

A PARADOX OF FINANCING: Privatization of Parastatals by Parastatals

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First I will provide some background on our company and our investment parameters, since this is an investment-oriented conference; discuss the case for privatization in Africa; discuss a specific project we are involved in, which is the Nacala Corridor in Mozambique and Malawi; discuss some of the structural trends in terms of how things have gone around the continent; and make some conclusions.

Background on RDC

RDC is a private company based in Pittsburgh that invests in and manages railways. We describe our business as “Emerging Corridors in Emerging Markets,” which means in some cases not just railways, but also railways and ports; railways and fiber optics; and generally anything we can do to maximize the value of railways in developing countries. I would also like to emphasize that everything we do is based on joint ventures. None of what we do is the “RDC show”; everything we do is with partners.

USA

Our core investment in the USA — and our only investment — is the **Iowa Interstate Railroad**. In some respects this railroad has a little bit to do with Africa in that it was abandoned in 1980 when the Rock Island Railroad liquidated. This railroad actually was taken from abandonment and put back in service and now serves as one of the four main lines from Chicago to Omaha in the USA. This is a joint venture with the shipper group Heartland Rail Corporation that bought the track basically for scrap in 1984.



Shown is a local train as much of our business is single wagonload, siding-to-siding business — as compared to unit trains.

Argentina

We have been involved in the first country to privatize its railways outside of the USA. Since 1991 we have been involved in Argentina and in fact we have been involved in Argentina so long that the company has been recapitalized and we have new partners. These are the railways that run from Buenos Aires to Chile (**ALL-Central**) and Buenos Aires to Brazil (**ALL-Mesopotámica**).

Guatemala

Our most challenging project has been the restoration of Guatemala's abandoned railway, **Ferrovias Guatemala**. Because the railway was abandoned, we were able to negotiate the rights for fiber optics, etc., which have the effect of cross-subsidizing a railway which had zero revenue at the start. In this particular case, we were able to raise financing on the local stock exchange. We have approximately 50 local partners, who are small investors, so we have a definite local component as a result of this.

We have not been able to finance reopening of the system to Mexico or to the Pacific. This is something we have been struggling with for a long time and continue to struggle with.

Peru

We are also partners in the World's Highest Railroad — the Central of Peru (**Ferrocarril Central Andino**). Among our partners is CDC of the UK, who is represented at this conference.

Estonia

Most recently we became involved in **Estonian Railways**, which is the first of the former Soviet Railways to be privatized. This is part of a massive railway system with enormous traffic volume. The tonnage that we haul on Estonian Railways on our 700-kilometer railway is approximately 20% of the entire freight tonnage of Spoornet. This is very high traffic density. In this particular case, in addition to Estonian investors and Rail World Inc. (USA) we have a UK Partner, which is Jarvis; their main business is infrastructure maintenance on the UK railways.

Malawi / Mozambique

Now let's talk about Africa. In 1999 we were able to participate in the privatization of Malawi Railways, now known as **Central East African Railways**. This is a joint venture with CFM, the National Railways of Mozambique; ERL, who is represented at this conference by Jack Edlow and Russell Neely; MANICA, a Mozambican freight forwarder — some of you have had the chance to meet Fernando Couto; and local investors.

This investment has been very important for the country because it was privatized before the recent famine occurred and the railway has been more able to deal with the famine as a result of it being in private hands.

This railway only connects with the northern railway of Mozambique. It's very much like Uganda and Kenya; Malawi Railways does not go to any place other than to Nacala. What we are working to accomplish this year is privatization and concessioning of the Nacala Corridor to create the first integrated port/railway system for general cargo in the world, to our knowledge. We expect to complete this transaction later this year.

Investment Parameters

Why invest in railways? How do you attract investment in railways? We have learned that there are four distinct necessities to make these types of businesses successful:

1. **Committed Government** — First we want to know that the government is committed and not just simply going through the motions because somebody got a consulting contract to come up with a privatization scheme that is not supported by the railways or other factions within the government.
2. **Rational Competition Among Bidders** — Once we know that a country is serious, then we want to know who our competition is going to be. If our competition is going to have a competitive advantage and we are likely to lose, we are not going to waste our resources.
3. **Local Partners** — As I have demonstrated, we want to have local partners. If we don't have local capitalists with local economic and political knowledge, we run the risk of making stupid mistakes; we don't want to go any place alone, and we have not done so yet.
4. **Railway Skills** — Last but not least, it is important to have railway skills. I put that at the bottom of the list because if you do not have the business structure together, it doesn't matter what business you are in, railways or other; it is not going to work.

