

KANSAS CITY SOUTHERN  
Form 10-Q  
July 19, 2016  
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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 June 30, 2016

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 incorporation or organization) (I.R.S. Employer Identification No.)

427 West 12th Street, 64105  
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  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  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  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

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

Class	July 12, 2016
Common Stock, \$0.01 per share par value	107,983,492 Shares



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## PART I — FINANCIAL INFORMATION

## Item 1. Financial Statements

Kansas City Southern and Subsidiaries  
Consolidated Statements of Income

	Three Months Ended		Six Months Ended	
	June 30, 2016	2015	June 30, 2016	2015
	(In millions, except share and per share amounts) (Unaudited)			
Revenues	\$568.5	\$585.8	\$1,131.2	\$1,188.9
Operating expenses:				
Compensation and benefits	109.0	108.0	219.1	225.6
Purchased services	53.7	57.0	104.6	115.1
Fuel	61.6	77.5	118.4	158.5
Mexican fuel excise tax credit	(34.0 )	—	(34.0 )	—
Equipment costs	27.2	29.9	53.9	59.0
Depreciation and amortization	75.7	70.8	150.0	139.3
Materials and other	55.4	55.8	111.4	116.8
Lease termination costs	—	—	—	9.6
Total operating expenses	348.6	399.0	723.4	823.9
Operating income	219.9	186.8	407.8	365.0
Equity in net earnings of affiliates	3.0	5.0	6.9	9.4
Interest expense	(24.4 )	(17.7 )	(48.0 )	(36.3 )
Foreign exchange loss	(24.0 )	(10.5 )	(27.5 )	(22.1 )
Other expense, net	(0.7 )	(1.2 )	(0.5 )	(2.0 )
Income before income taxes	173.8	162.4	338.7	314.0
Income tax expense	53.3	50.2	110.1	100.6
Net income	120.5	112.2	228.6	213.4
Less: Net income attributable to noncontrolling interest	0.4	0.4	0.7	0.8
Net income attributable to Kansas City Southern and subsidiaries	120.1	111.8	227.9	212.6
Preferred stock dividends	—	—	0.1	0.1
Net income available to common stockholders	\$120.1	\$111.8	\$227.8	\$212.5
Earnings per share:				
Basic earnings per share	\$1.12	\$1.01	\$2.11	\$1.93
Diluted earnings per share	\$1.11	\$1.01	\$2.11	\$1.92
Average shares outstanding (in thousands):				
Basic	107,720	110,334	107,891	110,322
Potentially dilutive common shares	187	181	203	200
Diluted	107,907	110,515	108,094	110,522
See accompanying notes to consolidated financial statements.				



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Consolidated Statements of Comprehensive Income

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2016	
	2015	2016	2015	2016
	(In millions) (Unaudited)			
Net income	\$120.5	\$112.2	\$228.6	\$213.4
Other comprehensive loss:				
Amortization of prior service credit, net of tax of less than \$(0.1) million	—	—	—	(0.1 )
Foreign currency translation adjustments, net of tax of \$(0.5) million, \$(0.2) million, \$(0.5) million and \$(0.3) million, respectively	(0.6 )	(0.2 )	(0.7 )	(0.5 )
Other comprehensive loss	(0.6 )	(0.2 )	(0.7 )	(0.6 )
Comprehensive income	119.9	112.0	227.9	212.8
Less: Comprehensive income attributable to noncontrolling interest	0.4	0.4	0.7	0.8
Comprehensive income attributable to Kansas City Southern and subsidiaries	\$119.5	\$111.6	\$227.2	\$212.0
See accompanying notes to consolidated financial statements.				

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Consolidated Balance Sheets

	June 30, 2016	December 31, 2015
	(In millions, except share and per share amounts) (Unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 293.6	\$ 136.6
Accounts receivable, net	176.9	171.9
Materials and supplies	141.2	137.9
Other current assets	112.1	90.6
Total current assets	723.8	537.0
Investments	34.7	34.7
Property and equipment (including concession assets), net	7,847.8	7,705.4
Other assets	71.1	63.9
Total assets	\$ 8,677.4	\$ 8,341.0
<b>LIABILITIES AND EQUITY</b>		
Current liabilities:		
Long-term debt due within one year	\$ 275.5	\$ 276.1
Short-term borrowings	—	80.0
Accounts payable and accrued liabilities	405.2	401.5
Total current liabilities	680.7	757.6
Long-term debt	2,281.8	2,045.0
Deferred income taxes	1,268.7	1,191.1
Other noncurrent liabilities and deferred credits	114.5	122.6
Total liabilities	4,345.7	4,116.3
Stockholders' equity:		
\$25 par, 4% noncumulative, preferred stock, 840,000 shares authorized, 649,736 shares issued, 242,170 shares outstanding	6.1	6.1
\$.01 par, common stock, 400,000,000 shares authorized; 123,352,185 shares issued; 107,911,597 and 108,461,144 shares outstanding at June 30, 2016 and December 31, 2015, respectively	1.1	1.1
Additional paid-in capital	950.3	947.1
Retained earnings	3,068.5	2,964.7
Accumulated other comprehensive loss	(5.4	) (4.7
Total stockholders' equity	4,020.6	3,914.3
Noncontrolling interest	311.1	310.4
Total equity	4,331.7	4,224.7
Total liabilities and equity	\$ 8,677.4	\$ 8,341.0
See accompanying notes to consolidated financial statements.		

