ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC
Form 10-K
March 16, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K

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

For the fiscal year ended December 31, 2006

Commission file number 1-10367

Advanced Environmental Recycling Technologies, Inc.
(Exact name of Registrant as specified in its charter)

Delaware	**71-0675758**
(State of Incorporation)	*(I.R.S. Employer Identification No.)*
914 N Jefferson Street **Post Office Box 1237** **Springdale, Arkansas**	**72764**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code:
(479) 756-7400

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Class A common stock, $.01 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No þ

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: þ No: o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check one):

Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer o

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

On June 30, 2006, the last business day of the registrant s most recently completed second fiscal quarter, the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity of the registrant was $103,046,769 (for the purposes hereof, directors, executive officers and 10% or greater shareholders have been deemed affiliates).

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

Number of shares of common stock outstanding at March 12, 2007: **Class A 44,812,956; Class B 1,465,530**

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our Definitive Proxy Statement for the 2007 Annual Meeting to be held June 14, 2007, and expected to be filed within 120 days of our fiscal year end, are incorporated by reference into Part III.

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Item 1. *Business.*

Summary

Advanced Environmental Recycling Technologies, Inc. (AERT) develops, manufactures, and markets composite building materials that are used in place of traditional wood or plastic products for exterior applications in building and remodeling homes and for certain other industrial or commercial building purposes. Our products are made primarily from approximately equal amounts of waste wood fiber, which have been cleaned, sized and reprocessed, and recycled polyethylene plastics. Our products have been extensively tested, and are sold by leading national companies such as the Weyerhaeuser Company (Weyerhaeuser), Lowe s Companies, Inc. (Lowe s) and Therma-Tru Corporation. Since our inception in 1989, we have sold over $454.5 million of products into the North American marketplace. Our composite building materials are marketed as a substitute for wood and plastic filler materials for standard door components, windowsills, brick mould, fascia board, decking and heavy industrial flooring under the trade names LifeCycle®, MoistureShield®, MoistureShield® CornerLoc®, Weyerhaeuser ChoiceDek® Premium, ChoiceDek® Premium Colors, MoistureShield® outdoor decking, and Basics™ outdoor decking. Weyerhaeuser ChoiceDek® products are available exclusively through Lowe s Home Improvement stores. We operate manufacturing facilities in Springdale, Lowell, and Tontitown, Arkansas; Junction, Texas and Alexandria, Louisiana. We also operate a warehouse and reload complex in Lowell, Arkansas. Operations will commence in the second quarter of 2007 at our third composite extrusion plant, which we refer to as Springdale South . Our customers are primarily regional and national door and window manufacturers, Weyerhaeuser our primary decking customer and regional building product distributors.

Products

Using the same basic process and material, we manufacture the following product lines:

- Commercial and residential decking planks and accessories such as balusters and handrails (MoistureShield and Weyerhaeuser ChoiceDek),
- Exterior door and window components,
- Exterior housing trim (MoistureShield), and
- Fence boards

The wood fiber content of our products gives them many properties similar to all-wood products, but we believe the plastic content makes our products superior to either all-wood or all-plastic alternatives because:

- Unlike wood, our products do not require preservatives or treatment with toxic chemicals nor do they require yearly water sealing or staining.
- Our products are less subject to thermal contraction or expansion and have greater dimensional stability than competing all-plastic products.
- Our products are engineered for superior moisture-resistance and will not swell or expand like wood.

Our products can be designed and extruded through dies to a desired shape in accordance with customer specifications, which helps the customer to minimize waste.

Our products are less subject to rotting, cracking, warping, and splintering, insect infestation and water absorption than conventional wood materials.

Our products can be aesthetically enhanced to provide a wood-like or grained surface appearance.

When combined with our unique tie coat primer, the life of exterior paint can be greatly enhanced, thus creating a low-maintenance non-wood trim and fascia system designed to enhance and complement fiber cement siding.

Our products can be combined with coloring agents and/or other additives to provide different colors and aesthetics.

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AERT s composites manufacturing process involves proprietary technologies, certain of which are patented. We also use manufacturing equipment that has been custom-built or modified to our specifications. Our composite building material became a patented product in June 1998 under U.S. Patent No. 5,759,680.

Based upon our extensive product testing and successful extended field history of over a decade, we offer a limited lifetime replacement warranty on our products against rot and fungal decay, and termite and insect damage.

Marketing and Sales

General Market Strategy. We have manufactured wood plastic composite products since 1989. Our products are designed for applications where we can add the greatest value and address market needs, i.e. for external applications where wood is prone to rot and/or requires substantial yearly maintenance in the form of staining or water sealing. Though we believe there are many possible applications for our wood/plastic composite technology, we have focused our resources and personnel on outdoor decking, door and window components, and soon outdoor fencing, which in our view represent the most attractive market opportunities at this time. Within our chosen markets, we are constantly working to develop and improve strong customer relationships.

Outdoor Decking Systems. Beginning in 1995, we sold our decking products exclusively to Weyerhaeuser Building Materials. That changed in 2004 when we entered into a new contract whereby Weyerhaeuser purchased all of our ChoiceDek Premium decking products for resale exclusively to Lowe s Companies under the Weyerhaeuser ChoiceDek brand. The Weyerhaeuser contract required us to produce, and Weyerhaeuser to purchase, a minimum number of truckloads of ChoiceDek Premium decking and accessories, which amount was set by Weyerhaeuser each year subject to a minimum annual quantity of 1,850 truckloads. Terms have recently been reached with Weyerhaeuser on a new contract that will replace the 2004 contract. The new contract, which is substantially similar to the 2004 contract, is currently being circulated for signatures of all parties, including AERT s bondholders, who must approve. Both Weyerhaeuser and independent lumber dealers can also special order MoistureShield decking from the Weyerhaeuser distribution network in certain markets. Weyerhaeuser recently announced a new three year agreement to provide Lowe s the exclusive right to carry the ChoiceDek Premium product line, which Lowe s sells in all of its 1,300+ home improvement stores across the U.S. Weyerhaeuser and AERT were named Lowe s Vendor of the Year for lumber products in 2005. Lowe s promotes ChoiceDek Premium through a national print and advertising campaign and sponsorship of major sporting events such as the NCAA basketball Final Four tournament and NASCAR races. We believe our relationship with Weyerhaeuser strengthens our competitive position in the decking marketplace and gives us the opportunity to develop and sell new products through the same home improvement warehouse channel.

We promote our decking products through displays and presentations at national, regional, and local home, lawn, and garden shows, and through in-store displays. We have an on-going print advertising program that targets the residential decking market. Lowe s is also conducting a national print and television advertising campaign for ChoiceDek Premium.

Weyerhaeuser purchases accounted for about 81% of our 2006 gross sales. If Weyerhaeuser were to cancel the Weyerhaeuser contract, we would have to develop an alternative distribution system for decking products, which could be expensive and time consuming. Though Weyerhaeuser has purchased substantially all of our decking production since 1995, there is no assurance that it will continue to do so (see Item 1A. Risk Factors The loss of one or more of our key customers could cause a substantial reduction in our revenues and profits and Note 2 to the financial statements regarding concentration of risk).

In October 2004, we began production of our new MoistureShield brand line of decking products, which consists of four colors and a wood-like embossed surface pattern. MoistureShield decking is currently sold to select primary distributors, who re-sell it to lumber dealers and contractor yards for sale to local deck builders and home builders. MoistureShield decking sales represented about 9% of total Company sales in 2006 and 2005, during which we had limited production capacity available to serve that market. In 2007 and beyond, the MoistureShield decking line will allow us to diversify our customer base. It also allows us to diversify the risk inherent in selling such a large portion of our production to one customer, Weyerhaeuser. It is our intent to grow the MoistureShield decking program as we identify opportune markets and that, over time, MoistureShield will become a larger portion of our sales.

In February 2007 we began manufacturing our new Basics™ line of outdoor decking. With smaller dimensions and a lower price point, Basics is designed to effectively compete against the largest segment of the outdoor decking market, pressure treated wood. Basics will initially be available through select independent building products distributors.

Total wholesale revenue from outdoor decking products (deck boards and handrail systems) was estimated by an independent industry research organization to be about $5.1 billion in 2005 (most recent data available). Of that amount, about 19% was spent on wood/plastic composite products such as we manufacture. They estimate that annual unit sales of wood/plastic composite decking products grew about 25% per year from 2000 to 2005 and are expected to continue double digit annual growth for the foreseeable future. Most end-user sales are for remodeling jobs.

Privacy Fencing Systems. In January 2007, we announced our newest product, LifeCycle™ Fencing. We estimate the privacy fence market to be $5.5 billion annual sales with metal products comprising 63% of the market and wood/other products at 27%. We believe there is a substantial market for an aesthetically pleasing fence product that will serve for twenty years or more, which we expect LifeCycle Fencing to do. In fact, we intend to certify LifeCycle fencing for use in hurricane-prone regions of the U.S. where its strength and durability could give it a clear competitive advantage over other, less durable, fencing products. We plan to begin manufacturing LifeCycle fencing for limited introduction in the second quarter 2007.

Door and Window Products. We sell our MoistureShield industrial products to door and window manufacturers for use as component parts of their products. For example, we manufacture a windowsill that is built into products like Portrait windows by Stock Building Supply and we manufacture door rails built into doors by Therma-Tru Corporation. In marketing, we emphasize the value-added feature of the MoistureShield composite product, which, unlike competing wood products, can be engineered to incorporate certain desired end-product characteristics that save our customers time and expense. Customers also avoid the need for chemical treatments to their final product, which are otherwise often necessary to prevent rot and sustain durability. The durability of our MoistureShield composite components allows our customers to extend the lifetime or warranties of their products while reducing or eliminating warranty claims costs.

Therma-Tru and Stock Building Supply each purchase a large portion of our industrial products. The loss of either customer would negatively impact sales and earnings. We are unable to predict the future size of the markets for MoistureShield industrial products; however, we believe that the national door and window, commercial and residential trim, and residential decking material markets are large and growing and will allow us to diversify our customer base over time as we add production capacity and focus on additional opportunities.

Exterior Trim and Fascia Products. We market an exterior trim and fascia system under the trade names MoistureShield Trim and MoistureShield CornerLoc. Three national homebuilders are now specifying and using the product. With our previous limitations on production capacity and focus to meet the demand for our decking systems, we have limited our Trim and CornerLoc production to date. We believe this product line has significant growth potential, and we are striving to increase production capacity so that we can increase production and initiate a marketing program, in conjunction with our MoistureShield distributors. This product line is currently being redesigned. The timetable of a full product launch is dependent upon our construction and financing timetable and the start-up of our Springdale South manufacturing facility (see Item 2 Properties and Item 7 Liquidity and Capital Resources).

Sales and Customer Service. We provide sales support and customer service through our own marketing department, through outside commissioned representatives with an affiliated entity, through Weyerhaeuser, and through training programs for our customers and their sales associates. Our in-house sales and customer support team is focused on serving commercial decking contractors and supporting the sales professionals at our regional building products distributor customers as well as Weyerhaeuser and Lowe s. Information and customer service are provided through the websites www.choicedek.com and www.moistureshield.com, and through a national toll-free customer assistance telephone number. We also use independent, outside sales representatives in some markets to serve door, window, and decking customers.

Cyclical Nature of Building Products Industry. Our products are used primarily in home improvement and new home construction. The home improvement and housing construction industries are subject to significant fluctuations in activity and periodic downturns caused by general economic conditions. High interest rates and economic uncertainty in particular can lead to reduced homebuilding and/or home improvement activity, such as since mid-2006. Reductions in such activity has an adverse effect on the demand for our products. We have focused a large portion of our business on the remodel and repair market segment, which we believe is less sensitive to interest rate fluctuations than the new homebuilding market.

Product Innovation. In our constant pursuit of satisfying our customers, and to keep up with changing trends in the marketplace, we routinely analyze the need to develop new products and improve existing products.

Raw Materials

Wood Fiber. The wood fiber we use is waste byproduct generated by hardwood furniture, cabinet, and flooring manufacturers. The cost of acquiring the waste wood has primarily been the handling and transportation costs involved in getting the material to our facilities. Costs vary with transportation costs in general, which are related to petroleum prices and the supply and demand for over-the-road trucking services. Our cost of sourcing waste wood fiber has increased over the last three years due to transportation costs, but remains a small proportion of our total costs. The housing slowdown starting in mid-2006 reduced the demand for hardwood building products and has caused some of our suppliers to temporarily close facilities, which has forced us to pay higher costs to source wood elsewhere.

Two suppliers accounted individually for about 40% and collectively for approximately 80% of our 2006 waste wood fiber purchases. Based on our discussions with other waste wood fiber suppliers, we believe that if the arrangements with one or both of these suppliers were terminated we would be able to obtain adequate supplies of waste wood fiber at an acceptable price from new suppliers. We are currently evaluating the feasibility of establishing an in-house wood fiber reclamation and cleaning system in northwest Arkansas.

