

DST SYSTEMS INC  
Form 10-Q  
November 10, 2008  
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, 2008**

**or**

**o 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 1-14036**

**DST SYSTEMS, INC.**

Edgar Filing: DST SYSTEMS INC - Form 10-Q

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**43-1581814**  
(I.R.S. Employer  
Identification No.)

**333 West 11<sup>th</sup> Street, Kansas City, Missouri**  
(Address of principal executive offices)

**64105**  
(Zip Code)

**(816) 435-1000**

(Registrant's telephone number, including area code)

**No Changes**

(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 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.

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

Number of shares outstanding of the Company's common stock as of October 31, 2008:

Common Stock \$0.01 par value 49,612,777

Table of Contents

**DST Systems, Inc.**

**Form 10-Q**

**September 30, 2008**

**Table of Contents**

	<b>Page(s)</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1.</u></b>	<b><u>Financial Statements (unaudited)</u></b>
	<b><u>Introductory Comments</u></b> 3
	<b><u>Condensed Consolidated Balance Sheet – September 30, 2008 and December 31, 2007</u></b> 4
	<b><u>Condensed Consolidated Statement of Income – Three and nine months ended September 30, 2008 and 2007</u></b> 5
	<b><u>Condensed Consolidated Statement of Cash Flows – Nine months ended September 30, 2008 and 2007</u></b> 6
	<b><u>Notes to Condensed Consolidated Financial Statements</u></b> 7-22
<b><u>Item 2.</u></b>	<b><u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u></b> 23-44
<b><u>Item 3.</u></b>	<b><u>Quantitative and Qualitative Disclosures about Market Risk</u></b> 44-45
<b><u>Item 4.</u></b>	<b><u>Controls and Procedures</u></b> 45-46
<b><u>Item 4T.</u></b>	<b><u>Controls and Procedures</u></b> 46
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>Item 1.</u></b>	<b><u>Legal Proceedings</u></b> 46
<b><u>Item 1A.</u></b>	<b><u>Risk Factors</u></b> 46-52
<b><u>Item 2.</u></b>	<b><u>Unregistered Sales of Equity Securities and Use of Proceeds</u></b> 52
<b><u>Item 3.</u></b>	<b><u>Defaults Upon Senior Securities</u></b> 53
<b><u>Item 4.</u></b>	<b><u>Submission of Matters to a Vote of Security Holders</u></b> 53
<b><u>Item 5.</u></b>	<b><u>Other Information</u></b> 53
<b><u>Item 6.</u></b>	<b><u>Exhibits</u></b> 53
<b><u>SIGNATURE</u></b>	53

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

The brand, service or product names or marks referred to in this Report are trademarks or service marks, registered or otherwise, of DST Systems, Inc. or its subsidiaries or affiliates or of vendors to the Company.

Table of Contents

**DST Systems, Inc.**

**Form 10-Q**

**September 30, 2008**

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**Introductory Comments**

The Condensed Consolidated Financial Statements of DST Systems, Inc. ( "DST" or the "Company" ) included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. These Condensed Consolidated Financial Statements should be read in conjunction with the Company's audited financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

The results of operations for the three and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year 2008.

Table of Contents**DST Systems, Inc.****Condensed Consolidated Balance Sheet***(in millions, except per share amounts)**(unaudited)*

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 99.5	\$ 109.4
Transfer agency investments	263.2	177.4
Accounts receivable	212.4	298.0
Deferred income taxes	28.4	30.7
Other assets	60.7	123.5
	664.2	739.0
Investments	1,604.4	1,940.3
Properties	483.4	494.1
Goodwill	117.0	117.9
Intangible assets	31.5	34.5
Other assets	68.4	70.1
Total assets	\$ 2,968.9	\$ 3,395.9
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities		
Current portion of long-term debt	\$ 921.2	\$ 963.9
Transfer agency deposits	263.2	177.4
Accounts payable	57.6	69.8
Accrued compensation and benefits	105.0	127.3
Deferred revenues and gains	52.2	69.7
Other liabilities	99.7	118.1
	1,498.9	1,526.2
Long-term debt	620.5	97.2
Income taxes payable	71.7	100.0
Deferred income taxes	305.8	452.8
Other liabilities	59.9	60.6
Total liabilities	2,556.8	2,236.8
Commitments and contingencies (Note 10)		
Stockholders' equity		
Common stock, \$0.01 par; 400 million shares authorized, 95.3 million shares issued	1.0	1.0
Additional paid-in capital	155.5	142.1
Retained earnings	2,501.2	2,328.9
Treasury stock (45.0 million and 34.5 million shares, respectively), at cost	(2,661.8)	(1,979.7)
Accumulated other comprehensive income	416.2	666.8
Total stockholders' equity	412.1	1,159.1
Total liabilities and stockholders' equity	\$ 2,968.9	\$ 3,395.9

The accompanying notes are an integral part of these financial statements.



Table of Contents**DST Systems, Inc.****Condensed Consolidated Statement of Income***(in millions, except per share amounts)**(unaudited)*

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Operating revenues	\$ 414.2	\$ 419.5	\$ 1,271.6	\$ 1,262.9
Out-of-pocket reimbursements	146.2	153.3	449.5	462.2
Total revenues	560.4	572.8	1,721.1	1,725.1
Costs and expenses	449.3	463.4	1,381.0	1,384.7
Depreciation and amortization	32.2	34.1	93.8	95.6
Income from operations	78.9	75.3	246.3	244.8
Interest expense	(13.8)	(11.6)	(40.3)	(49.2)
Other income (expense), net	2.8	14.9	(4.1)	41.6
Gain on sale of Asurion		996.3		996.3
Equity in earnings of unconsolidated affiliates	9.0	5.4	29.3	52.7
Income before income taxes	76.9	1,080.3	231.2	1,286.2
Income taxes	26.7	407.5	58.9	475.2
Net income	\$ 50.2	\$ 672.8	\$ 172.3	\$ 811.0
Average common shares outstanding	49.3	59.9	52.3	61.5
Average diluted shares outstanding	55.2	69.9	59.2	71.2
Basic earnings per share	\$ 1.02	\$ 11.24	\$ 3.30	\$ 13.18
Diluted earnings per share	\$ 0.91	\$ 9.62	\$ 2.91	\$ 11.37

The accompanying notes are an integral part of these financial statements.



Table of Contents**DST Systems, Inc.****Condensed Consolidated Statement of Cash Flows***(in millions)**(unaudited)*

	<b>For the Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows operating activities:</b>		
Net income	\$ 172.3	\$ 811.0
Depreciation and amortization	93.8	95.6
Net realized (gain) loss on investments	22.7	(8.0)
Gain on sale of properties	(0.1)	(13.3)
Gain on sale of Asurion		(996.3)
Amortization of share-based compensation	25.1	20.7
Equity in earnings of unconsolidated affiliates	(29.3)	(52.7)
Deferred income taxes	1.9	2.9
Changes in accounts receivable	55.5	(3.9)
Net proceeds from accounts receivable securitization program	30.0	70.0
Changes in accounts payable and accrued liabilities	(42.6)	(15.8)
Changes in income taxes payable	(15.9)	403.0
Other, net	(10.5)	(0.1)
Total adjustments to net income	130.6	(497.9)
Net	302.9	313.1
<b>Cash flows investing activities:</b>		
Capital expenditures	(79.7)	(58.3)
Proceeds from (investments in and advances to) unconsolidated affiliates	(34.4)	26.7
Investments in securities	(91.5)	(271.7)
Proceeds from sale of investments	73.5	46.6
Proceeds from sale of properties	0.1	42.5
Proceeds from sale of Asurion	39.2	980.0
Other, net	(0.4)	(14.9)
Net	(93.2)	750.9
<b>Cash flows financing activities:</b>		
Proceeds from issuance of common stock	4.7	84.9
Principal payments on debt	(36.8)	(20.0)
Proceeds from real estate credit agreement	114.0	
Net borrowings (payments) on revolving credit facilities	394.7	(410.5)
Common stock repurchased	(697.4)	(511.8)
Excess tax benefits from share based compensation	1.2	20.3
Net	(219.6)	(837.1)
Net increase (decrease) in cash and cash equivalents	(9.9)	226.9
Cash and cash equivalents, beginning of period	109.4	60.6
Cash and cash equivalents, end of period	\$ 99.5	\$ 287.5

The accompanying notes are an integral part of these financial statements.



Table of Contents

**DST Systems, Inc.**

**Notes to Condensed Consolidated Financial Statements**

*(unaudited)*

**1. Summary of Accounting Policies**

The Condensed Consolidated Financial Statements of DST Systems, Inc. ( "DST" or the "Company" ) included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ( "GAAP" ) have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. The Condensed Consolidated Balance Sheet as of December 31, 2007 has been derived from the audited Consolidated Balance Sheet at that date, but does not include all of the information and notes required by GAAP for complete financial statements. These Condensed Consolidated Financial Statements should be read in conjunction with the Company's audited financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

In the opinion of management, the accompanying unaudited Condensed Consolidated Financial Statements contain all adjustments (consisting of normal interim closing procedures) necessary to present fairly the financial position of the Company and its subsidiaries at September 30, 2008, and the results of operations for the three and nine months ended September 30, 2008 and 2007, and cash flows for the nine months ended September 30, 2008 and 2007.

Certain amounts in the prior year's financial statements have been reclassified to conform to the current year presentation.

The results of operations for the three and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year 2008.

**2. Other Current Assets**

Included in other current assets are the following items (in millions):

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Income tax recoverable	\$ 14.3	\$ 29.8

Edgar Filing: DST SYSTEMS INC - Form 10-Q

Prepaid expenses	22.7	29.6
Inventories	14.3	16.0
Other	9.4	8.9
Receivable from Asurion		39.2
	\$ 60.7	\$ 123.5

Table of Contents**3. Investments**

Investments are as follows (in millions):

	2008 Ownership Percentage	Carrying Value	
		September 30, 2008	December 31, 2007
<b>Available-for-sale securities:</b>			
State Street Corporation	3%	\$ 643.3	\$ 918.4
Computershare Ltd.	5%	218.2	256.0
Euronet Worldwide	4%	31.5	56.5
Other available-for-sale securities		207.1	279.2
		1,100.1	1,510.1
<b>Unconsolidated affiliates:</b>			
Boston Financial Data Services	50%	166.2	151.0
International Financial Data Services, U.K.	50%	59.2	57.3
International Financial Data Services, Canada	50%	27.0	24.4
Argus Health Systems	50%	16.5	16.1
Unconsolidated real estate affiliates		94.7	62.3
Other unconsolidated affiliates		8.7	9.8
		372.3	320.9
<b>Other:</b>			
Trading securities		44.1	51.3
Held-to-maturity		3.0	3.7
Investments, at cost		84.9	54.3
		132.0	109.3
<b>Total investments</b>		<b>\$ 1,604.4</b>	<b>\$ 1,940.3</b>

The following table summarizes certain information related to the Company's available-for-sale securities (in millions):

	September 30, 2008	December 31, 2007
Book cost basis	\$ 428.4	\$ 466.3
Gross unrealized gains	684.5	1,053.9
Gross unrealized losses	(12.8)	(10.1)
Market value	\$ 1,100.1	\$ 1,510.1

The following table summarizes the fair value and gross unrealized losses of the Company's investments by the length of time that the securities have been in a continuous loss position, as of September 30, 2008 (in millions):

Less than 12 months		Greater than 12 months		Total	
Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses

Edgar Filing: DST SYSTEMS INC - Form 10-Q

Common stock	\$	75.8	\$	12.3	\$	2.9	\$	0.5	\$	78.7	\$	12.8
--------------	----	------	----	------	----	-----	----	-----	----	------	----	------

Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the investments. These may not be reflected in an

Table of Contents

investment's current carrying value, thereby possibly requiring an impairment charge in the future. Such a charge could have a material effect on the Company's consolidated financial position and results of operations.

The Company recognized \$7.1 million and \$33.1 million of investment impairments for the three and nine months ended September 30, 2008 and \$3.1 million and \$5.1 million for the three and nine months ended September 30, 2007, which the Company believed were other than temporary. Impairments recorded during the three and nine months ended September 30, 2008 and 2007 relate to available-for-sale and cost method investments in the Investments and Other Segment and the Financial Services Segment. A decline in a security's net realizable value that is other than temporary is treated as a loss based on quoted or derived market value and is reflected in other income (expense), net line in the Condensed Consolidated Statement of Income.

The Company provides a cash management service for full service mutual fund transfer agency clients, whereby end of day available client bank balances are invested overnight by and in the name of the Company into credit-quality money market funds. Invested balances are returned to the full service mutual fund transfer agency client accounts the following business day. The Company had \$263.2 million and \$177.4 million of transfer agency investments and deposits at September 30, 2008 and December 31, 2007, respectively.

The following table summarizes equity in earnings (losses) of unconsolidated affiliates (in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
BFDS	\$ 4.6	\$ 7.6	\$ 15.2	\$ 23.6
IFDS, U.K.	2.6	3.0	8.5	10.4
IFDS, Canada	2.4	0.4	4.8	2.9
Argus	0.0	1.5	0.4	3.4
Other	(0.6)	(7.1)	0.4	(9.5)
Asurion				21.9
	\$ 9.0	\$ 5.4	\$ 29.3	\$ 52.7

In June 2008, the Company loaned \$34.5 million at variable rates of interest, secured by real estate and maturing on December 31, 2012, to an unconsolidated real estate joint venture. The other partner in the joint venture guaranteed 60% of the loan balance. At September 30, 2008, the amount due DST is \$34.5 million.

**4. Fair Value Measurements**

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). The Company did not elect the fair value measurement option under SFAS 159 for any of its financial assets or liabilities and, as a result, there was no impact on the Company's Condensed Consolidated Financial Statements.

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

On January 1, 2008, DST adopted SFAS No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy based on the source of the information. The FASB delayed the effective date to first quarter 2009 for nonfinancial assets and liabilities recognized or disclosed at fair value in the financial statements on a nonrecurring basis, in accordance with FASB Staff Position SFAS 157-2, Effective Date of FASB Statement No. 157. Management



Table of Contents

is currently evaluating the financial reporting requirements for these assets and liabilities and has not yet determined the impact on the consolidated financial statements.

SFAS 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

As of September 30, 2008, the Company held certain investment assets that are required to be measured at fair value on a recurring basis. These investments include the Company's available-for-sale and trading securities whereby fair value is determined using quoted prices in active markets. Accordingly, the fair value measurements of these investments have been classified as Level 1 in the table below.

The following table presents assets and liabilities measured at fair value on a recurring basis (in millions):

	Fair Value Measurements at Reporting Date Using			
	9/30/2008	Quoted prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities	\$ 1,100.1	\$ 1,100.1	\$	\$
Trading securities	44.1	44.1		
Total	\$ 1,144.2	\$ 1,144.2	\$	\$

At September 30, 2008, one of DST's unconsolidated affiliates had an interest rate swap with a fair market value liability of \$20.0 million (DST's proportionate share is \$10.0 million). The unconsolidated affiliate used inputs from quoted prices for similar assets and liabilities in active markets and other observable inputs directly or indirectly related to the measurement of the interest rate swap. The fair value measurement of the interest rate swap has been classified as Level 2 by the unconsolidated affiliate. The above table presents only assets and liabilities measured at fair value for which the Company controls, and accordingly excludes items held by unconsolidated affiliates.

**5. Goodwill and Intangible Assets**

*Goodwill*

The following table summarizes the changes in the carrying amount of goodwill for the nine months ended September 30, 2008, by segment (in millions):

Edgar Filing: DST SYSTEMS INC - Form 10-Q

	December 31, 2007	Acquisitions	Disposals	Other	September 30, 2008
Financial Services	\$ 108.5	\$ 0.4	\$	\$ (0.7)	\$ 108.2
Output Solutions	9.4			(0.6)	8.8
Total	\$ 117.9	\$ 0.4	\$	\$ (1.3)	\$ 117.0

Table of Contents*Intangible Assets*

The following table summarizes intangible assets (in millions):

	September 30, 2008		December 31, 2007	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortizable intangible assets:				
Customer relationships	\$ 36.7	\$ 7.4	\$ 36.7	\$ 4.6
Other	3.8	1.6	3.8	1.4
<b>Total</b>	<b>\$ 40.5</b>	<b>\$ 9.0</b>	<b>\$ 40.5</b>	<b>\$ 6.0</b>

Amortization of intangible assets for the three and nine months ended September 30, 2008 was approximately \$1.0 million and \$3.0 million, respectively, as compared to \$0.6 million and \$1.7 million, for the three and nine months ended September 30, 2007, respectively. The Company estimates that amortization expense attributable to intangible assets recorded as of September 30, 2008 will be approximately \$1.0 million for the remainder of 2008, \$3.6 million for 2009, \$3.1 million for 2010, \$3.0 million for 2011, \$2.8 million for 2012 and \$18.0 million thereafter.

