

DST SYSTEMS INC  
Form 10-Q  
November 05, 2009  
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## UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

x

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

For the quarterly period ended September 30, 2009

or

o

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-14036

## DST SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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

333 West 11th Street, Kansas City, Missouri

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

64105

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(Address of principal executive offices)

(Zip Code)

**(816) 435-1000**

(Registrant's telephone number, including area code)

**No Changes**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(do not check if a smaller reporting company)

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

Number of shares outstanding of the Company's common stock as of October 30, 2009:

Common Stock \$0.01 par value 49,720,650

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**September 30, 2009**

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**DST Systems, Inc.**

**Form 10-Q**

**September 30, 2009**

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**Introductory Comments**

The Condensed Consolidated Financial Statements of DST Systems, Inc. ( "DST" or the "Company" ) included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. These Condensed Consolidated Financial Statements should be read in conjunction with the Company's audited financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

The results of operations for the three and nine months ended September 30, 2009 are not necessarily indicative of the results to be expected for the full year 2009.

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

	September 30, 2009	December 31, 2008
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 96.2	\$ 78.7
Funds held on behalf of clients	213.2	209.3
Client funding receivable	98.4	
Accounts receivable	141.6	198.2
Deferred income taxes	33.1	30.0
Other assets	61.0	40.2
	643.5	556.4
Investments	1,511.6	1,220.8
Properties	530.5	512.3
Intangible assets	43.0	31.2
Goodwill	181.6	118.7
Other assets	62.6	70.0
Total assets	\$ 2,972.8	\$ 2,509.4
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities		
Current portion of debt	\$ 765.1	\$ 89.9
Client funds obligations	311.6	209.3
Accounts payable	54.6	51.2
Accrued compensation and benefits	98.1	111.7
Deferred revenues and gains	51.7	59.5
Other liabilities	88.8	94.3
Income taxes payable		36.3
	1,369.9	652.2
Long-term debt	498.4	1,345.4
Income taxes payable	51.4	46.8
Deferred income taxes	336.1	174.8
Other liabilities	67.0	52.0
Total liabilities	2,322.8	2,271.2
Commitments and contingencies (Note 11)		
Stockholders equity		
Common stock, \$0.01 par; 400 million shares authorized, 95.3 million shares issued	1.0	1.0
Additional paid-in capital	228.5	212.6
Retained earnings	2,690.8	2,508.0
Treasury stock (45.6 million shares), at cost	(2,682.2)	(2,688.8)
Accumulated other comprehensive income	411.9	205.4
Total stockholders equity	650.0	238.2
Total liabilities and stockholders equity	\$ 2,972.8	\$ 2,509.4

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

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2009	2008	2009	2008
Operating revenues	\$ 395.6	\$ 414.2	\$ 1,195.7	\$ 1,271.6
Out-of-pocket reimbursements	156.1	146.2	470.9	449.5
Total revenues	551.7	560.4	1,666.6	1,721.1
Costs and expenses	454.6	449.3	1,367.3	1,381.0
Depreciation and amortization	34.5	32.2	93.8	93.8
Income from operations	62.6	78.9	205.5	246.3
Interest expense	(8.8)	(13.8)	(28.9)	(40.3)
Other income (expense), net	33.2	2.8	60.6	(4.1)
Equity in earnings of unconsolidated affiliates	7.8	9.0	24.0	29.3
Income before income taxes	94.8	76.9	261.2	231.2
Income taxes	33.9	26.7	78.4	58.9
Net income	\$ 60.9	\$ 50.2	\$ 182.8	\$ 172.3
Average common shares outstanding	49.7	51.9	49.7	54.9
Average diluted shares outstanding	50.2	56.2	50.0	60.2
Basic earnings per share	\$ 1.22	\$ 0.97	\$ 3.68	\$ 3.14
Diluted earnings per share	\$ 1.21	\$ 0.90	\$ 3.65	\$ 2.86