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Consolidated Statements of Cash Flows

	Six Months Ended June 30, 2016    2015 (In millions) (Unaudited)	
Operating activities:		
Net income	\$228.6	\$213.4
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	150.0	139.3
Deferred income taxes	77.7	54.2
Equity in net earnings of affiliates	(6.9 )	(9.4 )
Share-based compensation	11.1	8.1
Excess tax benefit from share-based compensation	0.4	(4.4 )
Distributions from unconsolidated affiliates	5.0	7.8
Unrealized loss on foreign currency derivative instruments	7.3	22.5
Mexican fuel excise tax credit	(34.0 )	—
Changes in working capital items:		
Accounts receivable	(5.0 )	(11.7 )
Materials and supplies	(1.7 )	(23.2 )
Other current assets	7.4	15.6
Accounts payable and accrued liabilities	(19.7 )	(17.7 )
Other, net	(1.7 )	3.0
Net cash provided by operating activities	418.5	397.5
Investing activities:		
Capital expenditures	(258.5 )	(360.2 )
Purchase or replacement of equipment under operating leases	(5.4 )	(61.3 )
Property investments in MSLLC	(16.6 )	(3.9 )
Other, net	(2.8 )	(18.1 )
Net cash used for investing activities	(283.3 )	(443.5 )
Financing activities:		
Proceeds from short-term borrowings	6,498.7	8,409.6
Repayment of short-term borrowings	(6,579.0)	(8,568.6)
Proceeds from issuance of long-term debt	248.7	40.0
Repayment of long-term debt	(13.0 )	(52.3 )
Dividends paid	(71.6 )	(67.5 )
Shares repurchased	(59.2 )	(20.6 )
Debt costs	(2.6 )	—
Excess tax benefit from share-based compensation	(0.4 )	4.4
Proceeds from employee stock plans	0.2	3.9
Net cash provided by (used for) financing activities	21.8	(251.1 )
Cash and cash equivalents:		
Net increase (decrease) during each period	157.0	(297.1 )



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At beginning of year	136.6	348.0
At end of period	\$293.6	\$50.9

See accompanying notes to consolidated financial statements.

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Kansas City Southern and Subsidiaries

Notes to Consolidated Financial Statements

For purposes of this report, “KCS” or the “Company” may refer to Kansas City Southern or, as the context requires, to one or more subsidiaries of Kansas City Southern.

1. Basis of Presentation

In the opinion of the management of KCS, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal and recurring adjustments) necessary to fairly present the results for interim periods in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”). Pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”), certain information and note disclosures 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, 2015. The results of operations for the three and six months ended June 30, 2016, are not necessarily indicative of the results to be expected for the full year ending December 31, 2016. Certain prior year amounts have been reclassified to conform to the current year presentation.

2. New Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers, which requires companies to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration it expects to be entitled in exchange for those goods or services. The new standard will become effective for the Company beginning with the first quarter 2018 and can be adopted either retrospectively to each prior reporting period presented or as a cumulative effect adjustment as of the date of adoption. The adoption of this guidance is not expected to have a material impact on the Company’s consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases, which requires lessees to recognize a right-to-use asset and a lease obligation for all leases. Lessees are permitted to make an accounting policy election to not recognize an asset and liability for leases with a term of twelve months or less. Lessor accounting under the new standard is substantially unchanged. Additional qualitative and quantitative disclosures, including significant judgments made by management, will be required. The new standard will become effective for the Company beginning with the first quarter 2019 and requires a modified retrospective transition approach. Early adoption of the standard is permitted. The Company is currently evaluating the impacts the adoption of this accounting guidance will have on the consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, which simplifies several aspects of the accounting for employee share-based payment transactions including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification of related amounts within the statement of cash flows. The new standard will become effective for the Company beginning with the first quarter of 2017, with early adoption permitted. The adoption of this guidance is not expected to have a material impact on the Company’s consolidated financial statements.

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## Kansas City Southern and Subsidiaries

## Notes to Consolidated Financial Statements—(Continued)

## 3. Mexican Fuel Excise Tax Credit

Fuel purchases made in Mexico or the importation of fuel into Mexico is subject to an excise tax. During the second quarter of 2016, the Company determined that it could utilize a credit available under changes in Mexican law for the excise tax included in the price of fuel that is purchased and consumed in locomotives and certain work equipment in Mexico. As a result, the Company recognized a \$34.0 million year-to-date benefit during the quarter ended June 30, 2016. Utilization of the credit is limited to the total 2016 Mexico income tax liability and income tax withholding payment obligations of Kansas City Southern de Mexico, S.A. de C.V. (“KCSM”), with no carryforward to future periods.

