Direct Investment in Rail in Africa — A Private Sector Perspective

U.S./Sub-Saharan Africa Trade & Economic Cooperation Forum (AGOA)
Washington DC • August 2, 2010

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Today I would like to focus on the Nacala Corridor as a case study and then draw conclusions about trends in railways that are specific to Africa.

Background on RDC

As background on RDC, we are a small, privately held company based in Pittsburgh. We focus on Emerging Corridors in Emerging Markets, which means not just railways but also ports, communication lines, etc. And we always structure our work with Joint Ventures; I emphasize the words *Joint Ventures* because I would be remiss in standing before this audience and not mention the fact that the reason we were in Africa was because of Jack Edlow. Many of you know him; he is an Africa investor based here in Washington. It is never the "RDC Show", but rather a joint venture in which RDC is a participant.

The chart below shows the diversity of our investments ranging from the USA to Latin America to the Former Soviet Union, and indeed to Africa with the Nacala Corridor between Malawi and Mozambique.

CURRENT:	**Entity**	**Length Km**	**(Miles)**	**Employees**	**Tons Y. 2009 (in millions)**
USA	Iowa Interstate	954	(592)	206	11.7
Argentina	ALL Central	5,690	(3,535)	1,200	2.3
Argentina	ALL Mesopotamica	2,704	(1,680)	300	1.0
Guatemala	Ferrovías Guatemala	322	(200)	13	N/A
Peru	Ferrocarril Central Andino	535	(332)	431	1.8
PAST:					**Tons Last Yr of Investment**
Malawi	**Central East African Railways**	**797**	**(495)**	**417**	**0.22 (2008)**
Mozambique	**CDN-Nacala Corridor**	**873**	**(542)**	**404 Rail** **209 Port**	**0.2 Rail (2008)** **0.9 Port (2008)**
Estonia	Eesti Raudtee	693	(431)	2,345	44.4 (2006)

Thesis

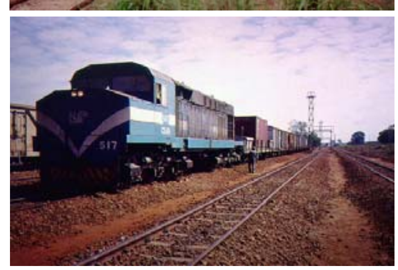
The thesis that I would like to share with you today is that the U.S. model of freight railroading, which is generally considered to be the most successful model in the world for freight rail, is what we try to export. Keeping in mind that culture is everything and that in working with joint ventures, there is no point in exporting something that will not take root from a cultural basis. And that is the reason RDC has gotten as far as it has in the diverse number of countries in which we operate.

One of the things that I like to do is oversimplify; if you'll excuse me as an American, I think we tend to oversimplify things sometimes, but I tried to fit the entire planet on one page. If you'll note the column on the right (table below), Africa as compared with the USA, Europe and Latin America is certainly in the middle of the pack as far as interesting investment opportunities for railways. In particular, the reason for that is not necessarily because Africa is perceived as a low-cost environment, which I would argue is not true, but rather that in Africa the main competitor is trucks. If you allow railways do their job, they can compete effectively with trucks depending on the size of the market and the distance to be traveled.

The Fundamentals of the World's Freight Railways on One Page

		USA	**Europe**	**Latin America**	**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

Case Study: Nacala Corridor



Next I will share a few visual aids, noting that I took every one of these photos; I'm a hands-on railway guy and an unapologetic railway enthusiast; and I have traveled over every kilometer of these railway systems to personally take these photos.

So let's talk about the Nacala Corridor and, in particular, the market it serves. It is not a high-density railway hauling iron ore downhill to the nearest port for export; but rather a general commodity railway which not only handles food products, etc. but also handles passengers. This is somewhat counterintuitive because one thinks of passengers as a social service, but I think that the passenger service that we provided, which is a good basic service, is an important model and a good demonstration why railways serving a general cargo market can also be very effective in moving passengers as long as you recognize that as a social service it requires some sort of subsidy or other economic consideration.