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

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

	<b>For the Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
<b>Cash flows operating activities:</b>		
Net income	\$ 182.8	\$ 172.3
Depreciation and amortization	93.8	93.8
Net losses on investments	4.8	22.7
Gain on the extinguishment of senior convertible debentures	(5.9)	
Gain on equity interest in Argus Health Systems, Inc.	(41.7)	
Amortization of share-based compensation	21.2	25.1
Equity in earnings of unconsolidated affiliates	(24.0)	(29.3)
Dividends from unconsolidated affiliates	29.3	
Deferred income taxes	25.7	1.9
Changes in accounts receivable	56.7	55.5
Proceeds from accounts receivable securitization program, net	10.0	30.0
Changes in accounts payable and accrued liabilities	(25.8)	(42.6)
Changes in income taxes payable	(41.0)	(15.9)
Other, net	3.1	(10.6)
Total adjustments to net income	106.2	130.6
Net	289.0	302.9
<b>Cash flows investing activities:</b>		
Capital expenditures	(70.2)	(79.7)
Proceeds from (investments in and advances to) unconsolidated affiliates	1.0	(34.4)
Investments in securities	(72.3)	(91.5)
Proceeds from sales/maturities of corporate and client funds investments	102.1	73.5
Net (increase) decrease in restricted cash and cash equivalents held to satisfy client funds obligations	132.7	(85.8)
Acquisition of interest in Argus Health Systems, Inc., net of cash acquired	(47.8)	
Proceeds from sale of Asurion		39.2
Other, net	0.3	(0.3)
Net	45.8	(179.0)
<b>Cash flows financing activities:</b>		
Proceeds from issuance of common stock	7.1	4.7
Principal payments on debt	(11.2)	(36.8)
Repurchases of senior convertible debentures	(131.3)	
Net increase (decrease) in client funds obligations	(144.2)	85.8
Proceeds from real estate credit agreement		114.0
Net borrowings (repayments) on revolving credit facilities	(30.1)	394.7
Common stock repurchased	(7.6)	(697.4)
Excess tax benefits from share based compensation		1.2
Net	(317.3)	(133.8)
Net increase (decrease) in cash and cash equivalents	17.5	(9.9)
Cash and cash equivalents, beginning of period	78.7	109.4
Cash and cash equivalents, end of period	\$ 96.2	\$ 99.5

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

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**DST Systems, Inc.**

**Notes to Condensed Consolidated Financial Statements**

*(unaudited)*

**1. Summary of Accounting Policies**

The Condensed Consolidated Financial Statements of DST Systems, Inc. ( "DST" or the "Company" ) included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission ( "SEC" ). Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ( "GAAP" ) have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. The Condensed Consolidated Balance Sheet as of December 31, 2008 has been derived from the audited Consolidated Balance Sheet at that date, but does not include all of the information and notes required by GAAP for complete financial statements. These Condensed Consolidated Financial Statements should be read in conjunction with the Company's audited financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008. The Company has performed an evaluation of subsequent events through November 5, 2009, which is the date these interim financial statements were filed with the SEC.

In the opinion of management, the accompanying unaudited Condensed Consolidated Financial Statements contain all adjustments (consisting of normal interim closing procedures) necessary to present fairly the consolidated financial position of the Company and its subsidiaries at September 30, 2009, and the results of operations for the three and nine months ended September 30, 2009 and 2008, and cash flows for the nine months ended September 30, 2009 and 2008.

Certain amounts in the 2008 financial statements have been reclassified to conform to the 2009 presentation.

The results of operations for the three and nine months ended September 30, 2009 are not necessarily indicative of the results to be expected for the full year 2009.

**2. Acquisition of Argus Health Systems, Inc.**

Prior to March 31, 2009, DST owned a 50% interest in Argus Health Systems, Inc. ( "Argus" ), which provides pharmacy claims processing and other related services to help clients manage pharmacy benefit programs. On March 31, 2009, DST purchased the remaining 50% interest of Argus for \$57.0 million in cash. As a result, Argus is no longer an unconsolidated affiliate of DST, but rather is a wholly owned subsidiary resulting in DST consolidating the results of Argus after March 31, 2009 rather than recording equity in earnings of Argus. On January 1, 2009 as required by generally accepted accounting principles, the Company adopted new accounting guidance for business combinations. In accordance with the guidance, the acquisition of the remaining 50% of Argus was treated as a step acquisition. Accordingly, DST remeasured its previously held equity interest in Argus to fair value, in the amount of \$57.0 million, and recorded a gain of \$41.7 million on March 31, 2009, which is included in other income (expense), net in the Condensed Consolidated Statement of Income. DST has recognized identifiable assets

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(comprised of proprietary software of \$26.0 million, customer relationships of \$14.0 million and other intangible assets of \$1.0 million) and goodwill resulting from the acquisition of the remaining 50% Argus interest and the remeasurement of DST's previously held equity interest. Based on the purchase price allocation, DST estimates that annual amortization expense from acquired Argus intangible assets will be approximately \$4.2 million. Goodwill of \$63.0 million arising from the acquisition is comprised of the assembled workforce of Argus and other assets and is included in the Financial Services Segment. None of the goodwill is expected to be deductible for income tax purposes. DST believes that the acquisition of Argus complements its existing DST Health Solutions business, increases the size of DST's healthcare processing capabilities and will enable the Company to provide broader product offerings to new and existing customers. Argus recorded revenues of approximately \$127.7 million during the year ended December 31, 2008. Assuming the acquisition of the remaining 50% of Argus had occurred on January 1, 2009 and 2008, the Company's total revenues would have been \$1,685.4 million and \$1,795.8 million for the nine months ended September 30, 2009

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and 2008, respectively. Consolidated proforma net income and diluted earnings per share would not have been materially different from the reported amounts for the nine months ended September 30, 2009 and 2008. The unaudited proforma amounts are not necessarily indicative of what actual consolidated results of operations might have been if the acquisition had been effective as of January 1, 2009 and 2008.