## 4. Flooding in the Southeastern United States

In March 2016, flooding in the southeastern United States caused damage to the Company’s track infrastructure and interruptions to the Company’s rail service. During the three months ended June 30, 2016, the Company determined that it would file a claim under its insurance program for property damage, incremental expenses and lost profits caused by this flooding event. Accordingly, during the three months ended June 30, 2016, the Company recognized a receivable for probable insurance recovery of \$7.0 million, which offsets the impact of incremental expenses recognized in the first half of 2016. The probable insurance recovery and incremental expenses have been recognized in Materials and other in the Consolidated Statements of Income. 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. As of the date of this filing, no payments have been received from the insurance program.

## 5. 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. 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 under the stock option and performance award plans.

The following table reconciles the basic earnings per share computation to the diluted earnings per share computation (in millions, except share and per share amounts):

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2015	
Net income available to common stockholders for purposes of computing basic and diluted earnings per share	\$ 120.1	\$ 111.8	\$ 227.8	\$ 212.5
Weighted-average number of shares outstanding (in thousands):				
Basic shares	107,720	110,334	107,891	110,322
Effect of dilution	187	181	203	200
Diluted shares	107,907	110,515	108,094	110,522
Earnings per share:				
Basic earnings per share	\$ 1.12	\$ 1.01	\$ 2.11	\$ 1.93
Diluted earnings per share	\$ 1.11	\$ 1.01	\$ 2.11	\$ 1.92

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

Stock options excluded as their inclusion would be anti-dilutive 48 125 185 74



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Notes to Consolidated Financial Statements—(Continued)

## 6. Property and Equipment (including Concession Assets)

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

	June 30, 2016	December 31, 2015
Land	\$217.2	\$ 218.1
Concession land rights	141.2	141.2
Road property	7,015.0	6,784.3
Equipment	2,354.8	2,326.1
Technology and other	163.6	159.3
Construction in progress	189.4	184.7
Total property	10,081.2	9,813.7
Accumulated depreciation and amortization	2,233.4	2,108.3
Property and equipment (including concession assets), net	\$7,847.8	\$ 7,705.4

Concession assets, net of accumulated amortization of \$573.0 million and \$538.0 million, totaled \$2,110.9 million and \$2,070.5 million at June 30, 2016 and December 31, 2015, respectively.

## 7. Fair Value Measurements

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 Company's derivative financial instruments are measured at fair value on a recurring basis and consist of foreign currency forward and option contracts, which are classified as Level 2 valuations. The Company determines the fair value of its derivative financial instrument positions based upon pricing models using inputs observed from actively quoted markets and also takes into consideration the contract terms as well as other inputs, including market currency exchange rates and in the case of option contracts, volatility, the risk-free interest rate and the time to expiration. The fair value of the foreign currency derivative instruments was a liability of \$7.3 million and \$46.0 million at June 30, 2016 and December 31, 2015, respectively.

The Company's short-term financial instruments include cash and cash equivalents, accounts receivable, accounts payable and short-term borrowings. 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 \$2,697.8 million and \$2,287.5 million at June 30, 2016 and December 31, 2015, respectively. The carrying value was \$2,557.3 million and \$2,321.1 million at June 30, 2016 and December 31, 2015, respectively. If the Company's debt were measured at fair value, the fair value measurements of the individual debt instruments would have been classified as either Level 1 or Level 2 in the fair value hierarchy.



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Notes to Consolidated Financial Statements—(Continued)

## 8. Derivative Instruments

The Company enters into derivative transactions in certain situations based on management's assessment of current market conditions and perceived risks. Management intends to respond to evolving business and market conditions and in doing so, may enter into such transactions as deemed appropriate.

**Credit Risk.** As a result of the use of derivative instruments, the Company is exposed to counterparty credit risk. The Company manages this risk by limiting its counterparties to large financial institutions which meet the Company's credit rating standards and have an established banking relationship with the Company. As of June 30, 2016, the Company did not expect any losses as a result of default of its counterparties.

**Foreign Currency Derivative Instruments.** The Company's Mexican subsidiaries have net U.S. dollar-denominated monetary liabilities which, for Mexican income tax purposes, are subject to periodic revaluation based on changes in the value of the Mexican peso against the U.S. dollar. This revaluation creates fluctuations in the Company's Mexican income tax expense and the amount of income taxes paid in Mexico. The Company enters into foreign currency derivative contracts to hedge its exposure to this cash tax risk.

In the first quarter of 2016, the Company entered into foreign currency forward contracts with an aggregate notional amount of \$400.0 million. Contracts with an aggregate notional amount of \$60.0 million matured on April 29, 2016 and obligated the Company to purchase a total of Ps.1,057.3 million at a weighted-average exchange rate of Ps.17.62 to each U.S. dollar. During April 2016, the Company entered into offsetting contracts with an aggregate notional amount of \$60.7 million. These offsetting contracts matured on April 29, 2016, and obligated the Company to sell a total of Ps.1,057.3 million at a weighted-average exchange rate of Ps.17.41 to each U.S. dollar. The remaining contracts will mature on January 17, 2017 and obligate the Company to purchase a total of Ps.6,207.7 million at a weighted-average exchange rate of Ps.18.26 to each U.S. dollar.

In the first quarter of 2015, the Company entered into foreign currency forward contracts with an aggregate notional amount of \$300.0 million. These contracts matured on January 15, 2016, and obligated the Company to purchase a total of Ps.4,480.4 million at a weighted-average exchange rate of Ps.14.93 to each U.S. dollar. During January 2016, the Company entered into offsetting contracts with an aggregate notional amount of \$251.0 million. These offsetting contracts matured on January 15, 2016, and obligated the Company to sell a total of Ps.4,480.4 million at a weighted-average exchange rate of Ps.17.85 to each U.S. dollar.

