KANSAS CITY SOUTHERN
Form 10-Q
October 26, 2010
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2010

or

¨ **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 1-4717

KANSAS CITY SOUTHERN

(Exact name of registrant as specified in its charter)

Delaware	**44-0663509**
(State or other jurisdiction of	*(I.R.S. Employer*
incorporation or organization)	*Identification No.)*
	64105
427 West 12th Street,	

Kansas City, Missouri
(Address of principal executive offices) *(Zip Code)*

816.983.1303

(Registrant s telephone number, including area code)

No Change

(Former name, former address and former fiscal year, if changed since last report.)

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 x 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

(Do not check if a 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 x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at October 19, 2010**
Common Stock, $0.01 per share par value	102,610,744 Shares

Table of Contents

Kansas City Southern

Form 10-Q

September 30, 2010

Index

Table of Contents

Kansas City Southern

Form 10-Q

September 30, 2010

PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

Introductory Comments

The Consolidated Financial Statements included herein have been prepared by Kansas City Southern, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). As used herein, KCS or the Company may refer to Kansas City Southern or, as the context requires, to one or more subsidiaries of Kansas City Southern. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) have been condensed or omitted, pursuant to such rules and regulations. The Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. The Consolidated Financial Statements and Management s Discussion and Analysis of Financial Condition and Results of Operations included in this Form 10-Q should be read in conjunction with the consolidated financial statements and the related notes, as well as Management s Discussion and Analysis of Financial Condition and Results of Operations, included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. Results for the three and nine months ended September 30, 2010 are not necessarily indicative of the results expected for the full year ending December 31, 2010.

Table of Contents

Kansas City Southern

Consolidated Statements of Income

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
	(In millions, except share and per share amounts)			
	(Unaudited)			
Revenues	$ 438.3	$ 386.1	$ 1,336.2	$ 1,073.4
Operating expenses:				
Compensation and benefits	87.3	83.4	271.7	240.4
Purchased services	48.0	37.1	140.9	129.3
Fuel	61.8	49.7	191.7	133.2
Equipment costs	37.5	41.8	117.5	122.1
Depreciation and amortization	46.1	44.6	138.8	138.9
Casualties and insurance	9.1	12.0	21.2	32.2
Materials and other	32.5	33.6	103.0	102.7
Total operating expenses	322.3	302.2	984.8	898.8
Operating income	116.0	83.9	351.4	174.6
Equity in net earnings of unconsolidated affiliates	5.2	1.9	16.2	4.9
Interest expense	(36.2)	(41.2)	(122.5)	(128.4)
Debt retirement costs	(1.9)		(49.3)	(5.9)
Foreign exchange gain (loss)	2.0	(1.5)	3.2	(0.6)
Other income, net	2.4	0.3	3.9	4.7
Income before income taxes and noncontrolling interest	87.5	43.4	202.9	49.3
Income tax expense	34.7	14.8	78.5	16.4
Net income	52.8	28.6	124.4	32.9
Noncontrolling interest	(0.1)	0.4	(1.2)	0.8
Net income attributable to Kansas City Southern and subsidiaries	52.9	28.2	125.6	32.1
Preferred stock dividends	2.7	2.8	8.2	8.3
Net income available to common stockholders	$ 50.2	$ 25.4	$ 117.4	$ 23.8
Earnings per share:				
Basic earnings per share	$ 0.49	$ 0.27	$ 1.18	$ 0.26
Diluted earnings per share	$ 0.48	$ 0.27	$ 1.17	$ 0.26
Average shares outstanding *(in thousands):*				
Basic	102,082	94,683	99,337	92,462
Potentially dilutive common shares	7,428	560	7,485	496

Diluted	109,510	95,243	106,822	92,958

See accompanying notes to consolidated financial statements.

