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Republic of Malawi

Railway Restructuring Project

Introduction

1. A joint World Bank/ODA/USAID mission visited Malawi in July 1994 to complete design of the proposed Railways Restructuring Project (RRP) and to begin work on the Restructuring Preparatory Plan (RPP) and other pre-project activities agreed upon by the Government of Malawi (GOM) and participating donor agencies during meetings last April. The July mission consisted of the team leader (from Abt Associates under contract with USAID), the Bank's project officer, two asset valuation experts, one for the Malawi Railways Ltd (MR), the other for the Lake Services Company (LS), an organization and management specialist, a housing specialist, and a corporate finance expert.

2. As corporate finance expert, my assignment was to recommend a capital structure for the new Malawi Railways Company (NMR), to review the feasibility of an employee stock purchase plan, and to draft terms of reference for an investment adviser to assist MR with the privatization bidding process and a liquidation adviser to assist in the sale of MR's non-transferred assets. During my stay in country from July 7-15, detailed discussions and working meetings were held with officials from MR, USAID, Ministry of Finance, Controller of the Department of Statutory Bodies, Ministry of Transportation, the Leasing Finance Company of Malawi, the Malawi Development Corporation, and the law firm of Krishna Savjani. The principal documents consulted were the World Bank Aide Memoire of May 19, 1994, the Bank's draft SAR of March 16, 1994, and "Malawi Railways Limited: Financial Simulations," May 29, 1994..

3. The present report is organized as follows: Under "Setting," the report very briefly summarizes the project rationale, its long term objectives, and what has been achieved to date in project preparation. The "Financial Analysis/Valuation" section examines the the assumptions and projections that are behind the free cash flows that ultimately would provide the basis for valuing NMR. A valuation of NMR would have important implications for how many assets are transferred and what capitalization and borrowing decisions are made by the NMR. Valuations have already been made based on book value and replaceable depreciated cost. Under "Capitalization," the report analyzes options for the capitalization of the NMR. The major variables in structuring the NMR balance sheet are leasing versus ownership of the permanent way and an equity infusion, including an employee stock purchase,

versus borrowing. This section concludes with a recommendation on the NMR capital structure and next steps. Annexes A and B outline terms of reference for the investment adviser and the liquidation adviser.

Setting

4. As noted in the World Bank appraisal documents, stark evidence of MR's current operational inefficiency is the fact that while the MR rail line to the Port of Nacala in Mozambique is the shortest and least expensive route for Malawi overseas freight traffic, it is at present carrying only 110,000 tonnes or 15% of this traffic. Meanwhile, continued dependence on more expensive routes via Dar Es Salam and Durban for hauling the bulk of overseas freight has pushed Malawian transport costs to a record high of 41% of the total landed cost of imports and exports. High transport costs translate into a loss to the Malawian economy of an estimated US$40-50 million per year, a significant drain in a marginal, agriculture-dependent economy in which the per capita income is only US$200 (1990). To give a single example of the kind of bind Malawi is in, plans to reduce dependency on maize and cooking oil imports through expanded domestic production have been stymied in part by the high transport charges which must be added to the cost of imported fertilizer.

5. The rationale for supporting the RRP is, then, quite clear: by improving railway reliability and efficiency, the project would lower the costs of Malawian exports and imported materials, thus improving foreign exchange balances and contributing to overall economic stability. To the end of greater efficiency and the attendant lowering of costs and increase in overseas traffic, the principal project objective is to refashion the MR and LS into commercially viable entities capable of generating profits independent of GOM subsidies. This means involving the private sector to a greater degree in both MR and LS as well as reformulating overall national transport policy and coordinating with Mozambique on transport from the Malawi border to the Port of Nacala.

6. At the April meetings of the GOM and donor agencies, it was agreed the two major pre-project activities would be undertaken as the RRP itself was being finalized. First, MR would take measures to stem its financial decline, including introducing new budgetary controls, discontinuing passenger traffic, and cutting back surplus staff. Second, an RPP would be carried out to develop options for forming the new companies. By the time of the July mission, agreement had been reached that MR and LS, formerly part of the Malawi Railway Group, would be separated and that the NMR would be established and incorporated under Malawi law. Those assets required by the NMR to carry on an overseas freight service business through the Port of Nacala would be transferred. The rest of MR's assets would be sold to pay off outstanding liabilities as part of

the "winding down" process. The GOM would receive equity in the NMR in exchange for the transferred assets.