Recycled Plastics. We use the following classes of industrial and consumer waste polyethylene:

- Low density polyethylene (LDPE) poly coatings or linings from recycled bleached food-board, which are generated from the hydro-pulping process;
- High density polyethylene (HDPE) and linear low density polyethylene (LLDPE) mixed plastic grocery bags from supermarket and store collection programs;
- HDPE ground container material;
- LLDPE stretch film from warehouses and packing waste; and
- Virgin HDPE and LDPE pellets.

The largest portion of the materials we use is highly contaminated with paper and other non-plastic materials, which lessen its value to other plastic recyclers. Our proprietary recycling process does not require the purity, extensive cleaning, additional washing, and melt filtration required for conventional plastics manufacturing, and can be conducted faster and more economically. By using primarily these contaminated waste plastics, we produce a usable, but lower cost, feedstock for our composite extrusion lines. We also purchase plastic raw materials from outside sources, including virgin resin producers. These materials are more expensive and more sensitive to price swings related to the petrochemical industry. We also are subject to various quality and consistency problems when dealing with third party scrap suppliers, which increases our costs.

One supplier accounted for about 34% of our 2006 polyethylene scrap purchases by weight. No other of our more than 100 polyethylene suppliers accounted for more than 10% of our purchases by weight.

Over the last several years, we believe three factors have caused an increase in the demand for scrap polyethylene and, consequently, the cost to us of acquiring raw materials for our manufacturing process.

As world political events conspired to raise the price of petroleum there was a related rise in the price of virgin plastic, which is a petroleum and natural gas derivative. This in turn increased the demand for scrap plastics since scrap can be substituted for virgin plastics in many manufacturing applications. We thus began competing with scrap plastic consumers that had not previously been in the market.

The relative decline in the value of the dollar versus major Asian currencies has made it economical for Asian manufactures to source scrap plastic in the U.S. for use in their countries. We have thus encountered significant competition for scrap plastics from foreign consumers that had not previously been a factor in the market. Demand for petrochemical products from China, India and other rapidly expanding economies is expected to increase.

As annual sales of wood composite decking products have grown, we and other composite decking manufacturers have become relatively large consumers of scrap plastics, which has created increasing competition for raw materials and driven up prices.

On the other hand, we believe that the economics of recycling are now such that more private and public entities will find it attractive to undertake removing plastic scrap from the waste stream and make it available to consumers like us.

Supply Contracts. We purchase raw materials under both supply contracts and purchase orders. In 2006, we purchased 45% of our polyethylene scrap and all of our waste wood via purchase orders. Purchase order acquisitions are one-time transactions that involve no long-term obligation. We also have both polyethylene and wood supply contracts, with terms that range from one to three years, which obligate us to purchase materials. The prices under these contracts are renegotiated semi-annually or annually. In the past three years, the amounts we have been obligated to purchase under the supply contracts have been significantly less than the amounts of these materials we have needed for production.

Competition for Raw Materials. As the wood/plastic composites industry grows, we sometimes compete for raw materials with other plastic recyclers or plastic resin producers. We believe that our ability to use highly contaminated polyethylene limits the number of competitors because most recycling processes require cleaner waste plastic sources. Nonetheless, we expect to continue to encounter new entrants into the plastics reclamation business. These new entrants may have greater financial and other resources than we do, and may include domestic and foreign beverage bottlers, manufacturers, distributors and retailers, forestry product producers, petrochemical and other companies. We increased our capacity for processing waste plastic in 2006, which reduced our dependence on outside suppliers and reduces our overall costs but it is still not to desired levels. There is no assurance that we will be able to control the effect that increasing waste plastic costs has on our profitability. (see Item 7. Management s Discussion and Analysis Liquidity and Capital Resources.)

Patented and Proprietary Technology

Our composite manufacturing process and our development efforts in connection with waste plastics reclamation technologies involve patents and many trade secrets that we consider to be proprietary. We have also developed certain methods, processes, and equipment designs for which we have sought additional patent protection. We have taken measures to safeguard our trade secrets by, among other things, entering into confidentiality and nondisclosure agreements, and restricting access to our facilities. We also have installed advanced security systems, including limited access and cameras, at all facilities including on-site security personnel. Should our trade secrets be disclosed notwithstanding these efforts, our business and prospects could be materially and adversely affected.

We have filed nineteen patent applications and have received issuance from the United States Patent and Trademark Office for fourteen patents, five of which relate to our composite materials manufacturing operations and product, and nine of which relate to waste plastics reclamation technologies. The patents cover our composite product, extrusion process and apparatus, our continuous down-stream cooling and forming conveyor system and our plastic reclamation process and equipment. The cost of patent protection and, in particular, patent litigation is extremely high. It can also strain resources and inhibit growth.

Industry Standards

Local building codes often require that building materials meet strength and safety standards developed by the International Code Commission and that, in order to qualify, the materials be evaluated by an independent testing organization. Our decking, handrails and stair applications are covered in a National Evaluation Report (NER) under NER-596, which provides local building inspectors and code officials with independent testing and installation information regarding our products. We believe that the NER listing has helped to increase sales and market acceptance of our decking products. We have recently renewed our building code listing and are currently in the process of upgrading and increasing the number of products covered for additional building code approval.

Regulation

AERT is subject to federal, state, and local environmental regulations. Environmental discharges and impacts from our manufacturing facilities including air, solid waste, and wastewater discharges must meet the standards set by environmental regulatory authorities in Texas, Arkansas, and Louisiana. Compliance with environmental laws has not had a material effect on our operating results or financial condition.

Our operations are also subject to workplace safety regulation by the U.S. Occupational Safety and Health Administration, and the states of Arkansas, Texas, and Louisiana. We provide safety awareness and training programs for all associates who work in a manufacturing environment.

Competition

Competition for Sales. Our products compete with high-grade western pine, cedar and other premium woods, aluminum, high-performance plastics, and an increasing number of composites and other construction materials. We believe that our products have superior physical characteristics, which make them a better value for the consumer. Manufacturers of some competing products, however, have long-established ties to the building and construction industry and have well-accepted products. Many of our competitors are larger and have research and development budgets, marketing staffs, and financial and other resources that surpass our resources.

Sales of non-wood decking products to date represent a small portion of the decking market. According to an independent research report the wood-alternative market share was 19% in 2005 and continues to grow. Pressure treated pine, cedar, redwood and other traditional woods constitute the vast majority of annual decking sales. We thus view wood decking as our principal competitor. The wood decking industry is highly segmented with many small to medium sized manufacturers. Wood decking is principally a commodity that competes as the low-priced product, whereas the more-expensive non-wood products must compete on features and performance.

Among manufacturers of alternative decking materials, we view Trex Company, TimberTech Ltd., Louisiana-Pacific Corporation, Tamko Building Products and Fiber Composites LLC as our primary competitors.

The market for door, windowsill, and trim products is highly segmented, with many competitors. We believe that our MoistureShield industrial products have superior characteristics and are competitively priced. We emphasize durability, which means that manufacturers and homebuilders using our products should see reduced warranty callbacks and higher customer satisfaction. Our product competes on durability and the ability of the customer to order a product that is custom manufactured to its specifications.

Employees

On December 31, 2006, we employed 664 people on a full-time basis. We had 60 associates at the Texas facility, of which four were executive and/or office personnel and 56 were full-time factory personnel. The

Arkansas facilities, including our corporate office and field sales team, employed 578 full-time associates, of which 110 were executives and/or sales or office personnel and 468 were full-time factory personnel. We had 26 full-time associates at our Louisiana facility. From time-to-time, we hire part-time employees to supplement our workforce.

Item 1A. *Risk Factors.*

Our business is subject to a number of risks, including but not limited to the following:

We have a working capital deficit

At December 31, 2006, we had a working capital deficit of $3,466,129 and at December 31, 2005, we had a working capital deficit of $687,039. The working capital deficit is the result of losses from operations, our decision to finance capital projects with cash generated from operations, and our need to fund rapid growth in sales.

We may be unable to secure an adequate quantity and quality of raw materials at economical prices

The largest component of our raw material costs is scrap polyethylene. The price that we must pay for these materials is related to the market prices of natural gas and petroleum, which have been rising and volatile in recent years. Our future profitability is contingent on us being able to manage raw material costs under these circumstances.

The loss of one or more of our key customers could cause a substantial reduction in our revenues and profits

We could be materially adversely affected if we were to lose one or more of our large existing customers. Our principal customer for our decking material is Weyerhaeuser, which accounted for 81% and 77% of our sales in 2006 and 2005, respectively. A few large door and window construction companies have historically purchased substantially all of our industrial component products. A loss of any one of our large customers would adversely affect our sales and profitability.

If we are unable to comply with certain debt covenants, our financial position and operations could be adversely affected

The bond agreement contains financial covenants, which include a current ratio of not less than 1.00 to 1.00 and a requirement that not more than 10% of accounts payable be in excess of 75 days past the invoice date. We were not in compliance with these two covenants at December 31, 2006; however, these covenants were waived by the bondholder as of December 31, 2006 through, and including, December 31, 2007. There is no assurance that we will be able to comply with these debt covenants in the future, or that the bondholder will waive or modify the covenants in the future. If we are unable to comply with the covenants or obtain a waiver or modification of the covenants in the future, then the bond debt, currently in the amount of $14.7 million, could immediately become due and payable, the bondholder could foreclose on the property used to secure the debt, and the bondholder could claim our revenues pledged as part of the bond agreement.

Restrictions regarding increased manufacturing capabilities could restrain our business growth

We increased our sales by $10.5 million in 2006, $23.7 million in 2005 and $20.1 million in 2004. Our products have seen significant growth, and our customers have significant established expansion plans. Our primary customers and markets are large, and continued sales growth will require significant capital expenditures for additional production equipment and manufacturing facilities. Although our goal is to become the number one composite producer in North America, there is no assurance that we will be able to secure the necessary financing, attain the necessary operational execution, or that the equipment and facilities will become operational in a timely manner to meet that goal.

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Our growth is limited by the availability of human capital resources

Future profitable growth will require us to recruit and retain qualified associates. We compete with many larger companies in the labor market, many of whom offer more attractive compensation packages than we are able to economically provide. Though we have adopted equity compensation plans to aid in our efforts to recruit and retain qualified associates, the accounting treatment for those plans results in a reduction in our earnings.

Declines in construction activity may adversely affect our business

Our products are sold in the home improvement and new home construction markets. These markets are subject to significant fluctuations in activity and periodic downturns caused by general economic conditions, as has been the case since mid-2006. Slowdowns in construction activity have an adverse effect on the demand for our products.

Fire disruptions may adversely affect our business

Our raw materials and manufacturing processes involve a greater than average risk of fire loss or disruption. Through the Company s history, we have experienced several fires, some of which severely disrupted our manufacturing operations. There was an accidental fire at our Junction, Texas facility in March 2003, which caused substantial damage and temporarily shut down plant operations. Although we have increased security and increased fire protection equipment at our facilities, another major fire could occur and materially adversely affect our operations.

Covenants in our bond agreements could restrict our ability to borrow, which could impair the improvement and expansion of our operations

Certain covenants in our bond agreements restrict the types and amounts of additional indebtedness that we may incur, including a requirement that, with certain exceptions, we may only incur additional indebtedness to the extent it would satisfy a debt incurrence coverage ratio of 250% of income before interest, taxes, depreciation and amortization to debt service. Those restrictions could inhibit our ability to improve and expand our current operations. Additionally, our ability to secure adequate working capital to support our day-to-day operations as we grow could be limited by the covenants in our bond agreements.

Future sales of shares could be dilutive and impair our ability to raise capital

The conversion of a significant number of our outstanding derivative securities into Class A common stock could adversely affect the market price of the stock. At December 31, 2006, there were warrants outstanding for 4,606,132 shares of Class A common stock at an average exercise price of $1.21, and options outstanding for 2,872,130 shares of Class A common stock at an average exercise price of $1.09. The exercise or conversion of a material amount of such securities will result in a dilution in interest for our other security holders. The convertible securities, whether converted into stock or not, could impair our ability to obtain additional capital because of the potential for dilution. Also, the holders of such securities may be expected to exercise their rights at a time when we would in all likelihood be able to obtain needed capital through a new offering of our securities on terms more favorable than those provided by the outstanding securities.

Item 1B. ***Unresolved Staff Comments.***

None.

Item 2. ***Properties.***

We operate the following manufacturing and recycling facilities:

We manufacture our MoistureShield and Weyerhaeuser ChoiceDek brand lines of decking products at our Springdale, Arkansas extrusion plant. That facility also produces door, window, and housing trim components. Springdale had four extrusion lines and a plastic recycling facility throughout 2006. The Springdale plant consists of 103,000 square feet and is located on ten-acres with a rail siding in the Springdale industrial district. Since 1999, we have added 30,440 square feet of shed storage space and installed a dual sprinkler system.

