Private Investment in Freight Rail — *Risks and Rewards*

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Macquarie Global Infrastructure Conference • New York • May 15, 2008

Background on RDC

Railroad Development Corporation (RDC) is a small privately held company based in Pittsburgh. We describe ourselves as being in the business of "Emerging Corridors in Emerging Markets", meaning we are not only involved with railways but also with port facilities in Africa, electricity distribution in Central America, etc. Once you have the railroad right-of-way, the idea is to exploit it to its full economic potential. Also, let me emphasize that everything RDC does begins as a joint venture; in some cases we are a 100% owner and in some cases we are a 5% owner.

RDC has a strong presence in Latin America, where we were actually one of the pioneers. We also have an interesting presence in Africa which we will discuss in more detail. And we used to have an investment in Europe, but not since January 2007. All of this is indicated in the Table below. Our railways reflect a broad range in size and location, from the 78 employees we had until recently in Guatemala to the thousands of personnel in Argentina.

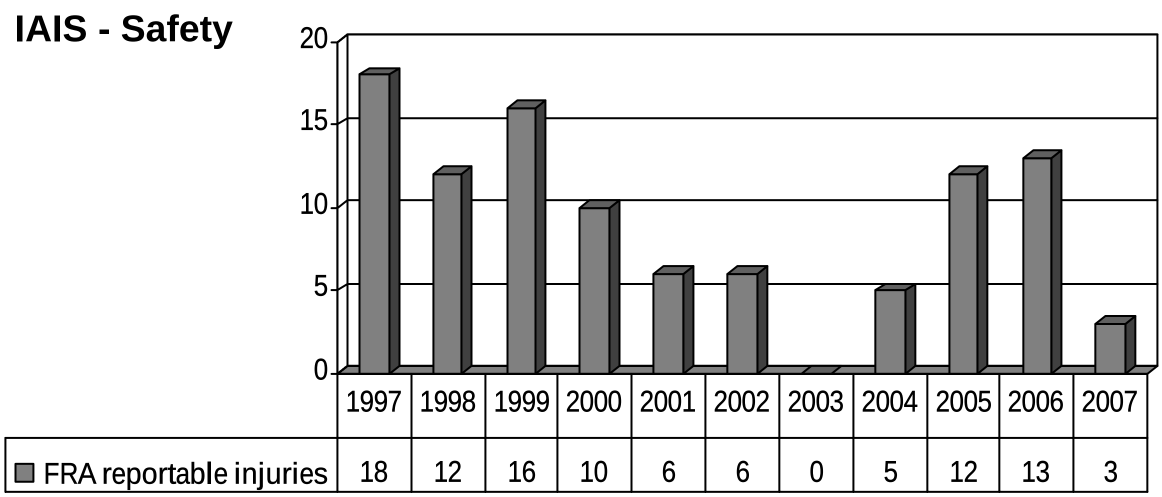
Country	Entity	Length		Employees	2006 Annual Tons (in millions)
		Km.	Miles		
USA	Iowa Interstate	1,005	623	190	6.7
Argentina	ALL Central	5,690	3,535	1,205	3.3
Argentina	ALL Mesopotamica	2,704	1,680	313	1.0
Guatemala	Ferrovias Guatemala*	322	200	78	0.09
Peru	Ferrocarril Central Andino	490	304	250	1.6
Malawi	Central East Africa Railways	797	495	446	0.19
Mozambique	Nacala Corridor	872	523	256 Rail 156 Port	0.09 Rail 0.80 Port
Estonia	Eesti Raudtee**	693	431	2,345	44.4