**6. Debt***Senior Convertible Debentures*

Holders of the Company's senior convertible debentures were eligible to convert these bonds during the three months ended March 31, 2008, June 30, 2008 and September 30, 2008 as a result of DST's common stock trading above 120% of the applicable conversion price (\$49.08) for at least 20 trading days during the period of 30 consecutive trading days ended December 31, 2007, March 31, 2008 and June 30, 2008, respectively. Actual conversions for the nine months ended September 30, 2008 have been less than \$0.1 million and the Company used cash to settle the principal portion of these conversions. Holders of the senior convertible debentures do not have the right to convert these bonds during the three months ending December 31, 2008 because the stock price conversion feature was not achieved for at least 20 trading days during the period of 30 consecutive trading days ended September 30, 2008. Conversion rights, and ultimate classification of the senior convertible debentures as a current or non-current liability, for subsequent quarters will be a function of future DST stock prices. At September 30, 2008 and December 31, 2007, the Company had \$839.7 million and \$839.8 million, respectively, of senior convertible debentures outstanding, all of which is classified as a current liability.

In July 2008, the Company announced a notice of put right in connection with \$300 million aggregate principal amount of 3.625% Series B convertible senior debentures due 2023. Series B convertible senior debenture holders had the right to require the Company to purchase the debentures on August 15, 2008, for cash, at a purchase price equal to the accreted principal amount of the debentures to be purchased plus any accrued and unpaid cash interest to August 15, 2008. The put right expired on August 20, 2008 and did not result in significant debenture purchases by DST during third quarter 2008.

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

At any time after August 20, 2008, DST has the right to redeem for cash all or part of the Series B convertible debentures, upon not less than 30 nor more than 60 days notice before the redemption date, for a price equal to the accreted principal amount of any Series B convertible debentures to be redeemed plus any accrued and unpaid cash interest through the redemption date.

In August 2008, the Company announced that it will pay contingent interest for the period August 20, 2008 to February 14, 2009 in connection with Series B convertible senior debentures. The interest obligation arises because the average trading price of the Series B debentures for the applicable five trading-day reference period exceeded 120% of the accreted principal amount of such debentures. The amount of contingent interest equals

Table of Contents

0.19% of the average trading price for the reference period, or \$2.55 per \$1,000 principal amount of such debentures. The interest payment date is February 17, 2009.

*Syndicated Line of Credit*

The Company amended its \$600 million syndicated line of credit facility as of June 16, 2008 to extend an expiring provision that allowed liens on real property securing indebtedness. At September 30, 2008 and December 31, 2007, the Company had \$475.4 million and \$48.7 million, respectively, of indebtedness under the syndicated line of credit facility.

*Equipment Credit Facility*

The Company entered into a \$50 million unsecured credit facility with a vendor in June 2008. Proceeds from loans made under the credit facility can be used to make purchases of the vendor's eligible equipment, software or services. Loans under this credit facility must be made prior to June 30, 2010, the draw period termination date. The maturity date for each loan under this credit facility is the earlier of i) the first day of the second calendar month following the third anniversary of the loan date or ii) August 1, 2013. Interest rates applicable to the loans under this credit facility are generally based on offshore LIBOR rate plus an applicable margin of 0.40% to 0.85%. The applicable margin is based on a grid schedule that adjusts borrowing costs up or down based upon the Company's consolidated leverage ratio. At September 30, 2008, \$6.8 million was outstanding under the equipment credit facility.

*Real Estate Credit Agreement*

On September 16, 2008, certain subsidiaries of DST entered into a credit agreement with a syndicate of lenders. The credit agreement provides for a five-year, non-revolving credit facility in an aggregate principal amount of up to \$120.0 million. Upon closing of the facility in September 2008, \$115.0 million was advanced to DST. The credit facility is secured by, among other things, the real estate and properties owned by these DST subsidiaries as well as an assignment of the related leases, rents and other benefits of these assets. The interest rate applicable to the credit agreement is a floating rate tied to either offshore LIBOR rate plus an applicable margin rate of 1.75% or the prime rate (as defined in the credit agreement), as elected by DST. Principal and interest payments are due on the first of each month beginning in November 2008, and are based on a 20 year amortization schedule. Subject to provisions in the credit agreement, DST may voluntarily prepay the loan in whole or in part without premium or penalty, though amounts repaid may not be reborrowed. Concurrent with the lease, sale or other transfer of any of the collateralized properties, DST must prepay an amount equal to 125% of the allocated amount of such property as set forth in the credit agreement. The credit agreement contains customary restrictive covenants, as well as certain customary events of default. Among other provisions, the credit agreement requires certain interest coverage ratios to be maintained. If any event of default occurs and is continuing, all amounts payable under the credit agreement may be declared immediately due and payable. The balance of the loan is due on September 16, 2013, the maturity date of the credit facility. The amount outstanding under this real estate credit agreement at September 30, 2008 was \$115.0 million.

**7. Income Taxes**

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

In general, the Company records income tax expense during interim periods based on its best estimate of the full year's effective tax rate. Certain items, however, are given discrete period treatment and, as a result, the tax effects of such items are reported in full in the relevant interim period. The Company's effective tax rate was 34.7% and 25.5% for the three and nine months ended September 30, 2008, respectively, compared to 37.7% and 37.0% for the three and nine months ended September 30, 2007, respectively. The Company recorded an income tax benefit of approximately \$23.9 million, resulting from a net reduction in the Company's liabilities for FIN 48 (including approximately \$10.4 million of interest and penalties) during first quarter 2008. The net decrease in FIN 48 liabilities is principally related to the resolution of an IRS examination matter (associated with a transaction that the Company consummated in the 2000 tax year) that was resolved in DST's favor. The full year 2008 effective tax rate can be affected as a result of variances among the estimates and amounts of full year

Table of Contents

sources of taxable income (e.g., domestic consolidated, joint venture and/or international), the realization of tax credits (e.g., historic rehabilitation, research and experimentation and state incentive), adjustments which may arise from the resolution of tax matters under review and the Company's assessment of its liability for unrecognized tax benefits.

**8. Stockholders' Equity***Earnings per share*

The computation of basic and diluted earnings per share is as follows (in millions, except per share amounts):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income	\$ 50.2	\$ 672.8	\$ 172.3	\$ 811.0
Dilutive securities at unconsolidated affiliates				(1.1)
Net income for dilutive computation	\$ 50.2	\$ 672.8	\$ 172.3	\$ 809.9
Average common shares outstanding (excluding restricted stock)	49.3	59.9	52.3	61.5
Incremental shares from assumed conversions of stock options, vesting of stock based compensation and debenture conversion	5.9	10.0	6.9	9.7
Average diluted shares outstanding	55.2	69.9	59.2	71.2
Basic earnings per share	\$ 1.02	\$ 11.24	\$ 3.30	\$ 13.18
Diluted earnings per share	\$ 0.91	\$ 9.62	\$ 2.91	\$ 11.37

The Company had approximately 50.3 million and 61.5 million shares outstanding at September 30, 2008 and 2007, respectively. For financial reporting purposes, however, unvested restricted shares in the amount of 2.6 million at both September 30, 2008 and 2007 are excluded from the determination of average common shares outstanding used in the calculation of basic earnings per share in the above table. Shares from options to purchase shares of common stock that were excluded from the diluted earnings per share calculation because they were anti-dilutive totaled 0.5 million and 0.2 million for the three and nine months ended September 30, 2008, respectively. There were no anti-dilutive shares from options to purchase common stock during the three and nine months ended September 30, 2007. The Company has issued convertible senior debentures that if converted in the future would have a potentially dilutive effect on the Company's stock. The Series A debentures are convertible into 11.0 million shares of common stock and the Series B debentures are convertible into 6.1 million shares of common stock, subject to adjustment. The Company intends to settle any conversions with cash for the principal and accrued and unpaid interest and issue common stock for any conversion value amount over the principal and accrued and unpaid interest amounts. Related to the debentures, the calculation of diluted earnings per share includes an incremental amount of shares assumed to be issued for the conversion spread when the Company's average daily stock price exceeds \$49.08 per share. There was additional dilution of approximately 3.1 million shares and 3.9 million shares for the three and nine months ended September 30, 2008, respectively, and 6.5 million shares and 6.1 million shares for the three and nine months ended September 30, 2007, respectively, related to the Company's average daily share price exceeding \$49.08 per share.

*Stock repurchases*

On May 12, 2008, DST's Board of Directors authorized the repurchase of an additional 5.0 million shares under the existing share repurchase authorization plan. The Company repurchased 3,011,587 shares of DST common stock for \$175.1 million or approximately \$58.14 per share during the three months ended September 30, 2008.



Table of Contents

For the nine months ended September 30, 2008, the Company had repurchased 10,635,252 shares of DST common stock for \$691.7 million at an average cost of \$65.04 per share. At September 30, 2008, approximately 1.2 million shares remained under the existing share repurchase authorization plan.

*Comprehensive income (loss)*

Components of comprehensive income (loss) consist of the following (in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income	\$ 50.2	\$ 672.8	\$ 172.3	\$ 811.0
Other comprehensive income (loss):				
Unrealized gains (losses) on investments:				
Unrealized holding gains (losses) arising during the period	(107.6)	(55.0)	(368.9)	43.2
Proportional share of unconsolidated affiliate interest rate swap	(2.6)	(0.4)	(3.1)	5.9
Less reclassification adjustments for net (gains) losses included in net income	3.5	0.1	14.1	(8.0)
Foreign currency translation adjustments	(46.2)	11.1	(37.4)	23.8
Deferred income taxes	53.2	20.5	144.7	(16.9)
Other comprehensive income (loss)	(99.7)	(23.7)	(250.6)	48.0
Comprehensive income (loss)	\$ (49.5)	\$ 649.1	\$ (78.3)	\$ 859.0

**9. Accounts Receivable Securitization Program**

On May 22, 2008, the Company renewed its \$200 million accounts receivable securitization program with a third party multi-seller asset-backed commercial paper conduit. The first amendment to the receivables purchase agreement (originally dated May 24, 2007) extends the conduit's purchase commitment until May 21, 2009. At September 30, 2008 and December 31, 2007, the total outstanding undivided interest in the receivables held by the conduit was \$100 million and \$70 million, respectively.

**10. Commitments and Contingencies**

The Company and its subsidiaries are involved in various legal proceedings arising in the normal course of their businesses. While the ultimate outcome of these legal proceedings cannot be predicted with certainty, it is the opinion of management that the final outcome in such proceedings, in the aggregate, would not have a material adverse effect on the consolidated financial condition, results of operations and cash flows of the Company.

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

The Company has letters of credit of \$6.2 million and \$3.3 million outstanding at September 30, 2008 and December 31, 2007, respectively. Letters of credit are secured by the Company's debt facility.

The Company has entered into agreements with certain officers whereby upon defined circumstances constituting a change in control of the Company, certain benefit entitlements are automatically funded and such officers are entitled to specific cash payments upon termination of employment.

The Company has established trusts to provide for the funding of corporate commitments and entitlements of Company officers, directors, employees and others in the event of a change in control of the Company. Assets held in such trusts at September 30, 2008 were not significant.

The Company has entered into an agreement to guarantee 50% of the obligations of a 50% owned joint venture as a tenant under a real estate lease for an office building. The initial term of the lease is 10 years and 7 months,

Table of Contents

commencing March 1, 2007 and expiring September 30, 2017, with two five-year options to extend. The base rent for the initial term is \$4.8 million per year, plus all operating expenses for the building.

The Company has entered into an agreement to guarantee 50% of a \$6.1 million line of credit provided to a 50% owned real estate joint venture. The line of credit becomes due and the Company's guarantee thereof expires on June 16, 2009. In April 2008, this line of credit was repaid.

The Company entered into an agreement to guarantee \$2.0 million plus any enforcement costs related to a \$32.0 million mortgage loan to a 33% owned real estate joint venture. The \$32.0 million loan matures on July 1, 2010. At September 30, 2008, total borrowings on the loan were \$28.4 million and the Company's guarantee totaled \$1.0 million.

The Company's 50% owned joint ventures are generally governed by shareholder or partnership agreements. The agreements generally entitle the Company to elect one-half of the directors to the board in the case of corporations and to have 50% voting/managing interest in the case of partnerships. The agreements generally provide that the Company or the other party has the option to establish a price payable in cash, or a promise to pay cash, for all of the other's ownership in the joint venture and to submit an offer, in writing, to the other party to sell to the other party all of its ownership interests in the joint venture or to purchase all ownership interests owned by the other party at such offering price. The party receiving the offer generally has a specified period of time to either accept the offer to purchase, or to elect to purchase the offering party's interest at the offering price. The Company cannot estimate the potential aggregate offering price that it could be required to receive or elect to pay in the event this option becomes operable; however, the amount could be material.

*Guarantees*

In addition to the guarantees entered into as mentioned above, the Company has also guaranteed certain obligations of certain joint ventures under service agreements entered into by the joint ventures and their customers. The amount of such obligations is not stated in the agreements. Depending on the negotiated terms of the guaranty and/or the underlying service agreement, the Company's liability under the guaranty may be subject to time and materiality limitations, monetary caps and other conditions and defenses.

In certain instances in which the Company licenses proprietary systems to customers, the Company gives certain warranties and infringement indemnities to the licensee, the terms of which vary depending on the negotiated terms of each respective license agreement, but which generally warrant that such systems will perform in accordance with their specifications. The amount of such obligations is not stated in the lease agreements. The Company's liability for breach of such warranties may be subject to time and materiality limitations, monetary caps and other conditions and defenses.

From time to time, the Company enters into agreements with unaffiliated parties containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective agreement. The amount of such obligations is not stated in the agreements. The Company's liability under such indemnification provisions may be subject to time and materiality limitations, monetary caps and other conditions and defenses. Such indemnity obligations include the following:

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

The Company has entered into purchase and service agreements with its vendors, and consulting agreements with providers of consulting services to the Company, pursuant to which the Company has agreed to indemnify certain of such vendors and consultants, respectively, against third party claims arising from the Company's use of the vendor's product or the services of the vendor or consultant.

In connection with the acquisition or disposition of subsidiaries, operating units and business assets by the Company, the Company has entered into agreements containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective agreement, but which are generally described as follows: (i) in connection with acquisitions made by the Company, the Company has agreed to indemnify the seller against third-party claims made against the seller relating to the subject subsidiary, operating unit or asset and arising after the closing of the transaction, and (ii) in connection with dispositions made by the Company, the Company has agreed to indemnify the buyer against damages incurred by the buyer due to the buyer's reliance on representations and warranties relating to the subject subsidiary, operating unit or business assets in the

Table of Contents

disposition agreement if such representations or warranties were untrue when made, or due to any breach of the representations, warranties, agreements or covenants contained in the agreement.

The Company has entered into agreements with certain third parties, including banks and escrow agents, which provide software escrow, fiduciary and other services to the Company or to its benefit plans or customers. Under such agreements, the Company has agreed to indemnify such service providers for third party claims relating to the carrying out of their respective duties under such agreements.

The Company has entered into agreements with lenders providing financing to the Company pursuant to which the Company agrees to indemnify such lenders for third party claims arising from or relating to such financings. In connection with real estate mortgage financing, the Company has entered into environmental indemnity agreements in which the Company has agreed to indemnify the lenders for any damage sustained by the lenders relating to any environmental contamination on the subject properties.

In connection with the acquisition or disposition of real estate by the Company, the Company has entered into real estate contracts containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective contract, but which are generally described as follows: (i) in connection with acquisitions by the Company, the Company has agreed to indemnify the seller against third-party claims made against the seller arising from the Company's on-site inspections, tests and investigations of the subject property made by the Company as part of its due diligence and against third-party claims relating to the operations on the subject property after the closing of the transaction, and (ii) in connection with dispositions by the Company, the Company has agreed to indemnify the buyer for damages incurred by the buyer due to the buyer's reliance on representations and warranties relating to the subject property made by the Company in the real estate contract if such representations or warranties were untrue when made and against third-party claims relating to operations on the subject property prior to the closing of the transaction.

In connection with the leasing of real estate by the Company, as landlord and as tenant, the Company has entered into occupancy leases containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective lease, but which are generally described as follows: (i) in connection with leases in which the Company is the tenant, the Company has agreed to indemnify the landlord against third party claims relating to the Company's occupancy of the subject property, including claims arising from loss of life, bodily injury and/or damage to property thereon, and (ii) in connection with leases in which the Company is the landlord, the Company has agreed to indemnify the tenant against third party claims to the extent occasioned wholly or in part by any negligent act or omission of the Company or arising from loss of life, bodily injury and/or damage to property in or upon any of the common areas or other areas under the Company's control.

At September 30, 2008 and December 31, 2007, the Company had not accrued any liability on the aforementioned guarantees or indemnifications as they relate to future performance criteria or indirect guarantees of indebtedness of others in accordance with FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.

**11. Accounting Standards**

*Accounting for Convertible Debt Instruments*

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

In May 2008, the FASB issued FASB Staff Position ( FSP ) No. APB 14-1, Accounting for Convertible Debt Instruments that may be Settled in Cash upon Conversion (Including Partial Cash Settlement). This FSP clarifies that issuers of convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. The FSP will be effective for financial statements issued for fiscal years beginning after December 15, 2008, and early adoption is not permitted. This FSP shall be applied retrospectively to all periods presented. DST is still evaluating the impact of this FSP, but currently believes that the adoption of this standard may have a negative impact on earnings per share for historical periods prior to March 31, 2006, but is not expected to have a significant impact on the Company's earnings per share prospectively.