RDC Role: Operator, Investor

We began looking at the Nacala Corridor project in 1996 in conjunction with Jack Edlow. In 1999 the Malawi railway was concessioned but that was only half of the corridor. So running only half a railway is like fighting a battle with one hand tied behind your back. Then there was a cyclone in 2003, etc. It was only in 2005 that we were finally able to obtain the financing to complete the concessioning of the Nacala Corridor. So between 1996 and 2005 – that's 9 years by my math – we limped along with incomplete financing and yet we did it. The end result was that the business was considered valuable enough that we sold our interests in the corridor to local investors in 2008. So what we did was a complete investment cycle, and a direct investment in railways in Africa. To my knowledge, that has not happened anywhere else in this generation or perhaps in this last century.

Financing

The financing, which took over 7 years to put together, and after a long struggle, came from OPIC; and we cannot thank them enough for being there for the Nacala Corridor when the other options did not work out. The equity was 25%, which was real equity, cash money in. And as a matter of great pride, we did not go back and renegotiate with the government.

Another interesting thing about this project is that it is not a mega project in terms of investment. The total investment, all in, was under US$50 million. So it is possible to restructure railways in a cost-effective manner, which is what RDC has also done in North America as a model to export and use elsewhere.

But it is also important to share with you what didn't work for us, and the reasons behind them. We were not successful in obtaining financing from the Millennium Challenge, interestingly because the project was not sponsored by the public sector; it didn't matter that there was private equity going in. The simple fact that the corridor was not nominated by the government made us ineligible. Ironically, as soon as our interests were sold, this has become a priority and now Malawi is looking for financing from the Millennium Challenge.

Also, in our experience the World Bank was not a solution. Our problem was that the Nacala Corridor was competing with the Beira Corridor, which was a pet project of the World Bank. As a result there was a conflict over which corridor was going to move the big business, which was the Moatize coal—the pot of gold at the end of the rainbow (Of course, back then we didn't know it was the pot of gold at the end of the rainbow.). The fact is that the World Bank financed the competing Sena Line to the tune of over US$100 million based on very little due diligence, and still had enough money to fund a study to try to discredit our Nacala project…in which they did not participate. Needless to say this was not helpful to the cause of railways in Africa. I don't want to spend too much time on this, but I think it is important to point out the danger of wasting time pursuing illusory solutions. While we did try to work with the World Bank, eventually we realized that it wasn't going to work.

What are the lessons here? Keep moving; stay flexible; and stay committed. Eventually things will happen, as was our experience.

Stakeholder Relationships

Of course there are the usual political anecdotes in terms of what the concessionaire “should have done.”

Yes, we did not staff all of the stations. Yes, we did not provide frequent service on lines with no traffic. This is normal for railways worldwide, and I would simply point out that these are exactly the types of press clips that you would find elsewhere in the USA, Europe, etc.

But my favorite controversy was the accusation that we bought locomotives with the wrong gauge. We found them on a banana plantation in Panama and we got the locomotives for the price of scrap and shipped them as deck cargo to Mozambique. They are, in fact, gauge-convertible locomotives, and the last time I was in Mozambique, they were working happily away in the yard in Nampula.

- **Ongoing efforts by public sector to discredit privatization at the local level**
  - **“Failure to fully staff all stations”**
  - **“Failure to rehabilitate 77 km”**
  - **“Failure to provide service on light density lines”**
  - **“Failure to purchase locomotives with the correct gauge”**

“Locomotives with Incorrect Gauge”

Gauge – Convertible U6Bs Loading in Panama for Mozambique

The Nacala Corridor in Context

So let’s step back and put the Nacala Corridor in context compared with some of RDC’s other non-USA investments. Note that the Nacala Corridor is bigger than Guatemala but much smaller than Estonia. Nonetheless, this is an interesting business and “every deal is a good deal if the price is right.”

