The industry's principal lenders helped give rise to today's fleet of ethanol plants. Will they help producers with the next stage?

By Katie Fletcher | Staff Writer, Ethanol Producer Magazine

The ethanol industry has known both sunny and rainy days. Leery of that volatility, many lenders have tended to dip their toes in the water when the skies were clear – like during the ethanol plant construction heyday of 2004–'06 – only to get out when dark clouds emerged. As much as the boom years fueled, and were fueled by, lending exuberance, the 2008–'09 downturn caused, and was caused by, an exodus of debt financing amid the financial crisis and resultant recession.

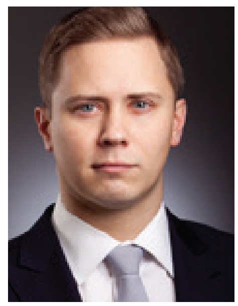
Now, however, with the recession over and ethanol plants making money, when will the lending institutions that bankrolled ethanol's first major build-out return to finance its second? The answer, surprisingly, is that some big lenders never really left. "This is what we do," says Tom Houser, vice president and lead relationship manager in agribusiness banking with CoBank. "We are not just looking to get in and get out in the industry that is in the ups or the downs. We are committed to this in the long term as a bank and a system. We are very much a relationship lender, not a transactional lender."

CoBank is considered one of four primary lenders in the traditional corn ethanol space. The others are AgStar Financial Services, AgCountry Farm Credit Services and Farm Credit Services of America. Jeff Kistner, president of Flag Leaf Financial Management Inc. and a former CoBank employee, says during 2005 and 2006 when the exuberance of the industry was peaking, many other financial institutions wanted to lend, and some ultimately did. "The core group of lenders stepped to the sideline because of the exuberance," he says.

CHRISTOPHER K. WU
Partner
Carl Marks Advisors
212-909-8400
cwu@carlmarks.com

The core lenders in the Farm Credit System avidly watched the industry from the sidelines, however, and because many took conservative approaches with their portfolios, they are still here today. Most of the others left. "Many of the lenders that put their toe in the water have exited the industry," says Randy Aberle, senior vice president of agribusiness for AgCountry Farm Credit Services.

There's a good chance that today's strong ethanol plant margins could revive lender interest in the space once again, however. Since fourth quarter 2013, the industry has been experiencing favorable weather, literally and figuratively. There has been with a strong export demand and positive plant margins due to record corn crops plus a decrease from the 2012 drought-induced record high corn price of $8 to around $4 at the end of July. "What producers and lenders need to be doing right now is using the record margins to amortize their debt, and the one key success factor for all the major producers through the cycle – a decade of ethanol – is really having significant amounts of liquidity to weather the storm," says Chris Wu, partner at Carl Marks Advisory Group LLC. "It's inevitable that margins will contract and those who have the stronger balance sheets survive."



C. SCOTT CHABINA
Director
Carl Marks Advisors
212-909-8400
schabina@carlmarks.com

Lenders agree that maintaining a strong balance sheet is important. Currently, advisors and lenders in the space say profits are giving some producers more options than they've had in a long time. "They've been able to pay down debt and avoid any imminent restructuring that was forced from certain lenders when margins weren't such a great time for these guys," says Scott Chabina, director with Carl Marks Advisory Group. "Now they're looking at some capital projects they've had on their shelves for anywhere between 18 to 24 months – looking at getting their own house in shape."

PROFIT PURCHASES

Many producers are, as Chabina says, optimizing operations and eyeing new technologies at their current facilities as no new corn ethanol plants are being built with the exception of Dakota Spirt AgEnergy Biorefinery near Spiritwood, North Dakota. Coproducts and new technologies are what profits are funding. "You see ethanol producers getting pretty creative, and in a commodity business they have to be really, because it's a pennies game," Chabina says. "As long as they can extract every bit of value out of the corn kernel they are going to do so."

New coproducts are coming, but corn oil, DDGS and Co2 remain the big three revenue sidestreams. Corn oil is now produced at 80 to 90 percent of corn ethanol plants, and those that aren't extracting it have mostly ruled it out to maintain a niche distillers grains customer base. "Corn oil projects have shown a pretty good return on investment and have been pretty widely accepted with most of the plants we've been working with," says Jason Johnson, vice president and agribusiness team leader with AgStar. "New technology is contributing to plant efficiency, and when there is economic payback we are financing that."

