

# The RDC Story, in Perspective

## *Iowa Interstate and Beyond*

HENRY POSNER III

Chairman of Iowa Interstate Railroad and Railroad Development Corp.

2012 Lexington Group Meeting • Peoria • October 5, 2012

Today I would like to discuss the Iowa Interstate in the broader context of its affiliation with Railroad Development Corporation (RDC).

Let's begin with this photo of the famous Government Bridge across the Mississippi River, the first version of which launched Abraham Lincoln on his railroad career.



One of the great things about PowerPoint is that you can drop all kinds of images into your presentation. The downside of PowerPoint is that if you use it, then people tend to believe it's true. This is a Soviet image, "October Revolution – A Bridge to a Glorious Future". So just because I'm saying something with PowerPoint doesn't necessarily mean it's true.



First let's talk about the basic agenda. I'll provide some background on RDC; talk about our investment philosophy; and then why we are different than most of the other companies in the short line and regional railroad business in the USA.

### Background on RDC

RDC is a small company in Pittsburgh and everything we do is based on Joint Ventures. A classic example is the joint venture that we were involved in with Ed Burkhardt in Estonia. We describe ourselves as focusing on "Emerging Corridors in Emerging Markets" because in some cases we're not just into railroads but also port facilities, etc.

The following table highlights our various railroad interests of the past and present. So, today is Diversity Day at the Lexington Group; you'll see a list of countries in Latin America, Africa, the Former Soviet Union, Western Europe and...Iowa. We have done a lot of interesting things in parts of the world that you normally wouldn't hear about at a U.S. conference.

**RDC Investments:**

CURRENT:	Entity	Length		Employees	Tons Y. 2011 (in millions)
		Km	(Miles)		
USA	Iowa Interstate	954	(592)	217	13.5
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)	480	1.9
Germany	Hamburg-Köln-Express	450	(280)	60	Passengers— start 7/2012
Colombia	Ferrocarril del Pacifico	196	(122)	135	Start 7/2012

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)

Iowa Interstate Railroad (IAIS)

Just to repeat what Jerry Lipka covered this morning, the Iowa Interstate is a piece of the former Rock Island Railroad and, unlike every other Class II and Class III railroad in the U.S., this was a railroad that was genuinely abandoned. The Rock Island is a unique story in North American railroad history.

Che Guevara’s slogan translated was, “The only struggle that is lost is that which is abandoned;” that was the Rock Island and reflects the cultural roots of the Iowa Interstate.



Tomorrow you will ride on the Iowa Interstate. We like to highlight our “new” GE locomotives; we are GE’s smallest customer which makes us very proud.

Here is another reminder that graphics can be used to prove anything. This particular graphic is the exact trend line in the transition from Socialism to Communism with Comrade Stalin at the throttle, so beware of anyone putting up graphics using PowerPoint...except when the graphic starts with the scale at zero.



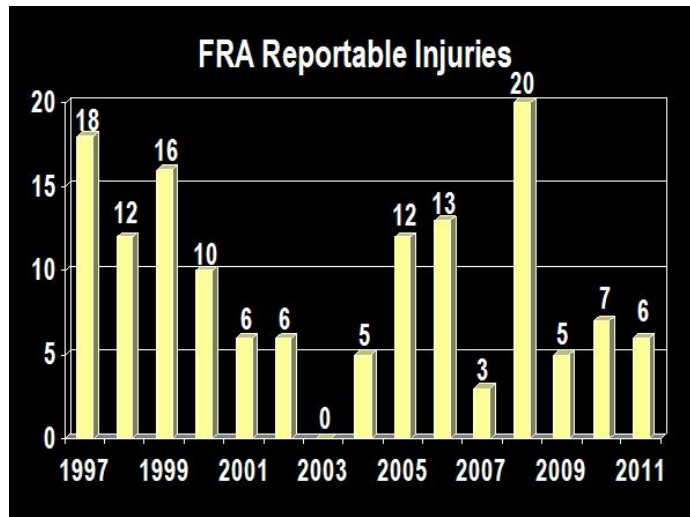
LA ÚNICA LUCHA QUE SE PIERDE ES LA QUE SE ABANDONA Che



One of the things we like to talk most about is our safety culture and safety record. IAIS won 2 Gold Harriman awards in the last decade before the Harriman awards were recently discontinued, and we are very proud of those accomplishments.