Table of Contents

*Earnings Per Share Participating Securities*

In June 2008, the FASB issued FSP No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. Under FSP EITF 03-6-1, certain share-based payment awards that allow holders to receive dividends before they vest should be treated as participating securities. Although unvested share-based payment awards with nonforfeitable rights to dividends have typically been included in the calculation of diluted EPS using the treasury stock method, these awards will now need to be included in the calculation of basic EPS using the two-class method, a change that will likely reduce both basic and diluted EPS. The FSP will be effective for financial statements issued for fiscal years beginning after December 15, 2008, and early adoption is not permitted. This FSP shall be applied retrospectively to all periods presented. Because DST's restricted stock awards allow holders the right to receive cash dividends, if any, DST may have to treat these awards as participating securities which could result in an additional dilutive impact to both basic and diluted EPS. Unvested restricted shares were 2.6 million at September 30, 2008. DST is still evaluating the impact of this FSP, but currently believes that the adoption of this standard will have a negative impact on basic and diluted earnings per share.

*Earnings Per Share*

The Financial Accounting Standards Board (the *FASB*) previously issued an exposure draft, revised in August 2008, on a proposed accounting standard that would amend SFAS No. 128, *Earnings per Share* ( *SFAS 128* ), to clarify guidance for mandatorily convertible instruments, the treasury stock method, contingently issuable shares, and contracts that may be settled in cash or shares.

The proposed amendment, which is designed for convergence with international accounting standards, would require the use of the *if-converted* method from the date of issuance of the convertible debentures. The proposed amendment would remove the ability of a company to support the presumption that the convertible securities will be satisfied in cash and not converted into shares of common stock. Accordingly, the Company's stated intention to settle conversions of its convertible debentures with cash for the principal and accrued and unpaid interest and issue common stock for any conversion value amount over the principal and accrued and unpaid interest amounts would no longer be accepted under SFAS 128, if amended as proposed. The final standard has yet to be issued. Retrospective application would be required for all changes to SFAS 128, except that retrospective application would be prohibited for contracts that were either settled in cash prior to adoption or modified prior to adoption to require cash settlement. For DST, adoption of this statement, as proposed, will require retroactive restatement of the Company's diluted earnings per share calculations subsequent to the issuance of the convertible debentures. In calculating diluted earnings per share under the revised SFAS 128 *if converted* method included in the exposure draft, the Company would need to increase net income for the interest expense associated with the convertible debentures, net of tax, and increase the incremental shares assumed to be issued upon conversion by 17.1 million shares (less shares already included in diluted earnings per share), the amount of shares that would be issued if all of the senior convertible debentures would be converted to equity. The revised SFAS 128 exposure draft also contains other EPS computational changes (e.g., treasury stock method considerations) that may have an effect on the Company's diluted earnings per share calculation. DST is continuing to monitor the FASB's progress towards finalizing this proposed accounting standard.

The proposed change in accounting principle would affect the calculation of diluted earnings per share during the period the debentures are outstanding, but would not affect DST's ability to ultimately settle the convertible debentures in cash, shares or any combination thereof.

The estimated impact of this new accounting standard reflects the Company's current estimates based upon the exposure draft in its current form. There may be material differences between these estimates and the actual impact of the standard when issued as final.





Table of Contents**12. Segment Information**

The Company's operating business units offer sophisticated information processing and software services and products. The Company has elected to organize and report on these business units as two operating Segments (Financial Services and Output Solutions). In addition, investments in equity securities, private equity fund investments, and certain financial interests, and the Company's real estate subsidiaries and affiliates have been aggregated into an Investments and Other Segment.

In first quarter 2008, the Company changed the measurement of certain occupancy cost components of its Output Solutions Segment. The Output Solutions Segment leases its California, Connecticut and Missouri production facilities from the Investments and Other Segment. Beginning in 2008, the Company began reporting financial results for the Output Solutions Segment on the basis that the Output Solutions Segment owned (instead of leased) these three production facilities. Management believes this action will improve its ability to analyze the Output Solutions Segment operating results taking into consideration the special purpose nature of the production plants. Reported results for the Output Solutions Segment and the Elimination Adjustments for periods prior to 2008 have been restated to reflect this change. The Company's restated segment results for the three and nine months ended September 30, 2007 and the years ended December 31, 2007, 2006 and 2005 are included in the tables below. The Investments and Other Segment continues to present rental revenues from the Output Solutions Segment along with the related depreciation expense associated with the properties, while the elimination of the inter-segment activity is included in the Elimination Adjustments. The impact of this change increased Output Solutions income from operations by \$1.9 million and \$5.6 million for the three and nine months ended September 30, 2008 and 2007, and correspondingly increased the Segment Eliminations loss from operations by \$1.9 million and \$5.6 million for the three and nine months ended September 30, 2008 and 2007.

Information concerning total assets by reporting segment is as follows (in millions):

	September 30, 2008	December 31, 2007
Financial Services	\$ 1,526.0	\$ 1,770.9
Output Solutions	243.2	261.0
Investments and Other	1,398.2	1,651.7
Elimination Adjustments	(198.5)	(287.7)
	\$ 2,968.9	\$ 3,395.9

The Company evaluates the performance of its Segments based on income before income taxes, non-recurring items and interest expense. Intersegment revenues are reflected at rates prescribed by the Company and may not be reflective of market rates.

Included in costs and expenses in the Investments and Other Segment for the nine months ended September 30, 2007 is a gain of \$12.4 million related to the sale of certain real property.

Summarized financial information concerning the Segments is shown in the following tables (in millions):



Edgar Filing: DST SYSTEMS INC - Form 10-Q

Table of Contents

	<b>For the Three Months Ended September 30, 2008</b>				
	<b>Financial Services</b>	<b>Output Solutions</b>	<b>Investments/ Other</b>	<b>Elimination Adjustments</b>	<b>Consolidated Total</b>
Operating revenues	\$ 282.2	\$ 128.8	\$ 3.2	\$	\$ 414.2
Intersegment operating revenues	2.2		12.9	(15.1)	
Out-of-pocket reimbursements	17.5	128.6	0.2	(0.1)	146.2
Total revenues	301.9	257.4	16.3	(15.2)	560.4
Costs and expenses	211.4	239.8	10.7	(12.6)	449.3
Depreciation and amortization	20.5	10.2	2.2	(0.7)	32.2
Income (loss) from operations	70.0	7.4	3.4	(1.9)	78.9
Other income (expense), net	0.2	(0.1)	2.7		2.8
Equity in earnings of unconsolidated affiliates	9.0				9.0
Earnings before interest and income taxes	\$ 79.2	\$ 7.3	\$ 6.1	\$ (1.9)	\$ 90.7

	<b>For the Three Months Ended September 30, 2007</b>				
	<b>Financial Services</b>	<b>Output Solutions</b>	<b>Investments/ Other</b>	<b>Elimination Adjustments</b>	<b>Consolidated Total</b>
Operating revenues	\$ 279.5	\$ 136.4	\$ 3.6	\$	\$ 419.5
Intersegment operating revenues	1.6		13.0	(14.6)	
Out-of-pocket reimbursements	16.5	136.9		(0.1)	153.3
Total revenues	297.6	273.3	16.6	(14.7)	572.8
Costs and expenses	210.7	254.0	10.8	(12.1)	463.4
Depreciation and amortization	21.6	10.6	2.6	(0.7)	34.1
Income (loss) from operations	65.3	8.7	3.2	(1.9)	75.3
Other income, net	1.0		13.9		14.9
Gain on sale of Asurion	996.3				996.3
Equity in earnings (losses) of unconsolidated affiliates	12.7		(7.3)		5.4
Earnings before interest and income taxes	\$ 1,075.3	\$ 8.7	\$ 9.8	\$ (1.9)	\$ 1,091.9

Earnings before interest and income taxes in the segment reporting information above less interest expense of \$13.8 million and \$11.6 million for the three months ended September 30, 2008 and 2007, respectively, is equal to the Company's income before income taxes on a consolidated basis for the corresponding periods.

Edgar Filing: DST SYSTEMS INC - Form 10-Q

Table of Contents

	<b>For the Nine Months Ended September 30, 2008</b>				
	<b>Financial Services</b>	<b>Output Solutions</b>	<b>Investments/ Other</b>	<b>Elimination Adjustments</b>	<b>Consolidated Total</b>
Operating revenues	\$ 859.4	\$ 402.6	\$ 9.6	\$	\$ 1,271.6
Intersegment operating revenues	6.3		36.6	(42.9)	
Out-of-pocket reimbursements	54.3	395.1	0.4	(0.3)	449.5
Total revenues	920.0	797.7	46.6	(43.2)	1,721.1
Costs and expenses	645.4	740.2	30.9	(35.5)	1,381.0
Depreciation and amortization	60.7	28.9	6.3	(2.1)	93.8
Income (loss) from operations	213.9	28.6	9.4	(5.6)	246.3
Other income (expense), net	(6.5)	(0.5)	2.9		(4.1)
Equity in earnings of unconsolidated affiliates	28.2		1.1		29.3
Earnings before interest and income taxes	\$ 235.6	\$ 28.1	\$ 13.4	\$ (5.6)	\$ 271.5

	<b>For the Nine Months Ended September 30, 2007</b>				
	<b>Financial Services</b>	<b>Output Solutions</b>	<b>Investments/ Other</b>	<b>Elimination Adjustments</b>	<b>Consolidated Total</b>
Operating revenues	\$ 831.4	\$ 421.4	\$ 10.1	\$	\$ 1,262.9
Intersegment operating revenues	5.4		38.0	(43.4)	
Out-of-pocket reimbursements	48.0	414.2	0.2	(0.2)	462.2
Total revenues	884.8	835.6	48.3	(43.6)	1,725.1
Costs and expenses	627.6	774.2	18.9	(36.0)	1,384.7
Depreciation and amortization	59.2	31.1	7.3	(2.0)	95.6
Income (loss) from operations	198.0	30.3	22.1	(5.6)	244.8
Other income, net	7.5		34.1		41.6
Gain on sale of Asurion	996.3				996.3
Equity in earnings (losses) of unconsolidated affiliates	63.5		(10.8)		52.7
Earnings before interest and income taxes	\$ 1,265.3	\$ 30.3	\$ 45.4	\$ (5.6)	\$ 1,335.4

Earnings before interest and income taxes in the segment reporting information above less interest expense of \$40.3 million and \$49.2 million for the nine months ended September 30, 2008 and 2007, respectively, is equal to the Company's income before income taxes on a consolidated basis for the corresponding periods.

Edgar Filing: DST SYSTEMS INC - Form 10-Q

Table of Contents

	Year Ended December 31, 2007					Consolidated Total
	Financial Services	Output Solutions	Investments/ Other	Elimination Adjustments		
Operating revenues	\$ 1,127.0	\$ 555.1	\$ 13.3	\$	\$	\$ 1,695.4
Intersegment operating revenues	7.6		49.8	(57.4)		
Out-of-pocket reimbursements	65.0	542.0	0.4	(0.3)		607.1
Total revenues	1,199.6	1,097.1	63.5	(57.7)		2,302.5
Costs and expenses	831.0	1,016.0	28.5	(47.5)		1,828.0
Depreciation and amortization	81.9	42.3	9.1	(2.7)		130.6
Income (loss) from operations	286.7	38.8	25.9	(7.5)		343.9
Other income, net	4.8		40.2			45.0
Gain on sale of Asurion	998.0					998.0
Equity in earnings (losses) of unconsolidated affiliates	72.8		(10.2)			62.6
Earnings before interest and income taxes	\$ 1,362.3	\$ 38.8	\$ 55.9	\$ (7.5)	\$	\$ 1,449.5

	Year Ended December 31, 2006					Consolidated Total
	Financial Services	Output Solutions	Investments/ Other	Elimination Adjustments		
Operating revenues	\$ 1,005.0	\$ 535.9	\$ 15.3	\$	\$	\$ 1,556.2
Intersegment operating revenues	6.2		48.1	(54.3)		
Out-of-pocket reimbursements	60.8	619.2	0.5	(0.9)		679.6
Total revenues	1,072.0	1,155.1	63.9	(55.2)		2,235.8
Costs and expenses	699.7	1,107.3	39.7	(46.1)		1,800.6
Depreciation and amortization	83.1	37.1	12.3	(2.6)		129.9
Income (loss) from operations	289.2	10.7	11.9	(6.5)		305.3
Other income, net	12.0	0.1	37.9			50.0
Gain on sale of business	52.8					52.8
Equity in earnings (losses) of unconsolidated affiliates	52.1		(4.4)			47.7
Earnings before interest and income taxes	\$ 406.1	\$ 10.8	\$ 45.4	\$ (6.5)	\$	\$ 455.8

Edgar Filing: DST SYSTEMS INC - Form 10-Q

Table of Contents

	Year Ended December 31, 2005						
	Financial Services	Output Solutions	Customer Management	Investments/Other	Elimination Adjustments	Consolidated Total	
Operating revenues	\$ 1,175.7	\$ 453.4	\$ 96.6	\$ 18.9	\$	\$ 1,744.6	
Intersegment operating revenues	8.0	33.8		48.2	(90.0)		
Out-of-pocket reimbursements	167.4	613.6	26.4	0.4	(37.3)	770.5	
Total revenues	1,351.1	1,100.8	123.0	67.5	(127.3)	2,515.1	
Costs and expenses	977.2	1,039.3	109.0	13.8	(118.7)	2,020.6	
Depreciation and amortization	111.5	29.5	3.3	16.4	(2.6)	158.1	
Income (loss) from operations	262.4	32.0	10.7	37.3	(6.0)	336.4	
Other income, net	17.2	0.3		96.7		114.2	
Gains on sale of businesses	120.4		153.8			274.2	
Equity in earnings (losses) of unconsolidated affiliates	45.1			(0.3)		44.8	
Earnings before interest and income taxes	\$ 445.1	\$ 32.3	\$ 164.5	\$ 133.7	\$ (6.0)	\$ 769.6	

Earnings before interest and income taxes in the segment reporting information above less interest expense of \$60.3 million, \$77.3 million and \$66.6 million for the years ended December 31, 2007, 2006 and 2005, respectively, is equal to the Company's income before income taxes on a consolidated basis for the corresponding year.

Table of Contents

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The discussions set forth in this Quarterly Report on Form 10-Q contain statements concerning potential future events. Such forward-looking statements are based upon assumptions by the Company's management, as of the date of this Quarterly Report, including assumptions about risks and uncertainties faced by the Company. In addition, management may make forward-looking statements orally or in other writings, including, but not limited to, in press releases, in the annual report to shareholders and in the Company's other filings with the Securities and Exchange Commission (SEC). Readers can identify these forward-looking statements by the use of such verbs as expects, anticipates, believes or similar verbs or conjugations of such verbs. If any of management's assumptions prove incorrect or should unanticipated circumstances arise, the Company's actual results could materially differ from those anticipated by such forward-looking statements. The differences could be caused by a number of factors or combination of factors including, but not limited to, those factors referred to below in Part II, Item 1A, Risk Factors. Readers are strongly encouraged to consider the factors referred to in such section and any amendments or modifications thereof when evaluating any forward-looking statements concerning the Company. The Company's reports filed with or furnished to the SEC on Form 8-K, Form 10-K, Form 10-Q and other forms and any amendments to those reports, may be obtained by contacting the SEC's Public Reference Branch at 1-800-SEC-0330 or by accessing the forms electronically, free of charge, through the SEC's Internet website at <http://www.sec.gov> or through the Company's Internet website, as soon as reasonably practicable after filing with the SEC, at <http://www.dstsystems.com>. The Company will not update any forward-looking statements in this Quarterly Report to reflect future events or developments.*

*The information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Condensed Consolidated Financial Statements and Notes thereto included in this Form 10-Q and the audited consolidated financial statements and notes thereto in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.*

**INTRODUCTION**

The business units of DST Systems, Inc. (DST or the Company) offer sophisticated information processing and software services and products. These business units are reported as two operating Segments (Financial Services and Output Solutions). In addition, investments in equity securities, private equity funds, and certain financial interests, and the Company's real estate subsidiaries and affiliates have been aggregated into an Investments and Other Segment.

**Financial Services**

The Company's Financial Services Segment provides sophisticated information processing and computer software services and products using proprietary software systems primarily to mutual funds, investment managers, insurance companies, healthcare providers, banks, brokers, financial planners, real estate partnerships, providers of healthcare plans, third party administrators, medical practice groups and healthcare providers. The Company's proprietary software systems include mutual fund shareowner, subaccount and unit trust recordkeeping systems for U.S. and international mutual fund companies; a defined-contribution participant recordkeeping system for the U.S. retirement plan market; investment management systems offered to U.S. and international investment managers and fund accountants; a business process management and customer contact system offered to mutual funds, insurance companies, brokerage firms, banks, healthcare payers, healthcare providers, cable television operators and mortgage servicing organizations; and healthcare claims administration processing systems and services, including consumer directed healthcare administration solutions, offered to providers of healthcare plans, third party administrators and medical practice groups.

The Financial Services Segment distributes its services and products on a direct basis and through subsidiaries and joint venture affiliates in the U.S., United Kingdom ( U.K. ), Canada, Europe, Australia, India, South Africa and Asia-Pacific and, to a lesser degree, distributes such services and products through various strategic alliances.