Even smaller improvements to increase plant efficiency are having an impact. "One of the interesting things is there has been production creep, about 1 to 2 percent with existing plants, just

based off of the efficiencies they've been able to obtain, without seeing major expansion or a new plant coming online," Johnson says.

LENDER ACTIVITY

Before considering financing, lenders are looking at credit profiles. "What we look at is if the existing ethanol plant has had a history of steady production, does it have an industry average yield – gallon per bushel – and does its debt profile follow the underwriting criteria as far as having additional capacity, mainly if it has an acceptable debt load," Houser says. "Borrowers have to have the profile so they can show the collateral value and the repayment capacity the lenders are comfortable with."

Lenders, who after the downturn added new agribusiness customers to their portfolios sparingly, have opened their doors more widely in the past 24 months. "We are very much interested in establishing new relationships with companies, in particular refinancing plants that have been up and running," Houser says.

The key word, though, is running. Cellulosic ethanol plants and other advanced biorefineries are an area the core lenders are not participating in yet. "Lenders loan to existing ethanol plants, known technology, known market channels, known collateral value, but nothing at present on a standalone basis relative to cellulosic," Houser says.

Aberle agrees. As a lender in the senior debt position, AgCountry usually waits for technology to be fully established and replicated multiple times before financing. "We like to be on the leading edge, but not the bleeding edge," he says.

Getting these projects up and running has not been easy. "The reason cellulosic and advanced biofuels are having a hard time getting going is, when you look at ethanol price to the margins, right now, the best value on a future cash flow basis is in that 90 cents to $1.20 range and it takes $2 [per gallon] to build," Kistner says. "You'll never get that return on investment back."

LENDING RISKS

Although they're not currently financing debt on advanced biofuels projects, many lenders are watching and waiting for the technology to develop. Uncertainty about the federal government's position on biofuels is, in no small part, contributing to lender hesitation in the space. "Advanced biofuels are a very tricky industry, not only technologically, but also because the higher theme for them is, if you do have a cut to the RFS on conventional ethanol and the advanced side, the fuels that we are supposed to be building towards, it's difficult for people wanting to invest in a space where they may cut the demand, the future market," Chabina says.

Larry Johnson, industry veteran and ethanol consultant, echoes Chabina's concern. By waiting to announce the renewable fuel standard's (RFS) 2014 renewable volume obligation (RVO) numbers, he says, the EPA is creating the opposite effect from its ostensible end goal. "They said they would like to see more cellulose and advanced biofuels, and everyone agrees with that, except who is going to put money into a still relatively unproven area of cellulosic ethanol when the EPA might cut back on the amount?"

Kistner agrees that policy uncertainty, and the commodity risk it poses, is deterring lenders from engaging in biofuels today. The bogy, he says, is whether ethanol producers will continue to make financial decisions that yield the sort of liquidity that can supersede the hurdle of government uncertainty, which is out of everyone's hands.

Ultimately lenders outside of the Farm Credit Service system are staying away, and those in the system are not lending to advanced biofuels yet. "Some of them have been attracted to the industry's currently positive margins, but for many there are still some pretty negative connotations associated with the industry," says Jason Johnson. "They have just decided to stay away from it from a policy standpoint at their banks, it is just not an area they are going to return to."

UMBRELLAS AT HAND

Although the downturn that spurred those negative connotations was half a decade ago, the loss is still fresh in everyone's memory. The ethanol industry is no longer in its infancy, and its maturation challenge will be creating and maintaining value over time, says Kistner.

The domestic ethanol market now is near or at a saturation point that could be temporary or long term, depending on the federal government's commitment to the RFS. The industry is producing close to the rate necessary to satisfy the renewable fuel volume of corn ethanol, which is 14.4 billion gallons this year. "This is a record rate, next year the RFS caps out at 15 billion gallons from corn," Larry Johnson says.

Although there is still uncertainty surrounding the RFS, in a commodity business uncertainty is certain. The core lenders, CoBank, AgStar, AgCountry and Farm Credit Services of America, understand this and have learned how to get comfortable lending to the industry.

Plant margins are strong, lenders are engaged, and producers are investing in new technologies. The outlook is bright, but umbrellas are being kept at hand. "It's just important to remember that in the sunny days that producers are enjoying now, you actually need to put the money away for a rainy day," Wu says.