Financial Analysis/Valuation

7. With the agreement now reached on which MR's assets need to be transferred to the NMR to make it an efficient freight operation, phase one of the restructuring process has been completed. What is of critical importance in the interim period before those assets are legally assumed by the NMR is to estimate their present value; this will affect decisions on debt settlement by the GOM as 100% shareholder in the NMR as well as setting the stage for privatization further down the line. The ideal method for valuing the transferred assets would be to offer NMR shares to private investors or to the public in competitive auction. In fact, this is precisely what the proposed RRP provides for as a future action, once the value of the NMR is enhanced by a turnaround in its international freight operations. For the present, two standard valuation methodologies have been used to estimate the value of transferred assets: net book value and replaceable depreciated costs.

8. A discounted cash flow analysis of NMR would be an essential component of setting the stage for privatization. By contrast to other valuation methodologies which assign a one-time, static value to the assets in question, the discounted cash flow approach focuses on performance of these assets, in this case the discounted value of the income flows likely to be generated by the restructured NMR. This approach, in other words, gives some measure of what an investor might be willing to pay now for equity in the NMR based on estimates of future cash flows.

9. Discounted cash flow analysis may also be helpful in determining the timing of privatization. Critical here is the estimate of the risk associated with investing in the NMR; i.e., the discount rate used in calculating the present value of the projected cash flows. The GOM as owner/operator will discount these flows at a lower rate than a private investor. The question a private investor might ask is whether he could achieve a significantly higher net income flow than the GOM to offset the higher risk he would attach to owning a strategic transport business in a land locked country dependent on international freight as its major source of revenue. The assumption underlying the strategy of the proposed RRP is that the answer would be "no" under present conditions. The GOM, therefore, must address the problem of risk, through achieving greater efficiency in freight operations or other measures, before attempting to sell or lease the NMR to private investors. In addition to determining an appropriate discount rate for NMR's free cash flows, two major challenges beyond the scope of this study are determining reasonable terminal value assumptions and

valuing NMR on the basis of ascertaining the most likely potential strategic and financial buyers for these assets.

10. Table 1 provides the free cash flows generated by NMR. The revenue and cost projections were provided by MR and are essentially the same as those used in the World Bank's Aide Memoire of May 19, 1994 and the Financial Simulations, May 29, 1994. Free cash flow, which is the basis of the valuation, is defined as projected operating income (EBIT) plus depreciation less changes in working capital less investments. The investment stream and the assumptions underlying the revenue and expense projections are attached as notes to Table 1. Table 2 lists the assets of the new company and valuations based on net book value and depreciated replaceable cost.

11. The World Bank reviewed three scenarios for valuation purposes: base case, restructuring and privatization. The restructuring scenario has been applied in Table 1. The major differences in these three projections is in the assumed volume of international traffic the new company would capture through the Nacala corridor. The assumptions were 144,000 MT rising to 238,500 MT in 6 years for the base case scenario, 144,000 MT rising to 300,000 MT in 6 years for the restructuring scenario (the case used in Table 1) and 144,000 MT rising to 525,000 MT in 6 years for the privatization strategy. All other assumptions were the same in each scenario. MR had 99,000 MT of international traffic for the year ending March 31, 1994.

12. As shown in Table 1, the NMR is likely to record a negative or low return on assets through the early years of the project if all assets are transferred. Return on assets (ROA) is calculated on the basis of two ratios: turnover defined as sales/assets and operating margins defined as EBIT/sales. The product of these two ratios is the return on assets, which is negative for the first five years in the case of the pro forma financial statements of the NMR. The EBIT/sales figure, which for a small US freight company would range between 13-22%, is negative in the case of the NMR and the turnover ratio is low initially at 9% and rises to only 14% in year 5. For a small US freight company the turnover ratio would range from 30-40%. The key to improving the NMR's operating margins may lie in reducing high administrative costs which, while declining from 29% to 23% over the 5 year period, are still high compared to the 12-18% range typical of the US counterpart.

13. Return on assets projections also offer insights into whether the NMR can improve its performance through leverage. A small freight company would typically have a total liabilities to total assets ratio of about 50%. The NMR will begin operations with no debt. However, if the return on assets is less than the interest charge on debt (defined as interest expense/assets), the company's financial performance as measured by return on equity will be

eroded by borrowing. The relationship is expressed as: return on equity=(return on assets - interest charge/assets)assets/equity. As a result, with negative ROA, any capital infusions to the NMR in the early years should be through equity, not borrowing. To avoid lowering the return on equity, USAID and the World Bank financing of the NMR investment program should be treated as a grant rather than a loan. The company has three potential sources of interest charges in its early years: working capital, borrowing for its investment program and general borrowing for operations (cash flow from operations is positive initially but does not cover investment expenses), and payments to stock holders, e.g., dividends, should they be required. If the World Bank finances the entire projected three year investment program, the NMR must only borrow for working capital.

