Assessing Risk in Emerging Markets Infrastructure — "It's never what you think." — Henry Posner III

Institutional Investor's Infrastructure Investment Forum • New York • June 28, 2007

The title of this discussion is "Assessing Risk in Emerging Markets Infrastructure" but this doesn't necessarily limit the discussion to Third World countries; it can even refer to small European countries, as we have experienced.

Our Iowa Interstate Railroad was formed from the ashes of the bankrupt and liquidated Rock Island, which ironically was put out of business by the public sector. So when we were downstairs in the Lincoln Room, I could not help but observe that Abraham Lincoln, who began his legal career with the Rock Island, might have said that it is very important to keep history in perspective.

As I listen to the discussions this morning, I could not help but think that many of the themes that have been discussed here are in fact themes that we have been through decades ago in the rail industry, which was after all private sector infrastructure that was run up to the brink of extinction by the public sector. So if we can extrapolate those lessons, making sure that we take care to note that we cannot translate everything, there are lots of lessons that we in the rail industry have learned that are valuable to other industries such as toll roads (where one must consider diversion risk—if toll charges are too much, traffic will go down to parallel roads) and airports (Pittsburgh was a hub airport for U.S. Airways until about five years ago but things happen and now it is just a local airport with a grossly oversized infrastructure for what it is today; it is basically tomorrow's airport today for yesterday's traffic base.).

To begin, I'll outline a brief background on our company, Railroad Development Corporation (RDC); discuss three case studies; present an overview of what I think the definition of risk is for transportation, particularly for rail; and then draw some conclusions.

Background on RDC

RDC is a small privately held company and we invest in "Emerging Corridors in Emerging Markets", and by that I mean that in a number of places we are not only involved with railways but also with port facilities, electricity distribution, and other businesses that flow from the combination of railways with adjacent businesses using right-of-ways.

Most importantly, our financial structure is based on joint ventures. RDC is a small company of five people and we manage railway investments in six countries, so we have to be extremely focused on how to structure businesses properly. In the railroad world 50 years ago, the rule in the track department was "1 man, 1 mile". So in our case, it is 1 employee, 1 country, in terms of how efficiently we need to manage our businesses.

The following is a list of our businesses.

Country	Entity	Length Km.	Length Miles	Employees	Avg. Annual Tons (in millions)
USA	Iowa Interstate	1,005	623	185	6.2
Argentina	ALL Central	5,350	3,324	1,012	3.4
Argentina	ALL Mesopotamica	2,740	1,703	313	1.4
Guatemala	Ferrovias Guatemala	322	200	100	0.13
Peru	Ferrocarril Central Andino	490	304	169	1.7
Malawi	Central East Africa Rwys	797	495	487	0.24
Mozambique	Nacala Corridor	872	523	227 Rail	0.27
Estonia	Eesti Raudtee*	693	431	2,389	44.3

*Re-nationalized Jan. 2007

Our Flagship is the Iowa Interstate, the former Rock Island, which RDC owns 100%. In all other cases, we are usually minority joint venture partners in railways in foreign countries. For the most part, we don't even own the railroad; we own a concession, meaning that we rent the assets from the government under a rehabilitate/operate/transfer scheme for usually 30 or more years in duration. RDC is heavily invested in Latin America and we are one of the pioneers in Africa. The last business listed is Estonia, a European country, but note that it was re-nationalized earlier this year and it is one of the case studies for today's discussion.

RDC has learned over the years four important investment parameters, in descending priority:

1. Committed government
2. Rational competition among bidders
3. Local partners
4. Investment and management skills

Most importantly is a committed government; if you haven't got a serious government, then you are wasting your time. Quite often the public sector will try to trot out investors as an example of what might potentially be allowed to happen and then use them as a stalking horse or, in some cases, a sacrificial lamb for some other agenda.

A classic example was a project that I named "Steel Jihad" which in 1996 was the rail privatization in Pakistan. It didn't work, simply because it in fact turned out to be one guy operating out of The World Bank with a budget to screw around with. We spent 1½ years coming up with a plan for restructuring the freight operation of Pakistan Railways; raised $90 million; and had to re-bid because Pakistan Railways felt that they really needed AC-traction locomotives as opposed to DC-traction locomotives. Then we found out that it was just some bozo with a consulting budget running us in circles. So you really have to make sure that the government is committed.

Second, rational competition among bidders is needed. If your competition is the national railways of France, South Africa or India, and probably in the future it will be the national railway of Russia, you are most likely wasting your time. I will confess to you that RDC does not have as much money as the government of Russia, or the governments of India, South Africa, etc.

