# Structuring Railway Concessions In Africa: An Investor's Perspective

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It is a great pleasure to be addressing this audience for the first time as an investor in Africa. For those of you who know me, I've been coming here for many years and it gives me a great deal of personal satisfaction that we have finally begun to do business here on the African continent.

Today's discussion is "Structuring Concessions in Africa, the Perspective of an Investor." The agenda will be as follows: an overview of RDC; what RDC sees as the fundamentals of Africa's railways, and why they are in some cases a sound investment; the difference between commercialization and concessioning, which I think is an important distinction; what RDC sees as the structural trends for railway concessions in Africa; structural considerations as an investor; and finally to draw some conclusions.

## Background on RDC – General

RDC is a Pittsburgh-based railway investment and management company. Our business is increasingly defined as "emerging corridors in emerging markets," meaning not just railways, but railways and ports, railways and fiber optics, and other ways of maximizing the value of railways in what is always a difficult environment. I would like also to emphasize that everything we do is a Joint Venture. We are involved in no businesses on our own – it is always with local partners – and this can be seen in how we have structured our businesses to date. Today I will try to be as transparent as possible with you so that you can understand the inner workings of how we put these deals together. Hopefully that will give you a better basis on which to understand not only how RDC does its business but also helpful to you regardless of whether you are a railway in Africa, a potential competitor of ours or a potential partner. I would like to say again with great pride that RDC is the only American railway company making investments in Africa.

## Background on RDC – Transactions

### Iowa Interstate Railroad

Our business in the USA is quite limited; we have investments in one railway – the Iowa Interstate Railroad (IAIS). IAIS is one of the main lines from Chicago to Omaha and it is one of the more difficult markets in the USA and in fact, this railroad was abandoned between 1980 and 1984. It was revived as a through route and RDC became involved in 1991 in order to stabilize the business. For a small railroad in the central USA, one thing that is quite interesting about the IAIS is that it has developed a low technology train control system based on an IBM AS400 computer and radio links. In fact, this system is so competitive that it is being used throughout South America and in South Africa on Spoornet.

### Buenos Aires al Pacifico & Ferrocarril Mesopotamico

RDC's involvement in rail privatization began in the first country where rail privatization occurred outside of the USA, specifically Argentina. In the early 1990s the railways in Argentina were almost closed and in the case of the Argentine railways, there was no place to go but up. The government of Argentina had made the then-courageous decision to privatize their railways. RDC wanted to be a part of this process and entered into a Joint Venture with an Argentine company. The result is the railway from Argentina to Brazil and from Argentina to Chile. Together these link the Mercosur common market, which also includes Paraguay and Uruguay.

### Ferrovias Guatemala

A most challenging project, and which to my knowledge has few parallels even in Africa, is the resurrection of the railway in Guatemala, which was abandoned in 1996. Despite the collapse of the financial markets in Central America, despite Hurricane Mitch in 1998, and despite having zero traffic, the railway was reopened in December of 1999 and is now functioning in the first phase of our plan to reopen the entire system. Interestingly, Ferrovias Guatemala is traded on the stock market in Guatemala. It is a very small capital market but it is an important model for developing countries. Your country may be small, but if the deal is a good one, it is possible to attract investor capital.

### Ferrocarril Central Andino

In September of 1999 RDC was also successful in winning a concession in Peru. We are a part of a Joint Venture for the Central Railway from Lima into the Andes Mountains. It is the world's highest railway and reaches an altitude of 3 miles. This railway is so steep that it is not possible to go up the mountains directly. The way we go up the mountains on a 4.2% gradient is through switchbacks (pictured above right). We have over a dozen switchbacks that allow us to go up to a height of 3 miles in the 100 miles between Lima and Galera.

In this case it is the first time that RDC has been able to attract international investors, specifically Commonwealth Development Corporation (United Kingdom) and Mitsui (Japan).

### Central East African Railways

In December of 1999 RDC was part of the consortium that privatized the Malawi railways, now known as Central East African Railways (CEAR). This is once again a Joint Venture and our partners include CFM – the national railway and port company of Mozambique – as well as investors from Mozambique, South Africa, Portugal, and Bermuda.

