FINANCING RAIL FREIGHT: A Global View

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Today I would like to discuss not only the economics of the overseas rail privatization business but also the ethics; increasingly in North America we are talking about a political component to our historically private sector business, so I think this has some bearing. As a financial audience, if you are looking at financing overseas ventures your jumping off point is probably the domestic industry. I will therefore attempt to build a bridge for you, starting from how the domestic industry is financed and translating that into an overseas context.

BACKGROUND ON RDC

Railroad Development Corporation (RDC) is quite different than RailAmerica and Genesee & Wyoming as (1) we are a privately held company; (2) our focus is on emerging corridors in emerging markets, meaning for the most part developing countries; and (3) our financial structure is largely based on joint ventures. None of our companies are 100% owned subsidiaries; they are all done with partners. Unlike our bigger competitors, RDC does business in Argentina, Guatemala, Malawi, Peru and most recently the former Soviet Republic of Estonia. In addition, we have our flagship operation the Iowa Interstate Railroad, which is the former Rock Island line from Chicago to Omaha.

As stated, all of our businesses are joint ventures with a high reliance on partners in terms of how we manage these businesses with a small staff of five people.

USA SHORT LINE TRENDS - STRUCTURAL

Let's discuss the US domestic industry, and in particular why RDC has not been competitive in this business. Basically the competition in the railroad acquisition business is not trucks, but rather other buyers. The historic trend has been that these properties are auctioned off for the highest price to literally dozens of waiting bidders. The result has been that acquisition prices have been very high; so while the labor costs may go down, they are substituted for by high debt costs in order to finance the acquisition price. We do not see this practice changing as long as there are many bidders for these lines, thus prices will continue to be high.

In the US there are fundamental strengths to the Short Line industry. The Short Lines will remain the retail arm of the carload freight business. There is a continuing trend of consolidation as smaller players sell out and are acquired by the RailAmericas and the Genesee & Wyomings of the world.

However, there are fundamental weaknesses in the industry, which did not exist as of five years ago. First of the all, the Class 1 railroads' costs are going down as labor shortages evolve, which means the cost advantage of the Short Lines has disappeared. Second, as the Class 1s get bigger and merge, any one particular Short Line is a smaller percent of their traffic base; therefore, a Class 1 will be less likely to consider any individual Short Line as much of a key to their success. While in the past the Short Line industry has been very useful to the Class 1s in terms of getting political support for mergers, there are not a lot of mergers on the horizon and the motivation is gone. And, as said before, there continues to be fierce competition among the Short Line conglomerates for additional transactions.

Finally, the most recent trend is that the public sector is increasingly being called on to finance our business, ranging from Class 1s to the Short Lines. This trend introduces an element of political risk into our business because you never know whether your competitor will be able to get government funding and be able to offer a higher price.

OVERSEAS TRENDS – STRUCTURAL

In the overseas business the competition is usually trucks as opposed to other railroads, which is different from the North American market. This is of course not the case in Open Access environments like Europe and Australia, but for the most part in Latin America, Africa and the Former Soviet Union trucks are the competition and not other railways. Open Access is actually worse than North American rail-to-rail competition by a substantial margin because in an Open Access environment, everybody runs over the same infrastructure and therefore has the same variable costs, and the result is airline style, cutthroat competition.

The overseas cost structure of course presents opportunities for improvement. It is good to buy into a high-cost environment because as a railway manager, you can lower your costs. In general, there is no fundamental reason why an overseas business cannot be as profitable as a domestic business.

In the overseas business there are negative fundamentals and substantial risks. In particular, the single biggest determinant of value is revenue, and it is often difficult to determine meaningful historic trends. For example, in Guatemala the railway was abandoned for three years before it was privatized, thus there was no historic traffic and all of the customers learned to use trucks. Secondly, as Open Access has evolved in Europe, the financial community has underestimated how bad it is in terms of profit margins. With regard to financing, each country has a different structure and a different environment, so it is not possible to take the cookie cutter method used in one country and apply it in another country. Each deal has to be constructed from scratch, from the bottom up; if not done efficiently, the transactions costs will be very high.

When entering a foreign country it is often the first rail privatization, therefore an important consideration is that you're not likely to find people who know about financing railways. And in general, trying to do business on another continent, in a different language, is challenging to say the least and quite often the biggest problems are not economic, but rather cultural.