Third, local partners. Where RDC has been successful it has been the quality of our local partners, even more than what we bring to the table, because it is usually macro considerations like politics and culture that will derail you and not whether you had AC-traction versus DC-traction locomotives.

Finally, railway investment and management skills are important; you cannot run a railroad without railroad skills. But don't underestimate the need to get the other top three things right from the beginning, or at least have the ability to fix them as they develop.

Case Study: Estonia

First, let's talk about Estonia. I'm sure that everyone has read that Estonia is the Westward-Facing, Post-Soviet, Internet-Driven Baltic Tiger and is the most Transparent and Dynamic Thrusting Example of Capitalism to ever hit the European business press. Well, that was not exactly our experience.

While the Internet goes everywhere, hotels are everywhere, and even the water company doesn't necessarily need to go anywhere but Estonia, 95% of Estonian Railways' traffic came from Russia. Our customers found it easier to bribe the Estonian government to change the laws to allow them to use our railroad at below-cost rates than it was to pay freight bills. So this Internet-Driven, Westward-Facing, Post-Soviet Baltic Tiger turned out to be quite corrupt.

In an ugly deal, which I am not at all proud of, but in which we tripled our investment, our consortium was basically forced out of the country after improving the safety performance by 75% and making significant inroads in achieving all of the government's objectives, including making the Estonian ports more competitive in a steadily increasing competitive environment. But what really trumped the day was that the private sector cannot compete with the public sector, because the public sector has more money and even more importantly it makes the rules.

In 2003, Estonia passed the Railways Act of 2003, allegedly due to its EU accession. The EU demanded that "monopolies" like us, even though it was an intensely competitive market and customers had three other countries to go through, hand over our main line to our competitors at rates that the government set. The end result was, because we are not completely stupid and had negotiated a privatization agreement that called for international arbitration, that they were going to lose; so, we settled. The problem with deals like this is that quite often it is a win for the politicians, a draw for the investors, and a loss for the people. The only people who are not sitting at the table when these types of deals come together are the people who pay for it.

Re-nationalization occurred in January of this year, which actually was not bad timing because in May 2007 the Estonians decided that they were going to insult the Russians. The last thing that I heard was that while we were running 45 million tons of traffic, the Russians have now said that the lines to Estonia only have the capacity for 20 million tons going forward. So even if we were still owning it and running it in a perfect way, the fact that the government chose to take on the Russians has cut the traffic in half for this company. It is one of those things that is not exactly in the business plan, and no amount of due diligence will protect you against it.

Case Study: Guatemala

Guatemala is the first example of a completely abandoned national railway restored to operation by the private sector. It was literally run into the ground by the government, abandoned and shut down in 1996. RDC got it running in 1999 despite being denied financing by the multilaterals. The World Bank has declared us a "Category A Environmental Problem", which means because squatters had moved on to the tracks and they had to step aside when the trains came back, we had created an environmental problem. Ignore the fact that trains pollute less than trucks; ignore the fact that about 10 people per week are killed on the Atlantic Highway; that does not change the fact that we are a Category A Environmental Problem. Nobody at The World Bank, nor at the IFC, nor the IDB is going to put their job on the line by financing a company that has committed the crimes that we have committed by taking an abandoned national railway and putting it back into operation.

The business was in fact so bad, because it was an abandoned national railway with no historic traffic base, that we negotiated a deal which allowed us to develop the right-of-way for alternative uses because we knew that the right-of-way type activities would be needed to cross-subsidize the rail operation. In fact, what we negotiated was the ability to use the right-of-way for electricity distribution, pipelines, etc. And there is a port facility that comes with the railroad; so there are all kinds of cross-subsidizations going on, recognizing the economics of taking an abandoned national railway and putting it back into operation.

This put us into conflict with private sector interests who were more interested in the use of the right-of-way because railways, I think without exception, are always worth more dead than alive. Even the Union Pacific, if you sold the track for scrap and sold the land, is probably worth more in liquidation than its current market capitalization, even under today's prices.

The Guatemalan government decided that the previous government had made a bad deal, so they passed a law declaring a piece of our concession "Lesivo". Lesividad is a Spanish legal concept that basically means what we did was against the best interests of the country. So they took a small piece of the concession, namely the rolling stock, and threatened to take it back. It is like buying a car and having the car dealer decide nine years later that they made a bad deal on the tires. If you can imagine your car sitting on blocks, that's where we will be if the government gets its way.

