. We’ve added new accounts in the consumer goods field. We don’t often mention the account by name, but we have been bringing on new business in the last year. Dave, do you know off hand the breakdown of sales growth for new versus existing accounts?

David Lupp: No, but we picked up a fairly decent sized account about a year ago that has ramped up throughout the year. That’s been good. And then we picked up another piece of an existing account that you could consider as a new customer and some smaller ones too.

Daniel Keane: We’ve been expanding relationships with customers that have been with us for three to five years.

David Lupp: It’s a mix, and we’re doing a little bit better job identifying prospects and working on them. The cycle time to pick up a new customer continues to be between one and two years once you start the discussions.

Deborah Pawlowski: And then it takes a couple years really to ramp up.

Daniel Keane: Well, you often ramp upward. As we’ve grown over the last few years, we’re serving larger and larger customers. They’re often buying millions of dollars of packaging, and typically the accounts do not shift their full-spend to us immediately. They will “put their toe in the water”, if I were to use that phrase, and start buying from us for certain lines and then we will see it ramp up over multiple years. I think that’s what Debbie was referring to. Often we start out with a product line and then as we continue to serve them well the relationship can grow.

John Lewis: Several years ago you had the Vistaprint contract and then you parted ways, and so one of the big battles you face is capacity utilization. Where do you think you are right now in terms of utilizing all of your presses?



Daniel Keane: I would guess that we're in the 60-70% range.

David Lupp: Yes, based on a seven-day work week, it would be in the 60% to 70% range.

John Lewis: Do you have any estimate of what Cap Ex would be for 2010?

David Lupp: If I were to guess now, and we don't see any major changes to our current maintenance Cap Ex base, in the \$1 million range.

Daniel Keane: \$1 to \$1.5.

Operator: Our next question is from the line of Frank Smith with Investment Group.

Frank Smith: Great quarter. On the tax rate for the fourth quarter, do you have any idea what that's going to be?

Daniel Keane: Probably zero. Until we establish a trend of pre-tax profitability, we won't be able to reverse that reserve for the NOLs.

Frank Smith: How much is that reserve?

Daniel Keane: The loss carry forward is about \$1.2 million, which means we'd have to generate about \$3.4 million of taxable income before we'd use it.

Frank Smith: What trends are you seeing here? Historically, you would sometimes see a stronger fourth quarter compared with other quarters in the year.

David Lupp: That's correct, third and fourth quarters are typically our stronger quarters. We would expect that to be a similar pattern.

Daniel Keane: A good reason for that is stock packaging.

David Lupp: Yes, stock packaging is a nice line for us, and it is popular.

Daniel Keane: With a lot of the uncertainties of the last year, we saw a softness, but I think stock box is finally seeming to stabilize. So that's a good sign.

Frank Smith: What is the employee count right now?

Daniel Keane: It's always fluctuating a little bit, but at the end of October, it was between 360 and 370.

Operator: It appears there are no further questions at this time.

Daniel Keane: We have made solid progress in the third quarter, and we will work to maintain our momentum in the fourth quarter and into the future. We are well-positioned to continue to grow our custom folding carton line while we expand our reach into the markets we serve and build our potential customer base for stock packaging and personalized print product lines.

Thank you for your time today and your continued interest in MOD-PAC and have a nice evening.