Another aspect of doing business in Africa is that the competition is often public sector railways. A week ago in the Sunday *New York Times* there was a front-page article about how South Africa is the engine of economic resurgence on the continent and how rail is one of the prime examples. What the article does not say is that it is South Africa's government railway that is participating in privatizations around the continent, and that in fact in their own country their railway is falling apart. RDC finds it very difficult to compete in such an environment and will not spend a lot of time pursuing transactions where the competitors are the national railways of France or the national railways of South Africa.

CASE STUDY 1 – OVERSEAS EXAMPLES

These photos depict the broad range of opportunities; the photo on the left is our operation in Guatemala and the photo on the right is our railway in Estonia.

	GUATEMALA	ESTONIA
TONS 2001	110,000	40,000,000
LINES OF BUSINESS	ATLANTIC: CONTAINERS, STEEL MEXICO: ? FIBER OPTICS: ?	OIL, FERTILIZER, METALS
PURCHASE PRICE	$0, PLUS 10% OF REVENUE	$60 MILLION FOR 64%
FINANCING	LOCAL CAPITAL MARKETS	STRATEGIC INVESTORS INTERNATIONAL CAPITAL MARKETS, IFC

In Guatemala the railway, which was abandoned for three years before it was revived, hauled 110,000 tons in 2001. In Estonia, the railway hauled 40 million tons, which is Big Time Railroading. Comparing Estonia with North America, the annual tonnage on Estonian Railways is 2% of the USA's, which is quite significant; and it is also 25% of Poland's annual tonnage. This is big time, broad gauge, Soviet style railroading. In contrast, a major aspect of the railway in Guatemala is that the potential is unknown.   What came with this railroad for free was the opportunity to develop ancillary businesses such as fiber optics, and to reopen the line to Mexico, both of which are works in progress.

In Guatemala we financed the deal in the local capital markets. There is a small market, thus we have Guatemalan partners. In the case of Estonia, the financing came from IFC; the international market; and strategic investors. But let me also clarify; RDC is only 5% of Estonian Railways; this is basically "The Ed Burkhardt Show" and not "The Henry Posner Show". So, these are examples of the broad range of opportunities and how they are financed.

Case Study 2 – Domestic Examples

Please recall the picture previously shown in the previous Case Study of a train going through a garbage dump in Guatemala. The picture below was taken when I used to be in charge of the freight operation in New York City that is now part of the New York & Atlantic. My basic point is that you don't have to go overseas to find Third World conditions.

	OAK POINT LINK	65TH STREET YARD
TONS 2001	0 INCREMENTAL	0
LINES OF BUSINESS	DETOUR FOR BRONX, LI ACCESS	ORIGINAL: INTERMODAL PROPOSED: TRANSLOAD
PURCHASE PRICE	$180 MILLION	$20 MILLION CIRCA 1982
FINANCING	PUBLIC	PUBLIC

But, down to business – this is a financial conference so one must ask, "What is the financial activity for rail freight in a place like New York City?" The bottom line is that in New York City $180 million was spent on the Oak Point Link, which today is handling the same trains that moved via a different route before the Oak Point Link was built. I believe there was a garbage train added but my question for New York is, "For $180 million was this really a great investment, and should you be talking about doing even more of these given that the impact on the market and the creation of transportation has been practically zero?" To go even farther back in history, the 65th Street Yard in Brooklyn was originally built as an intermodal terminal 20 years ago for a cost of $20 million, and still has never been used.

So, when we discuss our private sector industry and the risks associated with doing business in the USA, I would argue that as long as there is an undisciplined political component to the business, doing business in the USA – or at least in New York – may in fact be more risky than going to a poor country like Peru where the government is at least not the competition and where they are more focused on providing transportation as opposed to spending money.

CONCLUSION

In the USA the market continues to be transparent and highly competitive. Additionally, in order to be successful in this business, it's probably more about how you play the game and in particular, "Can you bid higher hoping that some government entity will take over your track budget?" than on customer focus. The prospect of increased financing from the public sector will further distort the market.

Overseas transactions are a risky business but the market is opaque, fragmented and less competitive than the USA. In this context, success will focus more on the ability to understand the country and who your partners are than anything else.

Thank you.

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