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HOW DEALS SQUARE UP

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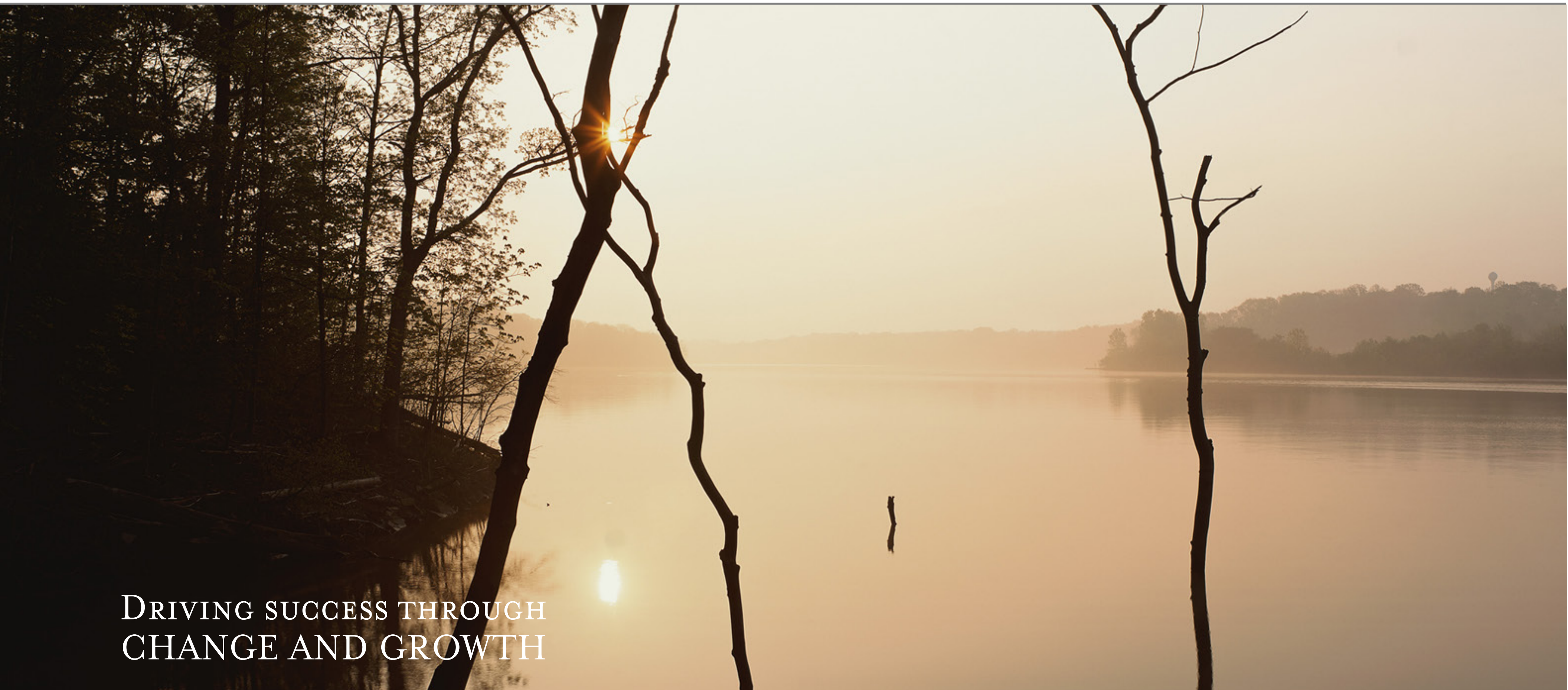

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After a long stretch of profitability, there are few U.S. ethanol producers "approaching the table" to sell. But that could change.

Like golf, ethanol mergers and acquisitions (M&A) is game of opposites. A golfer swings right to draw the ball left, left to cut it right, down to send it up. Ethanol M&A, too, work on ironic inverse relationships. Transaction numbers spike after bad times and dip during good times. High margins work against deals. Low margins produce them. Simply put, when profitability goes up, ethanol M&A activity generally goes down.