We lease an office, storage building, and parking lot adjacent to the Springdale facility. The lease is renewable yearly. The office and storage facility is comprised of 10,000 square feet on 2.36 acres and houses our corporate offices.

Our Junction, Texas facility manufactures primarily Weyerhaeuser ChoiceDek and Basics decking products. A fire in March 2003 reduced production capacity for the rest of 2003, but production increased through 2003 and 2004 as fire damage was repaired. Full restoration was slowed by litigation with one of the insurance carriers responsible for paying for fire damage (see Item 3. Legal Proceedings). The Junction plant consists of a 49,000 square foot manufacturing and storage facility on a seven-acre site. We believe that the Junction facility is currently suitable for composite materials manufacturing requirements on a regional basis.

Our industrial products paint system and finishing operations are in a 50,000 square foot facility near Tontitown, Arkansas.

We operate a 45,000 square foot facility at Lowell, Arkansas, which is used for plastic recycling, blending, and storage, and includes a railroad loading/unloading spur, truck scale, receiving station, and finished goods storage.

We operate two 100,000 square foot warehouses in Lowell, Arkansas that are connected by rail spurs and are used for raw materials storage. We also operate a 125,000 square foot warehouse in the same complex, which is used for finished goods processing and distribution. We have signed a lease for a 150,000 square foot warehouse, also in the Lowell complex, which will be used for both raw material and finished goods handling. We also lease ten acres of land adjacent to our Lowell plastic plant for storage and load-out of finished goods; this operation is designed to load up to five railcars and ten trucks at a time.

We lease a 30,000 square foot raw materials warehouse in Springdale, about a mile from our main factory. That facility will be abandoned when the new warehouse at Lowell becomes available.

We lease plastic recycling equipment and factory space in Alexandria, Louisiana, which commenced operations in June 2003. The lease is for five years from June 2003 through June 2008. We have made improvements and installed additional equipment to increase the facility s throughput. The upgrades provide flexibility to economically process different types of scrap plastic and to provide plastic feedstock of a quality and consistency necessary to efficiently operate our extrusion facilities.

We have constructed a new extrusion factory just to the south of our existing Springdale plant. Startup has been delayed twice by faulty equipment supplied by vendors. We believe we can begin operating the first of Springdale South s planned four production lines in the second quarter of 2007, but there is no assurance that we will be able to meet our current schedule. We anticipate installing the other three lines over the course of the next two years, subject to continued growth in demand for our products, availability of financing or adequate cash flow.

Item 3. *Legal Proceedings.*

Lloyd s of London

We have been sued by certain underwriters at Lloyd s of London (Lloyd s) in connection with a settlement of our Junction, Texas fire claim. Lloyd s filed suit January 19, 2005 in the Circuit Court of Washington County, Arkansas initially claiming we had committed fraud in the submission of our claim for damages and seeking a court order declaring the Lloyd s policy void from the inception. Following extensive discovery and depositions, Lloyd s amended the lawsuit and dropped the allegations of fraud and their request for an order declaring the policy void and filed an amended claim alleging we did not rebuild the facility exactly as it had existed prior to the March 2003 fire and also asking the court to decide what assets are part of the building and what assets are business property and to make certain declarations of coverage. The filing was unexpected by us because we cooperated fully with the claims underwriting process and believed that negotiations toward a final settlement of the claim were progressing.

We believe the Lloyd s lawsuit is without merit. We filed our initial counterclaim on January 24, 2005 denying all of Lloyd s allegations and seeking immediate and full reimbursement for rebuilding of the Junction plant. The counterclaim was subsequently amended and we were seeking not only to recover at least $2.4 million in actual damages, including additional business disruption damages, but also punitive damages for acts of bad faith committed by Lloyd s in their initial handling of the claim.

The parties participated in an unsuccessful court-ordered mediation on March 13, 2006. A summary judgment hearing was conducted on June 27, 2006, following which the Court ruled our business disruption loss is limited to $1.0 million, which reduces our current claim to $1.5 million; however, the Court ordered we could present the bad faith claim we filed against Lloyd s to the jury and if we are successful the jury can award punitive damages over and above the $1.5 million in actual damages. Trial has been set for August 6, 2007.

Advanced Control Solutions

On March 3, 2006, a Benton County Circuit Court jury found AERT liable for $655,769 in damages to Advanced Control Solutions (ACS) for future business opportunities that ACS alleges it lost when AERT discontinued using ACS programming and electrical contractor services and for missing equipment. The jury found that AERT also interfered with certain non-compete provisions of an employment agreement between ACS and an employee by hiring the employee after he had been terminated by ACS in December 2003. The jury also awarded AERT judgment against ACS for approximately $45,000 for ACS s failure to complete a programming contract. AERT has begun the appeal process at the Arkansas Supreme Court of Appeals, which we expect to take up to two years to resolve.

Other Matters

AERT is involved in other litigation arising from the normal course of business. In management s opinion, this litigation is not expected to materially impact the Company s results of operations or financial condition.

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

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2006.

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PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.***

Our Class A common stock is traded on the NASDAQ Capital Market System under the symbol ***AERT.*** As of March 12, 2007, there were approximately 1,600 holders of record of Class A common stock and 11 holders of record of Class B common stock. The price of our common stock was $2.02 on December 31, 2006. We have not previously paid cash dividends on the common stock and there are currently restrictions under various debt obligations that would prevent the payment of such dividends for the foreseeable future. The following table sets forth the range of high and low quarterly sales prices (as reported by NASDAQ) of our Class A common stock for the years ended December 31, 2006 and 2005.

	High	Low
Sales Price Range of Class A Common Stock		
Fiscal 2005		
First Quarter	$ 1.85	$ 1.25
Second Quarter	1.59	1.21
Third Quarter	1.74	1.19
Fourth Quarter	1.79	1.25
Fiscal 2006		
First Quarter	2.56	1.58
Second Quarter	3.71	1.95
Third Quarter	3.32	2.10
Fourth Quarter	2.37	1.48

No repurchases of common stock took place during 2006.

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Item 6. *Selected Financial Data.*

The following tables set forth selected historical data for the years ended December 31, 2002 through 2006, derived from our audited financial statements for each such year and should be read in conjunction with such financial statements and the footnotes attached thereto as well as the discussion contained herein in *Management s Discussion and Analysis of Financial Condition and Results of Operations*. Certain prior period amounts have been reclassified to conform to the current period presentation.

	Year Ended December 31,				
	2006	**2005**	**2004**	**2003**	**2002**
ements					
rations					
a:					
sales	$ 97,840,126	$ 87,312,560	$ 63,637,285	$ 43,520,563	$ 41,415,4
me (loss) re nordinary , accrued nium on erred k and me taxes	968,585	3,583,370	1,369,983	(665,921)	1,193,333

Average shares outstanding (in thousan

Basic
109,739

109,515

109,684

107,752

Potentially dilutive common shares
388

347

377

2,052

Diluted
110,127

109,862

110,061

109,804

Cash dividends declared per common share
$
0.195

$
—

$
0.585

$
—

See accompanying notes to consolidated financial statements.

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Kansas City Southern
Consolidated Statements of Comprehensive Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In millions) (Unaudited)			
Net income	$90.7	$100.1	$286.9	$235.9
Other comprehensive income (loss):				
Unrealized loss on cash flow hedges arising during the period, net of tax of $(0.2) million and $(0.6) million	(0.4)	—	(1.0)	—
Reclassification adjustment from cash flow hedges included in net income, net of tax of $0.1 million, $0.2 million and $0.2 million	0.1	—	0.3	0.2
Amortization of prior service credit, net of tax of $(0.1) million	—	—	(0.1)	(0.1)
Foreign currency translation adjustments, net of tax of $0.3 million, $(0.5) million, $0.3 million and $(0.4) million	0.5	(1.0)	0.7	(0.6)
Other comprehensive income (loss)	0.2	(1.0)	(0.1)	(0.5)
Comprehensive income	90.9	99.1	286.8	235.4
Less: Comprehensive income attributable to noncontrolling interest	0.6	0.3	1.4	1.3
Comprehensive income attributable to Kansas City Southern and subsidiaries	$90.3	$98.8	$285.4	$234.1

See accompanying notes to consolidated financial statements.

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Kansas City Southern
Consolidated Balance Sheets

	September 30, 2012	December 31, 2011
	(In millions, except share amounts)	
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 187.0	$ 72.4
Accounts receivable, net	200.8	166.0
Materials and supplies	123.6	109.6
Deferred income taxes	135.7	225.0
Other current assets	35.3	69.5
Total current assets	682.4	642.5
Investments	59.7	50.4
Restricted funds	7.7	21.7
Property and equipment (including concession assets), net	5,551.6	5,349.5
Other assets	122.8	108.9
Total assets	$ 6,424.2	$ 6,173.0
LIABILITIES AND EQUITY		
Current liabilities:		
Debt due within one year	$ 51.8	$ 36.3
Accounts payable and accrued liabilities	436.3	401.1
Total current liabilities	488.1	437.4
Long-term debt	1,557.0	1,602.8
Deferred income taxes	892.0	861.4
Other noncurrent liabilities and deferred credits	173.9	212.7
Total liabilities	3,111.0	3,114.3
Commitments and contingencies	—	—
Stockholders’ equity:		
$25 par, 4% noncumulative, preferred stock, 840,000 shares authorized, 649,736 shares issued, 242,170 shares outstanding	6.1	6.1
$.01 par, common stock, 400,000,000 shares authorized; 123,352,185 shares issued; 110,044,355 and 109,910,857 shares outstanding at September 30, 2012 and December 31, 2011, respectively	1.1	1.1
Paid-in capital	916.5	884.2
Retained earnings	2,096.2	1,875.3
Accumulated other comprehensive loss	(2.3)	(2.2)
Total stockholders’ equity	3,017.6	2,764.5
Noncontrolling interest	295.6	294.2
Total equity	3,313.2	3,058.7
Total liabilities and equity	$ 6,424.2	$ 6,173.0

See accompanying notes to consolidated financial statements.

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Kansas City Southern
Consolidated Statements of Cash Flows

	Nine Months Ended September 30,	
	2012	2011
	(In millions) (Unaudited)	
Operating activities:		
Net income	$286.9	$235.9
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	146.9	139.1
Deferred income taxes	142.3	120.2
Equity in net earnings of unconsolidated affiliates	(15.1)	(13.6)
Share-based compensation	8.3	6.4
Excess tax benefit from share-based compensation	(22.2)	—
Deferred compensation	7.3	15.9
Elimination of deferred statutory profit sharing liability	(47.8)	—
Distributions from unconsolidated affiliates	7.3	9.1
Gain on insurance recoveries related to hurricane damage	—	(25.6)
Cash payments related to hurricane damage	—	(1.9)
Insurance proceeds related to hurricane damage	—	36.6
Debt retirement costs	18.0	14.2
Changes in working capital items:		
Accounts receivable	(38.9)	(26.9)
Materials and supplies	(10.0)	(11.8)
Other current assets	3.0	(0.1)
Accounts payable and accrued liabilities	49.6	14.9
Other, net	(19.6)	(47.3)
Net cash provided by operating activities	516.0	465.1
Investing activities:		
Capital expenditures	(319.2)	(284.0)
Property investments in MSLLC	(31.4)	(29.0)
Insurance proceeds related to hurricane damage	—	12.4
Proceeds from disposal of property	12.2	6.8
Other, net	10.2	1.6
Net cash used for investing activities	(328.2)	(292.2)
Financing activities:		
Proceeds from issuance of long-term debt	329.7	500.0
Repayment of long-term debt	(363.8)	(521.9)
Debt costs	(19.3)	(18.2)
Proceeds from employee stock plans	1.1	1.8
Excess tax benefit from share-based compensation	22.2	—
Dividends paid	(43.1)	(2.9)
Net cash used for financing activities	(73.2)	(41.2)
Cash and cash equivalents:		

Net increase during each period	114.6	131.7
At beginning of year	72.4	85.4
At end of period	$187.0	$217.1

See accompanying notes to consolidated financial statements.

Kansas City Southern
Notes to Consolidated Financial Statements

1. Accounting Policies, Interim Financial Statements and Basis of Presentation
In the opinion of the management of KCS, the accompanying unaudited consolidated financial statements contain all adjustments necessary for a fair presentation of the results for interim periods. All adjustments made were of a normal and recurring nature. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted. These consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. The results of operations for the three and nine months ended September 30, 2012, are not necessarily indicative of the results to be expected for the full year ending December 31, 2012. Certain prior year amounts have been reclassified to conform to the current year presentation. Effective January 1, 2012, the Company adopted, on a retrospective basis, the new accounting guidance on the presentation of comprehensive income. As a result of the adoption, the Company reports net income and other comprehensive income in two separate consecutive statements.