The following table summarizes the consideration paid for Argus and the allocation of the fair value of Argus to the fair values of assets acquired and liabilities assumed at March 31, 2009 (in millions).

<b>Consideration</b>	
Cash paid for remaining 50% equity interest in Argus	\$ 57.0
Fair value of DST's equity interest in Argus before the business combination	57.0
Fair value of Argus	\$ 114.0
<b>Recognized amounts of identifiable assets acquired and liabilities assumed</b>	
Cash and cash equivalents	\$ 9.2
Funds held on behalf of clients	148.0
Client funding receivable	99.6
Accounts receivable	16.9
Other current assets	7.5
Properties (includes \$26.0 of proprietary software)	31.4
Intangible assets	15.0
Goodwill	63.0
Other non-current assets	2.9
Total assets	393.5
Client funds obligations	247.6
Other current liabilities	16.7
Deferred income tax liabilities	13.9
Non-current liabilities	1.3
Total liabilities	279.5
Net assets acquired	\$ 114.0

### 3. Client Funds/Obligations and Reclassification within Consolidated Statement of Cash Flows

#### *Funds Held on Behalf of Clients*

The Company had \$213.2 million and \$209.3 million of funds held on behalf of clients at September 30, 2009 and December 31, 2008, respectively. This amount is comprised of funds held on behalf of transfer agency clients and funds held on behalf of pharmacy processing clients.

End of day available client bank balances for full service mutual fund transfer agency clients are invested overnight by and in the name of the Company into credit-quality money market funds. Invested balances are returned to the full service mutual fund transfer agency client accounts the following business day. Based upon the Company's intent, these invested client balances represent assets that are restricted for use and have

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been classified as client funds obligations in the Company's Consolidated Balance Sheet.

Funds received from Argus clients for the payment of pharmacy claims incurred by its members are invested in cash and cash equivalents (credit-quality money market funds), short-term investments and available for sale debt securities (short-term) until the claim payments are presented to the bank. Certain of these amounts are included in funds held on behalf of clients in the Consolidated Balance Sheet and are also recorded as a client funds

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obligation liability. Funds held on behalf of clients represent assets that, based upon the Company's intent, are restricted for use solely for the purposes of satisfying the obligations to remit funds to pharmacies, which are classified as client funds obligations in the Company's Consolidated Balance Sheet.

The Company has reported the cash flows related to the purchases of investment funds (available for sale securities) held on behalf of clients and the cash flows related to the proceeds from the sales/maturities of investment funds held on behalf of clients on a gross basis in the investing section of the Consolidated Statement of Cash Flows. The Company has reported the cash inflows and outflows related to client fund investments with original maturities of 90 days or less on a net basis within net (increase) decrease in restricted cash and cash equivalents held to satisfy clients fund obligations in the investing section of the Consolidated Statement of Cash Flows. The Company has reported the cash flows related to client funds used in investing activities on a net basis within net increase (decrease) in client funds obligations in the financing section of the Consolidated Statement of Cash Flows.

*Client Funding Receivable*

Client funding receivables represent amounts due the Company for pharmacy claims paid in advance of receiving client funding and for pharmacy claims processed for which client funding requests have not been made. Client funding receivables were \$98.4 million at September 30, 2009.

*Client Funds Obligations*

Client funds obligations represent the Company's contractual obligations to remit funds to satisfy client pharmacy claim obligations and are recorded on the balance sheet when incurred, generally after a claim has been processed by the Company. In addition, client funds obligations include transfer agency client balances invested overnight. Client funds obligations represent liabilities that will be repaid within one year of the balance sheet date. The Company had \$311.6 million and \$209.3 million of client funds obligations at September 30, 2009 and December 31, 2008, respectively.

*Reclassification within Consolidated Statement of Cash Flows*

The Company has reclassified the net (increase) decrease in funds held on behalf of clients (formerly reported under the heading "changes in transfer agency investments") in the Consolidated Statement of Cash Flows from operating activities to investing activities for all periods presented. In addition, the Company has reclassified the net increase (decrease) in client funds obligations (formerly reported under the heading "changes in transfer agency deposits") in the Consolidated Statement of Cash Flows from operating activities to financing activities for all periods presented.