Table of Contents

**Output Solutions**

The Company's Output Solutions Segment provides single source, integrated print and electronic statement and billing output solutions. The Output Solutions Segment also offers a variety of related professional services, including marketing and personalization services, and postal optimization solutions. The Output Solutions Segment also provides electronic presentment, payment and distribution solutions.

The Output Solutions Segment conducts its operations from five production facilities located throughout North America and the U.K. DST Output is among the largest First-Class mailers in the U.S. and is one of the largest users of continuous, high-speed, full-color inkjet printing systems. DST Output Canada offers customer communications and document automation solutions to the Canadian market. DST International Output provides personalized print and electronic communications principally in the U.K.

The Output Solutions Segment distributes its products directly to customers and through relationships in which its services are combined with or offered concurrently through providers of data processing services. The Output Solutions Segment's products are also distributed or bundled with product offerings to customers of the Financial Services Segment.

In first quarter 2008, the Company changed the measurement of certain occupancy cost components of its Output Solutions Segment. The Output Solutions Segment leases its California, Connecticut and Missouri production facilities from the Investments and Other Segment. Beginning in 2008, the Company began reporting financial results for the Output Solutions Segment on the basis that the Output Solutions Segment owned (instead of leased) these three production facilities. Management believes this action will improve its ability to analyze the Output Solutions Segment operating results taking into consideration the special purpose nature of the production plants. Reported results for the Output Solutions Segment and the Elimination Adjustments for periods prior to 2008 have been restated to reflect this change. The Company's restated segment results for the three and nine months ended September 30, 2007 are included in the information that follows. The Investments and Other Segment continues to present rental revenues from the Output Solutions Segment along with the related depreciation expense associated with the properties, while the elimination of the inter-segment activity is included in the Elimination Adjustments.

**Investments and Other**

The Investments and Other Segment holds investments in equity securities, private equity funds, and certain financial interests, and the Company's real estate subsidiaries and affiliates. The assets held by the Investments and Other Segment are primarily passive in nature. The Investments and Other Segment holds investments in equity securities with a market value of approximately \$1.1 billion at September 30, 2008, including approximately 11.3 million shares of State Street Corporation (State Street), 29.6 million shares of Computershare and 1.9 million shares of Euronet Worldwide, Inc., with a market value of \$643.3 million, \$218.2 million and \$31.5 million, respectively, based on closing exchange values at September 30, 2008. Additionally, the Company owns and operates real estate mostly in the U.S. and U.K., which is held primarily for lease to the Company's other business Segments. The Company is a partner in certain real estate joint ventures that lease office space to the Company, certain of its unconsolidated affiliates and unrelated third parties.

Table of Contents**RESULTS OF OPERATIONS**

The following table summarizes the Company's operating results (in millions, except per share amounts):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
<b>Revenues</b>				
<b>Operating revenues</b>				
Financial Services	\$ 284.4	\$ 281.1	\$ 865.7	\$ 836.8
Output Solutions	128.8	136.4	402.6	421.4
Investments and Other	16.1	16.6	46.2	48.1
Elimination Adjustments	(15.1)	(14.6)	(42.9)	(43.4)
	414.2	419.5	1,271.6	1,262.9
% change from prior year period	(1.3)%		0.7%	
<b>Out-of-pocket reimbursements</b>				
Financial Services	17.5	16.5	54.3	48.0
Output Solutions	128.6	136.9	395.1	414.2
Investments and Other	0.2		0.4	0.2
Elimination Adjustments	(0.1)	(0.1)	(0.3)	(0.2)
	146.2	153.3	449.5	462.2
% change from prior year period	(4.6)%		(2.7)%	
<b>Total revenues</b>	\$ 560.4	\$ 572.8	\$ 1,721.1	\$ 1,725.1
% change from prior year period	(2.2)%		(0.2)%	
<b>Income from operations</b>				
Financial Services	\$ 70.0	\$ 65.3	\$ 213.9	\$ 198.0
Output Solutions	7.4	8.7	28.6	30.3
Investments and Other	3.4	3.2	9.4	22.1
Elimination Adjustments	(1.9)	(1.9)	(5.6)	(5.6)
	78.9	75.3	246.3	244.8
Interest expense	(13.8)	(11.6)	(40.3)	(49.2)
Other income (expense), net	2.8	14.9	(4.1)	41.6
Gain on sale of Asurion		996.3		996.3
Equity in earnings of unconsolidated affiliates	9.0	5.4	29.3	52.7
<b>Income before income taxes</b>	76.9	1,080.3	231.2	1,286.2
Income taxes	26.7	407.5	58.9	475.2
<b>Net income</b>	\$ 50.2	\$ 672.8	\$ 172.3	\$ 811.0
Basic earnings per share	\$ 1.02	\$ 11.24	\$ 3.30	\$ 13.18
Diluted earnings per share	\$ 0.91	\$ 9.62	\$ 2.91	\$ 11.37

Table of Contents

**Consolidated revenues**

Consolidated total revenues (including out-of-pocket ( OOP ) reimbursements) for the three and nine months ended September 30, 2008, decreased \$12.4 million or 2.2% and \$4.0 million or 0.2%, respectively, compared to the same periods in 2007. Consolidated operating revenues for the three months ended September 30, 2008, decreased \$5.3 million or 1.3% as compared to the same period in 2007, primarily due to lower Output Solutions operating revenues, partially offset by increases in mutual fund shareowner processing revenues, professional services provided by DST Health Solutions and AWD license fee revenues. Consolidated operating revenues for the nine months ended September 30, 2008, increased \$8.7 million or 0.7% as compared to the same period in 2007, primarily from increases in mutual fund shareowner processing services attributable to higher levels of accounts serviced, principally from new client conversions since second quarter 2007, partially offset by lower Output Solutions operating revenues attributable to lower images produced and a \$3.1 million contract termination fee in first quarter 2007.

Consolidated OOP reimbursements during the three and nine months ended September 30, 2008 decreased \$7.1 million or 4.6% and \$12.7 million or 2.7%, respectively, as compared to 2007. Lower Output Solutions OOP reimbursement revenues primarily resulting from changes in customer postage programs were partially offset by higher Financial Services OOP reimbursement revenues from higher volumes.

**Income from operations**

Consolidated income from operations for the three months ended September 30, 2008 was \$78.9 million, an increase of \$3.6 million or 4.8% compared to the same period in 2007. Absent a \$4.3 million charge for the partial termination of a non-qualified deferred compensation plan recorded during third quarter 2007, consolidated income from operations decreased \$0.7 million or 0.9% as compared to third quarter 2007. Output Solutions income from operations decreased \$2.1 million from lower revenues. Financial Services income from operations increased \$1.4 million as increased contributions from DST Health Solutions and AWD were partially offset by lower contributions from international financial services operations. Consolidated income from operations for the nine months ended September 30, 2008 was \$246.3 million, an increase of \$1.5 million or 0.6% compared to the same period in 2007. Higher contributions from mutual fund shareowner processing services were partially offset by lower contributions from the Investments and Other Segment, which recorded a \$12.4 million gain in 2007 from the sale of office buildings, lower contributions from international financial services operations in 2008 associated with lower revenues and higher personnel costs, and lower contributions from the Output Solutions Segment attributable to lower operating revenues (from lower images produced).

**Interest expense**

Interest expense for the three months ended September 30, 2008 was \$13.8 million, an increase of \$2.2 million or 19.0%, compared to the same period in 2007, primarily from higher average debt balances during 2008. As discussed below, the Company used proceeds from the Asurion sale in July 2007 to pay down debt. Increased share repurchase activity during 2008 has resulted in higher average debt balances. Interest expense for the nine months ended September 30, 2008 was \$40.3 million, a decrease of \$8.9 million or 18.1% compared to the same period in

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

2007 attributable to lower average interest rates partially offset by higher average debt balances. Costs associated with the accounts receivable securitization program, which began in May 2007, are included in other income (expense), as mentioned below.

### **Other income (expense), net**

Other income, net for the three months ended September 30, 2008 was \$2.8 million, as compared to \$14.9 million in the same period in 2007. During the three months ended September 30, 2008, the Company recorded \$7.1 million of investment impairments and \$2.2 million of gains from the sale of investments as compared to the three months ended September 30, 2007 when the Company recorded \$3.1 million of investment impairments and \$3.1 million of gains from the sale of investments. Absent net gains (losses) on securities and other investments, other income decreased \$7.2 million for the three months ended September 30, 2008 as compared to the same period in

Table of Contents

2007. In July 2007, the Company received \$980.0 million from the sale of Asurion Corporation. The majority of the proceeds from the Asurion transaction were used to pay down debt. The remainder of the proceeds was invested in cash and short-term investments and was used in December 2007 to satisfy income tax obligations associated with the Asurion sale. The decrease in other income (primarily interest income) as compared to third quarter 2007 is attributable to lower amounts of short-term investments, higher unrealized losses on marketable securities designated as trading and from higher accounts receivable securitization program costs associated with higher levels of accounts receivable sold.

Other income (expense), net for the nine months ended September 30, 2008 was a \$4.1 million expense, versus income of \$41.6 million in the same period in 2007. During the nine months ended September 30, 2008, the Company recorded \$33.1 million of investment impairments and \$11.7 million of gains from the sale of investments as compared to the nine months ended September 30, 2007 when the Company recorded \$5.1 million of investment impairments and \$13.1 million of gains from the sale of investments. Absent net gains (losses) on securities and other investments, other income decreased \$16.3 million for the nine months ended September 30, 2008 attributable to increased unrealized losses on marketable securities designated as trading in the amount of \$9.2 million, lower interest income from lower amounts of short-term investments in 2008, lower other income resulting from gains of \$2.5 million recorded during the nine months ended September 30, 2007 from the favorable settlement of a prior business acquisition dispute and the recovery of a Chapter 11 bankruptcy claim of an amount due from a previous customer and higher accounts receivable securitization program costs associated with higher levels of accounts receivable sold, partially offset by higher dividend income in 2008.

**Gain on sale of Asurion**

During the three and nine months ended September 30, 2007, the Company recorded a \$996.3 million gain from the sale of most of its investment in Asurion. In connection with the sale, DST received cash proceeds of \$980.0 million and receivables of \$45.5 million, of which \$6.3 million were collected in fourth quarter 2007 and \$39.2 million were collected in second quarter 2008.

**Equity in earnings (losses) of unconsolidated affiliates**

The following table summarizes the Company's equity in earnings (losses) of unconsolidated affiliates (in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
BFDS	\$ 4.6	\$ 7.6	\$ 15.2	\$ 23.6
IFDS, U.K.	2.6	3.0	8.5	10.4
IFDS, Canada	2.4	0.4	4.8	2.9
Argus	0.0	1.5	0.4	3.4
Other	(0.6)	(7.1)	0.4	(9.5)
Asurion				21.9
	\$ 9.0	\$ 5.4	\$ 29.3	\$ 52.7

Equity in earnings of unconsolidated affiliates increased \$3.6 million for the three months ended September 30, 2008 and decreased \$23.4 million for the nine months ended September 30, 2008, as compared to the same periods for 2007. The increase during the three months ended

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

September 30, 2008 is attributable to no impairments recorded by DST's real estate joint ventures in 2008 (as compared to approximately \$4.9 million, DST's share, in third quarter 2007) and increased earnings from IFDS Canada, partially offset by lower earnings from BFDS, IFDS U.K. and Argus Health Systems. As previously announced, DST sold the majority of its equity

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

### Table of Contents

interest in Asurion on July 3, 2007 and now accounts for this investment under the cost basis. The decrease in equity in earnings of unconsolidated affiliates during the nine months ended September 30, 2008 is primarily attributable to no equity in earnings of Asurion recorded in 2008 versus \$21.9 million for the nine months ended September 30, 2007 and from lower earnings from BFDS, Argus and IFDS U.K., partially offset by increased earnings from other real estate joint ventures (due to impairments recorded in 2007) and from increases in earnings from IFDS Canada.

Certain of the Company's joint ventures and, to a lesser extent, the Company, derive investment earnings related to cash balances maintained on behalf of customers. Average daily balances invested by the joint ventures were \$1.3 billion during third quarter of 2008 and \$1.4 billion during third quarter 2007. Average interest rates earned on the balances declined from 4.81% in third quarter 2007 to 1.93% in third quarter 2008. The net effect of these fluctuations resulted in an approximate \$11.3 million decline in interest earnings by the joint ventures, which resulted in a decrease of DST's equity of earnings of unconsolidated affiliates of \$3.4 million. Average daily balances invested by the joint ventures were \$1.4 billion during the nine months ended September 30, 2008 and \$1.5 billion during the same period in 2007. Average interest rates earned on the balances declined from 4.79% during the nine months ended September 30, 2007 to 2.45% for the same period in 2008. The net effect of these fluctuations resulted in an approximate \$27.5 million decline in interest earnings by the joint ventures, which resulted in a decrease of DST's equity of earnings of unconsolidated affiliates of approximately \$8.4 million during the nine months ended September 30, 2008.

DST's equity in BFDS earnings for the three and nine months ended September 30, 2008 decreased \$3.0 million and \$8.4 million, respectively, compared to the same periods in 2007. The decline in earnings for the three months ended September 30, 2008 is primarily attributable to lower investment earnings resulting from lower interest rates on cash balances maintained by BFDS on behalf of customers and lower operating revenues from lower client volumes, partially offset by lower compensation and benefit costs due to lower headcount resulting from staff reductions in second quarter 2008. The decline in earnings for the nine months ended September 30, 2008 is primarily attributable to lower investment earnings resulting from lower interest rates and from costs associated with a reduction in staffing levels.

DST's equity in IFDS U.K. earnings for the three and nine months ended September 30, 2008 decreased \$0.4 million and \$1.9 million, respectively, compared to the same periods in 2007, primarily from higher compensation costs and higher income taxes, partially offset by higher operating revenues from increased volumes at existing clients and from new clients. Accounts serviced by IFDS U.K. were 5.9 million at September 30, 2008, an increase of 0.1 million accounts as compared to June 30, 2008, December 31, 2007 and September 30, 2007.

DST's equity in IFDS Canada earnings for the three and nine months ended September 30, 2008 increased \$2.0 million and \$1.9 million, respectively, compared to the same periods in 2007. The increase in earnings during the three months ended September 30, 2008 is primarily attributable to higher operating revenues associated with higher shareowner accounts, lower income taxes resulting from the recognition of a deferred tax benefit and lower client conversion costs. The increase in earnings during the nine months ended September 30, 2008 is attributable to the same reasons mentioned above, partially offset by costs associated with new customer conversions during 2008. Accounts serviced by IFDS Canada were 10.7 million at September 30, 2008, unchanged from June 30, 2008, an increase of 3.2 million accounts or 42.7% from December 31, 2007 and an increase of 3.3 million accounts or 44.6% from September 30, 2007, primarily from the January 2008 conversion of a new remote mutual fund client with approximately 3.2 million accounts.

DST's equity in Argus Health Systems earnings for the three and nine months ended September 30, 2008 decreased \$1.5 million and \$3.0 million, respectively, as compared to the same periods in 2007. The decline in earnings during the three months ended September 30, 2008 is primarily attributable to lower investment earnings from lower interest rates on cash balances maintained by Argus on behalf of customers and from lower processing revenues. The decline in earnings during the nine months ended September 30, 2008 is attributable to the same reasons mentioned above and higher operating costs.





Table of Contents

The Other category in the table above includes principally various real estate joint ventures. DST's equity in other unconsolidated affiliates during the three and nine months ended September 30, 2008 increased \$6.5 million and \$9.9 million, respectively, as compared to the same periods in the prior year. The increase during the three months ended September 30, 2008 is attributable to lower impairments recorded by DST's real estate joint ventures in 2008 (approximately \$4.9 million was recorded in third quarter 2007) and from lower depreciation expense in third quarter 2008. The increase during the nine months ended September 30, 2008 is attributable to the reasons mentioned above, a 2008 gain from the early extinguishment of debt at a real estate joint venture and from higher rental revenues and cost efficiencies on various real estate joint ventures.

**Income taxes**

In general, the Company records income tax expense during interim periods based on its best estimate of the full year's effective tax rate. Certain items, however, are given discrete period treatment and, as a result, the tax effects of such items are reported in full in the relevant interim period. The Company's effective tax rate was 34.7% and 25.5% for the three and nine months ended September 30, 2008, respectively, compared to 37.7% and 37.0% for the three and nine months ended September 30, 2007, respectively. The lower effective tax rate for the three months ended September 30, 2008, compared to the same period in the prior year, is primarily due to the absence of income taxes related to the Asurion sale which resulted in an increase in the effective tax rate in third quarter 2007 and from favorable international income tax items in third quarter 2008. The lower effective tax rate for the nine months ended September 30, 2008, compared to the same period in the prior year, is primarily due to an income tax benefit of approximately \$23.9 million resulting from a net reduction in the Company's liabilities for FIN 48 (including approximately \$10.4 million of interest and penalties) in first quarter 2008, and from the absence of income taxes related to the Asurion sale. The net decrease in FIN 48 liabilities is principally related to the resolution of an IRS examination matter (associated with a transaction that the Company consummated in the 2000 tax year) that was resolved in DST's favor. Excluding the effects of discrete period items, the Company expects its tax rate to be approximately 36.4% for the year ending December 31, 2008. The full year 2008 effective tax rate can be affected as a result of variances among the estimates and amounts of full year sources of taxable income (e.g., domestic consolidated, joint venture and/or international), the realization of tax credits (e.g., historic rehabilitation, research and experimentation and state incentive), adjustments which may arise from the resolution of tax matters under review and the Company's assessment of its liability for unrecognized tax benefits.