The Case for Privatization in Africa

While the solution for African railways in the past has been unilateral aid by donors, that has mostly dried up as have the underlying assumptions. In general, railways in Africa are less risky as businesses to privatize simply because they have less traffic; they have gotten worse, not better; and therefore the need for change is higher. It is kind of like Argentina. The reason that Argentina was the first country to privatize its railways was because they felt that they had nothing left to lose. I think that in many parts of Africa this is almost where we are.

Most encouragingly, I think that in the last several years it has been proven that financing is available from the private sector as well as from donors in selected instances. But let me give an example of why aid doesn't work.



This is an example of a Donor locomotive in the mid 1990s.



The Donor locomotives now look like this. Throwing money at the problem is not a solution. What we are talking about with concessioning is as much institutional change as technological change.



Case Study: Financing the Nacala Corridor

Now let's discuss the Nacala Corridor. In 1996 we began looking for financing, and then the opportunity for privatizing Malawi came along and that transaction was actually completed in 1999. And finally in 2003 we have been able to raise the financing for the Nacala Corridor on the Mozambique side as follows: 25% of the financing will be private equity that will come from the various partners I have discussed earlier; private and quasi-private debt — notably OPIC and Nedcor, who are represented today — will comprise the other 75% of the financing. The donors have also been involved to the extent that emergency funding has been required because of the famine, and that is occurring even as we speak. But we never went back to the government and said that we need to renegotiate this deal — instead what we said was that we needed more time. Fortunately for us at the very last minute we were able to obtain the financing because our credibility was on the line. We are very grateful to OPIC and Nedcor for coming through on this.

Structural Trends in African Privatizations

What are the structural trends of Africa's privatizations? I came up with an exhibit (Table 1) of recent privatizations in Africa. There is really only one point I would like to make and that is that there are really three companies that are active in rail privatizations in Africa. SNCF, which is the government railway of France; Spoornet, which is the government railway of South Africa; and Railroad Development Corporation and our partners, who are the bunch of people that you see here today. I would like to take this theme and use that to draw some conclusions as to how railways can be financed in the future.

| TABLE 1 | Rail Investor | Beneficial Owner | Ultimate Owner |
|--|----------------|------------------|-----------------------|
| SITARAIL (Cote D'Ivoire / Burkina) | Sofrerail | SNCF | Govt. of France |
| CAMEROON | Comazar | Spoornet | Govt. of South Africa |
| SIZARAIL (DRC) | Comazar | Spoornet | Govt. of South Africa |
| ZAMBIA (pending) | Comazar | Spoornet | Govt. of South Africa |
| NACALA CORRIDOR | RDC & Partners | RDC & Partners | RDC & Partners |

Conclusions

As I have said before, I believe that aid programs actually competed with the private sector because they had the effect of freezing out or delaying the underlying economics that ultimately have driven Africa to the point where privatization is taking on momentum. As long as there was aid money, you didn't have to worry about restructuring because you could always ask the donors for new locomotives. Today privatization or concessioning has become accepted on the continent. The interesting thing about this is that the competition is now between private sector investors, like ourselves, and public sector investors.

Now let's talk about risk; we have heard a lot about risk in this conference. Let's use an example of risk as relating to how deals get financed.



As far as RDC is concerned, "This Is Not Scary." Pictured is a huayco in Peru. In the Andes there are different names for landslides just like in Alaska there are different names for snow. A huayco is a landslide in which the rocks are bigger than an automobile. This does not scare us.



We are also not scared by Mother Nature. In Guatemala there is a constant problem with washouts because our railway parallels the Motagua River. You can solve this with engineering and manual labor.



We are not afraid of hurricanes. You can always take bridges and drag them with a bulldozer half a mile and put them back into position.



We are not afraid of urban problems. This is our main line going through Guatemala City.



Although this sometimes scares people who finance railways, we are not afraid of squatters because the trains are bigger than the people.



I'm afraid of heights but not of insects. These are giant spiders in Malawi.