	GUATEMALA	NACALA CORRIDOR	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/year + 5% of revenue	$60 million for 66%
Initial Financing	RDC Local Capital Markets	SDCN OPIC CFM	Strategic investors Int’l Capital Markets IFC

I would argue that as a direct investor in Africa, the Nacala Corridor project falls in the middle of the pack against world railways as investment opportunities.

Another thing to consider is the risk of your investment. It's interesting that the risk of expropriation was actually higher in Europe and Latin America than in Africa. Despite all the stereotypes, we found the Nacala Corridor to be a much more stable investment environment and, in fact, the way out was the capital markets. Ultimately the project was able to get financing and we financed our way out and the end result was the transaction in which we received value for our investment.

Risk vs. Reward:	**Anticipated Risk**	**Actual Risk**	**Mitigation**	**Reward**
ESTONIA	Traffic	Expropriation	Privatization Agmt.	Sale
GUATEMALA	Traffic, Financing	Expropriation	CAFTA	Arbitration
NACALA	Traffic, Financing	Traffic, Financing	Capital Markets	Sale
USA	Traffic	Threat of Expropriation (re-regulation)	Capital Markets	Value, Growth

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

Industry Structural Trends in Africa

Let's look at the big picture perspective at the structural trends in Africa. The most important one is the last one: "African railroads are potentially as profitable as similar railways in the USA." I think this is a very important message for policy makers as well as the financial market.

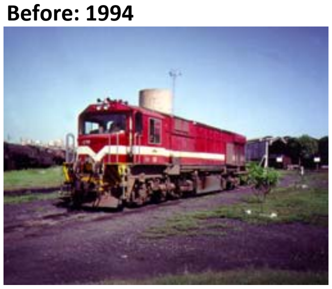
	POSITIVE
Revenue:	• African RR's compete with trucks, not other RR's, therefore margins are higher
	• African RR's have growing economies, market share upside
Costs:	• African RR cost structure presents much room for improvement
General:	• African RR's are potentially as profitable as similar railways in USA

On the other hand, there are constantly players in the market who have access to public funding. And I will confess to everyone in this room that we do not have as much money as the governments of China or South Africa, and RDC is not likely to compete with players like that, so we don't.

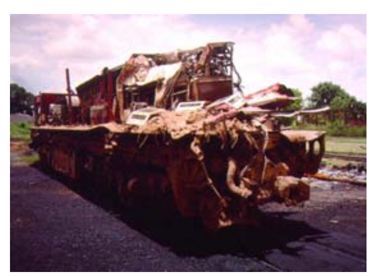
	NEGATIVE
Revenue:	• Revenue risk due to lack of meaningful historic trends
Costs:	• Lack of local experience for debt financing
General:	• Logistical and cultural gaps make opportunities difficult to identify and pursue
	• Competition in Africa is often public sector railways, such as Transnet (So. Africa)

The role of aid agencies also needs to be addressed. I would like to simply point out the Before and After photos that were taken in Mozambique. Note the brand new locomotives in 1994, followed by their condition in 2003.

Before: 1994



After: 2003



People do not put a value on something if they don't pay for it; and I would argue that aid programs to a certain extent are competition as well.

Conclusions

To conclude, rail is an interesting business and it can stand on its own. Further, I would argue that the best form of risk mitigation is not political risk insurance, but rather who the shareholders are and how the shareholders stick together through the tough times. And it is also important that there is basic Rule of Law.

But to repeat, the aid industry is part of the competition. So to a certain extent there is competition from both aid programs and government-owned railways from other countries. RDC is not likely to compete for those types of opportunities.

I would like to close with a quote from Samora Machel; "A luta continua!" (English translation, "The struggle continues!") There are plenty of railways in Africa; there are plenty of opportunities; and RDC would be very interested in taking the money we made in the Nacala Corridor and putting it back into the continent. As Transportation Secretary LaHood said earlier, "We will do all we can." And that is certainly true of Railroad Development Corporation. Ideally this will be an environment in which the public sector and the multi-laterals are part of the solution as opposed to being part of the problem. RDC will be out there as long as there are interesting opportunities.

Thank you very much.

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