Fortunately, the government did not think about CAFTA (the Central America Free Trade Agreement) which came into effect about a year ago. Last week RDC filed the first-ever claim against a government under CAFTA, so we are true pioneers in testing what this particular agreement will do for investors. We think we have an extremely strong case and we think that it will trigger the second of two liquidity events. (The first liquidity event was of course what happened when the government of Guatemala figured out what we were up to—let's say they relieved themselves in their undergarments.) The second liquidity event is going to be when we win our case under CAFTA, which is going to take years. We have already invested $15 million into a railroad that generates approximately $2 million of annual revenue because we made a commitment to Guatemala that we would give them a railroad, even though it was expensive and inconvenient. Fortunately for us there is a way out, through CAFTA. We think that we will win but we may not achieve our objective of giving the country a railroad, but they cannot fault us for not trying.

Case Study: Nacala Corridor

The Nacala Corridor consists of the railway in Malawi, the railway in northern Mozambique and the Nacala Port in Mozambique. It is the first private sector integration of ports and railways. It literally took us seven years to finance this project, which we did in pieces. First we privatized the railway in Malawi in 1999 and it wasn't until 2005 that we were able to raise the other piece of the financing.

Fortunately or unfortunately for us, at the same time The World Bank was financing a competing corridor, the Sena Line. While both events were happening, there was a large coal mine that had been idle since the civil war in Mozambique, and with coal prices going up, it seemed like it wasn't such a bad idea after all to be investing in a railway in this part of Africa. The problem was that the Sena Line got roughly $120 million in financing, with practically no due diligence, from The World Bank, whereas we had worked for seven years to raise $30 million. And the fact that the customer actually said that they were going to use us created enormous problems. Our problem is that the result was studies funded by The World Bank trying to convince the customer that they made the wrong decision and that they should be using the Sena corridor.

There are ongoing conflicts with various government entities such as the owner of the assets–the national railway–because all of a sudden this railway is valuable. People tend to be on their best behavior when you are having difficulties; but character really comes to the fore when you are dividing the spoils. So this is very much a Work In Progress and I can't really say where this is going to wind up, except that we have a fair level of confidence in our business acumen at this point. Even as I have described our disasters, we have achieved a liquidity event in Estonia; we will achieve a liquidity event in Guatemala; and we will see the same result ultimately from Nacala.

Risk Experience—An Overview

Now let's discuss RDC's experience with risk. In the table below I have put two columns together: anticipated risk—the risk you think that you are taking—versus the risk that actually materialized. In each case, the risks turned out to be quite different from what we thought.

	Anticipated Risk	Actual Risk
ESTONIA	traffic	expropriation
GUATEMALA	traffic, financing	expropriation
MOZAMBIQUE	traffic, financing	traffic, financing, shareholder conflict
USA	traffic	threat of expropriation (re-regulation)

In Estonia, we thought that that we would be taking the risk that somehow we would have to compete for more Russian traffic, but what we didn't realize was that through the expropriation of our business through the Railways Act, that we would actually be handed over to the Russians by our host government.

In the case of Guatemala, we thought that financing the railway and competing with trucks was going to be the big risk, and in fact, it turned out to be the expropriation of our right-of-way because it is worth more dead than alive.

In Mozambique, shareholder conflict exists. But that news is fundamentally good; it means that we've done something that is worth stealing, so we've got these internal conflicts going on.

To put this all into context, even in this country there are the same types of risks. Investing in railways in the USA, the risk historically has been traffic; but there is a movement afoot to re-regulate the railways and punish us for what we have done over the last 30 years to restructure ourselves. What would Abe Lincoln think about that?

Conclusions

In conclusion, the risk that you think you need to worry about is usually wrong. No amount of due diligence and no amount of lawyering is going to protect you from, for example, a government that decides it's going to change the law to suit themselves, such as happened in Estonia and Guatemala. Expropriation is not limited to developing countries. Estonia is a European country and the USA, well, is the USA.

The good news is that railroads are a good business. Warren Buffett has made a major investment in BNSF in the last couple of months. I think it's reflective of the times in which we live that the railroad business has become quite a good business; and that is in part my explanation for what is going on in terms of these expropriations. If you've got something that is valuable, it is worth stealing.

But how do you mitigate against these? Again, I would like to make the point that it is probably not having the most well-lawyered agreement, but rather shareholder structure—in other words, who your partners are, how flexible you are in dealing with these problems, etc.—because you never know what's going to happen. You need good partners who are prepared to see it through even more so than well-lawyered documents.