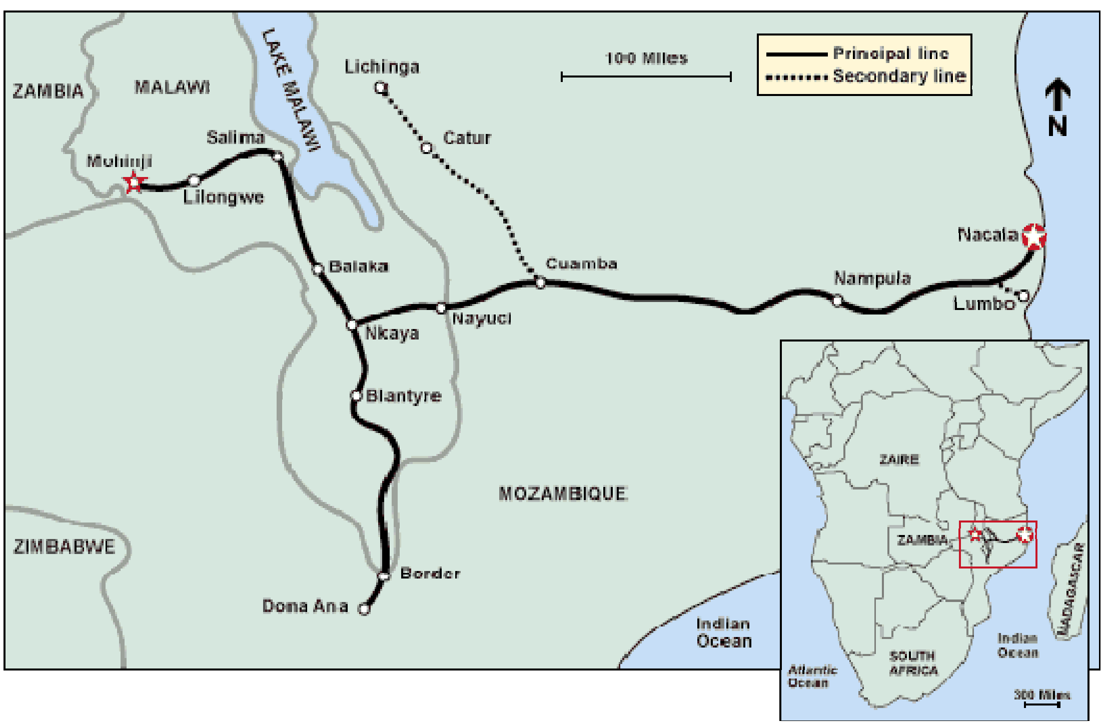
In fact, our locomotive fleet (pictured below right) is relatively modern, having been rebuilt in the last decade, so we are starting off with a railway that is at least functioning in comparison with what RDC took over in Guatemala.

RDC is also looking to be involved in Mozambique in the Nacala Corridor.  We expect that in the next several months the Nacala Railway and Port will be integrated with The Central East African Railways.