* Service suspended Sep. 2007
** Re-nationalized Jan. 2007

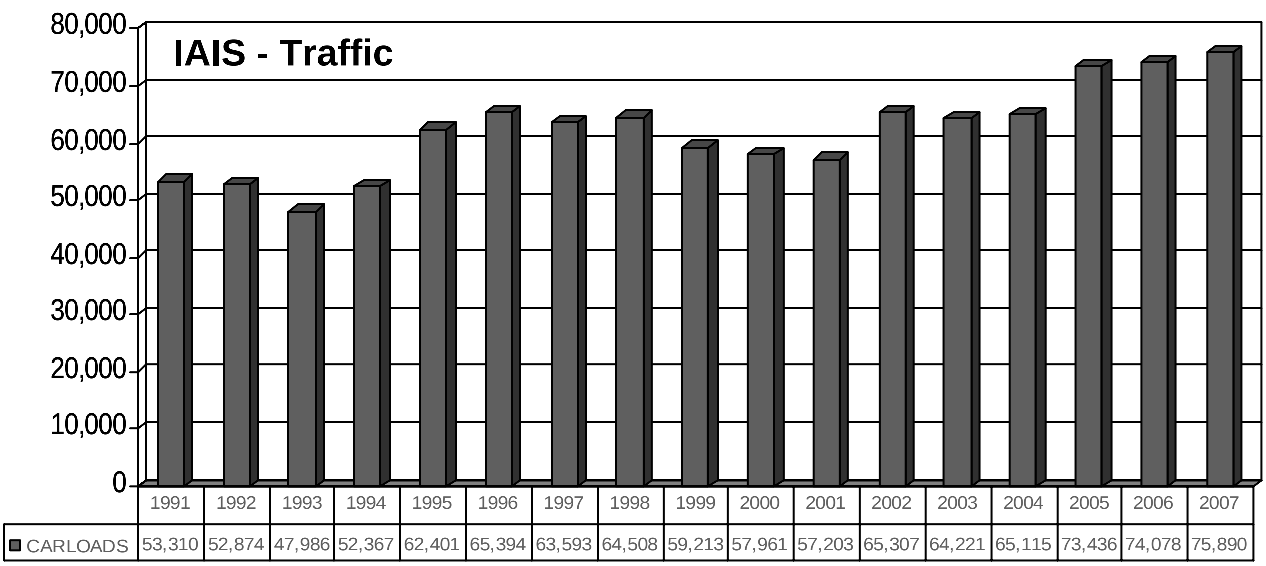
Case Study: USA – Iowa

The Iowa Interstate Railroad (IAIS) is the former Rock Island route from Chicago to Omaha, and is one of four railways in that corridor. IAIS was formed from one of the more important pieces of the Rock Island Railroad, which in the era of regulation liquidated and was in fact abandoned in 1980 as a through route. IAIS went through various restructurings before RDC got involved in 1991 and now we own 100% of the Iowa Interstate. IAIS is paralleled by three bigger railways, each of which is a New York Stock Exchange company; this is a highly competitive corridor.

What we are most proud of is our safety record. Note on the chart below that in year 2003 IAIS had no injuries which resulted in IAIS being awarded the Gold Harriman Safety Award, the industry's highest honor for safety. In fact, yesterday I was in Washington DC where IAIS was honored for the <u>second</u> time with the Gold Harriman Safety Award. So safety is a very important part of our business culture.



If you've got a safe operation, you are more likely to be providing good customer service, and if you're providing good customer service, then you're more likely to be growing the business.



Note the trend in traffic; the above chart should really start at zero carloads in 1980 when the line was abandoned; this was more than once described as a useless, parallel railroad. This is obviously a dramatic indication of how traffic has grown; one of the reasons that our business is increasing is due to the ethanol business.

IAIS recently placed an order to purchase 12 new GE locomotives at over $2 million each which will replace our existing locomotives on a 3-for-1 basis. I never thought that I would live to see the day, as someone who began his career in the era of regulation, when a railroad like the Iowa Interstate could afford to buy new locomotives; so we have certainly come a long way!

Case Study: Latin America – Guatemala

However, my experience of operating in the era of regulation prepared me for one of our more interesting businesses, which is the national railway in Guatemala. Our mainline actually operated through an open-air market (pictured left) occupied by squatters. The squatters were literally using our mainline as an open-air market except for when the trains came through.

The entire national railway was abandoned by the public sector in 1996, and RDC put it back into operation in 1999. But then the public sector put us out of business in 2007. This is the only example of a national railway where the private sector did the whole thing, including the funding and even including funding that was supposed to go into the infrastructure but was actually diverted by the government.

