DST SYSTEMS INC
Form 10-Q
August 04, 2015
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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 June 30, 2015

or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number 1-14036

DST Systems, Inc.
(Exact name of registrant as specified in its charter)

Delaware	43-1581814
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
333 West 11th Street, Kansas City, Missouri	64105
(Address of principal executive offices)	(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 x No ¨

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

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

Large accelerated filer x Accelerated filer o

Non-accelerated filer o Smaller reporting company o
(do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Number of shares outstanding of the Company’s common stock as of July 31, 2015:
Common Stock $0.01 par value — 35,843,952

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	June 30, 2015	December 31, 2014
ASSETS		
Current assets		
Cash and cash equivalents	$103.0	$151.7
Funds held on behalf of clients	214.6	356.2
Client funding receivable	44.6	43.4
Accounts receivable	354.7	349.6
Other assets	70.7	71.0
	787.6	971.9
Investments	453.6	656.6
Unconsolidated affiliates	311.1	298.7
Properties, net	417.2	403.6
Intangible assets, net	115.3	122.5
Goodwill	419.8	414.7
Other assets	58.6	74.9
Total assets	$2,563.2	$2,942.9
LIABILITIES AND EQUITY		
Current liabilities		
Current portion of debt	$151.7	$167.3
Client funds obligations	259.1	399.6
Accounts payable	93.7	101.8
Accrued compensation and benefits	123.8	168.0
Deferred revenues and gains	53.9	53.9
Income taxes payable	0.3	17.6
Other liabilities	107.1	113.7
	789.6	1,021.9
Long-term debt	346.5	385.6
Income taxes payable	89.6	80.1
Deferred income taxes	109.1	186.4
Other liabilities	34.3	32.5
Total liabilities	1,369.1	1,706.5
Commitments and contingencies (Note 9)		
Stockholders' Equity		
Preferred stock, $0.01 par; 10 million shares authorized and unissued	—	—
Common stock, $0.01 par; 400 million shares authorized, 50.0 million shares issued	0.5	0.5
Additional paid-in capital	125.1	114.4

Retained earnings	1,876.1	1,682.9
Treasury stock (13.6 million and 12.4 million shares, respectively), at cost	(886.8)	(748.3)
Accumulated other comprehensive income	79.2	186.9
Total stockholders' equity	1,194.1	1,236.4
Total liabilities and stockholders' equity	$2,563.2	$2,942.9

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Operating revenues	$500.4	$509.6	$996.1	$1,014.8
Out-of-pocket reimbursements	194.1	169.9	400.7	348.5
Total revenues	694.5	679.5	1,396.8	1,363.3
Costs and expenses	595.6	576.1	1,189.4	1,159.8
Depreciation and amortization	29.8	32.1	59.2	64.1
Income from operations	69.1	71.3	148.2	139.4
Interest expense	(6.1)	(7.0)	(12.2)	(13.6)
Other income, net	92.3	131.2	175.6	224.8
Equity in earnings of unconsolidated affiliates	12.8	9.6	27.7	15.0
Income before income taxes	168.1	205.1	339.3	365.6
Income taxes	60.6	67.3	124.0	127.4
Net income	$107.5	$137.8	$215.3	$238.2
Weighted average common shares outstanding	36.6	40.9	36.9	41.4
Weighted average diluted shares outstanding	37.0	41.2	37.3	41.8
Basic earnings per share	$2.94	$3.37	$5.84	$5.75
Diluted earnings per share	$2.91	$3.34	$5.78	$5.70
Cash dividends per share of common stock	$0.30	$0.30	$0.60	$0.60

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

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DST Systems, Inc.
Condensed Consolidated Statement of Comprehensive Income
(in millions)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net income	$107.5	$137.8	$215.3	$238.2
Other comprehensive income (loss), net of tax and reclassifications to earnings, derived from:				
Available-for-sale securities	(46.1)	(8.5)	(103.5)	(49.9)
Cash flow hedges	0.1	0.2	0.2	0.4
Foreign currency translation adjustments	5.9	1.7	(4.4)	2.1
Other comprehensive loss	(40.1)	(6.6)	(107.7)	(47.4)
Comprehensive income	$67.4	$131.2	$107.6	$190.8