After the 2008 downturn, for example, 29 ethanol plants traded hands in 18 transactions before the end of 2010, according to Mark Fisler, managing director at Los Angeles-based investment banking firm Ocean Park Advisors. "That was a huge amount of volume over a two-year stretch," Fisler says, explaining that improved margins, starting in 2010, yielded only five ethanol plant acquisitions in four deals in 2011. Then low M&A activity continued through the first half of 2012 following a generally profitable 2011.

Production margins sagged in 2012, spurring the sale of six ethanol plants late in the year and setting the stage for double-digit transactions in 2013. "We saw 13 ethanol plants acquired in 10 transactions that year," Fisler says. "It was driven mostly by weak balance sheets and distress coming off 2012. "Clearly, the industry sees more transactions on the heels of distressed cycles than it does during or after good times."

That last big M&A run ended when the ethanol industry cycled into an epic 18-month stretch of record margins from mid-2013 through late 2014. "I would characterize the last year and a half as a period of low M&A activity, but it depends on what you compare it to," Fisler says, explaining that there were five ethanol asset transactions completed in 2014. "There are a lot of reasons for that, including the fact that ethanol margins were so good through most of 2013 and 2014."

Most but not all M&A activity in the ethanol industry since 2008 has been a story of leaders acquiring laggards. A vast majority of the deals were financially distressed independent plants acquired by large, integrated ethanol producers. Today, Fisler says, "strategic producers" remain interested in acquiring ethanol plants, but sellers are scarce. "We're four months into the year and there really isn't an announced 2015 deal at this point," he says. "There are whispers about deals—and we are in talks with various people—but ethanol producers just aren't approaching the table. So there's a lot of interest in transactions but very few producers looking at a sale."

Fisler continues, "When you talk to a producer who just made 60, 70, 80 cents a gallon last year, it's pretty hard for them to get excited about where plants are trading. Ethanol plants are [selling for] roughly $1.60 per gallon on nameplate capacity or around $1.30 per gallon on their operating rate. So if you made 70 or 80 cents a gallon last year, that's not very interesting. Shareholders remember the last dividend check they made, and most of them don't want to let go of an asset for that low a number right now."

Notably, M&A activity in the ethanol sector doesn't follow industrial M&A activity in general. "The ethanol industry is characterized by single-purpose assets at location," Fisler says, explaining how some industries offer more opportunities for transactions than others. "There are a limited number of reasons for ethanol plant acquisitions."

The fact that this year's lower-margin environment has not spurred appreciable M&A activity could be the result of two things. First, it's early and transaction activity generally lags behind prevailing market conditions by several months. Second, many U.S. ethanol producers were able to strengthen their balance sheets and reduce their debt last year. "The massive run up in crush spreads provided meaningful liquidity to producers and gave them a number of capital market solutions for the first time in a while," says Scott Chabina, director at Carl Marks Advisors, a New York-based investment banking firm. Chabina cites three high-profile loans secured by producers in 2014, including a $66 million senior credit agreement completed by Southwest Iowa Renewable Energy, a $225 million senior secured credit facility completed by Green Plains Renewable Energy, and a $40 million loan and security agreement secured by Aventine Renewable Energy before the company moved ahead with its pending merger with Pacific Ethanol. "This was a great time to provide optionality, which is king in the world of ethanol. It's defensive. It's strategic. You need to be a low-cost producer and take advantage of the margins when the margins are there."

Chabina says ethanol producers, big and small, are still in good positions and able to act on strategic activities including M&A, refinancing and inside-the-fence capital projects. "Producers are looking at projects," he says. "In many cases, they're dusting off the CapEx books that have been on the shelf for a while because they're in a position to take advantage of having liquidity."