Table of Contents**Business Segment Comparisons****FINANCIAL SERVICES SEGMENT****Revenues**

Financial Services Segment total revenues for the three and nine months ended September 30, 2008 were \$301.9 million and \$920.0 million, an increase of \$4.3 million or 1.4% and \$35.2 million or 4.0%, as compared to the same periods in 2007. Financial Services Segment operating revenues for the three months ended September 30, 2008 were \$284.4 million, an increase of \$3.3 million or 1.2%, as compared to the same period in 2007, attributable to increases in mutual fund shareowner processing services, DST Health Solutions professional services and AWD software license fees, partially offset by lower international professional services revenue and lower data processing support revenues. The increase in mutual fund shareowner processing services is attributable to higher levels of accounts serviced principally from new client conversions since second quarter 2007. The increase in DST Health Solutions operating revenues for the quarter was primarily due to the recognition of \$2.5 million of previously deferred professional services revenues. The decrease in international professional services is attributable to lower software implementation services associated with weak market conditions. Data processing support revenues decreased by approximately \$2.5 million due to the expiration of a contract in June 2008. Financial Services Segment operating revenues for the nine months ended September 30, 2008 were \$865.7 million, an increase of \$28.9 million or 3.5%, as compared to the same period in 2007. The increase is attributable to higher mutual fund shareowner processing services from higher levels of accounts serviced, higher DST Health Solutions professional services and higher AWD software license fees, partially offset by lower international professional services revenue.

U.S. operating revenues for the three months ended September 30, 2008 were \$249.0 million, an increase of \$8.7 million or 3.6%, as compared to the same period in 2007. As mentioned above, the increase during the three months ended September 30, 2008 is attributable to increases in mutual fund shareowner processing services, DST Health Solutions professional services and AWD software license fees, partially offset by lower data processing support revenues. U.S. operating revenues for the nine months ended September 30, 2008 were \$752.9 million, an increase of \$35.8 million or 5.0%, as compared to the same period in 2007. The increase is attributable to higher mutual fund shareowner processing services from higher levels of accounts serviced, higher DST Health Solutions professional services and higher AWD software license fees. U.S. mutual fund servicing revenues during the three and nine months ended September 30, 2008 increased approximately 3.4% and 4.8%, respectively, as compared to the same periods in 2007, principally from new account conversions subsequent to second quarter 2007.

The following table summarizes mutual fund shareowner accounts serviced (in millions):

	September 30, 2008	June 30, 2008	December 31, 2007	September 30, 2007
Registered accounts:				
Non tax-advantaged	65.5	67.0	71.0	70.6
Tax-advantaged	47.0	47.4	46.2	45.9

Edgar Filing: DST SYSTEMS INC - Form 10-Q

	112.5	114.4	117.2	116.5
Subaccounts	9.4	5.4	1.9	1.7
Total	121.9	119.8	119.1	118.2

Total accounts serviced at September 30, 2008 were 121.9 million, an increase of 2.1 million accounts or 1.8% as compared to June 30, 2008, an increase of 2.8 million accounts or 2.4% from December 31, 2007 and an increase of 3.7 million accounts or 3.1% as compared to September 30, 2007.

Table of Contents

Registered accounts represent individually registered shareowner accounts (both tax-advantaged and non tax-advantaged) on the books of the transfer agent. Total registered accounts decreased 1.9 million accounts or 1.7% from the comparable amount at June 30, 2008, comprised of net declines in existing client accounts of 1.1 million, conversions to DST's subaccounting platform of 0.6 million, and conversions to non-DST subaccounting platforms of 0.2 million. The 4.7 million decrease in total registered accounts from December 31, 2007 is comprised of conversions to non-DST subaccounting platforms of 5.2 million, conversions to DST subaccounting platform of 0.9 million, partially offset by account growth from existing clients of 0.8 million and new client account conversions of 0.6 million. The 4.0 million decrease in total registered accounts from September 30, 2007 is primarily attributable to conversions to non-DST subaccounting platforms, partially offset by account growth from existing clients.

Tax-advantaged accounts are comprised of accounts used for individual and corporate retirement savings plans and for individual education savings plans. Included in tax-advantaged accounts are Individual Retirement Accounts or IRAs, defined contribution retirement accounts, and Educational Savings Plan Accounts, which include both Coverdell and Section 529 college plan savings accounts. Tax-advantaged accounts were 47.0 million at September 30, 2008, a decrease of 0.4 million or 0.8% as compared to June 30, 2008 and an increase of 0.8 million or 1.7% as compared to December 31, 2007. The increase is primarily attributable to net account growth from existing clients. The 1.1 million increase in tax-advantaged accounts serviced from September 30, 2007 is primarily attributable to account growth from existing clients. Tax-advantaged accounts represent 41.8% of total registered accounts serviced at September 30, 2008, as compared to 39.4% at September 30, 2007.

Subaccounts represent individual mutual fund account positions maintained on behalf of broker/dealers using DST's subaccounting platform (TA2000 Subaccounting). Subaccounts serviced were 9.4 million at September 30, 2008, an increase of 4.0 million subaccounts from June 30, 2008, comprised of conversions of new subaccounting clients of 3.6 million from non-DST platforms and conversions of 0.6 million registered accounts from TA2000, partially offset by net declines in existing client subaccounts of 0.2 million. The 7.5 million increase in total subaccounts from December 31, 2007 is comprised of 6.7 million of conversions of new subaccounting clients from non-DST platforms, conversions of 0.9 million of registered accounts from TA2000, partially offset by net declines in existing client subaccounts of 0.1 million. The 7.7 million increase in total subaccounts from September 30, 2007 is primarily attributable to new account conversions from non-DST platforms and conversions from TA2000.

During the quarter ended September 30, 2008, DST received new client commitments totaling approximately 0.5 million registered accounts, based on current levels. In early October 2008, the Company converted approximately 2.0 million new registered accounts to TA2000. The Company anticipates that 0.7 million new registered accounts will convert to TA2000 in 2009. The Company also anticipates that 0.7 million registered accounts will convert to subaccounting platforms during the remainder of 2008, of which 0.4 million will convert to TA2000 Subaccounting and 0.3 million will convert to non-DST subaccounting platforms. The Company also expects that 0.4 million new subaccounts will convert to TA2000 Subaccounting from non-DST platforms, of which 0.1 million will convert in 2008 and 0.3 million will convert in 2009 and 2010.

In summary, based on accounts serviced at September 30, 2008 and the conversion activity previously described (and without taking into account any other changes in accounts serviced during the remainder of 2008), total accounts serviced at December 31, 2008 are estimated to be 123.7 million, which are comprised of 113.8 million registered accounts and 9.9 million subaccounts. The actual number of accounts estimated to convert to and from various DST systems, as well as the timing of those events, is dependent upon a number of factors. Actual results could differ from the Company's estimates.

Defined contribution (DC) participants represent the number of active participants processed on DST's TA2000/TRAC platform. DC participants were 3.7 million at September 30, 2008, a decrease of 0.8 million or 17.8% compared to June 30, 2008 and a decrease 0.7 million or 15.9% from September 30, 2007. As previously announced, an existing TRAC client internalized its participant accounting during third quarter 2008 resulting in the loss of approximately 1.0 million participants. This third quarter decrease is partially offset by participant



Table of Contents

growth from existing clients. The decrease in participants from December 31, 2007 is principally for the same reasons stated above.

In October 2008, DST announced the formation of DST Retirement Solutions LLC ( DSTRS ), a wholly-owned subsidiary of DST, to meet the needs of defined contribution service providers. The new entity combines DST's TRAC technology solution with BFDS's defined contribution full plan administration and recordkeeping unit. From application service provider ( ASP ) to full outsourcing, DSTRS offers a variety of selective outsourcing options, including front- and back-office technology solutions for financial service organizations offering retirement plan recordkeeping for plans of any size.

Active U.S. AWD workstations were 157,600 at September 30, 2008, an increase of 68.2% over June 30, 2008 levels and an increase of 70.9% as compared to December 31, 2007. The increase in workstations is attributable to new license agreements in 2008.

International operating revenues for the three months ended September 30, 2008 were \$35.4 million, a decrease of \$5.4 million or 13.2% as compared to the same period in 2007, primarily from lower professional services revenue associated with weak market conditions. International operating revenues for the nine months ended September 30, 2008 were \$112.8 million, a decrease of \$6.9 million or 5.8%, as compared to the same period in 2007, primarily from lower professional services revenues and lower software license fee revenues. Active international AWD workstations were 35,600 at September 30, 2008, unchanged as compared to June 30, 2008 and an increase of 0.3% compared to December 31, 2007 levels.

Financial Services Segment software license fee revenues are derived principally from DST International (investment management systems), AWD (workflow management and CRM solutions) and DST Health Solutions (medical claims processing systems). Operating revenues include approximately \$11.9 million and \$38.6 million of software license fee revenues for the three and nine months ended September 30, 2008, an increase of \$2.0 million and a decrease of \$1.6 million, respectively, compared to the same periods in 2007. The increase during the three months ended September 30, 2008 is attributable to higher AWD software license fees, and to a lesser extent, higher investment management software license fees. The decrease during the nine months ended September 30, 2008 is primarily attributable to lower investment management software license fees, partially offset by higher AWD software license fees. While license revenues are not a significant percentage of DST's total operations, they can significantly impact earnings in the period in which they are recognized. Revenues and operating results from individual license sales depend heavily on the timing, size and nature of the contract.

**Costs and expenses**

Financial Services Segment costs and expenses (including OOP costs) during the three and nine months ended September 30, 2008 increased \$0.7 million or 0.3% and \$17.8 million or 2.8%, respectively, compared to the same periods in 2007. Costs and expenses in the Financial Services Segment are primarily comprised of compensation and benefits costs, reimbursable operating expenses and other costs. Reimbursable operating expenses included in costs and expenses were \$17.5 million and \$54.3 million during the three and nine months ended September 30, 2008, an increase of \$1.0 million and \$6.3 million, respectively, as compared to the same periods in 2007. Excluding reimbursable operating expenses, costs and expenses decreased \$0.3 million during the three months ended September 30, 2008 to \$193.9 million. The decrease in costs during the three months ended September 30, 2008 is attributable to \$3.3 million of lower costs associated with the partial termination of a non-qualified deferred compensation plan recorded during third quarter 2007, partially offset by higher costs associated with reductions in international staffing levels, higher compensation costs related to the achievement of goals from a prior business acquisition incurred in third

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

quarter 2008 and higher costs related to the new client subaccount conversion in 2008. Excluding reimbursable operating expenses, costs and expenses increased \$11.5 million during the nine months ended September 30, 2008 to \$591.1 million. The increase in costs during the nine months ended September 30, 2008 is attributable to higher compensation and benefit related costs to support new business growth and from reductions in staffing levels in the international operations, higher compensation costs related to the achievement of goals from a prior business acquisition, higher travel costs and higher costs related to the new subaccounting conversion in 2008, partially offset by lower ASI merger integration costs in

Table of Contents

2008 and \$3.3 million of lower costs associated with the partial termination of a non-qualified deferred compensation plan recorded during third quarter 2007.

**Depreciation and amortization**

Financial Services Segment depreciation and amortization costs for the three months ended September 30, 2008 decreased \$1.1 million or 5.1%, as compared to the same period in 2007. The decrease during the three months ended September 30, 2008 is attributable to lower internally developed software amortization and certain assets becoming fully depreciated in 2008. Financial Services Segment depreciation and amortization cost for the nine months ended September 30, 2008 increased \$1.5 million or 2.5% as compared to the same period in 2007, attributable to depreciation expense on new asset additions.

**Income from operations**

Financial Services Segment income from operations for the three months ended September 30, 2008 was \$70.0 million, an increase of \$4.7 million or 7.2%, as compared to the same period in 2007. The increase is attributable to increased contributions from DST Health Solutions and AWD, lower depreciation expense and the absence of a \$3.3 million charge in third quarter 2007 associated with the partial termination of a non-qualified deferred compensation plan discussed above, partially offset by lower contributions from international operations, primarily from lower professional services revenue and higher personnel costs, and lower data processing support revenues. Financial Services Segment income from operations for the nine months ended September 30, 2008 was \$213.9 million, an increase of \$15.9 million or 8.0%, attributable to the items mentioned above and from lower software license fee revenues and higher depreciation expense.

**OUTPUT SOLUTIONS SEGMENT**

**Revenues**

Output Solutions Segment total revenues for the three and nine months ended September 30, 2008 were \$257.4 million and \$797.7 million, a decrease of \$15.9 million or 5.8% and \$37.9 million or 4.5%, respectively, as compared to the same periods in 2007. Output Solutions Segment operating revenues for the three and nine months ended September 30, 2008 were \$128.8 million and \$402.6 million, a decrease of \$7.6 million or 5.6% and \$18.8 million or 4.5%, respectively, as compared to the same periods in 2007. The decrease during the three months ended September 30, 2008 is from lower images produced. The decrease during the nine months ended September 30, 2008 is attributable to lower images produced and a contract termination fee of \$3.1 million recorded in 2007. Out-of-pocket revenues for the three and nine months ended September 30, 2008 were \$128.6 million and \$395.1 million, a decrease of \$8.3 million or 6.1% and \$19.1 million or 4.6%, respectively, as compared to the same periods in 2007, primarily attributable to changes in customer postage programs.



## Edgar Filing: DST SYSTEMS INC - Form 10-Q

Output Solutions Segment images produced for the three and nine months ended September 30, 2008 totaled 3.4 billion and 10.6 billion, a decrease of 1.0 billion or 22.7% and 2.4 billion or 18.5%, respectively, as compared to the same periods in 2007. The decrease in images is due to certain telecommunications clients reducing the amount of transaction information included on invoices thereby lowering total images produced. The Company expects this trend to continue in 2008. If the amount of detail included in these billing statements declines in the future, this could reduce the number of pages included in a package mailed, which may adversely impact Output Solutions revenues and profitability.

Items mailed during the three and nine months ended September 30, 2008 totaled 577.0 million and 1,770.6 million, an increase of 1.9% and 2.9%, respectively, as compared to the same periods in 2007. The increase during the three and nine months ended September 30, 2008 are primarily due to the conversion of a new telecommunications client during fourth quarter 2007 and higher volumes from other existing clients. The increase during the three months ended September 30, 2008 was partially offset by certain privacy mailings that

Table of Contents

did not occur in third quarter 2008. Items mailed are reflective of the number of our clients underlying accounts/subscribers/customers who receive their communications via paper.

**Costs and expenses**

Output Solutions Segment costs and expenses (including OOP costs) during the three and nine months ended September 30, 2008 decreased \$14.2 million or 5.6% and \$34.0 million or 4.4%, respectively, as compared to the same periods in 2007. Costs and expenses in the Output Solutions Segment are primarily comprised of reimbursable operating expenses, compensation and benefits costs, material costs (principally paper and ink) and other operating costs. Reimbursable operating expenses included in costs and expenses were \$128.6 million and \$395.1 million during the three and nine months ended September 30, 2008, a decrease of \$8.3 million and \$19.1 million, respectively, as compared to 2007, primarily attributable to changes in customer postage programs. Excluding reimbursable operating expenses, costs and expenses decreased \$5.9 million during the three months ended September 30, 2008 to \$111.2 million, primarily from lower leased equipment costs resulting from the implementation of owned digital print technologies, lower material costs and lower compensation and benefit related costs, including \$0.8 million of costs associated with the partial termination of a non-qualified deferred compensation plan recorded during third quarter 2007. Excluding reimbursable operating expenses, costs and expenses decreased \$14.9 million during the nine months ended September 30, 2008 to \$345.1 million, for the same reasons mentioned above.

**Depreciation and amortization**

Output Solutions Segment depreciation and amortization during the three and nine months ended September 30, 2008 decreased \$0.4 million or 3.8% and \$2.2 million or 7.1%, respectively, compared to the same periods in 2007. The decrease during the three and nine months ended September 30, 2008 is attributable to the Company's use of accelerated depreciation methods on printers and inserters, partially offset by depreciation on new equipment purchased to replace assets that were previously leased.

**Income from operations**

Output Solutions Segment income from operations for the three months ended September 30, 2008 was \$7.4 million, a decrease of \$1.3 million or 14.9%, as compared to the same period in 2007. Decreases in operating revenues during third quarter 2008 were partially offset by lower costs and expenses and lower depreciation and amortization. Output Solutions Segment income from operations for the nine months ended September 30, 2008 was \$28.6 million, a decrease of \$1.7 million or 5.6%, as compared to the same period in 2007, primarily for the same reasons mentioned above and a contract termination fee of \$3.1 million recorded in 2007.

