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Kansas City Southern finds success with its north-south vision

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The Kansas City Star

When **Kansas City Southern** chairman and chief executive Mike Haverty recently received an entrepreneurship award, he invoked the name of the railroad's founder, Arthur Stilwell.

While the big railroads of the late 19th century were obsessed with building networks to connect the East Coast to the burgeoning West, Stilwell had a counterintuitive vision. He built Kansas City Southern as a north-south carrier running from the middle of the country to the Gulf of Mexico, a move that many thought strange.

"When we expanded into Mexico, we proved that the north-south strategy is just as relevant today as it was in Stilwell's time and that the company is nimble enough to take advantage of the tremendous business opportunities," Haverty said upon accepting the award.

More than a century after the railroad was founded, Haverty raised some eyebrows by extending Stilwell's vision and Kansas City Southern's reach deep into Mexico.

While Kansas City Southern initially embarked on its south-of-the-border adventure 11 years ago, it was only in 2005 that the company got full control of **Kansas City Southern de Mexico** from its Mexican partner and the Mexican government.

By that time, some viewed Haverty's moves to make Kansas City Southern the "NAFTA railroad" a strategic mistake. The promise of low-cost labor in Mexico and other developing countries had been usurped by the unbelievably cheap wages in China, making China a global magnet for manufacturers large and small.

But now, Mexico is again becoming an attractive site for business as record fuel and transportation costs are erasing the wage advantage of making things in Asia. Kansas City Southern de Mexico has the most direct route between Mexico City and Laredo, Texas, to take advantage of that shift.

"You're already seeing some real shifts in trade patterns, with fuel prices so high and ground transportation in China being a mess," said Chris Kuehl, managing director of the consulting firm **Armada Corporate Intelligence**. "Some of the emphasis has shifted back to Mexico and Latin America, and Kansas City Southern has this line that runs from western Mexico to (the border town) Nuevo Laredo. It was just a great move on their part."

It remains early in Kansas City Southern's development of its NAFTA railway, but rail analysts so far like what they see of its operations, from tip to terminus. The company has posted double-digit revenue and earnings growth for the past few quarters, helped by record fuel prices that are driving business to railroads. Its stock price is trading at the top end of its 52-week range and up 50 percent year to date.

Between its new intermodal facility being developed at the former **Richards-Gebaur Airport** and a new deepwater port at Lazaro Cardenas on Mexico's Pacific coast, the railroad is within distance of dozens of new developments in the U.S. and Mexico.

"The plan is there, the business is there and the growth is there," said Haverty in a recent interview. "We're exactly where we want to be right now, and all we have to do is execute."

China factor

Kansas City Southern had to overcome obstacles to get to this point. It became embroiled in a dispute with its transportation partner in Mexico over the sale of its stake in the Mexican railroad. In addition, Kansas City Southern had a tax dispute with the Mexican government that was valued at more than $1 billion.

Both were eventually settled, but by that time China began to overtake the rest of the world in attracting investment and economic growth.

Haverty said that even when the rush to invest in China was at its peak earlier this decade, he remained confident in the decision to expand into Mexico.

“When I’d go down to Mexico, I’d see all the manufacturing facilities being built along our line,” he said. “I didn’t see people in business not investing or pulling out of Mexico.”

In its recent presentations to analysts, Kansas City Southern displays nearly 40 investments along its line, including existing businesses, new plants, plant expansions and new intermodal facilities. One is **First Auto Works**, a prominent Chinese automaker that plans to build a factory in Mexico by 2010.

“They’re initially going to sell those cars in Mexico, Central America and South America,” Haverty said. “But eventually their target is the rest of North America as well. So we are very well positioned for automotive manufacturing, especially when that sector starts recovering.”

One of the anomalies of the current economic slowdown is that while most of the transportation sector has suffered, railroads generally have done well. One factor is fuel prices, even with railroad fuel surcharges.

Haverty acknowledged the advantage railroads have gained due to high fuel costs, but he also sees hot spots amid the slow economy.

“Obviously, all the railroads are benefiting from the fuel prices,” he said. “The economy’s not strong, but I don’t think it’s as bad as everybody thinks it is. If you’re a New York banker, in the mortgage business or a homebuilder, things are tough. For us, the automotive sector is off, but other commodity groups are growing right now, like coal and grain.”

In addition, Haverty said the north-south rail network established by Kansas City Southern in the U.S. and Mexico gives the company an advantage in terms of growth.

“We’re looking at new business opportunities that some of the other railroads don’t have,” he said.

U.S. Department of Transportation trade statistics seem to bear out Haverty’s optimism. Surface trade, which includes trucking, rails and pipeline, reached $74.1 billion in May among the NAFTA countries — the U.S., Mexico and Canada. That was nearly 7 percent higher than May 2007 and nearly double the trade level from May 1998, according to the **Bureau of Transportation Statistics**.