During 2015, the Company also entered into several foreign currency option contracts known as zero-cost collars. These contracts involved the Company's purchase of a Mexican peso call option and a simultaneous sale of a Mexican peso put option, with equivalent U.S. dollar notional amounts for each option and no net cash premium paid by the Company. During January 2016, zero-cost collar contracts with an aggregate notional amount of \$80.0 million matured, resulting in a cash payment of \$10.1 million. As of June 30, 2016, there were no outstanding zero-cost collar contracts.

The Company has not designated any of the foreign currency derivative contracts as hedging instruments for accounting purposes. The Company measures the foreign currency derivative contracts at fair value each period and recognizes any change in fair value in foreign exchange loss within the consolidated statements of income.

The following table presents the fair value of derivative instruments included in the consolidated balance sheets (in millions):

	Derivative Liabilities		
	Balance Sheet Location	June 30, 2016	December 31, 2015
Derivatives not designated as hedging instruments:			
Foreign currency forward contracts	Accounts payable and accrued liabilities	\$ 7.3	\$ 39.8
Foreign currency zero-cost collar contracts	Accounts payable and accrued liabilities	—	6.2
Total derivative liabilities		\$ 7.3	\$ 46.0





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Kansas City Southern and Subsidiaries  
Notes to Consolidated Financial Statements—(Continued)

The following table presents the effects of derivative instruments on the consolidated statements of income (in millions):

	Location of Gain/(Loss) Recognized in Income on Derivative	Amount of Gain/(Loss) Recognized in Income on Derivative			
		Three Months Ended		Six Months Ended	
		June 30, 2016	2015	June 30, 2016	2015
Derivatives not designated as hedging instruments:					
Foreign currency forward contracts	Foreign exchange loss	\$(18.0)	\$(6.9)	\$(15.8)	\$(16.3)
Foreign currency zero-cost collar contracts	Foreign exchange loss	—	(2.4 )	(3.9 )	(3.1 )
Total		\$(18.0)	\$(9.3)	\$(19.7)	\$(19.4)

9. Short-Term Borrowings

Commercial Paper. The Company’s commercial paper program generally serves as the primary means of short-term funding. As of June 30, 2016, KCS had no commercial paper outstanding. As of December 31, 2015, KCS had \$80.0 million of commercial paper outstanding at a weighted-average interest rate of 1.072%.

10. Long-Term Debt

Senior Notes

On May 16, 2016, KCS issued \$250.0 million principal amount of senior unsecured notes due June 1, 2026 (the “3.125% Senior Notes”), which bear interest semiannually at a fixed annual rate of 3.125%. The 3.125% Senior Notes were issued at a discount to par value, resulting in a \$1.3 million discount and a yield to maturity of 3.185%. The net proceeds from the offering were used to repay the outstanding commercial paper issued by KCS and for other general corporate purposes. The 3.125% Senior Notes are redeemable at the issuer’s option, in whole or in part, at any time, by paying the greater of either 100% of the principal amount to be redeemed and a formula price based on interest rates prevailing at the time of redemption and time remaining to maturity.

The 3.125% Senior Notes include certain covenants which are customary for this type of debt instrument issued by borrowers with similar credit ratings. The 3.125% Senior Notes are unsecured and unsubordinated obligations of the Company and are unconditionally guaranteed, jointly and severally, by The Kansas City Southern Railway Company (“KCSR”) and each current and future domestic subsidiary of KCS that guarantees the KCS revolving credit facility or certain other debt of KCS or a note guarantor.

Debt Exchange

During the first quarter of 2016, KCS entered into agreements with certain holders of KCSR and KCSM senior notes (collectively, the “Existing Notes”) to exchange Existing Notes for new securities issued by KCS. Each KCS note issued in exchange for an Existing Note has the same interest rate, interest payment dates and maturity date and substantially identical redemption provisions as the corresponding Existing Note. The KCS notes have the same terms (other than the issue date) as the corresponding notes issued by KCS in the exchange offers that closed on December 9, 2015. The following table summarizes the outstanding notes that were exchanged on March 29, 2016 (in millions):

Issuer of Existing Notes	Series of Existing Notes	Principal Amount Outstanding Prior to	Principal Amount of Notes Exchanged	Principal Amount Outstanding Following
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		Exchange		Exchange
KCSR	3.85% Senior Notes due 2023	\$ 5.0	\$ 4.2	\$ 0.8
KCSR	4.30% Senior Notes due 2043	12.4	11.1	1.3
KCSR	4.95% Senior Notes due 2045	23.3	22.5	0.8
KCSM	2.35% Senior Notes due 2020	35.4	17.8	17.6

The Company has accounted for this transaction as a debt exchange as the exchanged debt instruments are not considered to be substantially different. The balance of the unamortized discount and issue costs from the Existing Notes is being amortized as an adjustment of interest expense over the term of the KCS notes. There was no gain or loss recognized as a result of the exchange.