14. The negative return on assets and employed capital suggests that the value of the company to private investors and financial institutions would be increased if the asset base were reduced while measures were taken to improve the NMR's operating margins. Along these lines, one of the options examined in the section to follow is leasing rather than transfer of the permanent way.

Capitalization

15. The starting point for developing a capital structure for the NMR is valuing the assets transferred from MR, which represent equity owned by the GOM as 100% shareholder. Agreement was reached by the GOM and donor agencies to value these assets at the replaceable depreciated cost, a figure substantially greater than the net book value of the assets. (Table 2)

16. In drawing up a balance sheet for the NMR, current assets and liabilities are estimated based on the experience of MR and other freight companies. It is assumed that the NMR will need to borrow to sustain and expand its operations and to carry out its investment program. However, since the company will be unable to pay commercial rates of interest in its early years, the balance sheet assumes IDA terms, i.e., non-commercial rates and deferred actual payment of interest on loans and no repayment of principal. This suggests that the GOM should consider equity infusions in lieu of borrowing and leasing rather than asset transfers as options in financing the early expansion of the NMR.

17. Although there is no leasing law in Malawi, the country has had many years of experience with capital leases. One option for the NMR would be to lease the permanent way from the GOM either directly or through another subsidiary of the NMR established for this purpose. The main reason to consider leasing is to reduce the assets on the balance sheet and thereby improve the company's

return on assets and equity. (If a subsidiary of the old MR could benefit from MR's tax credit carryover, using a subsidiary of MR should also be considered.)

18. A key question is how to determine a fair lease payment. The net book value of the permanent way is 73.892 million mk as of 3/31/94 (on a depreciated replaceable cost basis the permanent way was valued by the World Bank team at 223.542 million mk). An annual payment that would equate the present value of those payments over 20 years discounted at 9% with the net book value of the permanent way is about 7.5 million mk. This is less than the annual depreciation of 13.870 million mk estimated for the permanent way valued at the depreciated replaceable cost by the World Bank (see schedule F of the May 29, 1994 Financial Simulations), but more than the anticipated annual repair and maintenance expense for the permanent way. Although the number of years of payment and the discount rate are subject to negotiations, Table 3 shows the effect of leasing the permanent way on return on assets and equity of the NMR. This can be compared with transferring the permanent way to the new company in Table 1. The comparison is summarized in Table 4. By reducing administrative costs to 15% of revenue (para 12), the ROA increases to 2.3% in 1995 and 7.0% in 1999 (Table 5).

19. What Tables 1, 2, and 4 suggest is that leasing of the permanent way rather than transferring it to the new company improves the performance of the NMR in many ways. Return on assets and return on capital employed turn positive year 2, meaning that leverage is beneficial and will increase the return on equity of the new company. The turnover ratio and the net free cash flow improve. Although on a net book value or depreciated replaceable cost basis, the value of the new company is less under the leasing option, the value will probably be greater on a discounted flow basis when that analysis is done because of the greater free cash flow. This is how it will be valued by private investors.

20. Working out leasing arrangements is potentially difficult. The GOM's continued ownership of the permanent way could delay the liquidation of the MR. To avoid this problem, the permanent way could be transferred to a government entity, like the Ministry of Transportation, or to another new company, a subsidiary of the NMR, which would lease it to the NMR. Another possibility is to transfer the permanent way to a subsidiary of the MR, if this would preserve MR's present tax credit of about 153 million mk. Ideally, this tax credit would be transferred to the NMR, but discussions with GOM officials were inconclusive on this point. Decisions on such organizational issues probably cannot be made until a transportation plan for the country has been drafted and approved by the government.

21. Whatever ownership or leasing arrangement is decided upon, a key issue is which entity would be responsible for maintaining and improving the permanent way. If it is transferred to the NMR, the NMR has this responsibility. The NMR has the greatest incentive in this regard since it is essential to creating a positive revenue stream. The GOM, on the other hand, may have neither the will nor the resources to maintain and improve the system if it is leased to the NMR. One course of action would be for the government to sub-contract with the NMR to take responsibility for these activities using some of the lease payments. In the leasing scenario, Table 3, we added 2.150 million mk/year to other NMR revenue for repair and maintenance of the permanent way. This figure is negotiable. Responsibility for upgrading the permanent way would also be negotiated between the NMR and the GOM. This approach would guarantee that the permanent way would be maintained and upgraded, thus contributing to expected improvement in the NMR's financial performance and enhancing the probability of successful privatization.