The breakdown of trade by rail also showed sharp increases in May. Imports were up 4.9 percent and exports up 7.6 percent from a year earlier.

New president

One part of Kansas City Southern’s business that shows promising potential is at its southernmost point at the port of Lazaro Cardenas. **Hutchison Port Holdings** began operating the port last November, and Kansas City Southern de Mexico has the rail line that moves goods off ocean carriers inland into Mexico.

Kansas City Southern is expecting capacity at Lazaro Cardenas of about 550,000 containers, or 20-foot equivalent units known as TEUs. The port is small compared with the ports of Los Angeles and Long Beach, which combined handle more than 15 million TEUs annually.

But by the time Hutchison’s development is completed, Lazaro Cardenas should be able to handle about 2.5 million TEUs annually, according to Haverty. As a deepwater port able to accommodate the biggest ocean liners, Lazaro Cardenas also has space available for expansion to accommodate four or five more port operators.

“If you project 10 to 15 years from now, it could be a port handling 10 to 12 million TEUs in total capacity,” Haverty said.

Haverty points out that 55 million people live in the region adjacent to Lazaro Cardenas.

Getting other port operators and ocean carriers interested in Lazaro Cardenas will be part of David Starling’s duties at Kansas City Southern. Starling was appointed president and chief operating officer in July. Previously, he headed the **Panama Canal Railway Co.**, a joint venture of Kansas City Southern and **Mi-Jack Products**.

In addition to his railroad experience, Starling has had longtime relations with ocean carriers and Hutchison, the biggest port operator in the world, through its operations at the Panama Canal.

“Our Mexican franchise makes us a major player,” Starling said.

Although Starling is new to the inner workings of Kansas City Southern, he was appointed executive representative of the railroad in July 2007 while heading Panama Canal Railway. That gave him authority to hold talks with ocean carriers on behalf of Kansas City Southern a year before he became president of the railroad.

Starling said the transition to his new role has been smooth so far.

“I like the team we have in place now,” he said. “It’s a participatory style of management. Mike likes to get everybody together and get their views on the issues before making a decision.”

Rick Paterson, transportation analyst for **UBS**, said congestion issues in Southern California could make Lazaro Cardenas a viable alternative for ocean carriers bringing goods from Asia.

Although a new labor pact was recently reached with the longshoremen’s union on the West Coast, Paterson noted that a work stoppage there six years ago created bottlenecks that crippled the economy.

“If that happens again, a lot of that business would go to Lazaro Cardenas in the future,” he said.

Overall, Paterson said he thinks Kansas City Southern has a good plan in place in Mexico with a railroad that will deliver industrial and consumer goods within Mexico, regardless of the future at Lazaro Cardenas.

“They’ve got to deliver on that potential within Mexico, which will include bringing Mexican imports into the U.S.,” he said. “The success of the port would just be icing on the cake.”

Intermodal model

From western Mexico, it’s 6,000 miles north to another big development for Kansas City Southern at the former Richards-Gebaur Airport in south Kansas City. The company in March began operating a rail-truck intermodal hub at the site, and **CenterPoint Properties** of Chicago is in the midst of developing an industrial park to attract warehouses and distribution centers.

Several bulldozers were busy moving dirt at the 1,300-acre site last week, now called **CenterPoint-KCS Intermodal Center**, while **Mazda** vehicles from Japan via a Tacoma, Wash., port were being taken off railcars on their way to dealerships around the country.

Brett Jensen, Kansas City Southern’s assistant vice president of sales and marketing, said volumes have risen since the railroad moved its intermodal operations to the new site from the East Bottoms.

“The geographic location has opened up some new business as we build up the intermodal network,” he said. “Kansas City will be a key site for us.”A CenterPoint executive said construction is proceeding on schedule, which means buildings could go up by year’s end, depending on when companies start establishing operations there.

There have been inquiries from trucking companies, third-party logistics firms and import-export firms, said Fred Reynolds, CenterPoint’s senior vice president of development.

“We think there’s going to be a strong demand for distribution from that location,” he said. “We think there will also be an export market to Mexico. That makes it even more attractive if you have full containers coming in and full containers going out.”

Reynolds said the weak economy does not discourage CenterPoint, which is building similar distribution centers in other parts of the country.

“The pipeline does appear to be strong,” he said. “The efficiencies and cost savings designed into these facilities make them attractive. Locationwise, (Kansas City) has got so much going for it.”

For Kansas City Southern, the NAFTA railroad it has built is for the long term, regardless of current economic headwinds.

“If you look at what has happened since NAFTA was enacted in 1994, it’s been a huge success,” Haverty said. “It’s been good for American consumers and American manufacturers. I think it’s worked the way it’s supposed to.”

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