2. Earnings Per Share Data
Basic earnings per common share is computed by dividing net income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share adjusts basic earnings per common share for the effects of potentially dilutive common shares, if the effect is not anti-dilutive. Potentially dilutive common shares include the dilutive effects of shares issuable under the Stock Option and Performance Award Plans and shares issuable upon the conversion of preferred stock to common stock. During the first quarter of 2011, the Company converted all of the remaining outstanding Cumulative Convertible Perpetual Preferred Stock, Series D, into 6,999,887 shares of common stock.
The following table reconciles the basic earnings per share computation to the diluted earnings per share computation (in millions, except share and per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income available to common stockholders for purposes of computing basic earnings per share	$90.0	$99.8	$285.3	$233.1
Effect of dividends on conversion of convertible preferred stock	—	—	—	1.3
Net income available to common stockholders for purposes of computing diluted earnings per share	$90.0	$99.8	$285.3	$234.4
Weighted-average number of shares outstanding (in thousands):				
Basic shares	109,739	109,515	109,684	107,752
Effect of dilution	388	347	377	2,052
Diluted shares	110,127	109,862	110,061	109,804
Earnings per share:				
Basic earnings per share	$0.82	$0.91	$2.60	$2.16
Diluted earnings per share	$0.82	$0.91	$2.59	$2.13
Potentially dilutive shares excluded from the calculation (in thousands):				
Stock options excluded as their inclusion would be anti-dilutive	—	121	81	97

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

3. Elimination of Deferred Statutory Profit Sharing Liability, Net
During the second quarter of 2012, the Company completed an organizational restructuring whereby all employees of Kansas City Southern de México, S.A. de C.V. ("KCSM") became employees of KCSM Servicios, S.A. de C.V. ("KCSM Servicios"), a wholly-owned subsidiary of the Company. KCSM Servicios provides employee services to KCSM, and KCSM pays KCSM Servicios market-based rates for these services. The effective date of this organizational restructuring was May 1, 2012.
Mexican employees are entitled to receive Mexican statutory profit sharing. The related cash payment to employees is based on an employer's net profit determined under accounting principles prescribed in Mexican law, rather than its net profit determined under U.S. GAAP. U.S. GAAP requires the recording of deferred liabilities or assets for financial reporting purposes on the differences between the amounts determined under the two different accounting principles.
As a result of the organizational restructuring, KCSM's obligation to pay Mexican statutory profit sharing terminated on the effective date. Accordingly, in the second quarter of 2012, KCSM recognized a $43.0 million net reduction to operating expense. This reduction includes the elimination of $47.8 million of the deferred Mexican statutory profit sharing liability, net of $4.8 million of transaction costs. KCSM Servicios became obligated to pay Mexican statutory profit sharing to its employees beginning on the effective date of the organizational restructuring.

4. Hurricane Alex
In the third quarter of 2011, the Company settled its insurance claim related to Hurricane Alex, which struck in 2010 and resulted in extensive damage to KCSM's track and bridge infrastructures, caused multiple track-related incidents and significantly disrupted the Company's rail service. As a result of this settlement, the Company recognized a gain on insurance recoveries of $25.6 million in the third quarter of 2011. This gain primarily represented the recovery of lost profits and the replacement value of property in excess of its carrying value, net of the self-insured retentions.

5. Property and Equipment (including Concession Assets)
Property and equipment, including concession assets, and related accumulated depreciation and amortization are summarized below (in millions):

	September 30, 2012	December 31, 2011
Land	$208.1	$207.4
Concession land rights	141.2	141.2
Road property	5,461.0	5,326.0
Equipment	861.1	833.7
Technology and other	125.5	123.3
Construction in progress	251.6	153.1
Total property	7,048.5	6,784.7
Accumulated depreciation and amortization	1,496.9	1,435.2
Property and equipment (including concession assets), net	$5,551.6	$5,349.5

Concession assets, net of accumulated amortization of $387.0 million and $347.1 million, totaled $1,893.3 million and $1,855.1 million at September 30, 2012 and December 31, 2011, respectively.

6. Fair Value Measurements
Assets and liabilities recognized at fair value are required to be classified into a three-level hierarchy. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability. Level 3

inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value in its entirety requires judgment and considers factors specific to the asset or liability.

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

The Company's derivative financial instruments are measured at fair value on a recurring basis and consisted of interest rate swap liabilities of $1.1 million as of September 30, 2012, which are classified as Level 2. The Company determines the fair value of its derivative financial instrument positions based upon pricing models using inputs observed from actively quoted markets. Pricing models take into consideration the contract terms as well as other inputs, including forward interest rate curves.
The Company's short-term financial instruments include cash and cash equivalents, accounts receivable, and accounts payable. The carrying value of the short-term financial instruments approximates their fair value.
The fair value of the Company's debt is estimated using quoted market prices when available. When quoted market prices are not available, fair value is estimated based on current market interest rates for debt with similar maturities and credit quality. The fair value of the Company's debt was $1,723.7 million and $1,741.3 million at September 30, 2012 and December 31, 2011, respectively. The carrying value was $1,608.8 million and $1,639.1 million at September 30, 2012 and December 31, 2011, respectively. If the Company's debt was measured at fair value, the individual debt instruments would have been classified as either Level 1 or Level 2 in the fair value hierarchy.

7. Derivative Instruments
In general, the Company enters into derivative transactions in limited situations based on management's assessment of current market conditions and perceived risks. However, management intends to respond to evolving business and market conditions and in doing so, may enter into such transactions more frequently as deemed appropriate.
Credit Risk. As a result of the use of derivative instruments, the Company is exposed to counterparty credit risk. The Company manages this risk by limiting its counterparties to large financial institutions which meet the Company's credit rating standards and have an established banking relationship with the Company. As of September 30, 2012, the Company did not expect any losses as a result of default of its counterparties.
Interest Rate Swaps. On March 5, 2012, The Kansas City Southern Railway Company ("KCSR"), a wholly-owned subsidiary of KCS, entered into four amortizing interest rate swaps with an aggregate notional amount of $320.0 million, which have been designated as cash flow hedges. The interest rate swaps effectively convert interest payments on a portion of outstanding term loans of KCSR from variable rates to fixed rates. The swaps are highly effective and as a result there will be minimal earnings impact associated with ineffectiveness of these hedges. As of September 30, 2012, the hedging instruments have an aggregate notional amount of $308.5 million at a fixed rate of 0.4942%. Settlements are indexed to the one-month London Interbank Offered Rate ("LIBOR") and will occur monthly through March 31, 2014.
The following table presents the fair value of derivative instruments included in the consolidated balance sheet (in millions):

	Liability Derivatives		
	Balance Sheet Location	September 30, 2012	December 31, 2011
Derivatives designated as hedging instruments:			
Interest rate swaps	Other noncurrent liabilities & deferred credits	$1.1	$—
Total derivatives designated as hedging instruments		1.1	—
Total derivatives		$1.1	$—

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

The following table presents the amounts affecting the consolidated statements of income for the three months ended September 30 (in millions):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain/(Loss) Recognized in OCI on Derivative (Effective Portion)		Location of Gain/(Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain/(Loss) Reclassified from Accumulated OCI into Income (Effective Portion)		Location of Gain/ (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain/ (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	
	2012	2011		2012	2011		2012	2011
Interest rate swaps	$ (0.6)	$ —	Interest expense	$ (0.2)	$ —	Interest expense	$ —	$ —
Total	$ (0.6)	$ —		$ (0.2)	$ —		$ —	$ —

The following table presents the amounts affecting the consolidated statements of income for the nine months ended September 30 (in millions):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain/(Loss) Recognized in OCI on Derivative (Effective Portion)		Location of Gain/(Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain/(Loss) Reclassified from Accumulated OCI into Income (Effective Portion)		Location of Gain/ (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain/ (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	
	2012	2011		2012	2011		2012	2011
Interest rate swaps	$ (1.6)	$ —	Interest expense	$ (0.5)	$ (0.4)	Interest expense	$ —	$ —
Total	$ (1.6)	$ —		$ (0.5)	$ (0.4)		$ —	$ —

As of September 30, 2012, the Company expects that approximately $0.9 million of net losses will be reclassified from accumulated other comprehensive loss into interest expense over the next 12 months.

8. Long-Term Debt

KCSR 8.0% Senior Notes. On January 25, 2012, pursuant to an offer to purchase and related solicitation of consents, KCSR commenced a cash tender offer for all of its $275.0 million outstanding aggregate principal amount of 8.0% Senior Notes due June 1, 2015 (the "8.0% Senior Notes"), and a consent solicitation to amend the related indenture (the "Proposed Amendments") to eliminate substantially all of the restrictive covenants contained therein. In conjunction with receiving the requisite consents, on February 13, 2012, the Company entered into the First Supplemental Indenture to effect the Proposed Amendments, which became operative on February 24, 2012.

On February 24, 2012, KCSR purchased $174.7 million principal amount of the tendered 8.0% Senior Notes in accordance with the terms and conditions of the tender offer set forth in the offer to purchase using the proceeds received under the Amendment No. 1 and Additional Term Advance Agreement ("Amendment No. 1") to the existing KCSR Amended and Restated Credit Agreement dated as of July 12, 2011 (the "Credit Agreement"), and available cash. On June 1, 2012, KCSR redeemed the remaining $100.3 million principal amount of the 8.0% Senior Notes using additional proceeds received under Amendment No. 1 to the Credit Agreement and cash on hand, at a redemption price of 104% of the principal amount.

KCSR Credit Agreement and Additional Term A Advances. On February 24, 2012, KCS, KCSR and certain other subsidiaries of the Company that guaranty the Credit Agreement entered into Amendment No. 1, which provides for additional Term A advances to KCSR in an aggregate principal amount of $275.0 million (the “Additional Term A Advances”) on substantially the same terms as those applicable to the existing Term A facility under the Credit Agreement. KCSR borrowed $175.0 million of the Additional Term A Advances on February 24, 2012, the effective date of Amendment No. 1, and borrowed the remaining $100.0 million of Additional Term A Advances on June 1, 2012.

The proceeds of the $275.0 million of borrowings under the Additional Term A Advances and available cash were used to purchase and redeem all of KCSR’s 8.0% Senior Notes, as described above.

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

The outstanding principal balance of the Additional Term A Advances bear interest at floating rates. At KCSR's option, the loans will bear interest at either the (i) greater of the (a) Bank of Nova Scotia's base rate, (b) federal funds rate plus 0.50% or (c) one-month LIBOR plus 1.00% (the "Base Rate") plus a margin of 0.25% or (ii) LIBOR plus a margin of 1.25%.
Except as amended and supplemented by Amendment No. 1, all terms of the Credit Agreement remain in full force and effect.
KCSR RRIF Loan Agreement. On February 21, 2012, KCSR, as borrower, entered into a financing agreement with the United States of America represented by the Secretary of Transportation acting through the Administrator of the Federal Railroad Administration.
The financing agreement provides KCSR with a 25-year, $54.6 million loan under the Railroad Rehabilitation and Improvement Financing Program (the "KCSR RRIF Loan"). The proceeds of the KCSR RRIF Loan were used to reimburse KCSR for 80% of the purchase price of thirty new locomotives (the "Locomotives") acquired by KCSR in the fourth quarter of 2011. The outstanding principal balance bears interest at 2.96% per annum. KCSR is required to make quarterly principal and interest payments on the KCSR RRIF Loan commencing March 15, 2012, except for the first payment that was comprised solely of interest accrued from the date the funds were advanced to KCSR, which was February 24, 2012.
The obligations under the financing agreement are secured by a first priority security interest in the Locomotives and certain related rights. In addition, the Company has agreed to guarantee repayment of the amounts due under the financing agreement and certain related agreements.
The financing agreement contains representations, warranties, covenants and events of default that are similar to those contained in other KCSR debt agreements. The occurrence of an event of default could result in the acceleration of the repayment of any outstanding principal balance of the KCSR RRIF Loan.
KCSR Revolving Credit Facility. During the first quarter of 2012, the Company repaid the December 31, 2011 outstanding balance of $50.0 million on KCSR's revolving credit facility.