22. In addition to the leasing versus ownership question, determining a capital structure for the NMR requires working out shareholding arrangements. If the GOM decides to privatize the NMR in part through a sale of shares to employees or to outside investors, one reasonable option for the GOM to consider is to offer two types of shares. Only one type of share--those offered to employees and private investors--would participate in dividend distributions initially. Both types of shares would participate in capital gains. Whether employees and outside private investors would initially have equal voting rights needs further study. Government shares would be converted into dividend participating shares when sold. This is a potentially complicated issue which might best be explored by the investment adviser to be contracted by MR.

23. Another consideration In NMR shareholding is whether to reserve some shares for purchase by NMR management and employees. To my knowledge there is no employee stock ownership plan now in existence in Malawi, though I understand that Industrial Gases may have initiated one recently. However, there are no legal or other constraints on instituting such a plan for the NMR. Interest in the plan could be heightened if the NMR offered to buy back employee shares at any time at the original purchase price, thus providing liquidity for employees. There are discussions under way regarding the establishment of a stock exchange in Blantyre, which, if successful, may provide a market for both employee and government owned shares in the NMR.

24. Time did not permit a review of the financial feasibility of employees purchasing shares of the NMR. Much would depend on the value of the shares and on the availability of schemes that may be offered to employees to purchase shares. The NMR is valued at 153.000 million mk under the leasing scenario (Table 3). 10% of the shares, if offered to employees, would translate into almost 15,300

mk/share for each transferred employee and 5,100 mk/share if all former employees of MR were eligible and participated. This may be prohibitive for all but the most senior level employees without a company supported promotion scheme.

25. If employees were offered shares in lieu of part of their severance pay or could borrow at low interest rates against the company's obligation to them for severance and pension payments or were offered shares at a preferential price, there may be some interest among employees to participate. This could be made more attractive if the company guarantees repurchase of employee shares at cost and limits dividend distributions to a class of stocks only available to qualifying employees and former employees and private investors. The employees may also be encouraged by the establishment of a Blantyre stock exchange where the NMR's shares could eventually be listed and traded. This issue also requires further study.

26. A final unresolved issue affecting the balance sheet is whether the NMR will continue to operate passenger rail service. The government is presently weighing the pros and cons of continuing some passenger service in those areas where alternative modes of transport are not available. MR has estimated the impact of such a plan on the number of employees and assets transferred to the NMR and on the NMR's ultimate profit and loss statement. Should the passenger option be chosen, the assumption is that the GOM will pay the NMR full costs for operating this service, a losing operation for railways worldwide.

27. The implications for the NMR's balance sheet of continued passenger service as well as its value to potential private investors depends on 1) whether the GOM or the NMR is responsible for the severance pay for the additional 190 employees MR estimates are required to run the passenger service, and 2) whether the GOM can be relied upon to pay in a timely manner the full cost of running the passenger service. Sufficient information was not available to analyze the full implications of passenger service on the value the NMR or the structure of its balance sheet. However, it would be substantial in both cases if the government does not have an obligation to pay the NMR full costs for continuing the passenger services. Preliminary estimates provided ;by MR suggest that fuel costs would rise by 45%, repair and maintenance costs would almost double, and an additional 190 employees would have to be retained. The severance obligation of 190 employees should the passenger service not be continued at a later date would be a disincentive to private investors buying the NMR and would negatively impact the price offered. Who is responsible, the GOM or the NMR, for this severance obligation should the additional employees be transferred should be made clear at the time that the NMR reaches an agreement with the GOM on a subsidy to continue the passenger service if this is required by the government.

Observations and Recommendations

Summary Observation

28. Based on the analysis herein, the NMR could be an attractive private investment, particularly if the permanent way is leased (Table 3) and G & A expenditures could be reduced (Table 5). The investment merits of the NMR are positive returns on assets and employed capital, potential for growth, positive cash flow from operations, low debt and large tax credits in the early years of operations.

Asset Structure

29. A comparison of outcomes in Tables 1 and 3 strongly supports the conclusion that leasing the permanent way is the most feasible option for NMR to attain quickly a positive return on assets and employed capital and thus to enhance the value of NMR to private investors. Not only does the permanent way have little value to a private investor, transferring it to NMR will result in negative earnings before interest and taxes because depreciation and the asset base are high. Admittedly, the assumptions used in the projections for Tables 1 and 3 are more conservative than those used by the World Bank team.

30. To improve margins and reduce the asset base, the GOM should transfer ownership of the permanent way to a separate government entity or to a new GOM company, which could be a minority owned subsidiary of NMR, in exchange for equity. That organization or company would lease the permanent way to NMR. In addition to NMR, this company would be a candidate for privatization.