Table of Contents

Kansas City Southern

Consolidated Balance Sheets

	September 30, 2010	December 31, 2009
	(In millions, except share amounts)	
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 68.8	$ 117.5
Accounts receivable, net	173.9	139.4
Restricted funds	28.5	35.8
Materials and supplies	106.1	106.4
Deferred income taxes	202.5	151.7
Other current assets	86.1	63.0
Total current assets	665.9	613.8
Investments	46.8	46.8
Property and equipment (including concession assets), net	4,821.7	4,722.4
Other assets	94.7	71.3
Total assets	$ 5,629.1	$ 5,454.3
LIABILITIES AND EQUITY		
Current liabilities:		
Debt due within one year	$ 22.3	$ 68.1
Accounts payable and accrued liabilities	419.6	342.7
Total current liabilities	441.9	410.8
Long-term debt	1,610.9	1,911.9
Deferred income taxes	674.8	558.6
Other noncurrent liabilities and deferred credits	230.0	247.2
Total liabilities	2,957.6	3,128.5
Commitments and contingencies		
Stockholders equity:		
$25 par, 4% noncumulative, preferred stock, 840,000 shares authorized, 649,736 shares issued, 242,170 shares outstanding	6.1	6.1
Series D cumulative convertible perpetual preferred stock, $1 par, 5.125%, 210,000 shares authorized and issued, 209,995 shares outstanding with a liquidation preference of $1,000 per share	0.2	0.2
$.01 par, common stock, 400,000,000 shares authorized; 116,352,298 and 110,583,068 shares issued at September 30, 2010 and December 31, 2009, respectively; 102,610,744 and 96,213,346 shares outstanding at September 30, 2010 and December 31, 2009, respectively	1.0	0.9
Paid-in capital	888.4	661.4
Retained earnings	1,496.1	1,378.8
Accumulated other comprehensive loss	(1.9)	(4.4)
Total stockholders equity	2,389.9	2,043.0
Noncontrolling interest	281.6	282.8

Total equity	2,671.5	2,325.8
Total liabilities and equity	$ 5,629.1	$ 5,454.3

See accompanying notes to consolidated financial statements.

Table of Contents

Kansas City Southern

Consolidated Statements of Cash Flows

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
	(In millions) (Unaudited)	
Operating activities:		
Net income	$ 124.4	$ 32.9
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	138.8	138.9
Deferred income taxes	77.0	15.7
Equity in undistributed earnings of unconsolidated affiliates	(16.2)	(4.9)
Share-based compensation	6.1	6.4
Excess tax benefit from share-based compensation	(15.7)	
Other deferred compensation	5.9	(1.8)
Distributions from unconsolidated affiliates	15.5	
Gain on sale of assets	(1.6)	(3.7)
Debt retirement costs	49.3	5.9
Changes in working capital items:		
Accounts receivable	(34.1)	3.6
Materials and supplies	0.8	(9.0)
Other current assets	7.7	(14.2)
Accounts payable and accrued liabilities	54.5	22.9
Other, net	(52.5)	13.6
Net cash provided by operating activities	359.9	206.3
Investing activities:		
Capital expenditures	(200.3)	(296.8)
Acquisition of an intermodal facility, net of cash acquired	(25.0)	
Property investments in MSLLC	(18.2)	(18.2)
Proceeds from disposal of property	6.2	13.6
Other, net	11.6	(9.0)
Net cash used for investing activities	(225.7)	(310.4)
Financing activities:		
Proceeds from issuance of long-term debt	300.7	189.8
Repayment of long-term debt	(662.0)	(264.5)
Proceeds from common stock issuance	214.9	73.9
Debt costs	(44.8)	(9.3)
Proceeds from employee stock plans	0.8	1.5
Excess tax benefit from share-based compensation	15.7	
Preferred stock dividends paid	(8.2)	(8.3)
Net cash used for financing activities	(182.9)	(16.9)

Cash and cash equivalents:		
Net decrease during each period	(48.7)	(121.0)
At beginning of year	117.5	229.9
At end of period	$ 68.8	$ 108.9

See accompanying notes to consolidated financial statements.

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements

1. Accounting Policies, Interim Financial Statements and Basis of Presentation

In the opinion of the management of KCS, the accompanying unaudited consolidated financial statements contain all adjustments necessary for a fair presentation of the results for interim periods. All adjustments made were of a normal and recurring nature. Certain information and footnote disclosure normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted. These consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. The results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of the results to be expected for the full year ending December 31, 2010. Certain prior year amounts have been reclassified to conform to the current year presentation.

During the first quarter of 2010, the Company elected to change its accounting policy for rail grinding costs from a capitalization method to a direct expense method. Previously, the Company capitalized rail grinding costs as an improvement to the rail. The Company believes it is preferable to expense these costs as incurred to eliminate the subjectivity in determining the period of benefit associated with rail grinding over which to depreciate the associated capitalized costs. The Company has reflected this change as a change in accounting principle from an accepted accounting principle to a preferable accounting principle in accordance with Accounting Standards Codification 250 Accounting for Changes and Error Corrections. Comparative financial statements for all periods have been adjusted to apply the change in accounting principle retrospectively.

