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Consolidation Inevitable in Biofuels Industry - Analyst

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The U.S. ethanol industry is experiencing a kind of "renaissance" year due to a convergence of factors such as higher-than-normal Renewable Identification Numbers (RINs), a favorable projected corn harvest and low corn prices bringing about favorable crush margins that, as a result, are allowing producers to reinvest in their distilleries to improve operational efficiencies.

Those reaping the benefits of peak performance are riding high, but those struggling financially; however, might be potential acquisition targets by prominent players in the industry that have a more robust balance sheet—suggesting an uptick in merger-and-acquisition (M&A) activity may be nearing, according to Christopher Wu, partner at Carl Marks Advisory Group (CMAG) and co-leader of the firm's energy practice in New York City.

Speaking with Hart Energy's DownstreamBusiness.com recently, Wu said: "I think what that does is it strengthens the resolve of the well-capitalized consolidators to continue the process of consolidating the ethanol industry bringing more operational discipline and capital discipline to the industry and a continuing trend of both 50-100 million-gallon-per-year (MMg/y) Delta-T/Fagen plants being selectively acquired by the majors, which include Valero Energy, Green Plains, Flint Hills Resources and so forth," Wu said.

He further explained, "The ethanol industry is an industry that has to demonstrate that it's viable every few years when there's a shortage of corn and the prices go up and people start criticizing the industry. But, I think the amount of cash flow the industry has generated this year is extremely favorable for future investment."

Historically, Wu characterized overall investment in the build-out of first- and second-generation biofuel projects to be "spotty" and "project-specific", particularly since the financial crisis of 2008-2010. "In aggregate, I would say it's not as robust as it was five or six years ago," Wu said.

"A lot of that has to do where crude oil and natural gas are right now. A lot of it is sort of the overbuilding due to the RFS [Renewable Fuel Standard] during that period of time and all commodities rising at an unnatural, cyclical high prior to the financial crisis of 2008, which was driven by demand from China. When you have commodities spiking people naturally look to develop alternatives as hedges," he noted.

Because biofuels, broadly speaking, has seen its ups and downs entrepreneurs are constantly looking to repurpose their ethanol assets, according to Wu. Therefore, some of them are being reformulated to be able to toggle between producing ethanol and producing specialty chemicals like butanol, which requires some investment dollars in retrofitting, but the technology is there. Wu cited companies like Gevo and Butamax Advanced Biofuels employing such strategies.

“This just assists the industry in having a high utilization capability and helps attenuate the volatile cycle of being tied to one input based on the commodity pricing of just one output,” Wu noted.

He concluded: “All commodity chemical industries—like ethanol—consolidate over time leaving the geographically-disadvantaged, operationally-disadvantaged and capital-disadvantaged producers to be winnowed out, merged, consolidated or closed. What you end up getting is a more disciplined industry that’s significantly consolidated that can attenuate the production throughout the cycle, make money and then it becomes valued more on a cycle average, EBITDA [earnings before interest, taxes, depreciation and amortization]-type profile.”

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