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The impacts of the reclassifications were as follows (in millions):

	For the Three Months Ended March 31,		For the Six Months Ended	For the Nine Months Ended	For the Years Ended December 31,		
	2009	2008	June 30, 2008	September 30, 2008	2008	2007	2006
<b>Cash flows - investing activities:</b>							
Net cash provided by (used in) investing activities - as previously reported	\$ (84.0)	\$ (37.1)	\$ (38.4)	\$ (93.2)	\$ (110.1)	\$ 865.6	\$ 31.3
Impact of reclassification	73.6	44.9	26.3	(85.8)	(31.9)	(51.8)	(32.2)
Net cash provided by (used in) investing activities - as reclassified	\$ (10.4)	\$ 7.8	\$ (12.1)	\$ (179.0)	\$ (142.0)	\$ 813.8	\$ (0.9)
<b>Cash flows - financing activities:</b>							
Net cash (used in) financing activities - as previously reported	\$ (23.8)	\$ (20.8)	\$ (163.4)	\$ (219.6)	\$ (356.9)	\$ (868.7)	\$ (412.5)
Impact of reclassification	(73.6)	(44.9)	(26.3)	85.8	31.9	51.8	32.2
Net cash (used in) financing activities - as reclassified	\$ (97.4)	\$ (65.7)	\$ (189.7)	\$ (133.8)	\$ (325.0)	\$ (816.9)	\$ (380.3)

This reclassification had no impact on the net change in cash and cash equivalents or cash flows from operating activities for any period presented.

Table of Contents**4. Investments**

Investments are as follows (in millions):

	2009 Ownership Percentage	Carrying Value	
		September 30, 2009	December 31, 2008
<b>Available-for-sale securities:</b>			
State Street Corporation	2%	\$ 556.5	\$ 416.1
Computershare Ltd.	5%	246.2	163.4
Euronet Worldwide	4%	45.3	21.9
Other available-for-sale securities		164.6	149.9
		1,012.6	751.3
<b>Unconsolidated affiliates:</b>			
Boston Financial Data Services	50%	151.4	167.4
International Financial Data Services, U.K.	50%	60.9	50.3
International Financial Data Services, L.P.	50%	32.2	24.3
Argus Health Systems			16.8
Unconsolidated real estate affiliates		88.7	89.5
Other unconsolidated affiliates		12.8	9.8
		346.0	358.1
<b>Other:</b>			
Trading securities		50.7	34.2
Held-to-maturity		6.9	3.0
Investments, at cost		95.4	74.2
		153.0	111.4
<b>Total investments</b>		<b>\$ 1,511.6</b>	<b>\$ 1,220.8</b>

The Company is a limited partner in various private equity funds. At September 30, 2009 and December 31, 2008, the Company's carrying value of these private equity fund investments was approximately \$86.1 million and \$63.1 million, respectively. At September 30, 2009, the Company had future capital commitments related to these private equity fund investments of approximately \$150.3 million.

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

	September 30, 2009	December 31, 2008
Book cost basis	\$ 339.2	\$ 394.2
Gross unrealized gains	658.5	386.7
Gross unrealized losses	(1.8)	(15.7)
Unrealized gain (loss) from changes in foreign currency exchange rates	16.7	(13.9)
<b>Market value</b>	<b>\$ 1,012.6</b>	<b>\$ 751.3</b>



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The following table summarizes the fair value and gross unrealized losses of the Company's investments by the length of time that the securities have been in a continuous loss position, as of September 30, 2009 (in millions):

	Less than 12 months		Greater than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Common stock	\$ 12.9	\$ 1.5	\$ 2.8	\$ 0.3	\$ 15.7	\$ 1.8

Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the investments. These may not be reflected in an investment's current carrying value, thereby possibly requiring an impairment charge in the future. Such a charge could have a material effect on the Company's consolidated financial position and results of operations.

The Company recognized \$26.8 million of investment impairments for the nine months ended September 30, 2009 compared to \$5.6 million and \$25.8 million for the three and nine months ended September 30, 2008, respectively, which were other than temporary. There were no investment impairments on available-for-sale securities for the three months ended September 30, 2009. The Company records lower of cost or market valuation adjustments on private equity fund investments and other cost method investments when impairment conditions are present. During the three and nine months ended September 30, 2009, the Company recorded \$0.2 million and \$3.3 million of net impairments, respectively, compared to \$1.5 million and \$7.3 million for the three and nine months ended September 30, 2008, on private equity fund and other investments related to adverse market conditions and from poor performance of the underlying investment. The impairments recorded related primarily to investments in the Financial Services Segment and the Investments and Other Segment. A decline in a security's net realizable value that is other than temporary is treated as a loss based on quoted or derived market value and is reflected in other income (expense), net in the Condensed Consolidated Statement of Income.

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

	For the Three Months Ended September 30,		For the Nine Months* Ended September 30,	
	2009	2008	2009	2008
BFDS	\$ 2.2	\$ 4.6	\$ 9.0	\$ 15.2
IFDS, U.K.		2.0		