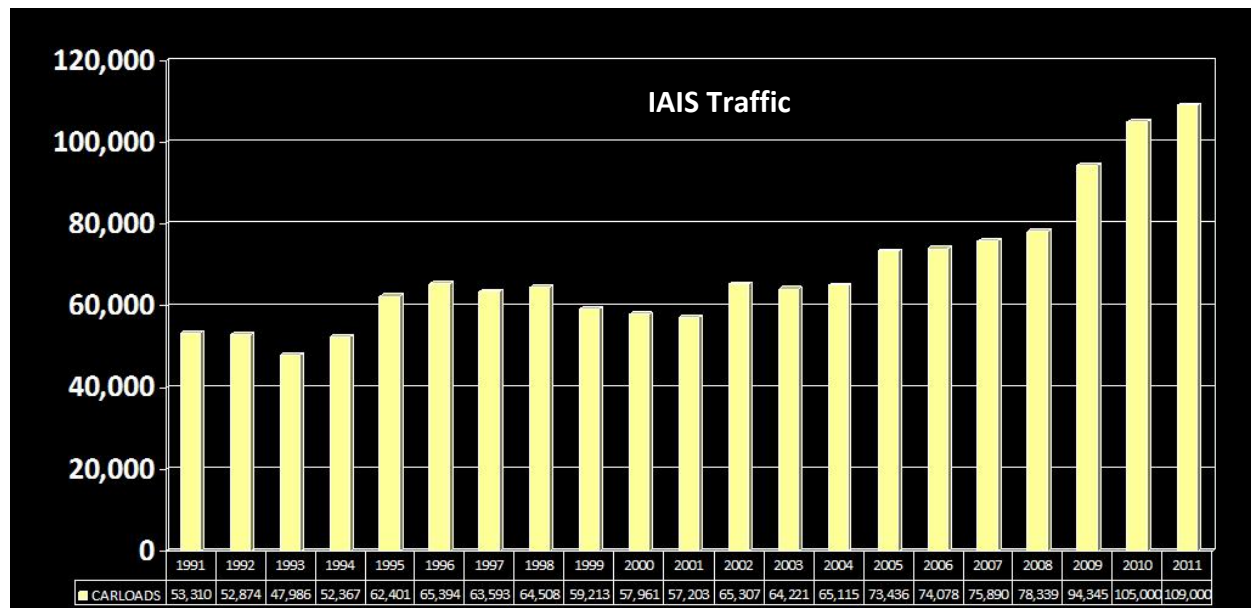
Safety really is the #1 objective of the Iowa Interstate Railroad. Safety is more important than profitability for the following reasons:

- If you have a safe railroad, you're more likely to have good service; and
- if you have good service, you're more likely to have more business; and
- If you got more business, you're more likely to be profitable.



It's difficult to manage with multiple priorities, so if we prioritize safety, then it drives everything else.

The next graph speaks for itself – traffic. Notice in the lower left-hand corner that the graph starts at zero. Of course, it helps to start as a formerly abandoned railroad. A lot of this is based on things we did not think up or do ourselves. We are not the people who invented ethanol and we did not make our investment in the IAIS in 1991 because we thought someone would figure out how to turn corn into fuel for SUVs. But better to be lucky than good, and of course we try to be both.



These photos show that IAIS is a modern Class II railroad that is more dissimilar than similar to our Rock Island roots. And we do celebrate our history on the IAIS and are not afraid to let people know that we are in fact a railroad. We have 2 Chinese steam locomotives, which among other things, set a world record for steam-hauled tonnage in the 21<sup>st</sup> century.



Peru: Ferrocarril Central Andino

Another interesting railroad is our railroad in Peru. RDC is a partner in a consortium with Peruvian investors in what used to be the World's Highest Railroad, and is now the 2<sup>nd</sup> highest railroad since construction of the railway to Tibet. The Central Andino is a spectacular railroad that really can't be captured in photos; you need to see it yourself. This is truly one of the 10 wonders of the railway world.