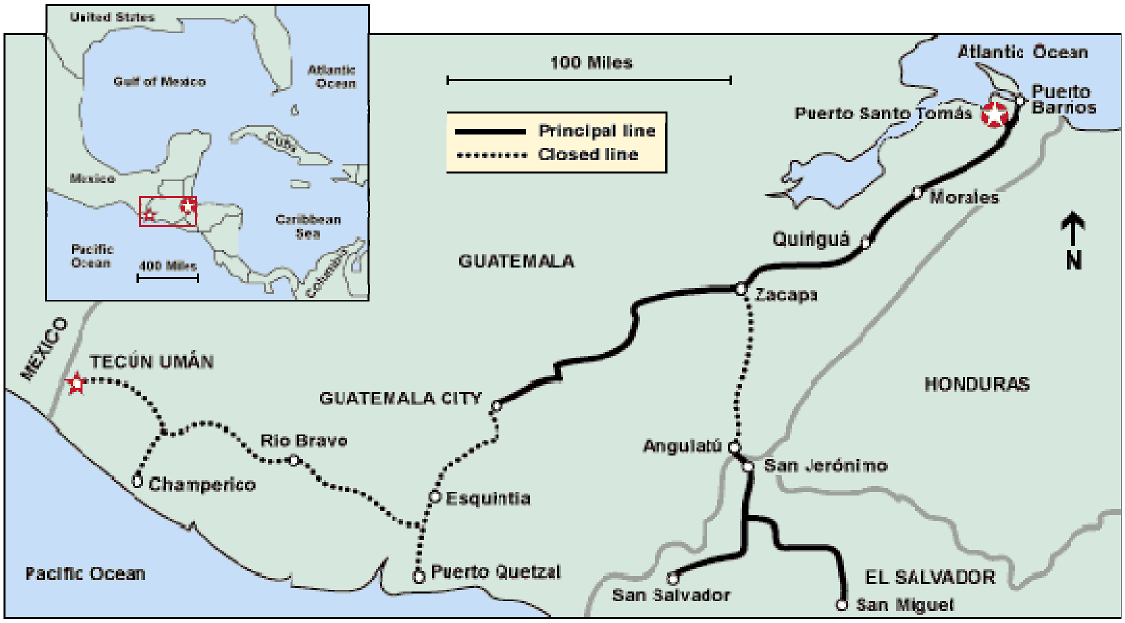
**RDC's Focus:  "Emerging Corridors in Emerging Markets"**

As mentioned at the beginning, RDC is an investor in emerging corridors in emerging markets. If you look at the map (Map 1), there is a railway in Malawi, a railway in Mozambique and a port in Mozambique.  To our knowledge, this has never been done in the private sector – the integration of a general cargo port with a general cargo railway.  I think this goes a lot toward creating the seamless service that has been often discussed.  This is not only a port and a railway, but also several countries.  What is interesting about this business is that it is also quite similar to the railway in Guatemala (Map 2).

Map 1 – Malawi's Railway & Mozambique's Nacala Railway/Port



Map 2 – Guatemala's Railway




While the railway in Guatemala was abandoned, there is still a right-of-way and in many places track in place all the way to the capital of El Salvador. In the long run what we expect to see is a reunification of the railway of El Salvador with the railway in Guatemala, giving us a second source of traffic. Again, this is an example of two countries' railways working together to reach the ocean. The other interesting thing is that in the future we will get Puerto Barrios back, so in about 15 years, we will be a railway/railway-port network if we do our jobs well. Thus our theme is "Emerging Corridors in Emerging Markets" and not just railways.

## The Fundamentals of Africa's Freight Railways Are Sound…

| | | USA | Europe | Latin America | Southern Africa |
|---|---|---|---|---|---|
| **REVENUE:** | ▪ **Competition** | Other RR | Other RR | Truck | Truck |
| | ▪ **Market Share** | Mature | Mature | Low | Medium |
| | ▪ **Traffic Base** | Mature | Mature | Expanding | Reviving |
| **COSTS:** | ▪ **Infrastructure** | Good | Excellent | Fair | Fair |
| | ▪ **Rolling Stock** | Good | Excellent | Poor | Fair |
| | ▪ **Staffing** | Low | High | High | High |
| | ▪ **Railway Capital Markets** | Mature | Emerging | Emerging | Minimal |

So why would an investor be interested in Africa? As I have stated in the past, cost control is important but revenue is more important. If you look at the fundamentals of the markets for railways in Africa, this is a very interesting market, especially compared with the USA and Europe. In Southern Africa, the competition for the most part is trucks. In the USA, the competition is other railways. The Iowa Interstate is one of four railways from Chicago to Omaha. In Europe, everybody is competing with everybody. In the United Kingdom, it is basically a free-for-all with freight operators cannibalizing each other's business and no one is making much money. In Africa, you can have a true franchise business, and that is what drives railway investment in Latin America, which I think has the most in common with Africa, and that is what I see evolving here. I would add that there are cost problems and over-staffing problems, and the infrastructure is not perfect (though I would argue that is better than what we have in Guatemala). However, I would rather have a cost problem than a revenue problem. The reason for that is that we as railway managers can control costs much more easily than we can control revenue. If the on-line steel mill goes out of business, there is no possibility of making money regardless of how efficient you are.