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## Kansas City Southern and Subsidiaries

## Notes to Consolidated Financial Statements—(Continued)

## 11. Equity

The following tables summarize the changes in equity (in millions):

	Three Months Ended June 30, 2016			Three Months Ended June 30, 2015		
	Kansas City Southern Stockholders Equity	Noncontrolling Interest	Total Equity	Kansas City Southern Stockholders Equity	Noncontrolling Interest	Total Equity
Beginning balance	\$3,941.4	\$ 310.7	\$4,252.1	\$3,829.5	\$ 309.0	\$4,138.5
Net income	120.1	0.4	120.5	111.8	0.4	112.2
Other comprehensive loss	(0.6 )	—	(0.6 )	(0.2 )	—	(0.2 )
Dividends on common stock	(35.6 )	—	(35.6 )	(36.5 )	—	(36.5 )
Share repurchases	(8.2 )	—	(8.2 )	(20.6 )	—	(20.6 )
Options exercised and stock subscribed, net of shares withheld for employee taxes	(1.4 )	—	(1.4 )	(0.4 )	—	(0.4 )
Excess tax benefit from share-based compensation	(0.1 )	—	(0.1 )	0.8	—	0.8
Share-based compensation	5.0	—	5.0	3.7	—	3.7
Ending balance	\$4,020.6	\$ 311.1	\$4,331.7	\$3,888.1	\$ 309.4	\$4,197.5

  

	Six Months Ended June 30, 2016			Six Months Ended June 30, 2015		
	Kansas City Southern Stockholders Equity	Noncontrolling Interest	Total Equity	Kansas City Southern Stockholders Equity	Noncontrolling Interest	Total Equity
Beginning balance	\$3,914.3	\$ 310.4	\$4,224.7	\$3,755.5	\$ 308.6	\$4,064.1
Net income	227.9	0.7	228.6	212.6	0.8	213.4
Other comprehensive loss	(0.7 )	—	(0.7 )	(0.6 )	—	(0.6 )
Dividends on common stock	(71.2 )	—	(71.2 )	(72.9 )	—	(72.9 )
Dividends on \$25 par preferred stock	(0.1 )	—	(0.1 )	(0.1 )	—	(0.1 )
Share repurchases	(59.2 )	—	(59.2 )	(20.6 )	—	(20.6 )
Options exercised and stock subscribed, net of shares withheld for employee taxes	(1.1 )	—	(1.1 )	1.7	—	1.7
Excess tax benefit from share-based compensation	(0.4 )	—	(0.4 )	4.4	—	4.4
Share-based compensation	11.1	—	11.1	8.1	—	8.1
Ending balance	\$4,020.6	\$ 311.1	\$4,331.7	\$3,888.1	\$ 309.4	\$4,197.5

## Share Repurchase Program

In May 2015, the Company announced a share repurchase program of up to \$500.0 million, which expires on June 30, 2017. Management's assessment of market conditions, available liquidity and other factors will determine the timing and volume of repurchases. Share repurchases are expected to be funded by cash on hand, cash generated from operations and debt. During the three months ended June 30, 2016, KCS repurchased 85,000 shares of common stock for \$8.2 million at an average price of \$97.29 per share. Since inception of this program, KCS has repurchased 2,864,596 shares of common stock for \$253.4 million at an average price of \$88.46 per share. The excess of

repurchase price over par value is allocated between additional paid-in capital and retained earnings.

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## Cash Dividends on Common Stock

On May 6, 2016, the Company's Board of Directors declared a cash dividend of \$0.330 per share payable on July 6, 2016, to common stockholders of record as of June 13, 2016. The aggregate amount of the dividends declared for the three and six months ended June 30, 2016 was \$35.6 million and \$71.2 million, respectively.

The following table presents the amount of cash dividends declared per common share by the Company's Board of Directors:

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2015	
Cash dividends declared per common share	\$0.330	\$0.330	\$0.660	\$0.660

## 12. Commitments and Contingencies

**Concession Duty.** Under KCSM's 50-year railroad concession from the Mexican government (the "Concession"), which would expire in 2047 unless extended, KCSM pays concession duty expense of 1.25% of gross revenues. For the three and six months ended June 30, 2016, the concession duty expense, which is recorded within materials and other in operating expenses, was \$3.7 million and \$7.3 million, respectively, compared to \$3.9 million and \$7.7 million for the same periods in 2015.

**Litigation.** The Company is a party to various legal proceedings and administrative actions, all of which, except as set forth below, are of an ordinary, routine nature and incidental to its operations. Included in these proceedings are various tort claims brought by current and former employees for job-related injuries and by third parties for injuries related to railroad operations. KCS aggressively defends these matters and has established liability provisions, which management believes are adequate to cover expected costs. Although it is not possible to predict the outcome of any legal proceeding, in the opinion of management, other than those proceedings described in detail below, such proceedings and actions should not, individually, or in the aggregate, have a material adverse effect on the Company's consolidated financial statements.