Guatemala: Ferrovías Guatemala

But not every place we operate is like Peru or Iowa. In Guatemala, we took the abandoned national railway, put it back in service, and ran it for 9 years with no public funding. Then we were forced to shut down, ironically for the same reasons that the Rock Island was liquidated; because railroads are usually worth more dead than alive. In this case, the value of our little railroad was dwarfed by the liquidation value. So some members of the Guatemalan business community asked the government to come after us on their behalf, but what they forgot was that they had signed the Central American Free Trade Agreement the month before they pushed the button on us. This photo is the last train in Guatemala and that is me on the right. I was not wearing a bowtie on that day but I was wearing a black armband.



Going into Guatemala we recognized that it wasn't Switzerland, but I was a trainmaster for Conrail in the Bronx and that certainly prepared me for that role. If you go to the Indiana Press table and see Roger Grant's latest book, you'll see a photo of me with John Baesch in Brooklyn on a Conrail line which doesn't look that different from the main line in Guatemala, so that was excellent training for what ultimately turned out to be the Guatemala Story.

To finish the story, after five years we did win our arbitration case against the Guatemalan Government and we are in the process of collecting. And we will collect.



But unfortunately the country has lost its railroad. These are photos of the main line; the Guatemalan people were empowered to steal from themselves. Our deal with the government of Guatemala is not unlike many short line deals in the U.S. where short lines lease a line from a Class I. In this particular case, we leased the assets from the government and the people stealing the bridges in broad daylight for scrap actually were stealing from themselves.

Colombia: Ferrocarril del Pacifico

Seeing as how we can't get enough of 3-foot gauge Latin American railroads that aren't in running condition, recently we went to Colombia and are now one of the partners in the revival of the Pacific Railway; we ran our first train in July 2012. The railway goes to the port of Buenaventura which is Colombia's corridor to Asia. It is a 3-foot gauge mountain railroad with 4.2% grades; physically it is like Peru and fortunately the country is more like Peru than Guatemala. We have some really interesting partners and that is the reason we're there.



Estonia: Eesti Raudtee



No story in front of this audience would be complete without talking about Eesti Raudtee—Estonian Railways (EVR). Ed Burkhardt was chairman of EVR; Earl Currie, who is also here, was the first Managing Director; and Mark Rosner, who is also here, was the second Managing Director. So there is a big concentration of Estonian Railways' history in the room today.

We are very proud of what we did for Estonian Railways—by increasing the traffic, reducing the personal injuries by 75%, and completely replacing the locomotive fleet; Ed Burkhardt can speak more eloquently on that subject. But the fact is that because the country joined the EU, that allowed for some perverse layers of regulation to be introduced and the railway was in fact renationalized, not unlike Guatemala, on behalf of some customers who found it easier to buy legislation than pay for transportation.

But we sold the company back to the government for three times what we paid, and I like to describe it as, “A win for the politicians, a draw for the investors, and a loss for the Estonian people.” Why? The Centre Party which led the re-nationalization had this poster, “We bought the Railway back!” (top) Others saw it as, “The re-Sovietization of the Estonian Railways.” (bottom)



But what we didn't realize was that five months later the railway would lose half of its business. The reason the railway was re-nationalized was because “you couldn't trust the private sector with a monopoly”. My question is: how could a so-called monopoly lose half of its business five months later? The Estonians had decided to teach the Russians a political lesson, and because we were in a highly competitive market, the Russians were able to re-route their traffic almost immediately, thus making the public's investment in this railway virtually worthless.

### Germany: Hamburg-Köln-Express (HKX)

Recently we started an intercity passenger business in Germany between Hamburg and Cologne which is roughly 500 km/350 miles. We started running in July 2012 with a daily train, and a goal of 3 trips per day once we solve some equipment challenges.

To be clear, we are operating a passenger service with no subsidy, and we are not out to cannibalize Deutsche Bahn, the national railway, by starting a price war. Our market is a different market than DB has traditionally been serving. Our demographics are more like Megabus. These passengers do not historically ride trains so we believe that we have actually expanded the market. Another interesting fact about our HKX organization is that our general manager Eva Kreienkamp comes from a non-railroad background. Usually you need a good general manager, as opposed to a good railroad person, if it's more important to deal with culture, etc. This should be done in conjunction with department heads who know the rail industry. So far this has been an excellent formula for us.