“Four years after start-up, Comazar and Spoornet International are active in 17 African countries...Many railway operators are hobbled by lack of rolling stock, poor maintenance and weak management. They are crying out for the kind of service offered by Comazar and Spoornet International, which has beaten off some of Europe’s best railway operators in winning railway concessions across Africa...”
(*Enterprise*, December 2001)

But let me tell you what does scare me. What scares me is reading about Spoornet’s activities around the continent and our ability to compete with the government railway of South Africa. What you see here (left) is an excerpt from a newspaper article from the end of Year 2001: “**...they have beaten off some of Europe’s best railway operators.**” Well, that’s an insult — they also have beaten off some of America’s best railway operators in winning railway concessions across Africa.

“Angry Customers say Shape Up or We’ll hit the Road...”

...Claims by Spoornet...that it could achieve greater efficiencies were “rubbish” and that its top management is “incompetent”...These outbursts were triggered, in part, by a proposal by Spoornet to reduce its wagon fleet from 90,000 to around 60,000 because Spoornet executives believe greater operating efficiencies would more than compensate. This is despite Spoornet’s inability to handle the business on offer with its current wagon fleet.”

(*Financial Mail*, 18 October 2002)

But what I think is truly scary is this domestic perspective on what is going on in South Africa right now. We have heard about how South Africa is active in rail privatizations around the continent and yet this is what is going on in South Africa (left). Spoornet is doing a scrapping program that reduces its capacity to handle traffic in its own country to the point where its own customers are making these kinds of comments in the press. As a personal note, as somebody who has been traveling in southern Africa since the early 1980s, I think this is a tragedy that a national railway system could be brought to this.

“Corporate SA is struggling with Spoornet’s poor service, lax management and soaring tariffs...a number of customers are calling for increased private-sector involvement...a **move...ruled out two years ago** when the current structure of Spoornet was introduced.”

(*Financial Mail*, 23 August 2002)

But what is most important from the perspective of this conference is that privatization in South Africa has been ruled out, even as South Africa is participating in privatizations elsewhere around the continent. The text on the left basically states that while South Africa is aggressively pursuing privatizations outside of South Africa, it has been successful in resisting it within its own country.

This is not intended as an attack on Spoornet, but simply an outside perspective on what should make sense for both South Africa and Southern Africa, which is: adherence to market forces as opposed to political forces. The reason I say that is because the lessons of history are quite clear; in the long run, market forces always win. Always.

To conclude, we believe that competition from the public sector represents greater risk than floods, famines, giant spiders, etc. I would encourage you to think back to my previous comment which was, “What are we looking for in terms of investment parameters? We are looking for a serious government and rational competition.” Well, this is not rational competition; we cannot compete with it. But we will go anywhere in the world if we can compete on an economic basis. Fortunately for RDC we have been able to do that in the case of the Nacala Corridor. I am personally very proud to be associated with what is essentially the first direct investment in rail by a private company on the continent.

Thank you.

Question-and-Answer Session

[Q] You mentioned that there are three main companies involved in African rail privatizations — the first one being the South African government, the second being the French government and the third one being yourself. If the government decided to restrict the process down to private venture companies, what is the main advantage to that? They would obviously lose two of the key bidders in the process and I do think that by taking out those two bidders they are taking a risk that the privatization might fail. What they are looking for is international finance and international expertise in the operation of the railways. So I am unclear as to what would be the benefit of restricting it to private venture companies?

[A] That is purely a policy decision for any country as to the type of investor that they are looking for. I can only comment as to what our perspective is. I believe that during my presentation I admitted that we have less money than the government of France and less money than the government of South Africa. Earlier in the day it was discussed that there are few investors interested in Africa and I think that, at least partially, the answer is that a rational private investor will think twice when competing with a public investor. I am not suggesting that individual countries should unilaterally restrict the type of investor they are looking for. All I am saying is that the rational economic result of that is that people would think twice before they take on the government of France or the government of South Africa.

[Q] In Southern Africa there are many borders to cross between, for example, South Africa and Tanzania. Why wouldn't it be beneficial to have a single operator on this corridor in order to provide a seamless service?