**Environmental Liabilities.** The Company's U.S. operations are subject to extensive federal, state and local environmental laws and regulations. The major U.S. environmental laws to which the Company is subject include, among others, the Federal Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA," also known as the Superfund law), the Toxic Substances Control Act, the Federal Water Pollution Control Act, and the Hazardous Materials Transportation Act. CERCLA can impose joint and several liabilities for cleanup and investigation costs, without regard to fault or legality of the original conduct, on current and predecessor owners and operators of a site, as well as those who generate, or arrange for the disposal of, hazardous substances. The Company does not believe that compliance with the requirements imposed by the environmental legislation will impair its competitive capability or result in any material additional capital expenditures, operating or maintenance costs. The Company is, however, subject to environmental remediation costs as described in the following paragraphs.

The Company's Mexico operations are subject to Mexican federal and state laws and regulations relating to the protection of the environment through the establishment of standards for water discharge, water supply, emissions, noise pollution, hazardous substances and transportation and handling of hazardous and solid waste. The Mexican government may bring administrative and criminal proceedings, impose economic sanctions against companies that violate environmental laws, and temporarily or even permanently close non-complying facilities.

The risk of incurring environmental liability is inherent in the railroad industry. As part of serving the petroleum and chemicals industry, the Company transports hazardous materials and has a professional team available to respond to and handle environmental issues that might occur in the transport of such materials.

The Company performs ongoing reviews and evaluations of the various environmental programs and issues within the Company's operations, and, as necessary, takes actions intended to limit the Company's exposure to potential liability.

Although these costs cannot be predicted with certainty, management believes that the ultimate outcome of identified matters will not have a material adverse effect on the Company's consolidated financial statements.

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Personal Injury. The Company's personal injury liability is based on semi-annual actuarial studies performed on an undiscounted basis by an independent third party actuarial firm and reviewed by management. This liability is based on personal injury claims filed and an estimate of claims incurred but not yet reported. Actual results may vary from estimates due to the number, type and severity of the injury, costs of medical treatments and uncertainties in litigation. Adjustments to the liability are reflected within operating expenses in the period in which changes to estimates are known. Personal injury claims in excess of self-insurance levels are insured up to certain coverage amounts, depending on the type of claim and year of occurrence. The personal injury liability as of June 30, 2016, was based on an updated actuarial study of personal injury claims through May 31, 2016, and review of the June 2016 experience. The personal injury liability activity was as follows (in millions):

	Six Months Ended June 30,	
	2016	2015
Balance at beginning of year	\$23.9	\$29.3
Accruals	2.4	4.4
Change in estimate	(0.6 )	(3.5 )
Payments	(2.0 )	(3.2 )
Balance at end of period	\$23.7	\$27.0

Certain Disputes with Ferromex. KCSM and Ferrocarril Mexicano, S.A. de C.V. ("Ferromex") use certain trackage rights, switching services and interline services provided by each other. KCSM and Ferromex had not agreed on the rates to be charged for trackage rights and switching services for periods beginning in 1998 through December 31, 2008, or for interline services for periods beginning in 1998 through February 8, 2010. Both KCSM and Ferromex had initiated administrative proceedings seeking a determination by the Mexican Secretaría de Comunicaciones y Transportes ("Secretary of Communications and Transportation" or "SCT") of the rates that KCSM and Ferromex should pay each other. The SCT issued rulings in 2002 and 2008 setting the rates for the services and both KCSM and Ferromex had challenged these rulings based on different grounds. Additionally, KCSM and Ferromex had not settled amounts payable to each other for trackage rights and switching services for the year ended December 31, 2009. In the first quarter of 2016, KCSM and Ferromex executed a settlement agreement resolving amounts payable to each other for trackage rights and switching services for periods beginning in 1998 through December 31, 2009, and for interline services for periods beginning in 1998 through February 8, 2010. Under this settlement agreement, KCSM and Ferromex also agreed to terminate all related administrative proceedings. This settlement agreement did not have a significant effect on the consolidated financial statements.

Tax Contingencies. Tax returns filed in the U.S. for periods after 2011 and in Mexico for periods after 2008 for KCSM and after 2009 for companies other than KCSM remain open to examination by the taxing authorities. An Internal Revenue Service (the "IRS") examination has been completed and settled for the 2012 U.S. federal tax return. The Servicio de Administración Tributaria (the "SAT"), the Mexican equivalent of the IRS, is currently examining the KCSM 2009, 2010 and 2011 Mexico tax returns and the 2013 Mexico tax return of KCSM Servicios, S.A. de C.V. ("KCSM Servicios"), a wholly-owned subsidiary of KCS. An SAT examination has been completed during the quarter without adjustment for the 2012 Mexico tax return of KCSM Servicios. The Company is litigating a Value Added Tax ("VAT") audit assessment from the SAT for KCSM for the year ended December 31, 2005. While the outcome of this matter cannot be predicted with certainty, the Company does not believe, when resolved, that this dispute will have a material effect on its consolidated financial statements. However, an unexpected adverse resolution could have a material effect on the consolidated financial statements in a particular quarter or fiscal year.