**INVESTMENTS AND OTHER SEGMENT**

**Revenues**

Investments and Other Segment total revenues, including out-of-pocket reimbursements, were \$16.3 million and \$46.6 million for the three and nine months ended September 30, 2008, a decrease of \$0.3 million or 1.8% and \$1.7 million or 3.5%, respectively, as compared to the same periods in 2007. Revenues are primarily derived from real estate activities. The majority of the real estate revenues are derived from the lease of facilities to the Company's other business segments. Operating revenues (excluding out-of-pocket reimbursements) were \$16.1 million for the three months ended September 30, 2008, a decrease of \$0.5 million or 3.0% as compared to the same period in 2007, primarily due to lower rental activity. Operating revenues (excluding out-of-pocket reimbursement) were \$46.2 million for the nine months ended September 30, 2008, a decrease of \$1.9 million or 4.0%, as compared to the same period in 2007, primarily due to reduced rental income resulting from the sale of office buildings in second quarter 2007 and the sale of other properties in first quarter 2007.

Table of Contents

**Costs and expenses**

Occupancy costs are the single largest costs included in costs and expenses in the Investments and Other Segment. Investments and Other Segment costs and expenses decreased \$0.1 million during the three months ended September 30, 2008, as compared to the same period in 2007, primarily due to \$0.2 million of lower costs resulting from the partial termination of a deferred compensation plan in 2007. Investments and Other Segment costs and expenses increased \$12.0 million during the nine months ended September 30, 2008, as compared to the same period in 2007. Included in costs and expenses during the nine months ended September 30, 2007 is a \$12.4 million gain resulting from the sale of office buildings. Absent this gain, costs and expenses decreased \$0.4 million during the nine months ended September 30, 2008, respectively, attributable to lower deferred compensation plan costs as mentioned above and from lower other occupancy costs.

**Depreciation and amortization**

Investments and Other Segment depreciation and amortization decreased \$0.4 million during the three months ended September 30, 2008, as compared to the same period in 2007, primarily resulting from an asset impairment in third quarter 2007. Investments and Other Segment depreciation and amortization decreased \$1.0 million during the nine months ended September 30, 2008 as compared to the same period in 2007, primarily from the sale of properties in 2007.

**Income from operations**

Investments and Other Segment income from operations was \$3.4 million and \$9.4 million for the three and nine months ended September 30, 2008, an increase of \$0.2 million or 6.2% and a decrease of \$12.7 million or 57.5%, respectively, as compared to the same periods in 2007. The increase during the three months ended September 30, 2008 is attributable to lower costs associated with the deferred compensation plan as described above and lower depreciation and amortization expense, partially offset by lower operating revenues from lower rental activity. The decrease for the nine months ended September 30, 2008 was primarily attributable to the absence of a \$12.4 million gain from the sale of office buildings recorded in 2007.

Table of Contents**Segment Operating Data**

The following table presents operating data for the Company's operating business segments:

	<b>September 30, 2008</b>		<b>December 31, 2007</b>	
<b>Financial Services Operating Data</b>				
Mutual fund shareowner accounts processed (millions)				
U.S.				
Registered accounts:				
Non tax-advantaged	65.5		71.0	
Tax-advantaged:				
IRA mutual fund accounts	27.8		27.5	
Other retirement accounts	4.8		4.7	
TRAC mutual fund accounts	5.4		5.3	
Section 529 and Educational IRAs	9.0		8.7	
	47.0		46.2	
Total registered accounts	112.5		117.2	
Subaccounts	9.4		1.9	
Total accounts serviced	121.9		119.1	
International				
United Kingdom (1)	5.9		5.8	
Canada (2)	10.7		7.5	
TRAC participants (millions)	3.7		4.8	
Automated Work Distributor workstations (thousands)	193.2		127.7	
DST Health Solutions covered lives (millions)	24.1		24.5	
	<b>For the Three Months Ended September 30, 2008</b>	<b>2007</b>	<b>For the Nine Months Ended September 30, 2008</b>	<b>2007</b>
<b>Output Solutions Operating Data</b>				
Images produced (billions)	3.4	4.4	10.6	13.0
Items mailed (billions)	0.6	0.7	1.8	2.0
<b>Other Operating Data</b>				
Pharmacy claims processed by Argus (millions)	137.7	145.5	428.4	436.4

(1) Processed by International Financial Data Services (U.K.) Limited, an unconsolidated affiliate of the Company.

(2) Processed by International Financial Data Services (Canada) Limited, an unconsolidated affiliate of the Company.



Table of Contents

**LIQUIDITY AND CAPITAL RESOURCES**

**Sources and Uses of Cash**

The Company's primary source of liquidity has historically been cash provided by operations. Principal uses of cash are operations, reinvestment in the Company's proprietary technologies, capital expenditures, stock repurchases, and payments on debt. Information on the Company's consolidated cash flows for the nine months ended September 30, 2008 and 2007 is presented in the Condensed Consolidated Statement of Cash Flows, categorized by operating activities, investing activities, and financing activities.

**Operating Activities**

Cash flows provided by operating activities were \$302.9 million and \$313.1 million for the nine months ended September 30, 2008 and 2007, respectively. The decrease in operating cash flows during 2008 is attributable to lower activity under the accounts receivable securitization program, higher payments of accounts payable and accrued liabilities (including accrued compensation and benefits) and higher payments of income taxes, partially offset by decreases in accounts receivable. The Company had \$99.5 million of cash and cash equivalents at September 30, 2008, a decrease of \$9.9 million from December 31, 2007. Operating cash flows during 2008 resulted principally from net income of \$172.3 million and non-cash items included in the determination of net income, including depreciation and amortization expense of \$93.8 million and equity in earnings of unconsolidated affiliates of \$29.3 million. Significant working capital related adjustments to net income include decreases in accounts payable and accrued liabilities of \$42.6 million, decreases in accounts receivable of \$55.5 million, increases in income taxes payable of \$15.9 million and proceeds from accounts receivable securitizations of \$30.0 million.

*Cash Management Service*

The Company provides a cash management service for full service mutual fund transfer agency clients, whereby end of day available client bank balances are invested overnight by and in the name of the Company into credit-quality money market funds. All invested balances are returned to the full service mutual fund transfer agency client accounts the following business day. The Company had \$263.2 million and \$177.4 million of mutual fund transfer agency client investments and deposits at September 30, 2008 and December 31, 2007, respectively.

**Investing Activities**

Cash flows used by investing activities were \$93.2 million during the nine months ended September 30, 2008, as compared to cash flows provided by investing activities of \$750.9 million during the nine months ended September 30, 2007. The increase in cash flows provided by investing activities during 2007 was primarily attributable to the \$980.0 million of proceeds received from the Asurion investment sale in third quarter 2007 and \$42.5 million of proceeds principally from the sale of office buildings in second quarter 2007. During 2008, higher capital expenditures and higher advances to unconsolidated affiliates were partially offset by the collection of the remaining Asurion sale proceeds of \$39.2 million and higher proceeds from the sale of investments during 2008.

The Company advanced \$34.4 million, net, to unconsolidated affiliates during the nine months ended September 30, 2008, including a loan to an unconsolidated real estate joint venture, but received net proceeds in the amount of \$26.7 million principally from the repayment of loans by unconsolidated affiliates during the nine months ended September 30, 2007. Related to the \$34.5 million advance during the nine months ended September 30, 2008, the other partner in the joint venture guaranteed 60% of the balance of this loan, which is secured by real estate, has variable rates of interest and matures on December 31, 2012.



Table of Contents*Capital Expenditures*

The following table summarizes capital expenditures by segment (in millions):

	<b>For the Nine Months Ended September 30,</b>			
	<b>2008</b>		<b>2007</b>	
Financial Services Segment	\$	32.2	\$	34.2
Output Solutions Segment		18.3		20.3
Investments and Other Segment		29.2		3.8
	\$	79.7	\$	58.3

Investments and Other Segment capital expenditures are primarily buildings and building improvements. In July 2008, the Investments and Other Segment purchased the DST International Output production facility, which was previously leased, and office buildings for approximately \$20.5 million. Future capital expenditures are expected to be funded primarily by cash flows from operating activities, secured term notes or draws from bank lines of credit, as required.

*Investments*

The Company made \$91.5 million of investments in available-for-sale securities and other investments during the nine months ended September 30, 2008, as compared to \$271.7 million during the nine months ended September 30, 2007. Included in the \$271.7 million of investment purchases during the nine months ended September 30, 2007 is approximately \$168.0 million of Asurion proceeds that were invested in short-term debt securities that matured on December 14, 2007. Proceeds from these short-term investments, along with other invested cash balances, were used in fourth quarter 2007 to satisfy tax obligations associated with the Asurion sale. During the nine months ended September 30, 2008, the Company received \$73.5 million from the sale of investments in available-for-sale securities and other investments as compared to \$46.6 million in the comparable 2007 period.

*Proceeds from the Sale of Asurion*

DST sold the majority of its equity interest in Asurion on July 3, 2007 and received cash proceeds of \$980.0 million during the nine months ended September 30, 2007. In addition, DST received receivables of \$45.5 million, of which \$6.3 million were collected in fourth quarter 2007 and \$39.2 million were collected in second quarter 2008.

*Business Acquisitions*

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

During the nine months ended September 30, 2007, the Company purchased two businesses in the Financial Services Segment for \$14.9 million. The minimum aggregate purchase price of \$14.9 million was paid in cash during third quarter 2007 and was funded with available cash balances and existing credit facilities. There are provisions in both business acquisition agreements that allow for additional consideration to be paid if certain operating performance measures are met.

### **Financing Activities**

Cash flows used by financing activities were \$219.6 million and \$837.1 million for the nine months ended September 30, 2008 and 2007, respectively. Cash outflows from share repurchases of \$697.4 million were partially offset by \$394.7 million of cash inflows from borrowings on revolving credit facilities and \$114.0 million (net of expenses) of proceeds from the five-year real estate credit agreement (discussed below) completed during the nine months ended September 30, 2008, as compared to cash outflows from share repurchases of

Table of Contents

\$511.8 million and borrowings on revolving credit lines of \$410.5 million during the nine months ended September 30, 2007.

*Common Stock Issuances and Repurchases*

The Company received proceeds of \$4.7 million and \$84.9 million from the issuance of common stock upon the exercise of employee stock options during the nine months ended September 30, 2008 and 2007, respectively. The decrease in proceeds from stock option exercises is attributable to lower volumes of stock options exercised in 2008 as compared to 2007.

On May 12, 2008, DST's Board of Directors authorized the repurchase of an additional 5.0 million shares under the existing share repurchase authorization plan. The plan allows, but does not require, the repurchase of common stock in open market and private transactions through December 31, 2009. The Company may enter into one or more plans with its brokers or banks for pre-authorized purchases within defined limits pursuant to Rule 10b5-1 to affect all or a portion of such share repurchases. The Company repurchased approximately 10,635,252 shares of DST common stock for \$691.7 million or approximately \$65.04 per share during the nine months ended September 30, 2008. Cash flows from operations and borrowings on debt facilities were used to repurchase these shares. At September 30, 2008, the Company had approximately 1.2 million shares remaining under the existing share repurchase authorization plan. During the nine months ended September 30, 2007, DST repurchased 6,011,900 shares of DST common stock for \$465.0 million or approximately \$77.34 per share.

Payments made for tax withholding obligations arising from the exercise of options to purchase the Company's stock are included in common stock repurchased in the Condensed Consolidated Statement of Cash Flows. The amount of such share withholdings for option exercises was \$5.7 million and \$46.8 million during the nine months ended September 30, 2008 and 2007, respectively.

*Off Balance Sheet Obligations*

As of September 30, 2008, the Company had no material off balance sheet arrangements, other than the Company's accounts receivable securitization program. On May 22, 2008, the Company renewed its \$200 million accounts receivable securitization program with a third party multi-seller asset-backed commercial paper conduit. The first amendment to the receivables purchase agreement (originally dated May 24, 2007) extends the conduit's purchase commitment until May 21, 2009. At September 30, 2008 and December 31, 2007, the total outstanding undivided interest in the receivables held by the conduit was \$100.0 million and \$70.0 million, respectively.

*Financing Sources*

The Company has used the following primary sources of financing: the syndicated line of credit facility; convertible debentures; subsidiary line of credit facilities; secured promissory notes; loans from unconsolidated affiliates; and secured borrowings, including the September 2008 real estate credit agreement. The Company has also utilized bridge loans to augment the above sources of debt financing. The Company's borrowings under its line of credit facilities increased \$394.7 million during the nine months ended September 30, 2008. The Company had \$1,541.7 million and \$1,061.1 million of debt outstanding at September 30, 2008 and December 31, 2007, respectively.

*Senior Convertible Debentures*

Holders of the Company's senior convertible debentures were eligible to convert these bonds during the three months ended March 31, 2008, June 30, 2008 and September 30, 2008 as a result of DST's common stock trading above 120% of the applicable conversion price (\$49.08) for at least 20 trading days during the period of 30 consecutive trading days ended December 31, 2007, March 31, 2008 and June 30, 2008, respectively. Actual conversions for the nine months ended September 30, 2008 have been less than \$0.1 million and the Company used cash to settle the principal portion of these conversions. Holders of the senior convertible debentures do not

Table of Contents

have the right to convert these bonds during the three months ending December 31, 2008 because the stock price conversion feature was not achieved for at least 20 trading days during the period of 30 consecutive trading days ended September 30, 2008. Conversion rights, and ultimate classification of the senior convertible debentures as a current or non-current liability, for subsequent quarters will be a function of future DST stock prices. At September 30, 2008 and December 31, 2007, the Company had \$839.7 million and \$839.8 million, respectively, of senior convertible debentures outstanding, all of which is classified as a current liability.

In July 2008, the Company announced a notice of put right in connection with \$300 million aggregate principal amount of 3.625% Series B convertible senior debentures due 2023. Series B convertible senior debenture holders had the right to require the Company to purchase the debentures on August 15, 2008, for cash, at a purchase price equal to the accreted principal amount of the debentures to be purchased plus any accrued and unpaid cash interest to August 15, 2008. The put right expired on August 20, 2008 and did not result in significant debenture purchases by DST during third quarter 2008.

At any time after August 20, 2008, DST has the right to redeem for cash all or part of the Series B convertible debentures, upon not less than 30 nor more than 60 days notice before the redemption date, for a price equal to the accreted principal amount of any Series B convertible debentures to be redeemed plus any accrued and unpaid cash interest through the redemption date.

In August 2008, the Company announced that it will pay contingent interest for the period August 20, 2008 to February 14, 2009 in connection with Series B convertible senior debentures. The interest obligation arises because the average trading price of the Series B debentures for the applicable five trading-day reference period exceeded 120% of the accreted principal amount of such debentures. The amount of contingent interest equals 0.19% of the average trading price for the reference period, or \$2.55 per \$1,000 principal amount of such debentures. The interest payment date is February 17, 2009.

*Syndicated Line of Credit*

The Company amended its \$600 million syndicated line of credit facility as of June 16, 2008 to extend an expiring provision that allowed liens on real property securing indebtedness. At September 30, 2008 and December 31, 2007, the Company had \$475.4 million and \$48.7 million, respectively, of indebtedness under the syndicated line of credit facility.

*Equipment Credit Facility*

The Company entered into a \$50 million unsecured credit facility with a vendor in June 2008. Proceeds from loans made under the credit facility can be used to make purchases of the vendor's eligible equipment, software or services. Loans under this credit facility must be made prior to June 30, 2010, the draw period termination date. The maturity date for each loan under this credit facility is the earlier of i) the first day of the second calendar month following the third anniversary of the loan date or ii) August 1, 2013. Interest rates applicable to the loans under this credit facility are generally based on offshore LIBOR rate plus an applicable margin of 0.40% to 0.85%. The applicable margin is based on a grid schedule that adjusts borrowing costs up or down based upon the Company's consolidated leverage ratio. At September 30, 2008, \$6.8 million was outstanding under the equipment credit facility.

*Real Estate Credit Agreement*

On September 16, 2008, certain subsidiaries of DST entered into a credit agreement with a syndicate of lenders. The credit agreement provides for a five-year, non-revolving credit facility in an aggregate principal amount of up to \$120.0 million. Upon closing of the facility in September 2008, \$115.0 million was advanced to DST. The credit facility is secured by, among other things, the real estate and properties owned by these DST subsidiaries as well as an assignment of the related leases, rents and other benefits of these assets. The interest rate applicable to the credit agreement is a floating rate tied to either offshore LIBOR rate plus an applicable margin rate of 1.75% or the prime rate (as defined in the credit agreement), as elected by DST. Principal and interest payments are due

Table of Contents

on the first of each month beginning in November 2008, and are based on a 20 year amortization schedule. Subject to provisions in the credit agreement, DST may voluntarily prepay the loan in whole or in part without premium or penalty, though amounts repaid may not be reborrowed. Concurrent with the lease, sale or other transfer of any of the collateralized properties, DST must prepay an amount equal to 125% of the allocated amount of such property as set forth in the credit agreement. The credit agreement contains customary restrictive covenants, as well as certain customary events of default. Among other provisions, the credit agreement requires certain interest coverage ratios to be maintained. If any event of default occurs and is continuing, all amounts payable under the credit agreement may be declared immediately due and payable. The balance of the loan is due on September 16, 2013, the maturity date of the credit facility. The amount outstanding under this real estate credit agreement at September 30, 2008 was \$115.0 million.