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

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

	Six Months Ended June 30, 2015	2014
Cash flows — operating activities:		
Net income	$215.3	$238.2
Depreciation and amortization	59.2	64.1
Net gains on investments	(160.6)	(149.7)
Gain on sale of properties	(3.1)	(0.6)
Amortization of share-based compensation	14.4	10.3
Equity in earnings of unconsolidated affiliates	(27.7)	(15.0)
Cash dividends from unconsolidated affiliates	3.2	1.5
Gain on contract to repurchase common stock	—	(18.1)
Deferred income taxes	(12.1)	(3.1)
Changes in accounts receivable	(4.3)	(13.5)
Changes in other assets	2.6	3.7
Changes in accounts payable and accrued liabilities	(11.4)	0.5
Changes in income taxes payable	(7.9)	24.5
Changes in deferred revenues and gains	(1.3)	(1.7)
Changes in accrued compensation and benefits	(44.8)	(23.1)
Other, net	3.8	10.3
Net cash provided from operating activities	25.3	128.3
Cash flows — investing activities:		
Cash paid for capital expenditures	(59.5)	(59.8)
Investments in securities	(43.6)	(44.4)
Proceeds from unconsolidated affiliates	10.5	8.6
Proceeds from sales/maturities of investments	234.9	214.9
Net change in restricted cash and cash equivalents held to satisfy client funds obligations	141.6	(14.0)
Proceeds from sale of properties	4.6	0.7
Acquisition of a business, net of cash acquired	(8.5)	—
Proceeds from sale of business, net of cash and cash equivalents sold	7.9	—
Net cash provided from investing activities	287.9	106.0
Cash flows — financing activities:		
Proceeds from issuance of common stock	7.4	9.8
Principal payments on debt	(9.2)	(130.0)
Net borrowings (repayments) on revolving credit facilities	(30.4)	118.5
Net repayments on accounts receivable securitization program	(15.0)	—
Net change in client funds obligations	(141.6)	14.0
Common stock repurchased	(154.7)	(205.7)
Payment of cash dividends	(22.1)	(24.5)
Excess tax benefits from share-based compensation	3.9	4.6
Other, net	(0.2)	(0.2)
Net cash used for financing activities	(361.9)	(213.5)
Net increase (decrease) in cash and cash equivalents	(48.7)	20.8

Cash and cash equivalents, beginning of period	151.7	62.5
Cash and cash equivalents, end of period	$103.0	$83.3

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

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DST Systems, Inc.
Notes to Condensed Consolidated Financial Statements
(unaudited)

1. Summary of Accounting Policies

The Condensed Consolidated Financial Statements of DST Systems, Inc. (“we”, “our”, “us”, the “Company” or “DST”) includud 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 we believe 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 our audited financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

In the opinion of management, the accompanying unaudited Condensed Consolidated Financial Statements contain all adjustments (consisting only of normal recurring adjustments) necessary to fairly state the consolidated financial position and the results of operations, comprehensive income and cash flows for the periods presented.

Certain amounts in the 2014 financial statements have been reclassified to conform to the 2015 presentation. The results of operations for the three and six months ended June 30, 2015 are not necessarily indicative of the results to be expected for the full year 2015.

Segment presentation

Beginning in 2015, we modified our reportable segment presentation to reflect changes in how we operate the business and make resource allocations. Certain operations, including the electronic presentment services for our financial services customers and our retirement plan participant communications and enrollment materials services, are now presented in the Financial Services segment rather than the Customer Communications segment. Additionally, real estate utilized principally by our business operations has been moved from our Investments and Other segment to the segment that utilizes the property. Real estate primarily occupied by third parties or unoccupied remains within the Investments and Other segment under the revised presentation. Prior periods have been revised to reflect the new reportable segments.