The following line items in the consolidated statement of income were affected by the change in accounting principle *(in millions, except per share amounts):*

	Three Months Ended September 30, 2009		
	As reported	**As adjusted**	**Change**
Purchased services	$ 36.4	$ 37.1	$ 0.7
Depreciation and amortization	44.8	44.6	(0.2)
Income before income taxes and noncontrolling interest	43.9	43.4	(0.5)
Income tax expense	14.9	14.8	(0.1)
Net income	29.0	28.6	(0.4)
Diluted earnings per share	$ 0.27	$ 0.27	$

	Nine Months Ended September 30, 2009		
	As reported	**As adjusted**	**Change**
Compensation and benefits	$ 240.5	$ 240.4	$ (0.1)
Purchased services	126.9	129.3	2.4
Depreciation and amortization	139.5	138.9	(0.6)
Income before income taxes and noncontrolling interest	51.0	49.3	(1.7)
Income tax expense	16.9	16.4	(0.5)
Net income	34.1	32.9	(1.2)
Diluted earnings per share	$ 0.27	$ 0.26	$ (0.01)

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

The following line items in the consolidated balance sheet were affected by the change in accounting principle *(in millions):*

	December 31, 2009		
	As reported	As adjusted	Change
Property and equipment (including concession assets), net	$ 4,747.2	$ 4,722.4	$ (24.8)
Deferred income tax liabilities	567.1	558.6	(8.5)
Other noncurrent liabilities and deferred credits	247.7	247.2	(0.5)
Retained earnings	1,394.6	1,378.8	(15.8)
Total equity	2,341.6	2,325.8	(15.8)

As of January 1, 2008, the cumulative effect of the change in accounting principle on property and equipment (including concession assets), deferred income tax liability, other noncurrent liabilities and deferred credits and retained earnings was ($20.5) million, ($7.3) million, ($0.4) million and ($12.8) million, respectively.

The following line items in the consolidated statement of cash flows were affected by the change in accounting principle *(in millions):*

	Nine Months Ended September 30, 2009		
	As reported	As adjusted	Change
Net cash provided by operating activities	$ 208.7	$ 206.3	$ (2.4)
Net cash used for investing activities	(312.8)	(310.4)	2.4

2. Earnings Per Share Data

Basic earnings per common share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Nonvested stock awards granted to employees and officers are included in weighted average shares as they are earned for purposes of computing basic earnings per common share. Diluted earnings per share adjusts basic earnings per common share for the effects of potentially dilutive common shares, if the effect is not anti-dilutive. Potentially dilutive common shares include the dilutive effects of shares issuable upon the conversion of preferred stock to common stock and shares issuable under the Stock Option and Performance Award Plan.

The following table reconciles the weighted average shares used for the basic earnings per share computation to the shares used for the diluted earnings per share computation *(in thousands)*:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Basic shares	102,082	94,683	99,337	92,462
Effect of dilution	7,428	560	7,485	496
Diluted shares	109,510	95,243	106,822	92,958

Potentially dilutive shares excluded from the calculation *(in thousands)*:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Stock options where the exercise price is greater than the average market price of common shares	142	49	205	75
Convertible preferred stock which is anti-dilutive		7,000		7,000

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

The following table reconciles net income available to common stockholders for purposes of basic earnings per share to net income available to common stockholders for purposes of diluted earnings per share *(in millions)*:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net income available to common stockholders for purposes of computing basic earnings per share	$ 50.2	$ 25.4	$ 117.4	$ 23.8
Effect of dividends on conversion of convertible preferred stock	2.6		8.0	
Net income available to common stockholders for purposes of computing diluted earnings per share	$ 52.8	$ 25.4	$ 125.4	$ 23.8

3. Hurricane Alex

Hurricane Alex made landfall on June 30, 2010, causing widespread damage and flooding in central and northeastern Mexico. The hurricane resulted in extensive damage to Kansas City Southern de México, S.A. de C.V. s (KCSM) track and bridge infrastructures, and also caused multiple track-related incidents and significantly disrupted the Company s rail service.

The Company maintains a comprehensive insurance program intended to cover such events. The property and casualty insurance program covers loss or damage to Company property and third party property over which the Company has custody and control and covers losses associated with business interruption. This program has combined coverage for both property damage and business interruption and has a self-insured retention amount of $10.0 million for flood related losses. In addition, the Company also maintains a general liability insurance program with a self-insured retention of $1.0 million in Mexico covering claims from third parties. The Company s policy limits are in excess of the hurricane losses incurred.