### France: RegioRail

Six years ago two people from France attended this conference, and at the time they were looking for people to get involved in saving the single-car “wagonload” service in Europe and the idea was to create

short lines in France. After six years, we have recently gotten into a joint venture with European rail-based forwarder EuroRail, and we are investing in a couple of existing short lines and hope to expand that to a national level to restore some of the traffic that has been lost. Until about four years ago, at the national level there were 800,000 single car shipments in France; they are down to 200,000 and a lot of that business will never come back because once you teach customers how to use trucks, it's a lost cause. But if we can get some of that back, it will be a very interesting business.

### RDC Investment Philosophy

So we've discussed what we've done but what are the common themes to our investments? There are no operational synergies like RailAmerica, Genesee & Wyoming, Watco, etc. where you have centralized purchasing and centralized dispatching to achieve operational efficiency among your various railroad interests. And there are no commercial synergies where traffic begins on one of our railroads and ends up in another country on another one of our railroads.

But there is a consistent theme: RDC as the "Investor of Last Resort," meaning in every one of these cases we were either the only interested party, which was true of the Iowa Interstate in 1991; or we were 1 of only 2. A classic example was the Estonian Railways where the winner was another investor group that offered twice as much as we did, but as it turns out had no money and one of their folks was wanted for money laundering. In that case, we were the Investor of Last Resort because there were only 2 offers and the first one turned out to be bogus.

Another theme that has worked out quite well for us is our focus on local partners. As good as we are as railway people, where we have succeeded has been because of who our local partners are more than anything else. The origin of this theme comes from my father Henry Posner, Jr. who died in March 2011 at the age of 92 and who was in the office on a regular basis until the age of 91. From the very beginning of the founding of RDC our investment philosophy was based on his wisdom:



- Always work with partners because you get better ideas, in addition to sharing the risk.
- Never make too good of a deal because if you make too good of a deal, the other person is always trying to claw back what they felt they lost.
- Encourage disagreement. RDC is a very diverse group of people and we have figured out ways to challenge each other in ways that allow us to make good decisions.
- Choose your battles, and choose the timing of those battles.
- Finally, recognize that "You don't know what you don't know." I can't tell you how many times we've used that phrase internally at RDC.

What is our methodology? Over the years we've developed a checklist in descending priority and if a project gets through to the bottom, then we may have something.

1. Is the country, or the territory of the USA, serious?
2. Who are the local partners? In the case of Iowa Interstate it was Heartland Rail Corporation.

3. Who are the competitors for the market? In other words, who is going to bid against you for this opportunity?
4. Who are the competitors in the market? That usually means trucks.
5. Can you structure something for the market that makes sense? Quite often for a freight deal it should be profitable but you need financing. In some cases there are passenger businesses out there where the competition is who will run it for the lowest subsidy.
6. Finally, recognize that the ultimate trap is to overpay, but conversely, "Every deal's a good deal if the price is right."

**Risk vs. Reward**

If you look at where we've invested to date, surprisingly the scariest place so far is Europe. The reason is the pervasive competition and the risk that somehow you'll misjudge the market. One of the scariest days in my railroad career was the day before we started up Hamburg-Köln-Express because it was our largest investment ever and we had no idea whether there was going to be the ridership or not. Fortunately, ridership has been strong since the first day.

And the risk is never what you think. In the case of Estonia, we thought the risk would be traffic, competing for alternate routes to Latvian ports,

	Anticipated Risk	Actual Risk	Mitigation	Reward
Estonia	Traffic	Expropriation	Privatization Agreement	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

Lithuanian ports and Russian ports. But the actual risk turned out to be expropriation, and in a European country. How did we mitigate that? We had a Privatization Agreement that called for arbitration, which the government was going to lose. So our reward was selling the railway back to the government, fortunately right before it lost half of its business.

In the case of Guatemala, we thought the risk would be whether we could get any business and whether we could finance the deal, but in fact, the actual risk was expropriation because the railroad was more of a real estate deal than a railroad deal as it was worth so much more dead than alive. And the mitigation there was the Central American Free Trade Agreement (CAFTA), and ultimately arbitration.

In the case of Mozambique and the Nacala Corridor, we thought that the risks would be both commercial and the inability to get financing, and those turned out to be the actual risks. The way we mitigated that was by treading water from 1999 to 2005, when we were finally able to secure financing and then sell our interest in 2008 to local investors.