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

	Three Months Ended September 30, 2012			Three Months Ended September 30, 2011		
	Kansas City Southern Stockholders' Equity	Noncontrolling Interest	Total Equity	Kansas City Southern Stockholders' Equity	Noncontrolling Interest	Total Equity
Beginning balance	$2,937.4	$ 295.0	$3,232.4	$2,567.8	$ 285.6	$2,853.4
Net income	90.1	0.6	90.7	99.8	0.3	100.1
Other comprehensive income (loss)	0.2	—	0.2	(1.0)	—	(1.0)
Dividends on common stock	(21.5)	—	(21.5)	—	—	—
Dividends on $25 par preferred stock	(0.1)	—	(0.1)	—	—	—
Options exercised and stock subscribed, net of shares withheld for employee taxes	0.8	—	0.8	1.3	—	1.3
Tax benefit from share-based compensation	8.1	—	8.1	—	—	—
Share-based compensation	2.6	—	2.6	1.1	—	1.1
Ending balance	$3,017.6	$ 295.6	$3,313.2	$2,669.0	$ 285.9	$2,954.9

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

	Nine Months Ended September 30, 2012			Nine Months Ended September 30, 2011		
	Kansas City Southern Stockholders' Equity	Noncontrolling Interest	Total Equity	Kansas City Southern Stockholders' Equity	Noncontrolling Interest	Total Equity
Beginning balance	$2,764.5	$ 294.2	$3,058.7	$2,431.1	$ 282.6	$2,713.7
Net income	285.5	1.4	286.9	234.6	1.3	235.9
Other comprehensive loss	(0.1)	—	(0.1)	(0.5)	—	(0.5)
Contribution from noncontrolling interest	—	—	—	—	2.0	2.0
Conversion of series D cumulative convertible preferred stock	—	—	—	(0.2)	—	(0.2)
Common stock issued for conversion of series D cumulative convertible preferred stock	—	—	—	0.2	—	0.2
Dividends on common stock	(64.4)	—	(64.4)	—	—	—
Dividends on $25 par preferred stock	(0.2)	—	(0.2)	(0.2)	—	(0.2)
Dividends on series D cumulative preferred stock	—	—	—	(2.7)	—	(2.7)
Options exercised and stock subscribed, net of shares withheld for employee taxes	1.8	—	1.8	0.3	—	0.3
Tax benefit from share-based compensation	22.2	—	22.2	—	—	—
Share-based compensation	8.3	—	8.3	6.4	—	6.4
Ending balance	$3,017.6	$ 295.6	$3,313.2	$2,669.0	$ 285.9	$2,954.9

Common Stock Dividend
On August 7, 2012, the Company's Board of Directors declared a cash dividend of $0.195 per share payable on October 3, 2012, to common stockholders of record as of September 10, 2012. The aggregate amount of the dividend declared was $21.5 million.

10. Commitments and Contingencies
Concession Duty. Under KCSM's 50-year railroad concession from the Mexican government (the "Concession"), KCSM paid concession duty expense of 0.5% of gross revenues for the first 15 years of the Concession period and, on June 24, 2012, KCSM began paying 1.25% of gross revenues, which is effective for the remaining years of the Concession. For the three and nine months ended September 30, 2012, the concession duty expense, which is recorded within materials and other in operating expenses, was $3.5 million and $6.2 million, respectively, compared to $1.3 million and $3.7 million for the same periods in 2011.
Litigation. The Company is a party to various legal proceedings and administrative actions, all of which, except as set forth below, are of an ordinary, routine nature and incidental to its operations. Included in these proceedings are various tort claims brought by current and former employees for job-related injuries and by third parties for injuries related to railroad operations. KCS aggressively defends these matters and has established liability provisions, which management believes are adequate to cover expected costs. Although it is not possible to predict the outcome of any

legal proceeding, in the opinion of management, other than those proceedings described in detail below, such proceedings and actions should not, individually, or in the aggregate, have a material adverse effect on the Company's consolidated financial statements.

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

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

The Company's Mexico operations are subject to Mexican federal and state laws and regulations relating to the protection of the environment through the establishment of standards for water discharge, water supply, emissions, noise pollution, hazardous substances and transportation and handling of hazardous and solid waste. The Mexican government may bring administrative and criminal proceedings, impose economic sanctions against companies that violate environmental laws, and temporarily or even permanently close non-complying facilities.
The risk of incurring environmental liability is inherent in the railroad industry. As part of serving the petroleum and chemicals industry, the Company transports hazardous materials and has a professional team available to respond to and handle environmental issues that might occur in the transport of such materials.
The Company performs ongoing reviews and evaluations of the various environmental programs and issues within the Company's operations and, as necessary, takes actions intended to limit the Company's exposure to potential liability. Although these costs cannot be predicted with certainty, management believes that the ultimate outcome of identified matters will not have a material adverse effect on the Company's consolidated financial statements.
Personal Injury. The Company's personal injury liability is based on semi-annual actuarial studies performed on an undiscounted basis by an independent third party actuarial firm and reviewed by management. This liability is based on personal injury claims filed and an estimate of claims incurred but not yet reported. Actual results may vary from estimates due to the number, type and severity of the injury, costs of medical treatments and uncertainties in litigation. Adjustments to the liability are reflected within operating expenses in the period in which changes to estimates are known. Personal injury claims in excess of self-insurance levels are insured up to certain coverage amounts, depending on the type of claim and year of occurrence. The personal injury liability as of September 30, 2012, is based on an updated actuarial study of personal injury claims through May 31, 2012, and review of the last four months' experience. For the nine months ended September 30, 2012 and 2011, the Company recorded a $7.0 million and $12.2 million reduction in personal injury liability due to changes in estimates as a result of the Company's continuing favorable claims development and settlement experience.
The personal injury liability activity was as follows (in millions):

	Nine Months Ended September 30,	
	2012	2011
Balance at beginning of year	$40.1	$62.2
Accruals	7.5	8.1
Change in estimate	(7.0)	(12.2)
Payments	(5.6)	(12.1)
Balance at end of period	$35.0	$46.0

Certain Disputes with Ferromex. KCSM and Ferrocarril Mexicano, S.A. de C.V. ("Ferromex") use certain trackage rights, haulage rights and interline services (the "Services") provided by each other. The rates to be charged after January 1, 2009, were agreed to pursuant to the Trackage Rights Agreement, dated February 9, 2010 (the "Trackage Rights Agreement"), between KCSM and Ferromex. The rates payable for these Services for the period beginning in 1998 through December 31, 2008, are still not resolved. KCSM is currently involved in discussions with Ferromex regarding the amounts payable to each other for the Services for this period. If KCSM cannot reach an agreement with Ferromex for rates applicable for Services prior to January 1, 2009, which are not subject to the Trackage Rights Agreement, the Mexican Secretaría de Comunicaciones y Transportes ("Secretary of Communications and Transportation" or "SCT") is entitled to set the rates in accordance with Mexican law and regulations. KCSM and Ferromex both initiated administrative proceedings seeking a determination by the SCT of the rates that KCSM and Ferromex should pay each other in connection with the Services. The SCT issued rulings in 2002 and 2008 setting the rates for the Services, and both KCSM and Ferromex challenged these rulings. Although KCSM and Ferromex have challenged these matters based on different grounds and these cases continue to evolve, management believes the amounts recorded related to these matters are adequate.

While the outcome of these matters cannot be predicted with certainty, the Company does not believe, when resolved, that these disputes will have a material effect on its consolidated financial statements.

SCT Sanction Proceedings. On July 23, 2008, the SCT delivered notice to KCSM of proceedings against KCSM, claiming, among other things, that KCSM refused to grant Ferromex access to certain trackage over which Ferromex alleges it has trackage rights on six different occasions and thus denied Ferromex the ability to provide service to a Mexican subsidiary of a large U.S. auto manufacturer at this location. On July 15, 2010, the SCT resolved to consolidate these six sanction proceedings into a single

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

proceeding, determining that the actions that motivated the underlying claims constitute a single occasion. On February 27, 2012, the SCT dismissed this proceeding on the basis that the extent of the Ferromex trackage rights had not been determined prior to the time KCSM refused Ferromex access.

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

Credit Risk. The Company continually monitors risks related to economic changes and certain customer receivables concentrations. Significant changes in customer concentration or payment terms, deterioration of customer creditworthiness or further weakening in economic trends could have a significant impact on the collectability of the Company's receivables and operating results. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. The Company has recorded provisions for uncollectability based on its best estimate at September 30, 2012.

Income Tax. Tax returns filed in the U.S. from 2009 through the current year and in Mexico for 2005 and from 2007 through the current year remain open to examination by the taxing authorities. The 2006 Mexico tax return is closed to examination except for certain depreciation adjustments included on an amended return. In March 2012, the 2004 Mexico tax return audit was completed without adjustment. The 2005 Mexico tax return is currently under examination. The Company believes that an adequate provision has been made for any adjustment (tax and interest) that may be due for all open years. However, an unexpected adverse resolution could have a material effect on the consolidated financial statements in a particular quarter or fiscal year.

Panama Canal Railway Company ("PCRC") Guarantees and Indemnities. The Company has issued three irrevocable standby letters of credit totaling approximately $0.5 million to fulfill the Company's fifty percent guarantee of PCRC's equipment loans. The Company agreed to fund fifty percent of any debt service reserve or liquidity reserve shortfall by PCRC, reserves which were established by PCRC in connection with the issuance of the 7.0% Senior Secured Notes due November 1, 2026 (the "Notes"). At September 30, 2012, the Company had issued and outstanding $3.8 million under a standby letter of credit to fulfill its obligation to fund fifty percent of these reserves. Additionally, KCS has pledged its shares of PCRC as security for the Notes.

11. Geographic Information

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

The Company's strategic initiatives, which drive its operational direction, are developed and managed at the Company's headquarters and targets are communicated to its various activity centers. Corporate management is responsible for, among others, KCS's marketing strategy, the oversight of large cross border customer accounts, overall planning and control of infrastructure and rolling stock, the allocation of capital resources based upon growth and capacity constraints over the coordinated network, and other functions such as financial planning, accounting, and treasury.

The role of each region is to manage the operational activities and monitor and control costs over the coordinated rail network. Such cost control is required to ensure that pre-established efficiency standards set at the corporate level are attained. The activity centers are responsible for executing the overall corporate strategy and operating plan established by corporate management as a coordinated system.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
Revenues	2012	2011	2012	2011
U.S.	$311.2	$301.2	$910.5	$859.8
Mexico	266.2	243.3	759.7	708.2
Total revenues	$577.4	$544.5	$1,670.2	$1,568.0

Property and equipment (including concession assets), net	September 30, 2012	December 31, 2011
U.S.	$3,064.2	$2,902.9
Mexico	2,487.4	2,446.6
Total property and equipment (including concession assets), net	$5,551.6	$5,349.5

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

The discussion below, as well as other portions of this Form 10-Q, contain forward-looking statements that are not based upon historical information. 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. Such forward-looking statements are based upon information currently available to management and management's perception thereof as of the date of this Form 10-Q. However, such statements are dependent on and, therefore, can be influenced by, a number of external variables over which management has little or no control, including: competition and consolidation within the transportation industry; the business environment in industries that produce and consume rail freight; revocation of the rail concession of Kansas City Southern's subsidiary, Kansas City Southern de Mexico, S.A. de C.V.; the termination, or failure to renew, agreements with customers, other railroads and third parties; interest rates; access to capital; disruptions to the Company's technology infrastructure, including its computer systems; natural events such as severe weather, hurricanes and floods; market and regulatory responses to climate change; credit risk of customers and counterparties and their failure to meet their financial obligations; legislative and regulatory developments and disputes; rail accidents or other incidents or accidents along KCS's rail network, facilities or customer facilities involving the release of hazardous materials, including toxic inhalation hazards; fluctuation in prices or availability of key materials, in particular diesel fuel; dependency on certain key suppliers of core rail equipment; changes in securities and capital markets; loss of key personnel; labor difficulties, including strikes and work stoppages; insufficiency of insurance to cover lost revenue, profits or other damages; acts of terrorism or risk of terrorist activities; war or risk of war; domestic and international economic conditions; political and economic conditions in Mexico and the level of trade between the United States and Mexico; and the outcome of claims and litigation. For more discussion about each risk factor, see Part II Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, which is on file with the U.S. Securities and Exchange Commission (File No. 1-4717) and Part I Item 1A — "Risk Factors" in the Form 10-K and any updates contained herein. Readers are strongly encouraged to consider these factors when evaluating forward-looking statements. Forward-looking statements should not be read as a guarantee of future performance or results and will not necessarily be accurate indications of the timing when, or by which, such performance or results will be achieved. As a result, actual outcomes or results could materially differ from those indicated in forward-looking statements. We are not under any obligation, and we expressly disclaim any obligation, to update or alter any forward-looking statements.

This discussion is intended to clarify and focus on Kansas City Southern's ("KCS" or the "Company") results of operations, certain changes in its financial position, liquidity, capital structure and business developments for the periods covered by the consolidated financial statements included under Item 1 of this Form 10-Q. This discussion should be read in conjunction with those consolidated financial statements and the related notes and is qualified by reference to them.

Critical Accounting Policies and Estimates

The Company's discussion and analysis of its financial position and results of operations is based upon its consolidated financial statements. The preparation of these consolidated financial statements requires estimation and judgment that affect the reported amounts of revenue, expenses, assets and liabilities. The Company bases its estimates on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the accounting for assets and liabilities that are not readily apparent from other sources. If the estimates differ materially from actual results, the impact on the consolidated financial statements may be material. The Company's critical accounting policies are disclosed in the 2011 Annual Report on Form 10-K.