31. For reasons discussed in para 21, the new owners of the permanent way should sub-contract the repair and maintenance work to NMR, although this could be a new company established by NMR and current or former MR employees. The leasing scenario, Table 3, assumes such an arrangement as a means to improve NMR's return on assets and employed capital while maintaining an acceptable return on assets for the lessor company. The GOM and NMR would have to agree on which entity was responsible for upgrading or expanding the permanent way.

32. Overall, the leasing scenario would achieve an ROA of 4.7% by 1999 for NMR, which is understated by the high transfer asset value envisioned by the GOM. In addition, the newly formed lessor entity would achieve an ROA of 6-10% based on the net book value of the permanent way.

Excess Cash

33. Both the "all assets transferred" and "leasing" scenarios yield significant surplus cash and that surplus cash earns a 1% real return on deposits in banks. However, this excess cash could be used for investments which yield a higher return to capital and higher profitability. NMR could further enhance performance by decreasing its G&A expenditures as a percentage of revenue to an international norm of 15% (Table 5 and para. 19)..

Timing of Privatization

34. NMR should be privatized immediately after it begins operations along the lines suggested by MR and the World Bank and refined in the leasing scenario in Table 3. NMR will be attractive for its positive EBIT under the leasing scenario, for its substantial cash flow, the tax credit which it will accumulate during its early years of operations and for the growth potential to carry international freight through the Nacala corridor. An investment adviser should be hired immediately to assist the government in this privatizing effort. Suggested terms of reference for this assignment are attached as annex A.

Valuation

35. NMR needs to be valued on a discounted cash flow basis. This should be part of the assignment of the investment adviser (para 34). This can not be done adequately with the information available which must include a ten year revenue and expenditure projection, assumptions for calculating terminal value, a more detailed analysis of an appropriate discount rate than discussed in the notes to Table 1 and some idea as to potential buyers.

36. The government's initial equity in NMR should be equivalent to the assets transferred valued at replaceable depreciated cost, or approximately 152 million mk. The government would also maintain ownership of the permanent way or receive equity equivalent to 223 million mk in another company established to lease the permanent way to NMR. Assets not transferred will be sold at competitive auction. Proceeds from this sale are estimated to be sufficient to pay off the present MR liabilities, estimated at approximately 125 million mk as of 3/31/93. A liquidation expert should be hired to manage the auction. Terms of reference for this assignment are attached as annex B.

Capital Structure

37. The government should consider setting aside 10% of the shares in NMR for purchase by employees of NMR and former employees of MR. The investment adviser should help MR and GOM establish criteria for determining which

employees and former employees would be eligible to participate. NMR and the government should consider innovative ways to broaden the number of persons participating in the purchase of NMR shares. 10% of the initial capital of NMR of 153 million mk is still a substantial amount of money for 3000 participants, if former MR employees are eligible to buy shares of NMR, not to mention the 1000 transferred to NMR. The government could facilitate participation in the scheme by guaranteeing repurchase of shares at the original purchase price and by providing installment payment financing on the basis of severance and pension obligations. These shares could ultimately help support the development of a Blantyre stock market should NMR become a profitable company, as envisioned.

38. GOM will probably have to subordinate its capital to attract new investment. Given the riskiness of such an investment and return requirements demanded by potential buyers, one idea may be to create two classes of stock. The new capital, which may include eligible employees, would receive preferred dividends until certain return requirements are achieved, at which point the government shares would become dividend participating. The government could phase in the sale of its shares over time as shareholder value is created by private management. A well developed Blantyre stock exchange would help enhance the value of NMR's shares by creating liquidity.

Passenger Service

39. The government has requested that NMR take responsibility for the continuation of passenger service in those areas where alternative public transportation is not available. NMR should insist that the full cost of these unprofitable services be reimbursed by the government, including any severance payment obligation to additional employees transferred to NMR for this purpose. Otherwise, the prospects for selling shares to private investors or to employees of NMR and former employees of MR will be greatly diminished and a franchise might be the only feasible method of ultimately privatizing NMR in the near term.

Next Steps

37. The following actions must be taken before NMR is privatized:

Hire a liquidation adviser
Liquidate MR's assets and payment of liabilities
Hire an investment adviser
Incorporate NMR and transfer assets from MR
Reach agreement on leasing of the permanent way from the GOM
Establish company or designate GOM agency to lease permanent way to NMR

Sign lease agreement and agreement covering repair, maintenance and upgrading of the permanent way Reach agreement with GOM on continuation of passenger service Establish an employee stock purchase plan Privatize NMR