Finally, in the USA there is political risk. As others have pointed out, the threat of re-regulation hangs over our industry and as long as there is the threat of re-regulation, capital markets will tend to overestimate risk and that will be a problem for our industry when it comes to attracting investment.



## Macro Conclusions

To draw some conclusions, risk is usually driven more by the public sector than the private sector. Railways are always worth more dead than alive, i.e. the Rock Island and Ferrovías Guatemala. Fortunately, railroads are worth more than they used to be, but on the other hand, they are more worth stealing. Let me emphasize that the expropriation risk turned out to be the biggest in Europe, i.e. Estonian Railways, driven by their ascension to the EU. Wealth plus regulation is a Petri dish for corruption. One cultural aspect of it is that Estonian Railways was more of a Russian enclave in a western European country: we were “a European railway that goes to Moscow, not Brussels.”

Shareholder structure is the best form of risk mitigation; who your partners are has everything to do with how you deal with problems. Secondly, it is important to have the Rule of Law, because if you don't, then you have to reach into institutions like free trade agreements, which are extremely expensive. While we won our case against Guatemala, and we will get paid, the cost of prosecuting that case was very, very high. Of course, the cost of the country losing its railway far exceeds the cost of our case.

So what makes RDC unique? I would characterize it as that we have a proprietary methodology for identifying, screening and structuring transactions. We get calls regularly from people who are extremely well-connected; have read about the rail renaissance; and really, really want us to come to their country and invest. Well, 90% or more of those contacts are bogus if you just use the checklist. Is the country serious? No? Easy decision. RDC has developed this methodology based on experience more than anything else, so I'm not revealing any trade secrets.

RDC is also unique in having a flexible culture in a staff of five who are multi-cultural and speak other languages. But we also have a broad base of resources, especially human resources. For example, our operation in Colombia is staffed with a general manager from South Africa who was our former GM in Mozambique. Our operations manager is Peruvian. Why? Because it is 4.2% grade in Latin America and Peruvian operating skills are needed, not American skills. The mechanical department consists of a South African because the locomotive fleet mostly resembles the locomotives in Mozambique; a handful of locomotives, cannibalizing enough from hulks to put together a locomotive based on spare parts. And we have an operations manager and a road foreman from Guatemala. While we have a number of staff from the USA, the core of our local groups is not American because of specific needs, and we can pull resources from other countries to meet those needs.

### INDUSTRY MACRO CONCLUSIONS:

- Risk is usually driven by the public sector
- Railways are worth more dead than alive...
- ...and worth more than they used to be...
- ...and therefore worth stealing
- Expropriation is not limited to developing countries (Example: Estonia, a member of the EU)
- Rail is a viable private sector business...as confirmed by value-driven expropriations!
- Shareholder Structure is best form of risk mitigation, not Business Plans
- Rule of Law is a secondary defense and more important than Privatization Agreements

### INVESTMENT PARAMETERS (*in descending priority*)

1. Is the country serious?
2. Local partners?
3. Competitors for the market
4. Competitors in the market
5. Structure for the market
6. “Every deal's a good deal if the price is right”

At this point, RDC has a developed network for deal flow and we have developed the reputation of Investor of Last Resort. We do give all kinds of very interesting but probably unworkable deals some preliminary attention. So we have a pipeline of opportunities which suggests that we do have a niche in the world today. We are not Genesee & Wyoming; we can't go to Wall Street for capital; but we can cobble deals together in an effective enough way so that the transaction costs are low enough to keep investing.

We are very proud of the role that we've played not only in the U.S., because we feel the IAIS is unique, but also being able to export what is considered to be the world's best rail industry is quite an honor. You won't see RDC in Australia because there are already plenty of other U.S. companies there; we won't be operating in Brazil because they already have an efficient rail network. But you will see RDC in the some of the world's more obscure places.



This is a 1950's Soviet poster from Kazakhstan which translates, "Come with us to the New Lands!" For RDC, every deal is a new deal, and every land is a new land, even Germany. We never thought we would be operating in Europe. Aren't the Europeans supposed to be teaching us about passenger service?

This photo (right) was taken in Mozambique and consists of multi-cultural people. RDC's motto is, "A Luta Continua..." ("The Struggle Continues...") There is nothing that RDC does that is easy, and the "D" in RDC stands for Danger.



Thank you.

###