### …Making Concessioning Preferable to Commercialization

| | COMMERCIALIZATION | CONCESSIONING |
|---|---|---|
| **Financing** | Public | Private |
| **Political Sensitivity** | High | Low |
| **Focus** | Internal (Process) | External (Customer) |
| **Management Stake** | Salary | Investment |

I would like to comment on the difference between commercialization and privatization. Commercialization is a good halfway measure toward optimizing the performance of railways. The problem with commercialization, which I would define as any transaction where the government remains the dominant shareholder, is that you are only going halfway. A company that is controlled by a government entity is more responsible to politicians than customers and the real question is therefore, "Are you trying to create transportation or are you trying to serve a political agenda?" I would argue that it is better to create transportation than to serve a political agenda and I will leave it at that.

### Structural Trends in Africa

Let's get specific about the positive structural elements about railways in Africa. As I have stated before, the railway competition in Africa for the most part is trucks and not other railways, and that is a positive. In many cases the economies are being restructured, which in the long run will make a bigger pie for the railways to compete with trucks for. On the cost side there is room for improvement; therefore, in general Africa is as good as an investment environment as one would find in the USA, Latin America, or any other place.

There are negatives, as there are with any business. The primary negative is in the revenue area because it is very difficult to predict the revenue stream when the railway has been either not running or badly run in the past. Secondly, if Open Access is implemented in Africa, and to my knowledge there is not a lot of that going on, you can look forward to a low-margin business that will be very difficult to finance. In the cost area, it is very difficult to get financing in a developing country especially when there is only one railway and it has always been in government hands. What RDC has to do for the most part is to fund these projects with our own capital, which is OK up until the point where transactions become bigger than we can handle. We are always looking to attract third party financing but for the most part we have had to look ourselves and our local equity partners to fund these projects.

In general, there are many logistical and cultural gaps that make it extra difficult to do business in a foreign country. We feel we have to be flexible culturally in order to integrate ourselves with the local culture. There are five top managers at Central East African Railways, and I am proud to say that RDC has only two people in Africa and we do not intend to make significant increases in that staffing level. We believe that the resources are all here and it is just a question of organizing the work and making sure everyone has their roles defined and the necessary resources to support them in their jobs. The physical assets and human resources are here, and it is just a question of management. Finally, in Africa we do find ourselves competing with state-owned railways and in those circumstances, since we have less money than for example the government of France, we will probably elect not to compete if French railways decide they want to participate aggressively in transactions in Africa.

## Structural Considerations for Investors

What are the most important characteristics from an investor's perspective? There are approximately six that I list in descending priority order with the most important element being a **committed seller**. We need to be convinced that the government is serious about concessioning as opposed to using potential investors as political stalking horses or free consultants. Second, we look for a **transparent and disciplined concessioning process** where, if we offer the best price or the best terms, we believe that there is a high likelihood that we will actually get the transaction. The third element is **local partners**. RDC has never done business in another country without local partners; it is extremely important to us and one of our core values. Fourth, we like to have **management investment** in the company, if not in the short term, in the long run. We believe that management having a financial stake in the success of the business is the best discipline we can have. Last but not least are the traditional railway skills – **marketing** and **cost control**.