TABLE 1

Malawi Railways Restructuring

Model Version:	All Assets Transferred
Date	14-Sep-94

Input Assumptions	
Sales/fixed assets	0.4
Sales/net fixed assets	0.4
Sales/accounts receivable	6.0
COGS/accounts payable	2.5
COGS/inventory	6.0
Tax rate	35.0%
% of assets leased	0.0%
Interest rate on surplus cash	1.0%
Interest rate on long term debt	5.0%
Term of long term debt	20
Interest rate on World Bank loan	2.0%
Discount rate	10.0%
Growth rate	2.0%

Output Summary	**1995**	**1996**	**1997**	**1998**	**1999**
ROA (EBIT/Avg. Assets-cash)	-3.2%	-3.1%	-2.6%	-2.1%	-1.6%
ROE (EBT/Avg. Equity)	-4.0%	-4.3%	-4.0%	-3.4%	-2.7%
EBIT/sales	-34.1%	-30.4%	-24.0%	-17.2%	-11.4%
Net interest expense/avg. assets	0.2%	0.4%	0.5%	0.5%	0.4%
Avg. assets/avg. equity	1.22	1.28	1.38	1.42	1.45
EBIT/avg. total invested capital-cash	-3.3%	-3.1%	-2.7%	-2.2%	-1.7%
Sales/assets-cash	0.09	0.10	0.11	0.12	0.14

TABLE 2

Malawi Railways Restructuring

Model Version: All Assets Transferred

(mk millions)

Assets Transferred *	**Amount**	**Original Cost**	**(3/31/94) Book Value**
Mainline locomotives	13	5.841	1.781
Shunting locomotives	7	0.675	0.170
Rolling stock	514	12.292	7.149
Permanent Way		93.210	73.892
Building/Platform		17.398	12.151
Plant & Equipment **		16.717	7.885
Total		146.133	103.028

The original plan was to transfer 8 locomotives, 10 shunts, 400 wagons, the permanent way and other assets. The 375.9 million mk depreciable replaceable cost used in the "All Assets Transferred" scenario is based on this list of transferred assets, not the one above which is now contemplated. The valuation was:

Permanent way	223.500
Rolling stock	118.200
Other	34.200
Total	375.900

** Plant & Equipment includes all plant as of 3/31/94 (for new and old companies). The final list of other assets to be transferred is not available.

	Valuations (millions mk)
Book value	103.027
Replaceable depreciated cost	375.900

TABLE 3

Malawi Railways Restructuring

Model Version Leasing Scenario
Date 14-Sep-94

Input Assumptions	
Sales/fixed assets	0.4
Sales/net fixed assets	0.4
Sales/accounts receivable	6.0
COGS/accounts payable	2.5
COGS/inventory	6.0
Tax rate	35.0%
% of assets leased	40.5%
Interest rate on surplus cash	1.0%
Interest rate on long term debt	5.0%
Term of long term debt	20
Interest rate on World Bank loan	2.0%
Discount rate	10.0%
Growth rate	2.0%
SG&A at standard % of sales	0.0%

Output Summary	**1995**	**1996**	**1997**	**1998**	**1999**
ROA (EBIT/Avg. Assets-cash)	-0.5%	0.3%	1.6%	3.1%	4.7%
ROE (EBT/Avg. Equity)	-0.8%	-0.1%	1.4%	3.1%	4.8%
EBIT/sales	-2.1%	1.3%	5.8%	10.3%	14.1%
Net interest expense/avg. assets	0.2%	0.4%	0.4%	0.4%	0.3%
Avg. assets/avg. equity	1.28	1.34	1.43	1.45	1.44
EBIT/avg. total invested capital-cash	-0.5%	0.3%	1.7%	3.3%	5.1%
Sales/assets-cash	0.24	0.25	0.27	0.30	0.33

TABLE 4

Malawi Railways Restructuring

Rate of Return Comparison: All Assets Transferred versus Leasing Scenario

Summary derived from Tables 1 & 3

	1995	1996	1997	1998	1999
ROA (full transfer)	-3.2%	-3.1%	-2.6%	-2.1%	-1.6%
ROA (Lease permanent way)	-0.5%	0.3%	1.6%	3.1%	4.7%
ROE (full transfer)	-4.0%	-4.3%	-4.0%	-3.4%	-2.7%
ROE (lease permanent way)	-0.8%	-0.1%	1.4%	3.1%	4.8%
EBIT/sales (full transfer)	-34.1%	-30.4%	-24.0%	-17.2%	-11.4%
EBIT/sales (lease permanent way)	-2.1%	1.3%	5.8%	10.3%	14.1%

ANNEX A

Terms of Reference

Investment Adviser

Overview of Project Objectives

1. The Government of Malawi (GOM) and the Board of Directors of Malawi Railways Ltd (MR) have decided that a new rail freight transport company will be established to take over all freight services presently provided by MR. The stock of the new company, the New Malawi Railway Company (NMR), will initially be held in its entirety by the GOM, but as soon as feasible a majority of the NMR stock will be sold to the private sector.