Nondistress Deals

While financial distress may be the surest expediter of ethanol plant transactions, it is not the only thing that makes deals occur. Fisler says multiple ethanol plants have been sold in recent years by what he calls nonlong-term investors. "These are your pure-play investor groups that see an opportunity in ethanol, put dollars into a plant, achieve good returns and want to exit their investment," he says, citing CHS's acquisition of Illinois River Energy LLC last April. "That's a perfect example of a plant that was owned by an offshore investor that didn't see the asset as strategic to retain. That deal was not driven by distress."

At the other end of the seller spectrum are farmer-owned ethanol plants, arguably the most unlikely transaction participants. Fisler says that about a third of U.S. ethanol plants can still be characterized as "steadfastly independent," and not interested in giving up control, regardless of margins. "Those types of ethanol plants are usually not going to trade. Even though there might be a real opportunity to merge four or five smaller plants together in a way that creates a greater internal balance sheet, better cash flows, greater ability to invest and grab new technology, they may not necessarily be interested in hearing that because they just want to keep what they've got."

Chabina says some near-term ethanol plant transactions could involve middle-of-the-road producers who have "earned their way out of trouble" and are considering selling while they're in a strong position. "Against the outlook of a more moderate 2015, it might make sense for some of these guys to explore their options and look at a sale," Chabina says, explaining that nondistressed facilities can command a premium from buyers seeking assets with specific attributes. "Many producers wanted to acquire gallons for scale a few years ago. Now, buyers are more disciplined and seeking assets that fill out their respective network for a number of reasons. Flint Hills' acquisition of Southwest Georgia Ethanol is a great example of that sort of approach. It was strategic purchase and it made sense for them given their existing resources."

Chabina adds, "The appetite from buyers is still there, but they are more discerning. They know what they want, and it's often not just a matter of gallons. Buyers are looking at the specific production history of a facility, its transportation and logistics situation, its management team, third parties services, grain storage and more. The attractiveness of each plant is unique to each prospective buyer. That's always been true, but today's buyers are more disciplined and won't simply stretch for gallons alone."

A new X-factor in ethanol M&A is the potential for more transactions to be driven by strategies to convert existing ethanol plants into

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facilities that can produce nonethanol fuels and chemicals. "We're seeing the emergence of companies interested in buying and retrofitting ethanol plants for other purposes, one being the possibility of producing higher-value, higher-margin specialty chemicals," Chabina says. "That tends to lead toward the discussion of the diversified, integrated biorefinery concept against the backdrop of the big second-generation ethanol plants that are coming online."

Having spearheaded the sale of the Central Minnesota Ethanol Co-op to Green Biologics last year (see "Back to the Future with N-butanol"), Fisler knows firsthand what the value proposition is, for both buyers and sellers, in transactions based on plant conversions. Green Biologics purchased CMEC in a creatively structured deal that gained a lot of attention in the biofuels M&A space. When completed, the reconfigured plant will have the capability to produce acetone, normal butanol and ethanol. "I'd be surprised if we don't see more deals like that in the future," he says.

Clear Signals Help

At press time, the ethanol industry was awaiting the U.S. EPA's final 2014 and proposed 2015 and 2016 renewable volume obligation (RVO) numbers, which instruct oil companies on their mandated biofuels blending obligations. Fisler doesn't expect the RVOs to have a major impact on ethanol plant M&A, but he does think improved policy certainty will invite more capital to the biofuels sector. "The type of improvement projects that a number of producers are looking at are quite large and would require the support of the lender community," Fisler says. "Better policy certainty might help facilitate that process, particularly if it gives the industry a runway for cellulosic ethanol or plant upgrades."

Chabina agrees that a stable regulatory and policy environment is key for biofuels finance markets. "It's critical to stay the course and send a clear signal that encourages companies to invest the time and capital in next-generation biofuels and, more broadly, biorefining," he says, adding that he believes M&A activity will pick up regardless of where the EPA lands on its RVOs. "Absent any truly adverse changes to the RFS or major weather events, margins are largely expected to be moderate. We're not expecting to see a lot of plants with their backs against the wall. There will still be some distressed asset sales, but they will be less a function of pure crush spreads and more a function of not being the low-cost producers in a normalized market."

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