## Conclusions

To conclude, the African market is a very diverse market: many railways, many of which do not connect with each other; lots of countries with conditions ranging from good to bad; a less competitive market because there are fewer players and more opportunities; on the other hand, it is more risky because a lot of the opportunities that appear to be out there are in fact illusory. Success in this business will rely on the ability to understand the country more than the ability to understand the railway business. Success will also rely on a willingness to take risks. At Railroad Development Corporation we have demonstrated a willingness to take risks, though we have been too cowardly to invest in the UK and Australia where Open Access, in my opinion, is probably a greater risk than political uncertainty in many other countries. And finally, it is very important to be both a Patient Investor and an Impatient Manager. We recognize that in developing countries conditions are different than in the USA or Europe so we are willing to keep going when hurricanes wipe us out or financial markets collapse. But we are not patient managers. Once we are involved in a business, we expect to stick to the plan and the timetable to the extent that Mother Nature will allow us, because it's a big world out there and we want to make our contribution to it.

The following is a case study of a railway that I think is worse than anything found in Africa, and that is the railway in Guatemala.

## CASE STUDY:  GUATEMALA

In Guatemala the railway was abandoned in 1996 and the only service provided was this private sector light rail operation (left). Because the railway was abandoned, there was no maintenance done and this is one of the bridges on the mainline (right).

A railway with no business will not support a European or even a South African standard of engineering. We agreed to replace 25% of the cross ties and none of the rails; this is an unballasted railway. This is the level of infrastructure that can be justified for an abandoned railway with a speculative traffic base. All we did was change 25% of the cross ties; this is 99% local content. The cross ties were produced locally and they were installed using manual labor. There is no sophisticated machinery or anything like found in most other countries.

Fifty people repaired this bridge and the most sophisticated piece of equipment was a cement mixer – 99% local content.

"Bad things happen to good people." In 1998 Hurricane Mitch occurred, which was not in our business plan, and this is one of our mainline bridges positioned approximately one half of a kilometer from the mainline.

After Hurricane Mitch, additional storms hit us and this is what our mainline looked like after it had been rehabilitated. Needless to say, we had to go back and do this work all over again, at least in terms of replacing the embankment.

Remember the bridge pictured on its side? Well, in this picture you will see some very creative engineering. The bridge on the left is being dragged into position by a bulldozer on a dirt ramp, which was being constructed 10 feet at time. We would drag the bridge 10 feet, the bulldozer would move the dirt to the front of the ramp, drag the bridge 10 more feet, etc. This is probably how Stonehenge was built. At any rate, it eliminated the need to put in a replacement bridge and it was 99% local content. Again, we do not have Donors in Central America so these are the resources that had to be fallen back upon.

And in 1999 we actually got this railway running and in the year 2000 we are actually moving traffic. Pictured to the right are revenue containers. This railway is functioning and this is the first example of a national railway system that was completely abandoned and then restored to commercial operation. The cost of this project – for 200 miles of mainline railway, the rolling stock, the startup costs, the computers, etc. – was under US$10 million.

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Let me close with the picture that I think encapsulates most distinctly everything RDC stands for, which is Joint Ventures. This photo (right) was taken in Nacala and pictured are Mozambicans and Americans working together in a very difficult business with very limited resources. The slogan of Samora Machel is particularly appropriate to our business – "A luta continua!" or "The struggle continues!" This is the philosophy behind Railroad Development Corporation.

## Question-and-Answer Session

**Q: How do you view separation of infrastructure from operations?**

A: When you separate infrastructure from operations you lose control over your ability to deliver the product. The main constraint on rail freight in the UK has been the unresponsiveness of Railtrack to the needs of the freight sector. In fact, last week I read a financial report that stated 'don't invest in Wisconsin Central' and the reason is because Railtrack said that they are going to raise the access fees even more. That is both a cost and revenue problem, but what is even worse with Open Access is the cannibalization of rail carriers competing with each other on more or less the same variable cost basis. Anyone can go out and lease a locomotive and compete for the right, for example, to haul Railtrack infrastructure trains. This is exactly what you see taking place today and that is one of the reasons that investment in the UK rail sector, at least on the freight side, is being discouraged. I will also argue that there is a compromising of safety that occurs when you separate infrastructure from operations. My personal opinion is that the accident at Ladbroke Grove was at least an indirect result of the separation of infrastructure from operations. What you had was a Railtrack controlled infrastructure, a Great Western passenger train, and a commuter train from a third company. I do not see how discipline, which holds our business together, can be clearly maintained when you have so many different companies trying to work together in such a complicated environment. I hope that answers your question.