*Overall Liquidity*

The Company believes that its existing cash balances and other current assets, together with cash provided by operating activities and, as necessary, the Company's bank and revolving credit facilities, will suffice to meet the Company's operating and debt service requirements and other current liabilities for at least the next 12 months. Further, the Company believes that its longer term liquidity and capital requirements will also be met through cash provided by operating activities, bank credit facilities and available-for-sale securities.

*Guarantees*

The Company has guaranteed certain obligations of certain joint ventures under service agreements entered into by the joint ventures and their customers. The amount of such obligations is not stated in the agreements. Depending on the negotiated terms of the guaranty and/or the underlying service agreement, the Company's liability under the guaranty may be subject to time and materiality limitations, monetary caps and other conditions and defenses.

In certain instances in which the Company licenses proprietary systems to customers, the Company gives certain warranties and infringement indemnities to the licensee, the terms of which vary depending on the negotiated terms of each respective license agreement, but which generally warrant that such systems will perform in accordance with their specifications. The amount of such obligations is not stated in the lease agreements. The Company's liability for breach of such warranties may be subject to time and materiality limitations, monetary caps and other conditions and defenses.

From time to time, the Company enters into agreements with unaffiliated parties containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective agreement. The amount of such obligations is not stated in the agreements. The Company's liability under such indemnification provisions may be subject to time and materiality limitations, monetary caps and other conditions and defenses. Such indemnity obligations include the following:

The Company has entered into purchase and service agreements with its vendors, and consulting agreements with providers of consulting services to the Company, pursuant to which the Company has agreed to indemnify certain of such vendors and consultants, respectively, against third party claims arising from the Company's use of the vendor's product or the services of the vendor or consultant.

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

In connection with the acquisition or disposition of subsidiaries, operating units and business assets by the Company, the Company has entered into agreements containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective agreement, but which are generally described as follows: (i) in connection with acquisitions made by the Company, the Company has agreed to indemnify the seller against third party claims made against the seller relating to the subject subsidiary, operating unit or asset and arising after the closing of the transaction, and (ii) in connection with dispositions made by the Company, the Company has agreed to indemnify the buyer against damages incurred by the buyer due to the buyer's reliance on representations and warranties relating to the subject subsidiary, operating unit or business assets in the disposition agreement if such representations or warranties were untrue when made, or due to any breach of the representations, warranties, agreements or covenants contained in the agreement.



Table of Contents

The Company has entered into agreements with certain third parties, including banks and escrow agents, which provide software escrow, fiduciary and other services to the Company or to its benefit plans or customers. Under such agreements, the Company has agreed to indemnify such service providers for third party claims relating to the carrying out of their respective duties under such agreements.

The Company has entered into agreements with lenders providing financing to the Company pursuant to which the Company agrees to indemnify such lenders for third party claims arising from or relating to such financings. In connection with real estate mortgage financing, the Company has entered into environmental indemnity agreements in which the Company has agreed to indemnify the lenders for any damage sustained by the lenders relating to any environmental contamination on the subject properties.

In connection with the acquisition or disposition of real estate by the Company, the Company has entered into real estate contracts containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective contract, but which are generally described as follows: (i) in connection with acquisitions by the Company, the Company has agreed to indemnify the seller against third party claims made against the seller arising from the Company's on-site inspections, tests and investigations of the subject property made by the Company as part of its due diligence and against third party claims relating to the operations on the subject property after the closing of the transaction, and (ii) in connection with dispositions by the Company, the Company has agreed to indemnify the buyer for damages incurred by the buyer due to the buyer's reliance on representations and warranties relating to the subject property made by the Company in the real estate contract if such representations or warranties were untrue when made and against third party claims relating to operations on the subject property prior to the closing of the transaction.

In connection with the leasing of real estate by the Company, as landlord and as tenant, the Company has entered into occupancy leases containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective lease, but which are generally described as follows: (i) in connection with leases in which the Company is the tenant, the Company has agreed to indemnify the landlord against third party claims relating to the Company's occupancy of the subject property, including claims arising from loss of life, bodily injury and/or damage to property thereon, and (ii) in connection with leases in which the Company is the landlord, the Company has agreed to indemnify the tenant against third party claims to the extent occasioned wholly or in part by any negligent act or omission of the Company or arising from loss of life, bodily injury and/or damage to property in or upon any of the common areas or other areas under the Company's control.

At September 30, 2008 and December 31, 2007, the Company had not accrued any liability on the aforementioned guarantees or indemnifications as they relate to future performance criteria or indirect guarantees of indebtedness of others in accordance with FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.

**OTHER**

**Comprehensive income (loss)**

The Company's comprehensive loss totaled \$49.5 million and \$78.3 million for the three and nine months ended September 30, 2008, respectively, as compared to comprehensive income of \$649.1 million and \$859.0 million for the three and nine months ended September 30, 2007. Comprehensive income (loss) includes net income of \$50.2 million and \$172.3 million for the three and nine months ended

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

September 30, 2008, respectively, as compared to \$672.8 million and \$811.0 million for the three and nine months ended September 30, 2007, and other comprehensive loss of \$99.7 million and \$250.6 million for the three and nine months ended September 30, 2008, respectively, as compared to other comprehensive loss of \$23.7 million and other comprehensive income of \$48.0 million for the three and nine months ended September 30, 2007. Other comprehensive income consists of unrealized gains and losses on available-for-sale securities, net of deferred taxes, reclassifications for net gains and losses included in net income, foreign currency translation adjustments, and the Company's share of an unconsolidated affiliate interest rate swap. The principal difference between net income and comprehensive income is the net change in unrealized gains and losses on available-for-sale securities.

Table of Contents

**Other than temporary impairments**

At September 30, 2008, the Company's available-for-sale securities had unrealized holding losses of \$12.8 million. If it is determined that a reduction in a security's net realizable value is other than temporary, a realized loss will be recognized in the statement of operations and the cost basis of the security reduced to its estimated fair value. The Company does not believe that the unrealized losses at September 30, 2008 are other than temporary.

The Company recognized investment impairments which the Company believed were other than temporary of \$7.1 million and \$33.1 million for the three and nine months ended September 30, 2008, respectively, as compared to \$3.1 million and \$5.1 million for the same periods in 2007. The impairments were for available-for-sale and cost method investments in the Investments and Other Segment and Financial Services Segment. A decline in a security's net realizable value that is other than temporary is treated as a loss based on quoted market value and is reflected in the other income (expense), net in the Condensed Consolidated Statement of Income.

**Seasonality**

Generally, the Company does not have significant seasonal fluctuations in its business operations. Processing and Output Solutions volumes for mutual fund customers are usually highest during the quarter ended March 31 due primarily to processing year-end transactions and printing and mailing of year-end statements and tax forms during January. The Company has historically added operating equipment in the last half of the year in preparation for processing year-end transactions, which has the effect of increasing costs for the second half of the year. Revenues and operating results from individual license sales depend heavily on the timing and size of the contract.

**Accounting Standards**

*Earnings Per Share*

The Financial Accounting Standards Board (the "FASB") previously issued an exposure draft on a proposed accounting standard that would amend SFAS No. 128, "Earnings per Share" (SFAS 128), to clarify guidance for mandatorily convertible instruments, the treasury stock method, contingently issuable shares, and contracts that may be settled in cash or shares.

The proposed amendment, which is designed for convergence with international accounting standards, would require the use of the "if-converted" method from the date of issuance of the convertible debentures. The proposed amendment would remove the ability of a company to support the presumption that the convertible securities will be satisfied in cash and not converted into shares of common stock. Accordingly, the Company's stated intention to settle conversions of its convertible debentures with cash for the principal and accrued and unpaid interest and issue common stock for any conversion value amount over the principal and accrued and unpaid interest amounts would no longer be accepted under SFAS 128, if amended as proposed. The final standard has yet to be issued. Retrospective application would be required for all changes to SFAS 128,

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

except that retrospective application would be prohibited for contracts that were either settled in cash prior to adoption or modified prior to adoption to require cash settlement. For DST, adoption of this statement, as proposed, will require retroactive restatement of the Company's diluted earnings per share calculations subsequent to the issuance of the convertible debentures. In calculating diluted earnings per share under the revised SFAS 128 if converted method included in the exposure draft, the Company would need to increase net income for the interest expense associated with the convertible debentures, net of tax, and increase the incremental shares assumed to be issued upon conversion by 17.1 million shares (less shares already included in diluted earnings per share), the amount of shares that would be issued if the senior convertible debentures would be converted to equity. Under this if converted method, diluted earnings per share would have been \$0.80 and \$8.42 (versus reported diluted earnings per share of \$0.91 and \$9.62) for the three months ended September 30, 2008 and 2007, respectively, and \$2.59 and \$10.04 (versus reported diluted earnings per share of \$2.91 and \$11.37) for the nine months ended September 30, 2008 and 2007, respectively. The above information presents only the effect on

Table of Contents

diluted earnings per share of the if converted method included in the exposure draft, but does not include any other computational changes (e.g., treasury stock method considerations) discussed in the exposure draft. DST is continuing to monitor the FASB's progress towards finalizing this proposed accounting standard.

The proposed change in accounting principle would affect the calculation of diluted earnings per share during the period the debentures are outstanding, but would not affect DST's ability to ultimately settle the convertible debentures in cash, shares or any combination thereof.

The estimated impact of this new accounting standard reflects the Company's current estimates based upon the exposure draft in its current form. There may be material differences between these estimates and the actual impact of the standard when issued as final.

*Accounting for Convertible Debt Instruments*

In May 2008, the FASB issued FASB Staff Position ( FSP ) No. APB 14-1, Accounting for Convertible Debt Instruments that may be Settled in Cash upon Conversion (Including Partial Cash Settlement). This FSP clarifies that issuers of convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. The FSP will be effective for financial statements issued for fiscal years beginning after December 15, 2008, and early adoption is not permitted. This FSP shall be applied retrospectively to all periods presented. DST is still evaluating the impact of this FSP, but currently believes that the adoption of this standard may have a negative impact on earnings per share for historical periods prior to March 31, 2006, but is not expected to have a significant impact on the Company's earnings per share prospectively.

*Earnings Per Share - Participating Securities*

In June 2008, the FASB issued FSP No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities. Under FSP EITF 03-6-1, certain share-based payment awards that allow holders to receive dividends before they vest should be treated as participating securities. Although unvested share-based payment awards with nonforfeitable rights to dividends have typically been included in the calculation of diluted EPS using the treasury stock method, these awards will now need to be included in the calculation of basic EPS using the two-class method, a change that will likely reduce both basic and diluted EPS. The FSP will be effective for financial statements issued for fiscal years beginning after December 15, 2008, and early adoption is not permitted. This FSP shall be applied retrospectively to all periods presented. Because DST's restricted stock awards allow holders the right to receive cash dividends, if any, DST may have to treat these awards as participating securities which could result in an additional dilutive impact to both basic and diluted EPS. Unvested restricted shares were 2.6 million at September 30, 2008. DST is still evaluating the impact of this FSP, but currently believes that the adoption of this standard will have a negative impact on basic and diluted earnings per share.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

In the operations of its businesses, the Company's financial results can be affected by changes in equity pricing, interest rates and currency exchange rates. Changes in interest rates and exchange rates have not materially impacted the consolidated financial position, results of operations or cash flows of the Company. Changes in equity values of the Company's investments have had a material effect on the Company's comprehensive income and consolidated financial position.

### **Available-for-sale equity price risk**

The Company's investments in available-for-sale equity securities are subject to price risk. The fair value of the Company's available-for-sale investments as of September 30, 2008 was approximately \$1.1 billion. The impact of a 10% change in fair value of these investments would be approximately \$67.2 million to comprehensive income. As discussed under Management's Discussion and Analysis of Financial Condition and Results of

Table of Contents

Operations - Comprehensive income (loss) above, net unrealized gains on the Company's investments in available-for-sale securities have had a material effect on the Company's comprehensive income and consolidated financial position.

**Interest rate risk**

The Company and certain of its joint ventures derive a certain amount of their service revenues from investment earnings related to cash balances maintained in transfer agency customer bank accounts for which the Company is the agent. The balances maintained in the bank accounts are subject to fluctuation. At September 30, 2008, the Company and its joint ventures had approximately \$1.6 billion of cash balances maintained in such accounts, of which \$1.3 billion was maintained at the joint ventures. The Company estimates that a 50 basis point change in interest earnings rate would increase or decrease consolidated net income, on an annual basis, by approximately \$2.1 million.

At September 30, 2008, the Company had approximately \$1.5 billion of debt, of which \$667.2 million was subject to variable interest rates (Federal Funds rates, LIBOR rates, prime rates). The Company estimates that a 10% change in interest rates would increase or decrease pre-tax income, on an annual basis, by approximately \$1.8 million.

At September 30, 2008, the Company's proportional share of an unconsolidated affiliate's interest rate swap was an unrealized loss of \$10.0 million and is included in other comprehensive income. The Company estimates that a 10% change in the interest rate would not be material to consolidated other comprehensive income.

In addition to the financial instruments listed above, the program fees incurred on proceeds from the sale of receivables under the Company's accounts receivable securitization program are determined based on variable interest rates associated with commercial paper.

**Foreign currency exchange rate risk**

The operation of the Company's subsidiaries in international markets results in exposure to movements in currency exchange rates. The principal currencies involved are the British pound, Canadian dollar, Australian dollar, Thai baht and Indian rupee. Currency exchange rate fluctuations have not historically materially affected the consolidated financial results of the Company. At September 30, 2008, the Company's international subsidiaries had approximately \$199.6 million in total consolidated assets, and for the three and nine months ended September 30, 2008, these international subsidiaries had approximately \$6.7 million and \$3.6 million net income, respectively. The Company estimates that a 10% change in exchange rates could change total consolidated assets by approximately \$20.0 million. Furthermore, a 10% change in exchange rates based upon historical earnings in international operations could change consolidated net income by approximately \$0.4 million.

The Company's international subsidiaries use the local currency as the functional currency. The Company translates all assets and liabilities at balance sheet date exchange rates and income and expense accounts at average rates during the period. While it is generally not the Company's practice to enter into derivative contracts, from time to time the Company and its subsidiaries do utilize forward foreign currency exchange contracts to minimize the impact of currency movements.

**Item 4. Controls and Procedures**

*Disclosure Controls and Procedures*

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, including without limitation, controls and



Table of Contents

procedures designed to ensure that information required to be disclosed in reports that it files under the Exchange Act is accumulated and communicated to the Company's management, including its Chief Executive and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based on an evaluation of the Company's disclosure controls and procedures as of the end of the period covered by this report conducted by the Company's management, with the participation of the Chief Executive and Chief Financial Officer, the Chief Executive and Chief Financial Officer believe that these controls and procedures were effective as of September 30, 2008.

*Internal Control over Financial Reporting*

There were no changes in the Company's internal control over financial reporting (as defined in Rules 13(a)-15(f) and 15(d)-15(f) under the Exchange Act) during the quarter ended September 30, 2008, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Item 4T. Controls and Procedures**

Not applicable.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company and its subsidiaries are involved in various legal proceedings arising in the normal course of their businesses. While the ultimate outcome of such legal proceedings cannot be predicted with certainty, management believes, after consultation with legal counsel, that the final outcome in such proceedings, in the aggregate, would not have a material adverse effect on the consolidated financial condition, results of operations or cash flows of the Company.

**Item 1A. Risk Factors**

There are many risks and uncertainties that can affect our future business, financial performance or share price. Many of these are beyond our control. A description follows of some of the important factors that could have a material negative impact on our future business, operating results, financial condition or share price. This discussion includes a number of forward-looking statements. You should refer to the description of the qualifications and limitations on forward-looking statements in the first paragraph under Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q. The risk factors have not changed materially from the date of our annual report on Form 10-K for the year ended December 31, 2007, except that we have included a risk factor on adverse conditions in the credit and financial markets.

Unless otherwise indicated or the context otherwise requires, reference in this section to we, ours, us or similar terms means the Company, together with its subsidiaries. The level of importance of each of the following trends and risks may vary from time to time, and the trends and risks are not listed in any specific order of importance. These risks, however, are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

**Trends or events affecting our clients or their industries could decrease the demand for our products and services.**

We derive our consolidated revenues from the delivery of products and services to clients in the mutual fund, investment management, healthcare, telecommunications and utilities, video/broadband/satellite TV, other financial service (i.e. brokerage, insurance, banking, financial planning and mortgage) and other industries. A decline or lack of growth in demand for our products and services in any of the industries we serve could

Table of Contents

adversely affect our business and earnings. Demand for our products and services among companies in those industries could decline for many reasons. Consolidation or limited growth in an industry could reduce the number of our clients and potential clients. Events that adversely affect our clients' businesses, rates of growth or numbers of customers they serve, including decreased demand for our customers' products and services, adverse conditions in our customers' markets or adverse economic conditions generally, could decrease demand for our products and services and the number of transactions we process. We cannot always predict the needs of changing industries or whether potential customers will accept our products or services. Concentrating our resources based on trends or events that do not occur as we expected could negatively impact any of our various businesses.