Finally, the rule of law is a good secondary defense, not a primary defense, but that saved the day for us in Estonia. And the rule of law became effective even in Guatemala, in the summer of 2006 with the signing of CAFTA; it's just that they forgot about that when they initiated the proceedings against RDC.

The bottom line is that this is useful history. One thing we have in the rail industry is a rich history. We celebrate it. I can tell you what happened in the rail industry 100 years ago because there are many books on rail history and it is part of a rich culture, probably unique to railroading. I can't really say that there is a rich culture and rich history of toll roads unless you go back to the mid-1800s, in which case maybe there is some history to be mined. But new forms of infrastructure financing such as toll roads are relatively novel, so you can't really go back and say that 30 years ago this toll road deal had this problem for the following reasons, which is why I say that the rail industry's history may be of significant value to other types of infrastructure.

Thank you.

Question-and-Answer Session

Can you describe how you perform due diligence and who your local partners are in these ventures?

The most important aspect of due diligence is finding local partners; after that it is a question of going to the market and auditing what type of traffic is available for the railway; constructing a business plan from the bottom up based on demand; and then figuring out how to restructure the company around that level of demand.

In the case of Guatemala, we went to every business that shipped by truck in the country and determined what they shipped, to develop a matrix of traffic. From that traffic we had to figure out what was divertible from truck to rail, and then perform a judgment as to how much we could realistically expect from that.

In Estonia, we had a consortium of extremely sophisticated international investors—Rail World Inc. from the USA; Emerging Europe Infrastructure Funds from London and headquartered in Washington; an Estonian investor group called Ganiger; and a British infrastructure company, Jarvis. Despite the experience, sophistication and firepower, all you need is somebody to pass a law that you hadn't anticipated and it is all academic.

In the case of Guatemala we couldn't find local partners that were bigger than us so we capitalized the company by selling stock on the local stock market. We have roughly 60 small investors in Ferrovias Guatemala.

How do you value railways—are there any rules of thumb?

Often they are a multiple of revenue. The only way to explain that is the 80/20 Rule where you can adjust your cost structure to somehow fit the revenue, so they usually end up being in the range of .5 to 2 times annual revenue if you had to put a number on it. That is an extremely dangerous, broad brush and probably misleading way to look at it, but when I think what the value is, that's my knee-jerk reaction to give you at least a quantum level as to how these things get valued.

I found it refreshing that your firm does not seem to have a public relations department. How do you handle public relations?

I am the Information Minister.

Have you looked at the DM&E?

No. To be honest, they didn't allow us to look at it because we are not big enough and not substantial enough to play with the big boys.

But might that not change?

I checked my voice mail as of 3 hours ago and we're still not on the list.

What is the DM&E?

The DM&E is a railroad which, if constructed and extended to the west, would be the third railroad into the coal territory of Wyoming.

Did EU membership affect your investment in Estonia?

Absolutely. Estonia's accession to the EU was the smokescreen under which the expropriatory laws were passed. I would argue further that wherever you have increased regulation, and this is what the EU meant, you usually have increased corruption. What was interesting was that I made that same comment to a European audience in Brussels in January, a much bigger group than today, and nobody disagreed with me. I like it when people disagree with me because it means that I am wrong; that I'll be educated for the future; and that I'll mend my ways, share and improve my perspective with people. I even used the word "corruption" in one of the slides, which usually gets people's attention, and nobody disagreed with me.

With that being said, we were also bidders in New York State for the Long Island Rail Road freight concession. It was a sealed bid process with World Bank type rules; you get one envelope to prove you're technically qualified; and the second sealed envelope with the price. We offered the highest price but they basically said that it was political so they accepted the second highest price, the implication being that if you're from out of town, you can't possibly know what it takes to run a railroad in New York City. I ran the Conrail freight operation in the South Bronx in the 1970s, but that was not good enough. I guess I was away from New York long enough to be considered an out-of-towner and could not be trusted with something as valuable or as potentially dangerous as the Long Island Rail Road freight operation. So don't think this type of behavior is limited to developing countries. Wherever you have wealth and regulation, it is a Petri dish for corruption.

Instead of attacking The World Bank, why don't you go to the real problem there, which is the board? They make the policies that you so dislike.

You have given me an insight that I have not heard before. And in fact, I gave kind of this presentation at The World Bank in front of 200 people and nobody pointed that out to me, but I take your point.

The World Bank has a culture of politeness, so you may not have heard what I have said before.

We have a safety culture at RDC as well as one of cultural politeness. I really appreciate your comment, and let me see what I can do with it. It's a very insightful, constructive comment and it's the first comment of its type that I've gotten. Thank you.

# # #