New authoritative accounting guidance

In April 2015, the Financial Accounting Standards Board (“FASB”) issued guidance which requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The guidance is effective January 1, 2016 with early adoption permitted. The guidance is a change in financial statement presentation only and will not have a material impact on the consolidated financial results. At June 30, 2015, the Company had approximately $4.1 million of debt issuance costs, net included in Other assets in the Consolidated Balance Sheet.

In April 2015, the FASB issued guidance that will help entities evaluate the accounting for fees paid in a cloud computing arrangement. The guidance is effective for annual reporting periods beginning after December 15, 2015. We do not expect the adoption of this new standard to have a material impact on our consolidated financial statements.

In February 2015, the FASB issued an accounting standard update, “Consolidation (Topic 810) - Amendments to the Consolidation Analysis.” The new consolidation guidance changes the way reporting enterprises evaluate whether (a) they should consolidate limited partnerships and similar entities, (b) fees paid to a decision maker or service provider are variable interests in a Variable Interest Entity (“VIE”), and (c) variable interests in a VIE held by related parties of the reporting enterprise require the reporting enterprise to consolidate the VIE. It also eliminates the VIE consolidation model based on majority exposure to variability that applied to certain investment companies and similar entities. The guidance is effective for us beginning with the first quarter 2016. Early adoption is permitted, including adoption in an interim period. We are currently evaluating the standard and the impact it will have on our consolidated financial statements.

In May 2014, the FASB issued an accounting standard, “Revenue from Contracts with Customers,” which requires companies to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration it expects to be entitled in exchange for those goods or services. The new standard will become effective for us beginning with the first quarter 2018 and may be adopted either retrospectively to each prior reporting period presented or as a cumulative effect adjustment as of the date of adoption. Early adoption of this standard is permitted as of January 2017. We are currently evaluating the standard, including which transition approach will be applied and the estimated impact it will have on the consolidated financial statements.

2. Investments

Investments are as follows (in millions):

	Carrying Value	
	June 30, 2015	December 31, 2014
Available-for-sale securities:		
State Street Corporation	$168.0	$350.7
Other available-for-sale securities	115.6	124.8
	283.6	475.5
Other:		
Trading securities	24.2	25.1
Cost method and other investments	145.8	156.0
	170.0	181.1
Total investments	$453.6	$656.6

Certain information related to our available-for-sale securities is as follows (in millions):

	June 30, 2015	December 31, 2014
Book cost basis	$115.8	$140.2
Gross unrealized gains	169.5	336.6
Gross unrealized losses	(1.7)	(1.3)
Market value	$283.6	$475.5

At June 30, 2015 and December 31, 2014, the carrying value of our available-for-sale investments was $283.6 million and $475.5 million, respectively. Deferred tax liabilities associated with the available-for-sale investments were approximately $69.2 million and $138.9 million at June 30, 2015 and December 31, 2014, respectively. During the six months ended June 30, 2015 and 2014, we received $224.5 million and $86.7 million, respectively, from the sale of investments in available-for-sale securities. Gross realized gains of $87.8 million and $2.1 million and gross realized losses of $0.9 million and $0.2 million were recorded during the three months ended June 30, 2015 and 2014, respectively, from the sale of available-for-sale securities. Gross realized gains of $163.3 million and $48.2 million and gross realized losses of $2.4 million and $0.3 million were recorded during the six months ended June 30, 2015 and 2014, respectively, from the sale of available-for-sale securities.

A decline in an available-for-sale 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, net in the Condensed Consolidated Statement of Income. We had no significant other than temporary losses in value for the three and six months ended June 30, 2015 and 2014.