Part of the reason that we did this venture was because, as mentioned earlier, we are in the corridor business and there is value in the right-of-way which was intended to help fund the rail infrastructure. However, private sector interests figured out that the land was very valuable and we believe that caused the government to retroactively declare that the privatization was "lesivo" or against the interests of the country. With that declaration, any prospects that we had, such as leasing the right-of-way, stopped immediately.

Pictured to the right is a heavy-haul sugar truck, operated by the private sector on our right-of-way without paying us; and operating between two rows of electricity distribution poles, put there by the private sector also without paying us. Railroads are usually, and possibly always will be, worth more dead than alive. In this particular case, this is an extreme example of how the real estate value is so high that it was in the interests of the local private sector to see us put out of business.

But even in Guatemala our culture is one of safety and we were able to operate this railway for 1.5 years with no personal injuries. Safety is a measurement of how well you're able to manage your business and even in this environment we were able to reduce the personal injuries.

Because of the action taken against us by the government, we filed the first-ever claim under the Central American Free Trade Agreement (CAFTA) against the government of Guatemala. This will be subject to binding arbitration in a neutral, fair setting; and we are highly confident of our position. But this country has lost its railway and this also has cast quite a pall on its investment prospects. We were forced to shut down the rail operation in September 2007.

Case Study: Europe – Estonia

Another case study is our former investment in Europe — Estonian Railways. It was privatized in 2001, and despite it being a very competitive transit market from Russia, we were able to increase the business during the five years it was a privatized company. We were also able to reduce the personal injuries by 75%. In addition, we completely replaced the locomotive fleet with used locomotives bought from the USA for a fraction of the price of new locomotives.

However, in 2003 legislation was passed which had the economic effect of expropriating most of the value of the company, which in turn triggered arbitration under the privatization agreement. The bottom line is that Estonian Railways was renationalized in 2007; this was "a win for the politicians and a draw for the investors" (we tripled our investment in 5.5 years), but it was a loss for the people.

Interestingly, not long after we sold the railway back to the government, Estonia took political action against their largest customer, Russia, and back in state hands the railway promptly lost half of its business and never got it back.

Estonia is a textbook example of why it's sometimes cheaper to buy legislation than it is to pay for transportation. The reason that the Railways Act was passed was because customers felt that it was cheaper to go to the government and get this law passed than to pay freight bills. And, in fact, that is how the system worked. The lesson is that you are only as good as the country in which you operate; and the Estonian state not only paid to buy the railway back but then destroyed its value by taking political action against their largest customer.

Case Study: Africa – Nacala Corridor

The Nacala Corridor is the first private sector integration of ports and railways for general cargo. Basically it is the integration of a port in Mozambique, a railway in Mozambique and a railway in Malawi. This transaction was done in pieces, beginning with the privatization of the railway in Malawi in 1999 and then the port and railway in Mozambique in 2005. It was done with substantial equity as well as debt financing.

This was a complex transaction but I want to mention that we have been subject to the "usual" controversies. Once something is done, if the government changes or there are factions within the government, they will always come back at you for not fully staffing the stations, or for not rehabilitating lines with no traffic, etc. My favorite controversy was that we "failed to purchase locomotives with the correct gauge," which of course is not true. We found locomotives on a banana plantation in Panama which we bought for the price of scrap and shipped them to Africa. They are actually gauge-convertible locomotives. Even in this era of high prices for rolling stock, you can find bargains out there.

But let's step back for a minute to observe the diverse railway investment opportunities available. Note the difference in the Table below in tonnage between Estonia and Guatemala — 42 million tons vs. 0.157 million. The Nacala Corridor is in the middle because it is not just a railway but also a port business.

	Latin America—Guatemala	Africa—Nacala Corridor	Europe—Estonia
Tons (2004)	157,000	300,000 rail	42,000,000
Lines of Business	Atlantic – containers, steel, sugar Pacific – ?? Electricity rights-of-way, etc. – ??	port and rail	oil, fertilizer, metals
Purchase Price	$0 + 10% of revenue	$7 million + $2 million/yr + 5% of revenue	$60 million for 66%
Initial Financing	RDC Local Capital Markets	SDCN OPIC CFM	Strategic investors Int'l Capital Markets IFC

Interestingly, the Nacala Corridor is also a success story because we are in the process of selling our interests to local investors. So at every stage along the way, RDC has had issues and challenges with each of our investments, but in the long run we think we have a reasonable business.