2. The newly established NMR will be responsible for train scheduling and for maintenance of the equipment, switching yards, and other assets transferred from the MR. Charges for freight and any continuing passenger services will be determined by NMR. In the case of passenger services, toll fees will be an internal accounting transfer between the GOM and the NMR.

3. In the privatization of the freight services, GOM's basic objective is to create a commercially viable operation which will contribute significantly to national transport demand. The incorporation of capital and managerial expertise from the private sector is essential to this end. At the same time, it is important to ensure that fair value is received for the majority of the stock in the NMR which eventually is to be sold to the private sector. GOM intends to withdraw completely from freight transport rather than providing some services directly while the NMR provides others.

Summary of Services Required

4. GOM's overall objective in hiring an investment adviser for a three to four month assignment in the field is to ensure that privatization of the NMR is transparent and results in an efficient and competitive freight service, providing a fair return to the GOM for its equity in the company. The investment adviser is expected to offer technical knowledge not available within the MR and, in particular, to apply to the Malawi case lessons from international experience in privatizing state-owned railways. Specifically, he/she will be responsible for providing the following services:

   * trategic support, defined as identifying and analyzing the options that need to be considered during each phase of the privatization process and recommending an appropriate course of action.

* the preparation of a prospectus providing potential investors information about the NMR. The investment adviser will organize a campaign to widely disseminate the prospectus and will serve as the channel for additional information that may be requested by potential investors.

* preparation of tender documents and criteria for evaluating bids.

* organization of a pre-bid conference and other promotional activities.

* prequalification of participants, advice on the bidding process itself, evaluation of results, and preparation of the documents and other actions required to complete the privatization, including drawing up franchise contracts or sales documents as appropriate.

* advice to the GOM and NMR during negotiations of a franchise contract or sale of shares to the successful bidder.

Detailed Description of Services

5. **Strategic support.** By the start of the investment adviser's assignment in Malawi, the NMR will have been legally established, assets such as locomotives and rolling stock transferred, and arrangements made for the lease of other assets. It is also probable that a lease contract will have been signed stipulating the rights and obligations of the rail freight company and the GOM on the use, maintenance, and upgrading of the permanent way. These completed actions notwithstanding, the investment adviser still has the discretion to propose fundamental changes that in his/her view will serve to enhance the success of privatization. He/she is expected to review all matters pertinent to the privatization project and to take the initiative to propose decisions and actions which are conducive to the success of the project. This will include an analysis and recommendation to the government on whether the NMR should be privatized through a franchise or sale.

6. **Preparation of the prospectus.** The investment adviser will prepare in English a prospectus which describes and analyzes the rail freight company and its potential. Because accounting information on the MR is incomplete, the adviser will need to model future railway freight operations, income and costs in order to predict net income flows. An important part of the prospectus will be a discussion of the merits of investing in NMR. The GOM and the NMR attach great importance to having the investment adviser responsible for preparing the prospectus consistent with international standards.

7. To ensure the transparency of the privatization process, the investment adviser will also serve as the exclusive channel through which all information is provided to potential investors. He/she will receive and respond to requests for additional information not included in the prospectus.

8. The bylaws of the rail freight company are a key component of the prospectus. The investment adviser will review these bylaws and propose whatever modifications are necessary to facilitate the privatization process. In particular, the adviser will introduce wording, as appropriate, to safeguard the rights of any minority stockholder, e.g. employees.

9. The investment adviser will review all assets, both NMR-owned and those leased to the NMR, and prepare a report for the GOM either endorsing the existing asset mix or recommending specific changes. He/she will also in similar fashion review and report on the NMR's debt and capital structure.

10. The GOM may request the NMR to continue passenger service on a government-subsidized basis, thus requiring employment of additional workers. The investment adviser will include in the prospectus a review of Malawi labor law to apprise potential investors of their obligations should the passenger service and its work force be terminated at some future date. He/she will also review the adequacy of the GOM subsidy for commuter services in order to attract private interest in operating or owning the NMR.

11. By the start of the investment adviser's assignment, it is likely that a lease agreement between the GOM and NMR on use and maintenance of the permanent way will have been drafted and signed. The adviser will review the agreement and propose additions and modifications, if appropriate.

12. One part of the lease agreement which will require special consideration are provisions dealing with the toll fees for the use of rail infrastructure. To establish a fair competitive market among alternative modes of transport, reductions in lease payments may be required. The investment adviser will propose criteria to be used to determine lease payments which meet efficiency and financial objectives and also cover the cost of maintaining the permanent way.