Overview

The Company is engaged in the freight rail transportation business, operating a coordinated rail network under one reportable business segment. The primary operating subsidiaries of the Company consist of the following: The Kansas City Southern Railway Company ("KCSR"), Kansas City Southern de México, S.A. de C.V. ("KCSM"), Meridian Speedway, LLC ("MSLLC"), and The Texas Mexican Railway Company ("TexMex"). The Company generates revenues and cash flows by providing customers with freight delivery services within its regions, and throughout North America through connections with other Class I rail carriers. Customers conduct business in a number of different industries, including electric-generating utilities, chemical and petroleum products, industrial and consumer products, agriculture and mineral products, automotive products and intermodal transportation. Appropriate eliminations and reclassifications have been recorded in deriving the consolidated financial statements.

Third Quarter Analysis

The Company reported quarterly earnings of $0.82 per diluted share on consolidated net income of $90.1 million for the three months ended September 30, 2012, compared to quarterly earnings of $0.91 per diluted share on consolidated net income of $99.8 million for the same period in 2011. The 2011 diluted earnings per share include $0.15 per diluted share from a gain on insurance recoveries related to the settlement of the insurance claim for lost profits, property damage and related incremental expenses from Hurricane Alex.

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The Company reported a 6% increase in revenues during the three months ended September 30, 2012, as compared to the same period in 2011, driven primarily by positive pricing impacts, a 7% increase in carloads/unit volumes and increased fuel surcharge, partially offset by the effect of fluctuations in the value of the Mexican peso against the U.S. dollar for revenues denominated in Mexican pesos and commodity mix.
Operating expenses increased 9% during the three months ended September 30, 2012, as compared to the same period in 2011, primarily due to the $25.6 million gain on insurance recoveries as a result of the settlement of the Hurricane Alex insurance claim recognized in the third quarter of 2011. In addition, operating expenses increased due to higher carload/unit volumes. These increases were partially offset by the effect of fluctuations in the value of the Mexican peso against the U.S. dollar for operating expenses denominated in Mexican pesos. Operating expenses as a percentage of revenues increased to 68.7% for the three months ended September 30, 2012, as compared to 66.6% for the same period in 2011. The third quarter 2011 operating expenses as a percentage of revenues would have been 470 basis points higher if the gain on insurance recoveries had been excluded from the financial results.
KCSM's revenues and operating expenses are affected by fluctuations in the value of the Mexican peso against the U.S. dollar. Based on the volume of revenue and expense transactions denominated in Mexican pesos, revenue and expense fluctuations generally offset, with insignificant net impacts to operating income.
On August 7, 2012, the Company's Board of Directors declared a cash dividend of $0.195 per share payable on October 3, 2012, to common stockholders of record as of September 10, 2012. The aggregate amount of the dividend declared was $21.5 million.

Results of Operations
The following summarizes KCS's consolidated income statement components (in millions):

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Change Dollars
Revenues	$577.4	$544.5	$32.9
Operating expenses	396.7	362.7	34.0
Operating income	180.7	181.8	(1.1)
Equity in net earnings of unconsolidated affiliates	4.4	4.7	(0.3)
Interest expense	(24.1)	(32.2)	8.1
Debt retirement costs	—	(3.9)	3.9
Foreign exchange gain (loss)	3.7	(7.2)	10.9
Other income (expense), net	(0.1)	0.6	(0.7)
Income before income taxes	164.6	143.8	20.8
Income tax expense	73.9	43.7	30.2
Net income	90.7	100.1	(9.4)
Less: Net income attributable to noncontrolling interest	0.6	0.3	0.3
Net income attributable to Kansas City Southern and subsidiaries	$90.1	$99.8	$(9.7)

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011	Change Dollars
Revenues	$1,670.2	$1,568.0	$102.2
Operating expenses	1,127.9	1,106.8	21.1
Operating income	542.3	461.2	81.1
Equity in net earnings of unconsolidated affiliates	15.1	13.6	1.5
Interest expense	(76.6)	(97.7)	21.1
Debt retirement costs	(18.0)	(14.2)	(3.8)
Foreign exchange gain (loss)	4.1	(6.9)	11.0
Other income (expense), net	(0.8)	2.3	(3.1)

Income before income taxes	466.1	358.3	107.8
Income tax expense	179.2	122.4	56.8
Net income	286.9	235.9	51.0
Less: Net income attributable to noncontrolling interest	1.4	1.3	0.1
Net income attributable to Kansas City Southern and subsidiaries	$285.5	$234.6	$50.9

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Revenues

The following summarizes revenues (in millions), carload/unit statistics (in thousands) and revenue per carload/unit:

	Revenues Three Months Ended September 30,			Carloads and Units Three Months Ended September 30,			Revenue per Carload/Unit Three Months Ended September 30,		
	2012	2011	% Change	2012	2011	% Change	2012	2011	% Change
Chemical and petroleum	$106.4	$102.6	4 %	62.8	64.5	(3 %)	$1,694	$1,591	6 %
Industrial and consumer products	138.0	136.8	1 %	85.5	86.8	(1 %)	1,614	1,576	2 %
Agriculture and minerals	90.7	100.8	(10 %)	50.2	57.2	(12 %)	1,807	1,762	3 %
Total general commodities	335.1	340.2	(1 %)	198.5	208.5	(5 %)	1,688	1,632	3 %
Energy (i)	89.3	82.8	8 %	82.5	80.1	3 %	1,082	1,034	5 %
Intermodal	82.0	65.7	25 %	243.3	208.0	17 %	337	316	7 %
Automotive	48.2	36.7	31 %	28.1	21.4	31 %	1,715	1,715	—
Carload revenues, carloads and units	554.6	525.4	6 %	552.4	518.0	7 %	$1,004	$1,014	(1 %)
Other revenue	22.8	19.1	19 %						
Total revenues (ii)	$577.4	$544.5	6 %						
(ii) Included in revenues:									
Fuel surcharge	$72.1	$67.9							

(i) Effective January 1, 2012, the Company established the Energy commodity group, which includes the previous Coal commodity group and certain amounts previously included within the Agriculture and minerals and Chemicals and petroleum commodity groups. Prior period amounts have been reclassified to conform to the current year presentation.

	Revenues Nine Months Ended September 30,			Carloads and Units Nine Months Ended September 30,			Revenue per Carload/Unit Nine Months Ended September 30,		
	2012	2011	% Change	2012	2011	% Change	2012	2011	% Change
Chemical and petroleum	$306.3	$304.7	1 %	185.2	193.4	(4 %)	$1,654	$1,575	5 %
Industrial and consumer products	413.8	380.3	9 %	254.2	249.5	2 %	1,628	1,524	7 %
Agriculture and minerals	308.6	312.6	(1 %)	168.1	179.7	(6 %)	1,836	1,740	6 %
Total general commodities	1,028.7	997.6	3 %	607.5	622.6	(2 %)	1,693	1,602	6 %
Energy (i)	228.2	231.9	(2 %)	218.3	228.8	(5 %)	1,045	1,014	3 %
Intermodal	226.5	181.9	25 %	679.4	578.5	17 %	333	314	6 %
Automotive	125.3	102.2	23 %	75.2	62.0	21 %	1,666	1,648	1 %
Carload revenues, carloads and units	1,608.7	1,513.6	6 %	1,580.4	1,491.9	6 %	$1,018	$1,015	—

Other revenue	61.5	54.4	13	%
Total revenues (ii)	$1,670.2	$1,568.0	7	%
(ii) Included in revenues:				
Fuel surcharge	$208.5	$180.6		

(i) Effective January 1, 2012, the Company established the Energy commodity group, which includes the previous Coal commodity group and certain amounts previously included within the Agriculture and minerals and Chemicals and petroleum commodity groups. Prior period amounts have been reclassified to conform to the current year presentation.

Freight revenues include both revenue for transportation services and fuel surcharges. For the three and nine months ended September 30, 2012, revenues increased $32.9 million and $102.2 million compared to the same periods in 2011, primarily due to positive pricing impacts, increased carloads/unit volumes and fuel surcharge, partially offset by the effect of fluctuations in the value of the Mexican peso against the U.S. dollar for revenues denominated in Mexican pesos. Revenue per carload/unit decreased by 1%

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for the three months ended September 30, 2012 and was flat for the nine months ended September 30, 2012, compared to the same periods in 2011, reflecting commodity mix.

KCS’s fuel surcharge is a mechanism to adjust revenue based upon changing fuel prices. Fuel surcharges are calculated differently depending on the type of commodity transported. For most commodities, fuel surcharge is calculated using a fuel price from a prior time period that can be up to 60 days earlier. In a period of volatile fuel prices or changing customer business mix, changes in fuel expense and fuel surcharge may differ.

The following discussion provides an analysis of revenues by commodity group:

Revenues by commodity group
for the three months ended
September 30, 2012

Chemical and petroleum. Revenues increased $3.8 million and $1.6 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to increases in pricing and fuel surcharge, partially offset by decreases in volume and fluctuations in the value of the Mexican peso against the U.S. dollar. Revenues increased for the three and nine months ended September 30, 2012, due to positive pricing impacts for plastics and chemicals used to manufacture glass and paint. For the nine months ended September 30, 2012, petroleum volumes decreased compared to the same period in 2011, primarily due to a customer’s lost business; however, the recovery of some of this business in the third quarter of 2012 mitigated this decline.

Industrial and consumer products. Revenues increased $1.2 million for the three months ended September 30, 2012, compared to the same period in 2011, primarily due to an increase in pricing, partially offset by a decrease in volume. Revenues increased $33.5 million for the nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to an increase in pricing, fuel surcharge and volume, partially offset by a decrease in fluctuations in the value of the Mexican peso against the U.S dollar. Metals and scrap grew in the first half of 2012 primarily due to increases in pricing and high demand for slab and steel coil driven by strength in the automotive and oil and gas industries; however, in the third quarter of 2012, the metals market experienced a decline in end-market pricing, causing customers to delay purchases until the market stabilizes. In addition, competition from foreign manufacturers has also reduced demand for North American steel products. Paper product revenue increased primarily due to improved pricing. Growth slowed in the third quarter with some production slowdowns and loss of traffic.

Revenues by commodity group
for the three months ended
September 30, 2012

Agriculture and minerals. Revenues decreased $10.1 million and $4.0 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to decreases in volume and fluctuations in the value of the Mexican peso against the U.S. dollar, partially offset by increases in pricing and fuel surcharge. Food products volumes decreased due to lost cross border corn syrup business and lower dried distillers grain volume. Cross border grain shipments increased during the first quarter of 2012, as 2011 volumes were negatively impacted by a strong Mexico harvest; however, drought driven increases in the price of corn caused third quarter grain volumes to decrease as a higher percentage of Mexico grain purchases were imported via ports and local crops. Ores and minerals volumes decreased compared to the same periods in 2011, primarily due to a customer’s lost business.

Energy. Revenues increased $6.5 million for the three months ended September 30, 2012, compared to the same period in 2011, primarily due to increases in pricing and volume. Revenue decreased $3.7 million for the nine months ended September 30, 2012, compared to the same period in 2011, primarily due to a decrease in volume, partially offset by an increase in pricing. In the first half of 2012, utility coal revenues declined due to a reduction in demand as a result of utility maintenance outages, historic low natural gas prices and a warmer than average winter. In the third quarter of 2012, the decline slowed as volumes increased due to hotter than average summer weather. Frac sand volumes increased as a result of new business and a strong demand due to higher crude oil prices.

Intermodal. Revenues increased $16.3 million and $44.6 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to increases in volume and pricing. The increase in volume was driven by strong cross border auto part business, conversion of truck traffic to rail and Trans-Pacific imports via the Port of Lazaro Cardenas.

Automotive. Revenues increased $11.5 million and $23.1 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to increases in volume and pricing, partially offset by fluctuations in the value of the Mexican peso against the U.S. dollar. The increase was driven by strong year over year growth in North American automobile sales for Original Equipment Manufacturers, increased import/export volume through the Port of Lazaro Cardenas and increased length of haul through new cross border vehicle routings.

Operating Expenses

Operating expenses, as shown below (in millions), increased $34.0 million and $21.1 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to the gain on insurance recoveries related to Hurricane Alex recognized in the third quarter of 2011 and higher carload/unit volumes. These increases were partially offset by the fluctuations in the value of the Mexican peso against the U.S. dollar for operating expenses denominated in Mexican pesos. In addition, the increases in operating expenses for the nine months ended September 30, 2012, compared to the same period in 2011, were partially offset by the elimination of the deferred Mexican statutory profit sharing liability as a result of the organizational restructuring in the second quarter of 2012.

