

Capital Strategies to Position a Company for the Future

by Susan Wyka

Whether planning to build a new ethanol plant or operating an existing facility, having a solid capital strategy plan is instrumental in determining future success. However, those planning or developing a new plant must realize that times have changed. The debt and equity capital markets, have tightened significantly due to several factors, including higher and more volatile corn prices, intensified competition, margin compression, the high cost of construction and technological innovation.

The ethanol investment landscape is indeed changing. Most U.S. banks have cut back on lending to the ethanol industry. Average projects without defining characteristics will struggle to get financing in today's market. Institutional equity from the major private equity funds and interest from Wall Street are also getting tougher to find. They too are looking for a "hook" in addition to a strong management team. Transactions that get funded must have a competitive advantage that allows them to be successful. Examples of ways a proposed project can differentiate itself include:

- > An advantaged location
- > Transportation flexibility
- > Sustainable cost advantage
- > Existing asset leverage (brownfield sites)
- > Margin management with offtake and origination locked up with credible partners
- > Strong project development and management team
- > Ability to expand scale and scope of operations.

If a project has a competitive advantage, bank financing is typically structured as a construction loan and a seven-year term loan secured by all of the fixed assets and a pledge of the equity. A separate working capital line is often provided by the same lending syndicate and secured by the accounts receivable and inventories. While the loan is seven years in length, lenders are looking to be paid off in four years or less through a sweep mechanism. Each year, depending on the company's debt service coverage ratios, the lender will "sweep" the company's excess cash flow to prepay the loan.

Pricing for bank financing today ranges from London Interbank Offered Rate (LIBOR) plus 350 basis points to LIBOR plus 450 basis points with two or more points up front. The amount of leverage that most banks are willing to tolerate for projects is in the \$1 to \$1.20 per gallon range with equity investors funding the remaining project costs. Equity dollars are required to be the first into the project.

Another option for raising additional debt is issuing tax-exempt and/or taxable bonds, which are subordinated to the senior debt. Rates range from 8 percent to 12 percent for these types of bonds. The final maturity is typically 10 years, and principal payments are back-ended, or after the senior debt is paid off.

While commercial and agricultural banks continue to tighten their lending criteria, nonbank capital, such as that from finance companies and alternative lenders, is flowing into the renewable energy sector to finance the debt portion of projects. Some of the nonbank lenders are willing to offer longer loan amortizations and eliminate the sweep mechanisms. On the equity side, new funds are being formed to invest in the renewable energy sector. Foreign debt and equity capital are also entering the U.S. renewable energy market. However, these new groups are just as selective and only finance plants with high return potential driven by unique and sustainable characteristics.

For those operating plants, it's important to define a clear strategic vision and direction for the company. How is it going to survive and thrive in the increasingly competitive and complex environment? The capital strategy is a key component to realizing this vision. It must evolve and be updated in conjunction with the life cycle of the business. There are various scenarios that ethanol plant directors and owners should be considering:

- > Expansion of an existing plant to improve economies of scale
- > Diversification into other areas to reduce risk
- > Acquire or merge with other companies
- > Improve efficiencies through energy and operational optimization
- > Refinance debt to improve long-term cash flow
- > Recapitalize the company by selling a minority or majority of the equity to provide some liquidity and reduce the risk to existing shareholders
- > Sell the whole company

Having an exit strategy is an important part of overall capital strategy planning. As the industry matures and undergoes a structural shift from construction to growth, liquidity and consolidation, one will have the opportunity to be an acquirer or be purchased in full or in part. Maximizing valuation should be a continual goal if the plan is to exit either partially or fully.

Valuation is driven by existing and projected earnings and qualitative components that drive success such as management, location, feedstock and transportation flexibility, contracts and relationships. Equally important are market conditions, which determine multiples of earnings or gallons being produced. Currently, valuations are depressed due to uncertainty about corn prices and the previously mentioned challenges facing the industry.



Figure 1. Ethanol company stock performance versus the S&P 500

SPX - S&P 500, ADM - Archer Daniels Midland, PEIX -Pacific Ethanol Inc., AVR - Aventine Renewable Energy Inc., VSE - VeraSun Energy, XNL - Xethanol Corp.

As a buyer, today's market may be favorable as purchase prices close in on the price to build a plant. The cost to build a plant can be as high as \$2 per gallon or more, not including working capital. While private company valuations for ethanol companies are being quoted in the \$2.50 to \$3.50 per gallon range, there aren't many merger and acquisition transactions being completed in the market. Public company valuations have declined from their highs in 2006 and have moved adversely compared to the Standard & Poors 500 (Figure 1).

The evolution of the renewable energy sector continues to move rapidly. Companies need to be positioned, both strategically and operationally, to succeed over time. Understanding the capital markets and having a capital strategy plan are keys to a well thought-out plan for the future. Looking at short- and long-term options, including an exit strategy, will position the company to maximize equity value and provide optimal returns for all shareholders.

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