KCSM has not historically assessed VAT on international import transportation services provided to its customers based on a written ruling that KCSM obtained from the SAT in 2008 stating that such services were exempt from VAT (the "2008 Ruling"). Notwithstanding the 2008 Ruling, in December 2013, the SAT unofficially informed KCSM

of an intended implementation of new criteria effective as of January 1, 2014, pursuant to which VAT would be assessed on all international import transportation services on the portion of the services provided within Mexico. Additionally, in November 2013, the SAT filed an action to nullify the 2008 Ruling, potentially exposing the application of the new criteria to open tax years. In February 2014, KCSM filed an action opposing the SAT's nullification action. While the SAT's unofficial communication to KCSM is not enforceable and the 2008 Ruling continues to be in effect, KCSM notified its customers in December 2013 of the potential assessment of VAT on international import transportation services; however, implementation of any VAT assessment will depend on future developments and any guidance published by the SAT. Due to the pass-through nature of VAT assessed on services provided to customers, the Company does not



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believe any ultimate requirement to assess VAT on international import transportation services will have a significant effect on its consolidated financial statements. However, unexpected adverse implementation criteria imposed by the SAT for open tax years could have a material effect on the consolidated financial statements of the Company in a particular quarter or fiscal year.

**Contractual Agreements.** In the normal course of business, the Company enters into various contractual agreements related to commercial arrangements and the use of other railroads' or governmental entities' infrastructure needed for the operations of the business. The Company is involved or may become involved in certain disputes involving transportation rates, product loss or damage, charges, and interpretations related to these agreements. While the outcome of these matters cannot be predicted with certainty, the Company does not believe that, when resolved, these disputes will have a material effect on its consolidated financial statements.

**Credit Risk.** The Company continually monitors risks related to economic changes and certain customer receivables concentrations. Significant changes in customer concentration or payment terms, deterioration of customer creditworthiness or further weakening in economic trends could have a significant impact on the collectability of the Company's receivables and its operating results. If the financial condition of the Company's customers were to deteriorate and result in an impairment of their ability to make payments, additional allowances may be required. The Company has recorded provisions for uncollectability based on its best estimate at June 30, 2016.

**Panama Canal Railway Company ("PCRC") Guarantees and Indemnities.** At June 30, 2016, the Company had issued and outstanding \$5.3 million under a standby letter of credit to fulfill its obligation to fund fifty percent of the debt service reserve and liquidity reserve established by PCRC in connection with the issuance of the 7.0% Senior Secured Notes due November 1, 2026 (the "PCRC Notes"). Additionally, KCS has pledged its shares of PCRC as security for the PCRC Notes.

## 13. Geographic Information

The Company strategically manages its rail operations as one reportable business segment over a single coordinated rail network that extends from the Midwest and Southeast portions of the United States south into Mexico and connects with other Class I railroads. Financial information reported at this level, such as revenues, operating income and cash flows from operations, is used by corporate management, including the Company's chief operating decision-maker, in evaluating overall financial and operational performance, market strategies, as well as the decisions to allocate capital resources.

The following tables provide information by geographic area (in millions):

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Revenues				
U.S.	\$286.8	\$287.4	\$579.1	\$ 599.3
Mexico	281.7	298.4	552.1	589.6
Total revenues	\$568.5	\$585.8	\$1,131.2	\$ 1,188.9

	June 30, December 31,	
	2016	2015
Property and equipment (including concession assets), net		
U.S.	\$4,774.8	\$ 4,642.6
Mexico	3,073.0	3,062.8
Total property and equipment (including concession assets), net	\$7,847.8	\$ 7,705.4



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Notes to Consolidated Financial Statements—(Continued)

## 14. Condensed Consolidating Financial Information

Pursuant to Securities and Exchange Commission (“SEC”) Regulation S-X Rule 3-10 “Financial statements of guarantors and issuers of guaranteed securities registered or being registered”, the Company is required to provide condensed consolidating financial information for issuers of certain of its senior notes that are guaranteed. During 2015 and the first quarter of 2016, the Company completed a debt exchange whereby current holders of KCSR notes exchanged their notes for new KCS notes. As such, condensed consolidating financial information is presented with KCS as issuer of the new KCS notes and the 3.125% Senior Notes and with KCSR as issuer of the remaining Existing Notes that were not exchanged.

As of June 30, 2016, KCS had outstanding \$244.8 million principal amount of Floating Rate Senior Notes due October 28, 2016, \$257.3 million principal amount of 2.35% Senior Notes due May 15, 2020, \$439.1 million principal amount of 3.00% Senior Notes due May 15, 2023, \$199.2 million principal amount of 3.85% Senior Notes due November 15, 2023, \$250.0 million principal amount of 3.125% Senior Notes due June 1, 2026, \$448.7 million principal amount of 4.30% Senior Notes due May 15, 2043 and \$499.2 million principal amount of 4.95% Senior Notes due August 15, 2045, which are unsecured obligations of KCS, and are also jointly and severally and fully and unconditionally guaranteed on an unsecured senior basis by KCSR and certain wholly-owned domestic subsidiaries of KCS.

The 3.125% Senior Notes were registered under KCS’s shelf registration statement filed and automatically effective as of November 20, 2014. The Company filed a registration statement on Form S-4 with the SEC in connection with an exchange offer with respect to the remaining KCS notes, which was declared effective on June 27, 2016. As a result, the Company is providing the following condensed consolidating financial information (in millions).