Hurricane Alex affected revenues as customers were required to use alternate carriers or modes of transportation until rail service was restored. Based on data contained in the Company s initial insurance claim filing, which will be updated and adjusted, the Company currently estimates that resulting lost revenues in the third quarter of 2010 were $33.0 million, less related avoided costs. Additionally, the Company incurred losses of $32.0 million related to property damage and incremental expenses. Through the insurance programs, the Company expects to recover its losses, net of related self-insured retentions of $11.0 million. Accordingly, the Company recognized a receivable for probable insurance recoveries which offsets the impact of incurred losses related to property damage and incremental expenses. The recognition of remaining probable insurance recoveries represents a contingent gain, which will be recognized when all contingencies have been resolved, which generally occurs at the time of final settlement or when nonrefundable cash payments are received.

The initial claim filing includes estimates of costs the Company expects to incur in the fourth quarter of 2010 related to ongoing property repair which are expected to be fully offset by probable insurance recoveries. As of the date of this filing, no payments have been received from the insurance programs.

4. KCSM Post-Employment Benefits

Mexican law requires that KCSM provide certain post-employment benefits to its union and non-union employees. These plans provide statutorily calculated benefits which are payable upon retirement, death, disability, voluntary or involuntary termination of employees based on length of service.

During September 2010, KCSM completed negotiations with the Mexican labor union. Among other matters resolved in these negotiations, KCSM is not required to provide an incremental benefit to its union employees upon retirement. Previous to the agreement reached with the Mexican labor union, KCSM had recorded a liability for an incremental retirement benefit which was based on various factors including retirement eligibility based on a combination of age and years of credited service and the employee s salary at the time of retirement. KCSM has no legal obligation to fund any benefit previously calculated under these factors.

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

The completion of the negotiations resulted in a new measurement date for KCSM s post-employment benefit obligations as of September 30, 2010. These post-employment benefit obligations are funded as obligations become due. The following table reconciles the change in the benefit obligations as of and for the nine months ended September 30, 2010 (*in millions*):

	Nine Months Ended September 30, 2010
Benefit obligation at beginning of period	$ 15.9
Service cost	1.0
Interest cost	1.1
Actuarial gain	(6.2)
Foreign currency gain	(0.7)
Benefits paid	(0.8)
Benefit obligation at end of period	$ 10.3

The assumptions used to determine benefit obligations and costs are selected based on current and expected market conditions. Discount rates are selected based on low risk government bonds with cash flows approximating the timing of expected benefit payments. The Mexico bond market is utilized for the KCSM post-employment obligation.

Weighted average assumptions used to determine the benefit obligation were as follows:

	September 30, 2010	December 31, 2009
Discount rate	7.5%	8.5%
Rate of compensation increase	4.5%	4.5%

5. Property and Equipment (including Concession Assets)

Property and equipment, including concession assets, and related accumulated depreciation and amortization are summarized below *(in millions)*:

	September 30, 2010	December 31, 2009
Land	$ 177.9	$ 162.9
Concession land rights	141.2	137.6
Road property	4,811.7	4,644.4
Equipment	701.4	679.3
Technology and other	130.4	125.3
Construction in progress	143.5	165.6
Total property	6,106.1	5,915.1

Accumulated depreciation and amortization	1,284.4	1,192.7
Net property and equipment (including concession assets)	$ 4,821.7	$ 4,722.4

Concession assets, net of accumulated amortization of $290.5 million and $259.4 million, totaled $1,775.9 million and $1,768.0 million at September 30, 2010 and December 31, 2009, respectively.

6. Fair Value Measurements

The Company s short term financial instruments include cash and cash equivalents, accounts receivable, and accounts payable. The carrying value of the short term financial instruments approximates their fair value.

The fair value of the Company s debt is estimated using quoted market prices when available. When quoted market prices are not available, fair value is estimated based on current market interest rates for debt with similar maturities and credit quality. The fair value of the Company s debt was $1,740.1 million and $2,031.1 million at September 30, 2010 and December 31, 2009, respectively. The carrying value was $1,633.2 million and $1,980.0 million at September 30, 2010 and December 31, 2009, respectively.

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

Assets and liabilities recognized at fair value are required to be classified into a three-level hierarchy. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company s assessment of the significance of a particular input to the fair value in its entirety requires judgment and considers factors specific to the asset or liability.

The following tables present the Company s assets and liabilities measured at fair value on a recurring basis (*in millions)*:

	Fair Value Measurements			Net Assets (Liabilities) at Fair Value
	Level 1	Level 2	Level 3	
September 30, 2010				
Interest rate contracts	$	$ (1.1)	$	$ (1.1)
Fuel swap contracts		0.2		0.2
Net liabilities, at fair value	$	$ (0.9)	$	$ (0.9)