	Three Months Ended September 30,		Change	
	2012	2011	Dollars	Percent
Compensation and benefits	$108.4	$109.3	$(0.9)	(1%)
Purchased services	54.6	50.6	4.0	8%
Fuel	89.5	86.5	3.0	3%
Equipment costs	41.9	41.4	0.5	1%
Depreciation and amortization	49.8	47.9	1.9	4%
Materials and other	52.5	52.6	(0.1)	—
Gain on insurance recoveries related to hurricane damage	—	(25.6)	25.6	(100%)
Total operating expenses	$396.7	$362.7	$34.0	9%

	Nine Months Ended September 30,		Change	
	2012	2011	Dollars	Percent
Compensation and benefits	$323.5	$314.1	$9.4	3%
Purchased services	169.3	153.5	15.8	10%
Fuel	264.7	258.0	6.7	3%
Equipment costs	119.7	125.5	(5.8)	(5%)
Depreciation and amortization	146.9	139.1	7.8	6%
Materials and other	146.8	142.2	4.6	3%
Elimination of deferred statutory profit sharing liability, net	(43.0)	—	(43.0)	100%
Gain on insurance recoveries related to hurricane damage	—	(25.6)	25.6	(100%)
Total operating expenses	$1,127.9	$1,106.8	$21.1	2%

Compensation and benefits. Compensation and benefits decreased $0.9 million for the three months ended September 30, 2012, compared to the same period in 2011, primarily due to reduced Mexican statutory profit sharing expense as a result of the organizational restructuring in the second quarter of 2012 and the fluctuations in the value of the Mexican peso against the U.S. dollar. These decreases were partially offset by increased incentive compensation expense, annual salary and benefit rate increases and increased carload/unit volumes. Compensation and benefits increased $9.4 million for the nine months ended September 30, 2012, compared to the same period in 2011, primarily due to increased incentive compensation expense, annual salary and benefit rate increases and increased carload/unit volumes. These increases were partially offset by reduced Mexican statutory profit sharing expense as a result of the organizational restructuring in the second quarter of 2012, and the fluctuations in the value of the Mexican peso against the U.S. dollar.

Purchased services. Purchased services expense increased $4.0 million and $15.8 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, due to higher joint facility income recognized in the third quarter of 2011 as a result of non-recurring usage of certain trackage rights, increases in volume-sensitive costs, primarily equipment maintenance expense and joint facility expenses, and higher track structure maintenance expense.

Fuel. Fuel expense increased $3.0 million and $6.7 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to higher diesel fuel prices and higher consumption. These increases were partially offset by the fluctuations in the value of the Mexican peso against the U.S. dollar and improved fuel efficiency.

Equipment costs. Equipment costs increased $0.5 million for the three months ended September 30, 2012, compared to the same period in 2011, primarily due to an increase in the use of other railroads' freight cars due to increased traffic volumes, partially offset by lower locomotive expense due to the acquisition of 75 locomotives during the third quarter of 2011, which were previously leased by the Company under an operating lease agreement. Equipment costs decreased $5.8 million for the nine months ended

September 30, 2012, compared to the same period in 2011, primarily due to lower locomotive lease expense, as described above. This decrease was partially offset by an increase in the use of other railroads' freight cars due to increased traffic volumes.
Depreciation and amortization. Depreciation and amortization expense increased by $1.9 million and $7.8 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to a larger asset base.
Materials and other. Materials and other expense decreased $0.1 million for the three months ended September 30, 2012, compared to the same period in 2011, primarily due to lower casualty expense. This decrease was partially offset by increases in concession duty expense and employee expenses. Materials and other expense increased $4.6 million for the nine months ended September 30, 2012, compared to the same period in 2011, primarily due to the recognition of a larger reduction in the personal injury liability during the nine months ended September 30, 2011, as compared to the same period in 2012, and increases in employee expenses, concession duty expense and property tax expense. These increases were partially offset by lower casualty expense. KCSM paid concession duty expense of 0.5% of gross revenues for the first 15 years of the Concession period, and on June 24, 2012, KCSM began paying 1.25% of gross revenues, which is effective for the remaining years of the Concession. The concession duty rate increase is expected to increase expense in the fourth quarter of 2012, as compared to 2011, by approximately $2.0 million.
Elimination of deferred statutory profit sharing liability, net. As a result of the organizational restructuring in the second quarter of 2012, KCSM's obligation to pay Mexican statutory profit sharing terminated as of May 1, 2012, and accordingly, KCSM recognized a $43.0 million net reduction to operating expense. This reduction includes the elimination of $47.8 million of the deferred Mexican statutory profit sharing liability, net of $4.8 million of transaction costs.
Gain on insurance recoveries related to hurricane damage. In the third quarter of 2011, the Company settled its insurance claims related to Hurricane Alex and recognized a $25.6 million gain on insurance recoveries which primarily represented the recovery of lost profits and the replacement value of property in excess of its carrying value, net of the self-insured retentions.

Non-Operating Income and Expenses
Equity in net earnings of unconsolidated affiliates. Equity in net earnings from unconsolidated affiliates decreased $0.3 million for the three months ended September 30, 2012, compared to the same period in 2011, primarily due to lower equity in earnings from the operations of Ferrocarril y Terminal del Valle de México, S.A. de C.V., due to higher volume sensitive costs. For the nine months ended September 30, 2012, equity in net earnings from unconsolidated affiliates increased $1.5 million, compared to the same period in 2011, primarily due to an increase in equity in earnings from the operations of Panama Canal Railway Company resulting from an increase in container volumes during the first quarter of 2012.
Interest expense. Interest expense decreased by $8.1 million and $21.1 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to lower average interest rates as a result of the Company's refinancing activities.
Debt retirement costs. Debt retirement costs decreased $3.9 million and increased $3.8 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011. On June 1, 2012, the Company redeemed the remaining $100.3 million principal amount of the outstanding 8.0% Senior Notes due June 1, 2015 (the "8.0% Senior Notes"), issued by KCSR, and recognized debt retirement costs of $5.1 million related to the call premium and the write-off of unamortized debt issuance costs. On February 24, 2012, KCSR purchased $174.7 million principal amount of the 8.0% Senior Notes, and recognized debt retirement costs of $12.9 million related to the tender premium and the write-off of unamortized debt issuance costs. On July 12, 2011, KCSR entered into an amended and restated credit agreement and wrote off $3.9 million in unamortized debt issuance costs related to the previous credit agreement. In the second quarter of 2011, KCSM purchased and redeemed the remaining $32.4 million principal amount and all of the outstanding $165.0 million aggregate principal amount of its 7 $^5/_8$% Senior Notes due

December 1, 2013 and 7 $^{3}/_{8}$% Senior Notes due June 1, 2014, respectively. KCSM recognized debt retirement cost of $10.3 million related to the call and tender premiums and the write-off of unamortized debt issuance costs.
Foreign exchange. Fluctuations in the value of the Mexican peso against the U.S. dollar resulted in a foreign exchange gain of $3.7 million and $4.1 million for the three and nine months ended September 30, 2012, compared to a foreign exchange loss of $7.2 million and $6.9 million for the same periods in 2011.
Other income (expense), net. Other income (expense), net, decreased by $0.7 million and $3.1 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, primarily due to lower miscellaneous income.
Income tax expense. Income tax expense increased $30.2 million and $56.8 million for the three and nine months ended September 30, 2012, compared to the same periods in 2011, due to higher pre-tax income and increased effective tax rates due to foreign exchange rate fluctuations. The effective income tax rate was 44.9% and 38.4% for the three and nine months ended September 30, 2012, compared to 30.4% and 34.2% for the same periods in 2011. For the nine months ended September 30, 2012, as

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compared to the same period in 2011, the increase in the effective income tax rate was partially offset by the reduction of a deferred tax asset valuation allowance in the second quarter of 2012 related to state net operating losses.

Liquidity and Capital Resources

Overview

In recent years, KCS has improved its financial strength and flexibility by decreasing leverage, extending debt maturities, increasing liquidity and reducing interest expense and preferred stock dividends. Though KCS's cash flows from operations are sufficient to fund operations, capital expenditures, debt service and dividends, the Company may, from time to time, use external sources of cash (principally bank debt, public and private debt, and leases) to refinance existing indebtedness and to fund new investments and equipment additions. On September 30, 2012, total available liquidity (the unrestricted cash balance plus revolving credit facility availability) was $587.0 million. As of September 30, 2012, the total cash and cash equivalents held outside of the U.S. in foreign subsidiaries was $72.4 million. This cash is available to fund company operations without incurring additional income taxes.

The Company believes, based on current expectations, that cash and other liquid assets, operating cash flows, access to debt and equity capital markets, and other available financing resources will be sufficient to fund anticipated operating, capital, debt service and other commitments in the foreseeable future.

Beginning in the first quarter of 2012, the Company's Board of Directors has declared quarterly cash dividends of $0.195 per share on its common stock. Subject to the discretion of the Board of Directors, capital availability and a determination that cash dividends continue to be in the best interest of its stockholders, the Company intends to pay a quarterly dividend on an ongoing basis.

KCSR 8.0% Senior Notes. On January 25, 2012, pursuant to an offer to purchase and related solicitation of consents, KCSR commenced a cash tender offer for all of its $275.0 million outstanding aggregate principal amount of 8.0% Senior Notes and a consent solicitation to amend the related indenture (the "Proposed Amendments") to eliminate substantially all of the restrictive covenants contained therein. In conjunction with receiving the requisite consents, on February 13, 2012, the Company entered into the First Supplemental Indenture to effect the Proposed Amendments, which became operative on February 24, 2012.

On February 24, 2012, KCSR purchased $174.7 million principal amount of the tendered 8.0% Senior Notes in accordance with the terms and conditions of the tender offer set forth in the offer to purchase using the proceeds received under the Amendment No. 1 and Additional Term Advance Agreement ("Amendment No. 1") to the existing KCSR Amended and Restated Credit Agreement dated as of July 12, 2011 (the "Credit Agreement"), and available cash.

On June 1, 2012, KCSR redeemed the remaining $100.3 million principal amount of the 8.0% Senior Notes using additional proceeds received under Amendment No. 1 to the Credit Agreement and cash on hand, at a redemption price of 104% of the principal amount.

KCSR Credit Agreement and Additional Term A Advances. On February 24, 2012, KCS, KCSR and certain other subsidiaries of the Company that guaranty the Credit Agreement entered into Amendment No. 1, which provides for additional Term A advances to KCSR in an aggregate principal amount of $275.0 million (the "Additional Term A Advances") on substantially the same terms as those applicable to the existing Term A facility under the Credit Agreement. KCSR borrowed $175.0 million of the Additional Term A Advances on February 24, 2012, the effective date of Amendment No. 1, and borrowed the remaining $100.0 million of Additional Term A Advances on June 1, 2012.

The proceeds of the $275.0 million of borrowings under the Additional Term A Advances and available cash were used to purchase and redeem all of KCSR's 8.0% Senior Notes, as described above.

The outstanding principal balance of the Additional Term A Advances bear interest at floating rates. At KCSR's option, the loans will bear interest at either the (i) greater of the (a) Bank of Nova Scotia's base rate, (b) federal funds rate plus 0.50% or (c) one-month LIBOR plus 1.00% (the "Base Rate") plus a margin of 0.25% or (ii) LIBOR plus a margin of 1.25%.

Except as amended and supplemented by Amendment No. 1, all terms of the Credit Agreement remain in full force and effect.

KCSR RRIF Loan Agreement. On February 21, 2012, KCSR, as borrower, entered into a financing agreement with the United States of America represented by the Secretary of Transportation acting through the Administrator of the Federal Railroad Administration.

The financing agreement provides KCSR with a 25-year, $54.6 million loan under the Railroad Rehabilitation and Improvement Financing Program (the “KCSR RRIF Loan”). The proceeds of the KCSR RRIF Loan were used to reimburse KCSR for 80% of the purchase price of thirty new locomotives (the “Locomotives”) acquired by KCSR in the fourth quarter of 2011. The outstanding principal balance bears interest at 2.96% per annum. KCSR is required to make quarterly principal and interest payments on the KCSR RRIF Loan commencing March 15, 2012, except for the first payment that was comprised solely of interest accrued from the date the funds were advanced to KCSR, which was February 24, 2012.

The obligations under the financing agreement are secured by a first priority security interest in the Locomotives and certain related rights. In addition, the Company has agreed to guarantee repayment of the amounts due under the financing agreement and certain related agreements.

The financing agreement contains representations, warranties, covenants and events of default that are similar to those contained in other KCSR debt agreements. The occurrence of an event of default could result in the acceleration of the repayment of any outstanding principal balance of the KCSR RRIF Loan.

KCSR Revolving Credit Facility. During the first quarter of 2012, the Company repaid the December 31, 2011 outstanding balance of $50.0 million on KCSR’s revolving credit facility.

For a further discussion of the agreements representing the indebtedness of KCS, see “Liquidity and Capital Resources — Debt and Capital Structure” in the Annual Report on Form 10-K for the year ended December 31, 2011 of KCS.

Interest Rate Swaps. On March 5, 2012, KCSR entered into four amortizing interest rate swaps with an aggregate notional amount of $320.0 million, which have been designated as cash flow hedges. The interest rate swaps effectively convert interest payments on a portion of KCSR’s outstanding term loans from variable rates to fixed rates. As of September 30, 2012, the hedging instruments have an aggregate notional amount of $308.5 million at a fixed rate of 0.4942%. Settlements are indexed to one-month LIBOR and will occur monthly through March 31, 2014. The counterparties to the swaps are participants in KCSR’s credit facility and meet the Company’s credit rating standards.