## Condensed Consolidating Statements of Comprehensive Income - KCS Notes

	Three Months Ended June 30, 2016				
	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	\$—	\$ 260.8	\$ 312.2	\$ (4.5 )	\$ 568.5
Operating expenses	1.7	170.5	180.9	(4.5 )	348.6
Operating income (loss)	(1.7 )	90.3	131.3	—	219.9
Equity in net earnings of affiliates	113.5	1.5	2.6	(114.6 )	3.0
Interest expense	(20.5 )	(21.0 )	(15.4 )	32.5	(24.4 )
Foreign exchange loss	—	—	(24.0 )	—	(24.0 )
Other income (expense), net	27.7	(0.2 )	3.9	(32.1 )	(0.7 )
Income before income taxes	119.0	70.6	98.4	(114.2 )	173.8
Income tax expense (benefit)	(1.1 )	27.5	26.9	—	53.3
Net income	120.1	43.1	71.5	(114.2 )	120.5
Less: Net income attributable to noncontrolling interest	—	0.4	—	—	0.4
Net income attributable to Kansas City Southern and subsidiaries	120.1	42.7	71.5	(114.2 )	120.1
Other comprehensive loss	(0.6 )	—	(1.2 )	1.2	(0.6 )
Comprehensive income attributable to Kansas City Southern and subsidiaries	\$119.5	\$ 42.7	\$ 70.3	\$ (113.0 )	\$ 119.5

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Notes to Consolidated Financial Statements—(Continued)

## Condensed Consolidating Statements of Comprehensive Income - KCS Notes—(Continued)

Three Months Ended June 30, 2015

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	\$—	\$ 260.7	\$ 329.7	\$ (4.6 )	\$ 585.8
Operating expenses	1.8	189.8	212.0	(4.6 )	399.0
Operating income (loss)	(1.8 )	70.9	117.7	—	186.8
Equity in net earnings of affiliates	107.4	1.6	4.5	(108.5 )	5.0
Interest expense	(0.1 )	(19.5 )	(9.5 )	11.4	(17.7 )
Foreign exchange loss	—	—	(10.5 )	—	(10.5 )
Other income (expense), net	11.4	(1.2 )	—	(11.4 )	(1.2 )
Income before income taxes	116.9	51.8	102.2	(108.5 )	162.4
Income tax expense	5.1	19.7	25.4	—	50.2
Net income	111.8	32.1	76.8	(108.5 )	112.2
Less: Net income attributable to noncontrolling interest	—	0.4	—	—	0.4
Net income attributable to Kansas City Southern and subsidiaries	111.8	31.7	76.8	(108.5 )	111.8
Other comprehensive loss	(0.2 )	—	(0.4 )	0.4	(0.2 )
Comprehensive income attributable to Kansas City Southern and subsidiaries	\$111.6	\$ 31.7	\$ 76.4	\$ (108.1 )	\$ 111.6

Six Months Ended June 30, 2016

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	\$—	\$ 527.6	\$ 612.6	\$ (9.0 )	\$ 1,131.2
Operating expenses	2.8	370.4	359.2	(9.0 )	723.4
Operating income (loss)	(2.8 )	157.2	253.4	—	407.8
Equity in net earnings of affiliates	217.2	3.0	6.0	(219.3 )	6.9
Interest expense	(39.4 )	(42.6 )	(29.9 )	63.9	(48.0 )
Foreign exchange loss	—	—	(27.5 )	—	(27.5 )
Other income, net	52.8	0.1	9.8	(63.2 )	(0.5 )
Income before income taxes	227.8	117.7	211.8	(218.6 )	338.7
Income tax expense (benefit)	(0.1 )	46.0	64.2	—	110.1
Net income	227.9	71.7	147.6	(218.6 )	228.6
Less: Net income attributable to noncontrolling interest	—	0.7	—	—	0.7
Net income attributable to Kansas City Southern and subsidiaries	227.9	71.0	147.6	(218.6 )	227.9
Other comprehensive loss	(0.7 )	—	(1.3 )	1.3	(0.7 )
Comprehensive income attributable to Kansas City Southern and subsidiaries	\$227.2	\$ 71.0	\$ 146.3	\$ (217.3 )	\$ 227.2

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## Kansas City Southern and Subsidiaries

## Notes to Consolidated Financial Statements—(Continued)

## Condensed Consolidating Statements of Comprehensive Income - KCS Notes—(Continued)

Six Months Ended June 30, 2015

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	\$—	\$ 544.7	\$ 653.5	\$ (9.3 )	\$ 1,188.9
Operating expenses	3.0	391.6	438.6	(9.3 )	823.9
Operating income (loss)	(3.0)	153.1	214.9	—	365.0
Equity in net earnings of affiliates	199.3	22	8.5	(201.5 )	9.4
Interest expense	(0.1)	(39.7 )	(20.0 )	23.5	(36.3 )
Foreign exchange loss	—	—	(22.1 )	—	(22.1 )
Other income (expense), net	23.4	1.8 )	(0.1 )	(23.5 )	(2.0 )
Income before income taxes	219.1	14.8	181.2	(201.5 )	314.0
Income tax expense	6.9	43.8	49.9	—	100.6
Net income	212.7	1.0	131.3	(201.5 )	213.4
Less: Net income attributable to noncontrolling interest	—	0.8	—	—	0.8