Nonetheless, doing business in Africa is not like doing business anywhere else. One of the things to be dealt with in this environment is that the competition is often aid agencies. Pictured on the left is a locomotive donated in 1994 by U.S. Aid, and pictured on the right is what the same locomotive fleet looks like 9 years later. People do not respect what they are given; people respect things they have to pay for.

Another interesting fact about Africa is that most of the privatizations in Africa have been done by the government of South Africa's state railway (see Table below). If you go to South Africa and ask them what their plans are for privatization even on lines that have no traffic, they will tell that they are philosophically opposed to the idea of private sector operation of infrastructure, even though they are operating infrastructure elsewhere around the continent.

Structural Trends in African Privatizations

	Rail Investor	Ultimate Owner
SITARAIL (Cote D'Ivoire/Burkina)	Comazar	Govt. of South Africa
CAMEROON	Comazar	Govt. of South Africa
SIZARAIL (DRC)	Comazar	Govt. of South Africa

Structural Trends in African Privatizations

	Rail Investor	Ultimate Owner
ZAMBIA	Spoornet	Govt. of South Africa
NACALA CORRIDOR	RDC	RDC & Partners
KENYA / UGANDA	Sheltam	Sheltam & Partners

Conclusions Specific to Africa

The point that I would like to make is that in Africa, the competition is between public sector investors and private sector investors. I will make the unsurprising statement that RDC does not have as much money as the government of South Africa, and that I don't think we will be successful in competing with them elsewhere. You must choose your battles.

Conclusions for the Rail Industry

Railways are a network business and they are only as strong as the weakest link. For example, in North America there is very little traffic that stays on just one railway. Usually two or three railways are involved so you need to be aware of the weakest link. In Estonia, we were almost 100% dependent on Russian traffic. And in the Nacala Corridor there are several countries involved in getting to landlocked countries.

In each of the cases just presented there have been risks, but interestingly the actual risks came from the public sector as opposed to the normal risks anticipated such as traffic, financing, etc.

Risk vs. Reward

(NOTE: Public Sector = Primary Source of Risk!)

	Anticipated Risk	Actual Risk	Mitigation	Reward
Estonia	Traffic	Expropriation	Privatization Agmt.	Sale
Guatemala	Traffic, Financing	Expropriation	CAFTA	Arbitration
Mozambique	Traffic, Financing	Traffic, Financing	Capital Markets	Sale
USA	Traffic	Threat of Expropriation (re-regulation)	Capital Markets	Value, Growth

But when these incidents do occur, there is usually some sort of mitigation which ranges from Estonia where the privatization agreement ultimately resulted in a sale; to Guatemala, where much to the government's surprise, we were able to trigger the Central American Free Trade Agreement; and to Mozambique where local investors became interested in buying us out.

Interestingly, in the USA we also have the threat of expropriation, to the extent that re-regulation would have the economic effect of representing expropriation. But the quick answer to that is that Wall Street is going to slap this one down because you can't have railways funding expanded capacity while at the same time revenue is being handed back to customers. In other words, you can't expect funding of increased capacity and at the same time government regulation of pricing. As someone who worked for the Rock Island in the 1970s, we really don't want to go back there. We are running our freight trains at 25mph now on lines that we ran passenger trains at 10mph back in the era of regulation.

So to conclude, risk usually comes more from the public sector than from the private sector, possibly because railways are worth more dead than alive and there is more value worth stealing than there used to be. In addition, expropriation is not limited to developing countries; as long as there is the threat of re-regulation in the USA, Wall Street is going to be keeping that in mind.

With that being said, the fact that we are being considered for such types of expropriation suggests that at least there is some value there. Also, the best defense is having good partners and shareholders; it is also important to be operating in an environment where there is the Rule of Law.

In RDC's view of the world, you are only as good as the country in which you operate. If there are countries out there that are serious, there should be plenty of investors and operators like us interested in taking on challenges anywhere on the planet. There is an important role for private sector companies, even small ones like RDC, and we are always looking for the next opportunity.

Thank you.

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