**Q: Regarding the "Fundamentals of Africa's Freight Railways are Sound" discussion, one of the top fundamentals for railways in Africa is the fact that truck weights are very high and compounding the issue is that enforcement is not practiced to any great degree. Has RDC considered this an issue before investing and if so, has RDC developed a particular strategy to deal with this issue because just recently in Malawi, the gross vehicle weight will be officially raised further?**

A: To answer your question, a level playing field is the ideal that I believe we should all aspire to, but if we wait for the playing field to be leveled, then nothing will ever happen. We make our investment decisions based on the current unfair environment in which railways operate. We have not seen a case yet where a railway's playing field was leveled, with the exception of New Zealand – to their credit – and also a tax case in Australia and that's to their credit. They were basically windfalls to the railway. We certainly do not make business decisions in the hope that we are going to get a windfall. We have to move on and we will compete with trucks based on whatever the environment is. There is benefit to an organization like SARA making the case on a regional basis because country by country I do not think you can support the cost of the lobbying that it takes. I would like to point out Bob Mortensen, who is Managing Director-Africa for RDC; he is one of our two people in Africa and we are very proud that he is also Vice President of the Southern Africa Railway Association. This is one of our contributions toward leveling the playing field and an entity like SARA is probably the best vehicle for making those types of cases. The world is unfair but if we wait for it to be fair, then we are out of business, so we have to move on.

**Q: In the case of concessioning, how do you address the risk of political interference and the concern that a public monopoly is being replaced by a private monopoly?**

A: That is a political reality that has to be accepted and it is not just Africa. There was a labor dispute in Argentina where it was suggested that because the railway was on strike, the concession should be revoked. But the discipline that underlies our industry is that that type of threat is seldom carried through. Political threats may be made but countries are usually more serious about attracting foreign capital. Sometimes it makes politicians feel good to talk about renationalizing the railways, but for the most part railway nationalization has been a failure, and in the case of Argentina it bankrupted the country. The whole question of whether we are creating private monopolies rather than public monopolies can be answered very easily in Guatemala where we are the railway monopoly. But the railway hasn't been run for 3 years, so what did people do when the railway wasn't running? Yes, we are a railway monopoly but in fact, because of the trucks, we are not the transport monopoly. Even in the zone of influence of The Central East African Railways, we compete more with ports than with trucks; we compete with Dar es Salaam via the TAZARA and truck; we compete with Beira by truck; and we compete with Durban by truck. So increasingly there are fewer and fewer monopolies out there and that is the discipline that prevents us from being a true monopolist.

**Q: How do you view the impact of privatization on employment?**

A: In the short run the answer usually is that employment is reduced; The World Bank plays a very important role in financing the redeployment of people who lose their jobs. But I think the fundamental question is, "Is the railway's business to provide employment or to provide transportation?" In some countries it may be that the objective is to provide employment and that is a decision for each individual country. But if a country chooses to privatize, what usually happens in the short run is that employment is reduced, with a restructuring payment financed by The World Bank to help the people who lose their jobs. Hopefully in the long run, employment increases as traffic grows.

Having said all of that, this was not the case in Guatemala. In Guatemala the railway was abandoned and if you include the people who were working on the track programs at any given time, we figured that we created approximately 500 jobs; some were short-term and others longer-term. Again, we are very proud of what we've done in Guatemala because it actually increased employment, which is one of the few cases where that happened with a privatization.

**Q: I agree that New Zealand is an excellent environment for railways, so how do you explain the management changes at Wisconsin Central?**

A: I think the problems with Wisconsin Central were the result of what happened in England, not in New Zealand. What happened in England was that people underestimated how bad Open Access was and they also underestimated the resistance of Railtrack to growing the business. Those two factors, combined with the fact that England was their biggest investment, created a negative financial result and I think that is the answer.

Thank you very much.

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