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 at June 30, 2015 and December 31, 2014 (in millions):

	Less than 12 months		Greater than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2015						
Common stock	$31.5	$1.7	$—	$—	$31.5	$1.7
December 31, 2014						
Common stock	$17.1	$1.3	$—	$—	$17.1	$1.3

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DST Systems, Inc.
Notes to Condensed Consolidated Financial Statements (continued)
(unaudited)

We are a limited partner in various private equity funds which are primarily accounted for using the cost method. At June 30, 2015 and December 31, 2014, our carrying value of these private equity fund investments was approximately $131.2 million and $141.4 million, respectively. At June 30, 2015, we had future capital commitments related to these private equity fund investments of approximately $5.2 million. Additionally, we have other investments with a carrying value of $14.6 million at both June 30, 2015 and December 31, 2014.

We record lower of cost or market valuation adjustments on cost method and other investments when impairment conditions, such as adverse market conditions or poor performance of the underlying investment, are present. We recorded no impairments on cost method and other investments during the three and six months ended June 30, 2015 and recorded $1.3 million and $1.6 million of impairments during the three and six months ended June 30, 2014, respectively.

3. Unconsolidated Affiliates

Investments in unconsolidated affiliates are as follows (in millions):

		Carrying Value	
	Ownership Percentage	June 30, 2015	December 31, 2014
International Financial Data Services (U.K. and L.P.)	50%	$201.7	$186.0
Boston Financial Data Services, Inc.	50%	80.1	77.6
Unconsolidated real estate and other affiliates		29.3	35.1
Total		$311.1	$298.7

Equity in earnings of unconsolidated affiliates are as follows (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
International Financial Data Services (U.K. and L.P.)	$9.7	$1.0	$17.0	$3.1
Boston Financial Data Services, Inc.	1.1	1.2	2.5	3.0
Unconsolidated real estate and other affiliates	2.0	7.4	8.2	8.9
Total	$12.8	$9.6	$27.7	$15.0

4. Fair Value Measurements

Authoritative accounting guidance on fair value measurements 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 June 30, 2015 and December 31, 2014, we held certain investment assets and certain liabilities that are required to be measured at fair value on a recurring basis. These investment assets include our money market funds, available-for-sale equity securities 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. Fair value for deferred compensation liabilities that are credited with deemed gains or losses of the underlying hypothetical investments, primarily equity securities, have been classified as Level 1. In addition, we have investments in pooled funds and interest rate and foreign currency derivative instruments that are required to be reported at fair value. Fair value for investments in pooled funds is determined using net asset value. Fair value for the derivative instruments was determined using inputs from quoted prices for similar assets and liabilities in active markets that are directly or indirectly observable. Accordingly, our investments in pooled funds and derivative instruments have been classified as Level 2.

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DST Systems, Inc.
Notes to Condensed Consolidated Financial Statements (continued)
(unaudited)

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

		Fair Value Measurements at Reporting Date Using		
	June 30, 2015	Quoted prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds (1)	$165.4	$165.4	$—	$—
Equity securities (2)	307.8	307.8	—	—
Pooled funds (2)	5.4	—	5.4	—
Deferred compensation liabilities (3)	(24.2)	(24.2)	—	—
Derivative instruments (3)	(0.4)	—	(0.4)	—
Total	$454.0	$449.0	$5.0	$—

		Fair Value Measurements at Reporting Date Using		
	December 31, 2014	Quoted prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds (1)	$141.0	$141.0	$—	$—
Equity securities (2)	500.6	500.6	—	—
Pooled funds (2)	5.6	—	5.6	—
Deferred compensation liabilities (3)	(25.1)	(25.1)	—	—
Derivative instruments (3)	(0.5)	—	(0.5)	—
Total	$621.6	$616.5	$5.1	$—

(1) Included in Cash and cash equivalents and Funds held on behalf of clients on the Condensed Consolidated Balance Sheet.
(2) Included in Investments on the Condensed Consolidated Balance Sheet.
(3) Included in Other liabilities on the Condensed Consolidated Balance Sheet.