**The demand for our products and services could decrease if we do not continually address our and our clients' technology and capacity requirements.**

Our clients use computer technology-based products and services in the complex and rapidly changing markets in which they operate. We must substantially invest in technology and systems to meet customer demand for transaction processing and volume capacities. If we do not meet clients' technology and capacity demands in advance of our competitors or if the investments we make are not cost-effective or do not result in successful products or services, our businesses could be adversely affected.

**Damage to our facilities or declining real estate values could impact our operations or financial condition.**

We own, lease and manage real estate as part of our business. The performance of our services also depends upon facilities that house central computer operations or operating centers or in which we process information, images, bills or statements. Declining property values in the markets in which we own investment properties may adversely affect our financial condition. Significant damage to any of our operating facilities could interrupt the operations at those facilities and interfere with our ability to serve customers.

**We may be unable to attract and retain capable technical personnel for our processing businesses or quality executives to manage the complex structure of our business.**

Our success depends on recruiting and retaining adept management and personnel with expertise in software and systems development and the types of computer hardware and software we utilize. Losing key personnel or not hiring qualified personnel could have a material adverse effect on our operations. Companies in our industry compete fiercely for qualified management and technical personnel. We cannot guarantee that we will be able to adequately compete for or keep qualified personnel. Lack of qualified management could increase the risk of unfavorable business strategies, especially in a complex business like ours with multiple segments and operating entities. Lack of qualified technical personnel could also affect our ability to develop the systems and services our clients demand.

**Our businesses are subject to substantial competition.**

We are subject to intense competition from other established service providers in all industries we serve. Competitors may offer more appealing pricing structures. Some of our clients have developed or are developing the in-house capacity to perform the transaction processing,

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

recordkeeping, and output services they have paid us to perform. Some of our competitors and clients have greater financial and human resources and access to capital than we do.

Our failure to successfully compete in any of our operating segments could have a material adverse effect on our financial results. Competition could also affect the revenue mix of services we provide, resulting in decreased revenues in lines of business with higher profit margins.

Table of Contents

**An increase in subaccounting services performed by brokerage firms could adversely impact our revenues.**

Our mutual fund transfer agency competition includes brokerage firms that perform subaccounting services for customers who purchase or sell shares of our clients' mutual funds. A brokerage firm typically maintains an omnibus account with us that represents the aggregate number of shares of a mutual fund owned by the brokerage firm's customers. The omnibus account structure results in fewer mutual fund shareowner accounts on our systems, which adversely affects our revenues.

We offer subaccounting services to brokerage firms that perform mutual fund shareowner subaccounting. As the recordkeeping functions in connection with subaccounting are more limited than traditional shareowner accounting, the fees charged are generally lower on a per unit basis. There is a risk that clients who determine to use the omnibus accounting structure of brokerage firms would convert accounts currently on our traditional recordkeeping system to our subaccounting system, or to the subaccounting systems of other transfer agents, which could result in lower revenues.

**We and companies in which we own a significant interest are subject to government regulation. Any regulatory violations could adversely affect our business.**

A number of our businesses are subject to U.S. or foreign regulatory oversight, as well as recordkeeping and reporting obligations. Any violation of those obligations or related laws or regulations could expose us or those businesses to costly fines or sanctions or damage our reputation, which could adversely affect our business or financial performance.

**Our clients are subject to government regulation that could affect our business.**

Our clients are subject to extensive government regulation, including investment adviser, broker/dealer and financial and healthcare privacy regulations. Any violation by our clients of applicable laws and regulations could diminish their business or financial condition and thus their demand for our products and services. Demand could also decrease if we do not continue to offer products and services that help our clients comply with regulations.

**We operate internationally and are thus exposed to foreign political, economic and other conditions that could adversely affect our revenues from or support by foreign operations.**

Consolidated revenues from our subsidiaries in Asia, Australia, Canada, Europe and elsewhere outside the U.S. are an important element of our revenues. Inherent risks in our international business activities could decrease our international sales and have a material adverse effect on our overall financial condition, results of operations and cash flow. These risks include potentially unfavorable foreign economic conditions, political conditions or national priorities, foreign government regulation, potential expropriation of assets by foreign governments, the failure to bridge cultural differences, and limited or prohibited access to our foreign operations and the support they provide. We may also have difficulty repatriating profits or be adversely affected by exchange rate fluctuations in our international business.

**Various events may cause our financial results to fluctuate from quarter to quarter or year to year. The nature of these events might inhibit our ability to anticipate and act in advance to counter them.**

We cannot always control when and whether events occur, that could cause varying financial results. Unfavorable results may occur that we did not anticipate or take advance action to address. The various reasons our quarterly and annual results may fluctuate include unanticipated economic conditions and costs for starting up significant client operations, for hiring staff, and for developing products. Our results may also vary as a result of pricing pressures, increased cost of supplies, timing of license fees, the evolving and unpredictable markets in which our products and services are sold, changes in accounting principles, and competitors' new products or services.

Table of Contents

**Our revenues and profit margins could decrease if clients cancel contracts, fail to renew contracts, renegotiate contracts or use our services at less than anticipated rates.**

Client contract terminations, non-renewals, renegotiations or under- utilization of our services could decrease our revenues and profit margins. We derive revenue by selling products and services under long-term contracts. We cannot unilaterally extend the terms of these contracts when they expire. Some of these contracts contain termination for convenience clauses, which enable clients to cancel the agreements by providing written notice to us. Any failure to extend these contracts under their current terms, or any early termination of these contracts by customers, could adversely affect our business.

**Claims against us, including claims for the lost market value of securities and class action claims, could cause significant liability and damage our reputation and business prospects.**

Our proprietary applications and related services involve the processing of financial transactions for our clients and their customers. The dollar amount of transactions processed is vastly higher than the revenues derived from providing these services. We may be subject to damage claims, including class-action claims, for delays in transaction processing; for calculation errors, errors resulting in disclosure of confidential information, or other processing or operational errors; or for mismanagement of claims or other processes. Because of the sensitive nature of the financial and healthcare transactions we process, our liability and alleged damages may significantly exceed the fees we receive for performing the service at issue. Litigation can include class action claims based, among other theories, upon various regulatory requirements and consumer protection and privacy laws that class action plaintiffs may attempt to use to assert private rights of action. Any of these claims and related settlements or judgments could affect our profitability, damage our reputation, decrease demand for our services, or cause us to make costly operating changes.

**We are substantially dependent on our intellectual property rights, and a claim for infringement or a requirement to indemnify a client for infringement could adversely affect us.**

We have made substantial investments in software and other intellectual property on which our business is highly dependent. Any loss of our intellectual property rights, or any significant claim of infringement or indemnity for violation of the intellectual property rights of others, could have a material adverse effect on our financial condition, results of operations and cash flow. We rely on patent, trade secret and copyright laws, nondisclosure agreements, and other contractual and internal security measures to protect our proprietary technology. We cannot guarantee these measures will be effective. Our products and services rely on technology developed by others, including open source software, and we have no control over possible infringement of someone else's intellectual property rights by the provider of this technology. The owner of the rights could seek damages from us rather than or in addition to the persons who provide the technology to us. We could be subject at any time to intellectual property infringement claims that are costly to evaluate and defend. Our clients may also face infringement claims, allege that such claims relate to our products and services, and seek indemnification from us.

**Failure to protect the confidential information of our clients could hurt our business.**

We often maintain trade secrets and proprietary information, including sensitive financial and personal health information of our clients customers, electronically. A material breach of our security systems and procedures could lead to significant claims for liability, cause our

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

customers to reconsider using our services and products, damage our reputation, or otherwise have a material adverse effect on us. We maintain systems and procedures to protect against unauthorized access to electronic information and computer viruses, but we cannot guarantee these systems and procedures will always protect us. Rapid advances in technology may prevent us from anticipating all potential security threats, and the limits of technology and skills or the prohibitive cost of more advanced security solutions might prevent us from addressing these threats.



Table of Contents

**We do not control certain businesses in which we have significant ownership.**

We invest in joint ventures and other unconsolidated affiliates as part of our business strategy, and part of our net income is derived from our pro rata share of the earnings of those businesses. Despite owning significant equity interests in those companies and having directors on their boards, we do not control their operations, strategies or financial decisions. The other owners may have economic, business or legal interests or goals that are inconsistent with our goals or the goals of the businesses we co-own. Our pro rata share of any losses due to unfavorable performance of those companies could impact our financial statements.

**We own interests in companies under agreements that may inhibit our ability to sell our interests and the other owners may ask us to increase our investment.**

We own interests in Boston Financial Data Services, International Financial Data Services Limited Partnership, International Financial Data Services Limited, Argus Health Systems, Inc. and various real estate joint ventures. Our interests in these companies are subject to buy/sell arrangements, which may restrict our ability to sell our interests when we believe it is prudent to do so. These arrangements may also require that we purchase the other owners' interests to prevent someone else from acquiring them. The businesses or other owners may encourage us to increase our investment in or make contributions to the businesses at an inopportune time.

**The financial results of our reinsurance subsidiary could be adversely affected if actual loss experience exceeds estimated loss experience.**

Our subsidiary, Vermont Western Assurance, Inc., which we refer to as Vermont Western, reinsures a portion of the risk in connection with replacing lost stock certificates for registered shareholders of unrelated companies. Vermont Western utilizes underwriting procedures and actuarial advisors to assess risk and establish reserves against loss. Vermont Western does not control clients' loss experience. Vermont Western could inaccurately assess risk at any time and actual loss experience could exceed estimates. Vermont Western's results, if unfavorable, could have a material adverse effect on our financial condition, operating results or cash flow.

**We hold equity investments in companies that operate in various industries, and the value of those investments could decrease.**

We hold significant investments in available-for-sale equity securities of other companies or other financial interests that are subject to fluctuations in market prices. A significant decline in the value of our equity investments could have a material adverse effect on our financial condition or results of operations. We may not always be able to resell those investments at higher prices than we paid for them or than the value of the consideration used to acquire them.

**Various plans, agreements, laws and organizational documents may make more difficult or prevent a change in control.**

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

Provisions in our Certificate of Incorporation, Bylaws, certain plans and agreements, and applicable laws could make it more difficult for a party to make a tender offer for our shares or complete a takeover, which is not approved by our Board of Directors. The provisions include:

- super-majority stockholder approval required for certain actions
- staggered terms for directors
- specific procedures for stockholders to nominate new directors
- cumulative voting in election of directors
- the Board's authority to issue and set the terms of preferred stock

Table of Contents

- a stockholders' rights plan giving stockholders' rights to purchase preferred stock if certain changes in our ownership occur
- various rights of debenture holders, joint venture co-owners, lenders and certain customers and executives in the event of a change in control
- public reporting of ownership and of changes in ownership by stockholders with at least a 5% interest in us
- legal restrictions on business combinations with certain stockholders

**Because of contractual commitments, a change in control could affect our operating results and weaken our management retention and incentive tools.**

A change in control of the Company would trigger various rights and obligations in service agreements with our customers, in agreements governing our joint ventures, and in incentive award and employment agreements with our management. A change in control could also allow some clients to terminate their agreements with us or to obtain rights to use our processing software. We are parties to joint venture agreements that allow other co-owners to buy our equity interests if we undergo a change in control. A change in control or a termination of employment without cause or their resignation for good reason (each as defined in applicable agreements) after a change in control could accelerate certain restricted stock and other awards we have granted to our management employees. This award vesting may decrease an employee's incentive to continue employment with us. Certain executive officers have agreements with us that require us to continue to employ them for three years after a change in control or to pay certain amounts if we terminate their employment without cause or they resign for good reason following a change in control. The executives might not be incented to achieve results for the new owners of our business, and the cost of keeping the executives on the payroll might deter potential new owners from acquiring us or hinder new owners from hiring replacement management.

**Our equity incentive and stockholders' rights plans could have a dilutive effect on our common stock.**

Our directors, officers and certain managers have received restricted stock and options to purchase our common stock as part of their compensation. These equity grants could have a dilutive effect on our common stock. A change of control would trigger the right of stockholders under our stockholders' rights plan to purchase 1/1000th shares of our preferred stock for each share of our common stock, which could be dilutive in value to common stockholders who do not exercise those rights.

**Conversion of our debentures could have a dilutive effect on our common stock or affect our liquidity.**

## Edgar Filing: DST SYSTEMS INC - Form 10-Q

In August 2003, we issued \$840 million aggregate principal amount of convertible senior debentures. Issuing common stock to settle conversions could be dilutive to the price of our common stock, and settlement of conversions for cash could affect our financial condition, operating results and cash flow. The debentures are convertible into shares of common stock under specified circumstances, which we refer to as Conversion Triggers. We cannot accurately predict when certain Conversion Triggers outside of our control may occur. To satisfy a conversion notice subsequent to a Conversion Trigger, we must deliver our common stock unless we properly notify the holder that we will settle with cash or a combination of cash and shares of common stock. How we settle a conversion notice will depend on liquidity, financial needs, or other circumstances existing at the time of a Conversion Trigger.

### **Adverse conditions in the credit and financial markets could adversely affect our business, financial condition and results of operations**

As widely reported, financial markets in the United States, Europe and Asia have been experiencing extreme disruption in recent months including, among other things, extreme volatility in security prices, severely diminished liquidity and credit availability, rating downgrades of certain investments and declining valuations of

Table of Contents

others. Governments have taken unprecedented actions intended to address extreme market conditions that include severely restricted credit and declines in real estate values. The Company believes the current credit and financial market conditions could adversely affect its operations in several ways including, but not limited to, the following:

- While the Company's syndicated revolving credit facility does not expire until June 2010, adverse economic conditions could impair the Company's ability to access credit markets if additional financing is required by the Company.
- If one or more of the banks in the syndicated revolving credit facility were not able to or otherwise fail to fulfill their funding obligations under the facility, the Company's financial condition could be adversely impacted.
- In connection with any potential alteration of the Company's syndicated revolving credit facility to meet a business need, it is possible that the syndicate of banks could require current market pricing rates as part of the terms of amending the facility which could adversely impact the Company's interest expense and cash flow.
- The current tightening of credit in financial markets may adversely affect the abilities of clients to obtain financing and could result in a cancellation of, a decrease in, or inability to pay for the products and services provided by the Company.
- The Company's suppliers may also be adversely affected, and the lack of their access to the credit markets to fund key supplier operations could lead to a shortage or cancellation of key supplier products and services, which could have an adverse effect on the Company's operations.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

**Stock repurchases**

The following table sets forth information with respect to shares of Company common stock purchased by the Company during the three months ended September 30, 2008.

**Period**

Edgar Filing: DST SYSTEMS INC - Form 10-Q

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
July 1 - July 31	1,101,469(1)	56.46	1,100,000	3,140,535(2)
August 1 - August 31	609,261(1)	62.68	600,000	2,540,535(2)
September 1 - September 30	1,316,827(1)	57.49	1,311,587	1,228,948(2)

(1) For the three months ended September 30, 2008, the Company purchased, in accordance with the 2005 Equity Incentive Plan (formerly the 1995 Stock Option and Performance Award Plan), 15,970 shares of its common stock for participant income tax withholding in conjunction with stock option exercises, as requested by the participants. These purchases were not made under the publicly announced repurchase plans or programs, but were allowed by the rules of the Compensation Committee of the DST Board of Directors. Of these shares, 1,469 shares were purchased in July 2008, 9,261 shares were purchased in August 2008 and 5,240 shares were purchased in September 2008.

(2) On May 12, 2008, DST's Board of Directors authorized the repurchase of an additional 5.0 million shares under the existing share repurchase authorization plan. The plan allows, but does not require, the repurchase of common stock in open market and private transactions through December 31, 2009. The Company may enter into one or more plans with its brokers or banks for pre-authorized purchases within defined limits pursuant to Rule 10b5-1 to effect all or a portion of such share repurchases.

Table of Contents

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

(a) **Disclosure of Unreported 8-K Information**

None.

(b) **Material Changes to Director Nominee Procedures**

None.

**Item 6. Exhibits**

(a) Exhibits:

- 10.1 The Fifth Amendment dated June 16, 2008 to the Syndicated Credit Agreement by and among the Company and a syndicate of financial institutions including but not limited to Bank of America, N.A., Citibank, N.A., Citigroup Global Markets, Inc. and Banc of America Securities LLC, dated as of June 28, 2005, which is attached as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on June 29, 2005 (Commission File No. 1-14036).
- 10.2 The Credit Agreement by and among DST Realty, Inc., Westside Investment Park, L.L.C., DST Realty of California, Inc., DST Realty Connecticut, Inc. and a syndicate of financial institutions including but not limited to Bank of the West and Enterprise Bank and Trust, dated September 16, 2008, which is attached as Exhibit 10.1 to the Company's Current Report on Form 8-K filed

Edgar Filing: DST SYSTEMS INC - Form 10-Q

- September 22, 2008 (Commission File No. 1-14036), is hereby incorporated by reference as Exhibit 10.2.
- 31.1 Certification of Chief Executive Officer of Registrant  
31.2 Certification of Chief Financial Officer of Registrant  
32 Certification Pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer of Registrant and Chief Financial Officer of Registrant

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, and in the capacities indicated, on November 10, 2008.

DST Systems, Inc.

/s/ Kenneth V. Hager

Kenneth V. Hager  
Vice President, Chief Financial Officer and Treasurer  
(Principal Financial Officer)