13. The investment adviser will propose provisions for dealing with the respective responsibilities of the GOM and NMR in the event of railway accidents.

14. **Preparation of tender documents.** The investment adviser will prepare the tender documents for either a franchise to operate the NMR or for the sale of at least 51% of the stock of NMR. This documentation will provide for the prequalification of potential investors or investor groups, guarantees to be provided by participants, an explanation of the tendering process, the information to be included in the tenders submitted by potential investors, the

criteria to be used in evaluating the tenders, the process of tender evaluation, and the procedures for transferring the stock or the parameters of a franchise agreement once the tender process has been completed.

15. It is probable that the tenders will contain proposals from the potential investors which stipulate the amount the investor will pay for the majority of stock, the amount that will be invested to increase the efficiency and capacity of the rail freight company, and the annual payment which will be made for the franchise. It is possible that investors will also be requested to stipulate additional elements, such as the length of the franchise, the freight services which will be provided or the number of present workers who will continue to be employed by the company. The investment adviser will analyze these and other elements which might be included in the tendering process and will propose that combination which maximizes the likelihood of success of the privatization exercise in terms of the objectives of the GOM and the NMR. The adviser will also propose the criteria to be used in evaluating tenders received.

16. **Pre-bid conference/promotional activities.** The investment adviser will prepare a report proposing strategies and measures to stimulate the interest of potential Malawian and foreign investors in the NMR and to increase both the quality and quantity of tenders. He/she will also organize and manage a pre-bid conference for potential investors.

17. Prequalification of participants/bid process advisory and evaluation. If prequalification of investors is used, the investment adviser will participate in the required evaluation. He/she will participate in the evaluation of tenders received and in the selection of the most appropriate investor or group of investors. He/she will also prepare the documents which are required for the transfer of the majority of the stock of NMR or for operating NMR as a franchise.

Basis for Establishing Fees for Services

18. The budget available for consultancy fees is limited. However, in addition to a standard fixed fee, consideration may be given to a success fee financed from NMR stock sale to private investors. Proposals for the investment adviser's position should include, along with professional qualifications, proposed fees, both fixed and success, and criteria used in arriving at the figures in question. Fees may be payable in Malawi mk, United States dollars or a combination. The exchange rate on the day on which the technical proposals are opened will be used in the evaluation of the economic proposals. The consultancy firm or individual will be responsible for complying with Malawi tax laws on fees.

Information to be Included in the Responses to the Request for Proposals

19. Proposals are expected to be submitted in English. The technical proposal which lists the qualifications of the firm or individual, and the economic proposal, outlining a fee structure for services rendered, should be submitted separately with each placed in a sealed envelope. No indication of proposed fees should appear in the technical proposal. If the technical proposal includes a Malawi consultant or consultants who would be associated with the proposed consultancy services, the name or names should be indicated. The technical proposal should stipulate the time required between the date of the signing of the contract for the consultancy services and the date on which the tender documents will be ready for distribution. The technical proposal should stipulate how the consultants propose to approach each of the components of the consultancy services, who would undertake the work and his/her qualifications, the amount of time to be devoted to each activity, and the period of time over which the work would be done. The economic proposal should stipulate the proposed fees, including the success fee, and the currency in which they would be payable. Net fees and the taxes on these fees should be presented separately.

ANNEX B

Terms of Reference

Liquidation Adviser

Overview

1. The Government of Malawi (GOM) and the Board of Directors of Malawi Railways Ltd (MR) have decided to liquidate MR and to create a new stock holding company under the name of the New Malawi Railway Company (NMR) to manage all freight services presently provided by MR. MR will transfer to NMR only those assets essential to international freight operations handled through the port of Naacala, Mozambique. Assets not transferred will be sold and the proceeds usd to pay off MR's creditors. MR will hire a liquidation adviser for an assignment of three to four months to organize and manage all phases of the sale process from preparation of bidding procedures to negotiation of sales agreements.

Summary of Services Required

2. The liquidation adviser is expected to offer technical knowledge not available within MR and the GOM. MR will provide a list of assets which GOM has designated for sale and which have been valued by an outside expert. Specifically, he/she will be responsible for providing the following services:

* establishing the rules and procedures for a competitive auction and forms of acceptable payment to winning bidders in consultation with MR and the Department of Statutory Bodies,

* preparing criteria for evaluating bids,

* preparing a brochure describing in precise terms each asset to be sold,

* drafting bid documents and sales contracts,

* compiling and disseminating information on asset sale to a wide array of potential bidders both in and outside Malawi,

* organizing and conducting a pre-bid conference and viewing of the assets for potential investors,

* assessing bids received, and

* assisting MR in negoitating final sales agreements.