5. Intangible Assets and Goodwill

Intangible assets

The following table summarizes intangible assets (in millions):

	June 30, 2015		December 31, 2014	
	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization
Amortizable intangible assets				
Customer relationships	$165.0	$63.6	$165.0	$57.8
Other	29.9	16.0	29.9	14.6

Total	$194.9	$79.6	$194.9	$72.4

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DST Systems, Inc.
Notes to Condensed Consolidated Financial Statements (continued)
(unaudited)

Amortization expense of intangible assets for three and six months ended June 30, 2015 was approximately $3.6 million and $7.2 million, respectively, as compared to $3.8 million and $7.6 million for the three and six months ended June 30, 2014, respectively. The following table summarizes the estimated annual amortization for intangible assets recorded as of June 30, 2015 (in millions):

Remainder of 2015	$7.1
2016	14.1
2017	14.0
2018	13.8
2019	13.1
Thereafter	53.2
Total	$115.3

Goodwill

The following table summarizes the changes in the carrying amount of goodwill for the six months ended June 30, 2015, by segment (in millions):

	December 31, 2014	Acquisitions	Disposals	Other	June 30, 2015
Financial Services	$234.4	$9.9	$—	$(4.9)	$239.4
Healthcare Services	155.0	—	—	—	155.0
Customer Communications	25.3	—	—	0.1	25.4
Total	$414.7	$9.9	$—	$(4.8)	$419.8

Due to the new segment reporting effective as of January 1, 2015, goodwill of approximately $6.7 million was reallocated from the Customer Communications segment to the Financial Services segment based on the relative fair values of the businesses transferred. Prior period amounts above have been revised to reflect the reallocated goodwill.

6. Debt

We are obligated under notes and other indebtedness as follows (in millions):

	June 30, 2015	December 31, 2014
Accounts receivable securitization program	$105.0	$120.0
Revolving credit facilities	13.9	44.3
Senior notes	370.0	370.0
Related party credit agreements	2.6	3.7
Other indebtedness	6.7	14.9
	498.2	552.9
Less current portion of debt	151.7	167.3
Long-term debt	$346.5	$385.6

Accounts receivable securitization program

We securitize certain of our domestic accounts receivable through an accounts receivable securitization program with a third-party bank. The maximum amount that can be outstanding under this program is $150.0 million. In May

2015, the Company renewed its accounts receivable securitization program. The facility will expire by its terms in May 2018, unless renewed.

The outstanding amount under the program was $105.0 million and $120.0 million at June 30, 2015 and December 31, 2014, respectively. During the six months ended June 30, 2015 and 2014, total proceeds from the accounts receivable securitization program were approximately $499.6 million and $505.1 million, respectively, and total repayments were approximately $514.6 million and $505.1 million, respectively.

Revolving credit facilities

At June 30, 2015, the syndicated line of credit facility provides for revolving unsecured credit in an aggregate principal amount of up to $850.0 million. During the six months ended June 30, 2015 and 2014, total proceeds from our revolving credit facilities were approximately $377.8 million and $521.2 million, respectively, and total repayments were approximately $408.2 million and $402.7 million respectively, which comprise the net cash flows presented within the financing section of the Condensed Consolidated Statement of Cash Flows.

Fair value

Based upon the borrowing rates currently available to us for indebtedness with similar terms and average maturities, the carrying value of long-term debt, with the exception of the Senior Notes, is considered to approximate fair value. The estimated fair values of the Senior Notes were derived principally from quoted prices for similar financial instruments (Level 2 in the fair value hierarchy).

As of June 30, 2015 and December 31, 2014, the carrying values and estimated fair values of the Senior Notes were as follows (in millions):

	June 30, 2015		December 31, 2014	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Senior notes - Series A	$40.0	$40.1	$40.0	$40.5
Senior notes - Series B	105.0	109.8	105.0	110.5
Senior notes - Series C	65.0			