KCS’s primary sources of liquidity are cash flows generated from operations, borrowings under its revolving credit facilities and access to debt and equity capital markets. Although KCS has had adequate access to the capital markets, the financial terms under which funding has been obtained contain restrictive covenants which limit or preclude certain actions, including the ability to incur additional debt for any purpose other than refinancing existing debt, create or suffer to exist additional liens, make prepayments of particular debt, pay dividends on common stock, make investments, engage in transactions with stockholders and affiliates, issue capital stock, sell certain assets, and engage in mergers and consolidations or in sale leaseback transactions. Though these covenants may restrict or prohibit certain activities, the covenants contain a number of qualifications, thresholds and exceptions that provide the Company with what management believes is an appropriate degree of flexibility to conduct its operations. The Company was in compliance with all of its debt covenants as of September 30, 2012.

KCS’s operating results and financing alternatives can be unexpectedly impacted by various factors, some of which are outside of its control. For example, if KCS were to experience a reduction in revenues or a substantial increase in operating costs or other liabilities, its earnings could be significantly reduced, increasing the risk of non-compliance with debt covenants. Additionally, the Company is subject to external factors impacting debt and equity capital markets and its ability to obtain financing under reasonable terms is subject to market conditions. Volatility in capital markets and the tightening of market liquidity could impact KCS’s access to capital. Further, KCS’s cost of debt can be impacted by independent rating agencies which assign debt ratings based on certain factors including credit measurements such as interest coverage and leverage ratios, liquidity and competitive position.

Three credit rating agencies provide their views of the company’s outlook and ratings. In the third quarter of 2012, Fitch Ratings (“Fitch”) initiated coverage of KCS and KCSR and assigned an investment grade rating to the KCSR Credit Agreement. Fitch also assigned an investment grade Issuer Default Rating (“IDR”) to KCS and KCSR. In addition, Fitch upgraded KCSM’s IDR and senior unsecured debt rating to investment grade during the third quarter. Standard & Poor’s Rating Services (“S&P”) and Moody’s Investors Service (“Moody’s”) each rate the KCSR Credit Agreement as investment grade. Both agencies rate the remaining debt, preferred stock and corporate credit of KCS, KCSR and KCSM as non-investment grade. These ratings and outlooks change from time to time and can be found on the websites of S&P, Moody’s and Fitch.

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Cash Flow Information

Summary cash flow data follows (in millions):

	Nine Months Ended September 30, 2012	2011
Cash flows provided by (used for):		
Operating activities	$516.0	$465.1
Investing activities	(328.2)	(292.2)
Financing activities	(73.2)	(41.2)
Net increase in cash and cash equivalents	114.6	131.7
Cash and cash equivalents beginning of year	72.4	85.4
Cash and cash equivalents end of period	$187.0	$217.1

Cash flows from operating activities increased $50.9 million for the nine month period ended September 30, 2012, compared to the same period in 2011, primarily as a result of increased net income and the changes in working capital items, resulting mainly from the timing of certain payments and receipts. These increases were partially offset by insurance proceeds of $36.6 million related to hurricane damage received during 2011. Net cash used for investing activities increased $36.0 million primarily due to an increase in capital expenditures and insurance proceeds of $12.4 million related to hurricane damage received during 2011. Additional information regarding capital expenditures is provided below. Net cash used for financing activities increased $32.0 million primarily due to the payment of common stock dividends.

Capital Expenditures

KCS's cash flows from operations are sufficient to fund capital expenditures; however, the Company may, from time to time, use external sources of cash (principally bank debt, public debt and private debt) to fund capital expenditures. The following table summarizes capital expenditures by type (in millions):

	Nine Months Ended September 30, 2012	2011
Roadway capital program	$210.8	$189.4
Locomotive acquisitions	—	103.8
Equipment (i)	37.7	10.6
Capacity	25.3	12.5
Information technology	4.7	6.7
Other	18.4	34.8
Total capital expenditures (accrual basis)	296.9	357.8
Locomotives financed under operating lease buyout	—	(91.0)
Change in capital accruals	22.3	17.2
Total cash capital expenditures	$319.2	$284.0

(i) In the second quarter of 2012, KCSR paid $19.6 million to purchase 315 jumbo covered hoppers that were previously leased under an operating lease.

For 2012, internally generated cash flows are expected to fund cash capital expenditures which are currently estimated to be between $490.0 million and $515.0 million.

Other Matters

Approximately 80% of KCSR employees are covered by collective bargaining agreements. KCSR participates in industry-wide bargaining as a member of the National Carriers' Conference Committee. Long-term settlement agreements were reached and ratified during 2011 and the first half of 2012 covering all of the participating unions,

effectively bringing the current bargaining round to a close. These agreements will be in effect through December 2015.
KCSM Servicios union employees are covered by one labor agreement, which was signed on June 23, 1997, between KCSM and the Sindicato de Trabajadores Ferrocarrileros de la República Mexicana ("Mexican Railroad Union"), for a term of 50 years, for the purpose of regulating the relationship between the parties. Approximately 80% of KCSM Servicios employees are covered by this labor agreement. The compensation terms under this labor agreement are subject to renegotiation on an annual basis and all other

benefits are subject to negotiation every two years. As a result of the labor agreement signed on April 19, 2012, compensation terms for the period from July 1, 2012 through June 30, 2013, were finalized. Additionally, this labor agreement enabled KCS to complete the organizational restructuring whereby all employees of KCSM became employees of KCSM Servicios. KCSM Servicios provides employee services to KCSM, and KCSM pays KCSM Servicios market-based rates for these services. The union labor negotiation with the Mexican Railroad Union has not historically resulted in any strike, boycott or other disruption in KCSM's business operations.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There was no material change during the quarter from the information set forth in Part II, Item 7A. "Quantitative and Qualitative Disclosure about Market Risk" in the Annual Report on Form 10-K for the year ended December 31, 2011.

Item 4. Controls and Procedures

(a) Disclosure Controls and Procedures

As of the end of the period for which this Quarterly Report on Form 10-Q is filed, the Company's Chief Executive Officer and Chief Financial Officer have each reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have each concluded that the Company's current disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and include controls and procedures designed to ensure that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

(b) Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting that occurred during the third quarter of 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II — OTHER INFORMATION

Item 1. Legal Proceedings
For information related to the Company's settlements and other legal proceedings, see Note 10, Commitments and Contingencies under Part I, Item 1 of this quarterly report on Form 10-Q.

Item 1A. Risk Factors
There were no material changes during the quarter to the Risk Factors disclosed in Item 1A — "Risk Factors" in our annual report on Form 10-K for the year ended December 31, 2011.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
None.

Item 3. Defaults upon Senior Securities
None.

Item 4. Mine Safety Disclosures
Not applicable.

Item 5. Other Information
At a meeting held on August 7, 2012, the Board of Directors of the Company approved an amendment and restatement to the Company's Bylaws, which included changes to the procedures by which stockholders may recommend nominees to the Company's board of directors, including the following:

(i)Explicitly providing that the advance notice provisions contained in Section 3 of the Company's Bylaws are the exclusive means for a stockholder to make nominations or submit other business (other than matters properly brought under Rule 14a-8 under the Securities Exchange Act of 1934, as amended) before an annual meeting of the stockholders and disallows a stockholder to bring business if it takes action contrary to the notice to the Company or if the notice includes an untrue statement of a material fact or omits a material fact. (Article II, Section 3(a) and Article II, Section 3(b)).

(ii)Providing that any stockholder of record may bring business before an annual meeting or nominate a director for the annual or special meeting in accordance with the advance notice provisions set forth in the Bylaws, rather than only those stockholders owning one percent (1%). (Article II, Section 3(a)(3)(A); Article II, Section 3(b)(2)(A); and Article II, Section 10).

(iii)Moving the window for notification of stockholder nomination of directors and proposals for matters other than director nominations (other than proposals submitted for inclusion in the proxy statement) to not earlier than 90 days and no later than 60 days prior to the anniversary date of the prior year's annual stockholder meeting, rather than 150 days to 90 days for director nominations and 90 to 45 days for other proposals. (Article II, Section 3(a)(i) and Article II, Section 3(b)(i)).

(iv)Moving the window for notification of stockholder director nominees and proposals when the annual meeting date advances more than 30 days prior to or is delayed 60 days after the one-year anniversary of the previous annual meeting to not earlier than 90 days prior and no later than 60 days before the annual meeting or the 10th day following Public Announcements, to conform to the notice period described in (iii) above. The timing for notice for director nomination(s) at a special stockholder meeting was moved to conform with these times also. (Article II, Section 3(a)(i); Article II, Section 3(b)(i); and Article II, Section 10). "Public Announcement" shall mean disclosure in a press release reported by the Dow Jones News Service, Associated Press or a comparable national news service or in a document publicly filed by the Company with the Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the Securities Exchange Act of 1934, as amended.

(v)Adding a definition of a Stockholder Associated Person to include a beneficial owner and any person controlling, directly or indirectly, or acting in concert, with such stockholder who has proposed business for the annual meeting or has nominated a director for an annual or special meeting. (Article II, Section 3(a)(ii)).
(vi)Expanding the required disclosure regarding the director nomination or business proposal is made to include, among other things, rights to dividends on the shares of the Company beneficially owned by the stockholder or Stockholder

Associated Person that are separate from the underlying shares of the Company, a description of any derivative instruments, short positions, options, hedging transactions, voting arrangements and other economic and voting interests the stockholder or Stockholder Associated Person has with respect to the Company’s securities, and also requiring that the proposal from the stockholder or Stockholder Associated Person must state whether the stockholder will deliver a proxy statement or form of proxy to stockholders. (Article II, Section 3(a)(ii) and Article II, Section 3(b)(ii)).

(vii)In addition to (vi) above, expanding the required disclosure regarding any director nomination at the annual meeting or a special meeting to include, among other things whether any hedging or other transactions have been entered into on behalf of the nominee and a written statement that the nominee, as director, will owe fiduciary duties under Delaware law and consent to be named in the proxy. The nominee must also agree to supplement with such other information as may reasonably be necessary to determine the eligibility of such nominee and information that could be material to a stockholder’s understanding of the independence of such nominee or lack thereof. (Article II, Section 3(b)(ii) and Article II, Section 10).

As a result of changes concerning the Company’s advance notice provisions (see item (iii) above), to be timely for the 2013 annual meeting, if it occurs on May 3, 2013, proposals to nominate directors, and proposals for matters other than director nominations (other than proposals submitted for inclusion in the proxy statement), must be received at the Company’s principal executive offices no earlier than February 2, 2013, and no later than March 4, 2013.

A copy of the Company’s Amended and Restated Bylaws were filed as Exhibit 3.1 to the Company’s Current Report on Form 8-K filed on August 13, 2012 and are incorporated by reference herein.

The amendments also included other changes unrelated to the procedures by which stockholders may recommend nominees to the Company’s board of directors, which are summarized in the Company’s Current Report on Form 8-K filed on August 13, 2012 and incorporated by reference herein.

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Item 6. Exhibits

Exhibit No.	Description of Exhibits Filed with this Report
31.1	Principal Executive Officer's Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 is attached to this Form 10-Q as Exhibit 31.1.
31.2	Principal Financial Officer's Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 is attached to this Form 10-Q as Exhibit 31.2.
32.1	Principal Executive Officer's Certification furnished Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 is attached to this Form 10-Q as Exhibit 32.1.
32.2	Principal Financial Officer's Certification furnished Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 is attached to this Form 10-Q as Exhibit 32.2.
101	The following unaudited financial information from Kansas City Southern's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (Extensible Business Reporting Language) includes: (i) Consolidated Statements of Income for the three and nine months ended September 30, 2012 and 2011, (ii) Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2012 and 2011, (iii) Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011, (iv) Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 and 2011, and (v) the Notes to Consolidated Financial Statements.

Exhibit No.	Description of Exhibits Incorporated by Reference
3.1	Amended and Restated Bylaws of Kansas City Southern as amended and restated to August 7, 2012, filed as Exhibit 3.1 to the Company's Current Report on Form 8-K, filed on August 13, 2012 (File No. 1-4717), is incorporated herein by reference as Exhibit 3.1.
10.1	Employment Agreement dated July 24, 2009, between The Kansas City Southern Railway Company and David R. Ebbrecht, filed as Exhibit 10.1 to the Company's Current Report on Form 8-K, filed on August 13, 2012 (File No. 1-4717), is incorporated herein by reference as Exhibit 10.1.

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SIGNATURES

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 October 19, 2012.

Kansas City Southern

/s/ MICHAEL W. UPCHURCH
Michael W. Upchurch
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

/s/ MARY K. STADLER
Mary K. Stadler
Senior Vice President and Chief Accounting Officer
(Principal Accounting Officer)