[A] I think that is an excellent point. Please note that the Nacala Corridor is an isolated railway that only goes between northern Mozambique and northern Malawi. I think that you are exactly right to the extent that railways should strive to offer seamless service, which is a competitive advantage. The only thing I would say is that in the USA we have 600 privately owned railways and they all successfully interchange traffic, which suggests that at some point railway systems become too big. At some point there is a strategic advantage to being bigger, but at some point there is a strategic loss to being too big. I think that probably the break point is where the customer starts to see a disadvantage from having only one railway company to deal with. But you make a very good point and I think that's an important thing for the audience to reflect on.

[Q] I feel that it is unfortunate that Mr. Posner used a public platform to criticize Spoornet and I would like to ask several questions. First question — if Spoornet were not doing what it is doing throughout Africa, who would? After all, it has been discussed that there are very few companies interested in rail privatization in Africa.

[A] Let me answer that question in two parts. First of all I believe that if Spoornet had done what it said it was going to do 5 to 10 years ago, which is to take a serious look at privatization, what you would probably have is more than one railway company in South Africa. If you look at what is happening with branch lines in South Africa, Spoornet's policy seems to be to close and scrap branch lines as opposed to taking the chance that a private operator would succeed or fail. This is also evident, I believe, in the scrapping program in which, as I understand it, freight wagons are not being sold even outside of South Africa; they are only being allowed to be scrapped.

With regard to who else might have done it, again, if there were several railway companies in South Africa, my guess is that one or more of them would be active in other countries. But more to the point I think there have been other private sector operators that have taken a look around Africa and just never done anything because they saw who the competition was. Those names include RailAmerica, Wisconsin Central and others. I am sure there are more names but my memory fails at the moment. What was the second question?

[Q] The second question — was the Nacala Corridor put up for competitive tender or was it open to everybody?

[A] The transaction in Mozambique began as a negotiated transaction well before the privatization of Malawi Railways and that began in the mid 1990s. But as that evolved, Malawi decided to embark on their own privatization process.

[Q] The third question was that you had criticized Spoornet for being a parastatal but you also say that in the Nacala Corridor CFM is your partner which is also a State enterprise.

[A] I think the difference is that CFM is basically holding the interests of the State as a passive investor. CFM is not the operator but there is an important need to provide an economic interest to the people of Mozambique because we are, in effect, using their assets as the basis for the

management and operation of the Nacala Corridor. So to the extent that this becomes a gold mine we feel, and the government of Mozambique felt, that it was important that the State have a piece of the pie to the extent that there was a big payoff at the end. This is a quite common model for privatization and is typical of what has been done, for example, in Latin America.

[Q] Your comments about Spoornet are unfortunate and I wish you had talked with us before you made your remarks. We are moving ahead with privatization in South Africa. And, outside of South Africa our participation is small – no more than 20% in other countries.

[A] Thank you. I can only say that we do have lots of contacts with Spoornet over the years and I hope that despite the comments that I have made, which I hope are not construed as an attack on Spoornet but rather an outsider's opinion as to what an alternative strategy might be, that we would be welcome at some point to participate on the operation of light density lines in South Africa – for example, those that are currently closed or in danger of being scrapped.

One other interesting thing that I would like to point out is that like Spoornet, we are a minority partner in most of the transactions in which we are involved. It is unusual to find us with ownership of more than 20%. In the case of the Nacala Corridor our ownership is in the teens as a percent of the total capitalization, just like Spoornet. By the way, the only railroad that we are a majority owner of is in Guatemala. That's because we couldn't find any big partners who thought that taking over an abandoned national railway that could not be financed was a great business investment.

[Q] Isn't political risk a major factor in your investment policy?

[A] I would just like to reinforce one of the comments I made earlier which may have been misinterpreted. Political risk is not as significant as economic risk; that is the way we see the world. I think that if you look at what has happened to RDC in other countries, for example, where governments have changed. In two instances, the government changed and the new government approached us and said, "You did a privatization with the previous government so you must have done something illegal and we are going to investigate." Our response in both cases was, "Fine; you are welcome to investigate us. In the meantime, we're going to run the railroad." And in both cases, nothing else happened.

I think one of the securities that we see in doing business in a country like Mozambique is that Mozambique is not a rich country and does not have the resources to screw around with politics. Their future is based on economic development and that is the experience we have had there. Politics occurs everywhere but it is not the major risk as far as Railroad Development Corporation is concerned.

Thank you.

[END]