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Capital Strategies to Position a Biodiesel Business

by Susan Wyka

Whether planning to build a new biodiesel 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 vegetable oil prices, intensified competition (especially from integrated commercial oilseed operators) emerging technological threats (e.g., renewable diesel fuel), the high cost of construction and rapid industry growth.

Biodiesel prices have remained stable over the last six months (Figure 1). However, rising feedstock prices have negatively impacted investor returns.

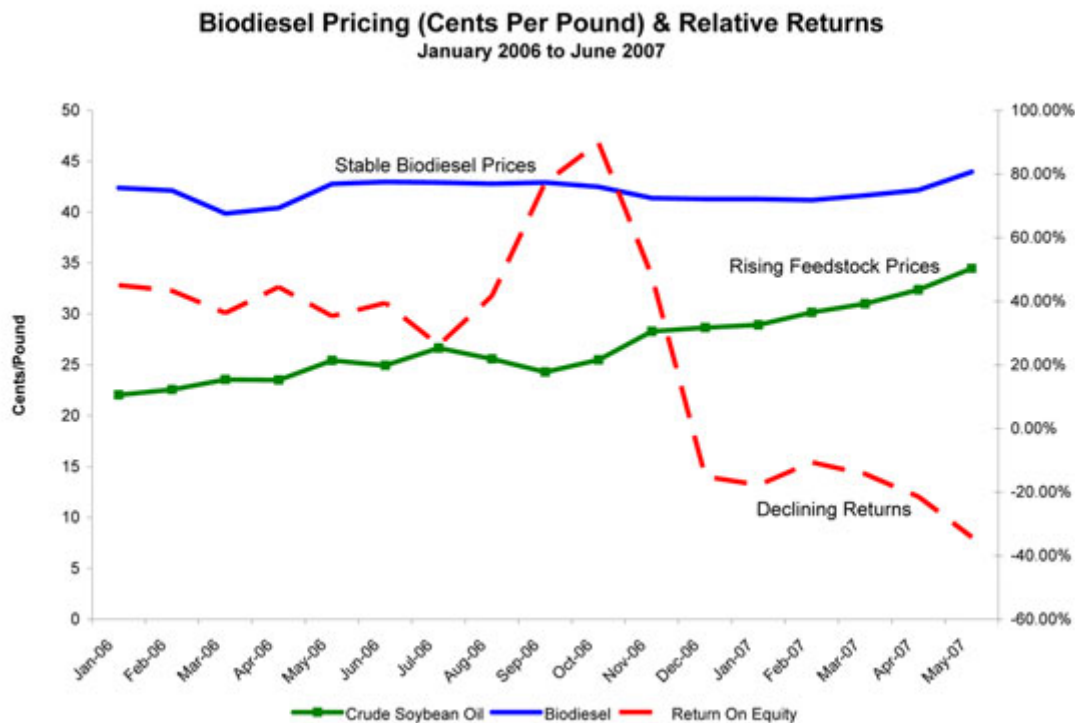


Figure 1

Those planning to develop a new biodiesel plant are finding it difficult to obtain capital to fund development. Most U.S. banks have cut back on lending to the biodiesel industry, and those transactions that do get funded are built around some sustainable competitive advantages that position the project for success. Average projects lacking these characteristics will struggle to get financing in today's market. Institutional equity from major private equity funds and interest from Wall Street are also getting tougher to find. They too are looking to invest in projects that stand out in a crowd—for all the right reasons. Examples of ways a proposed project can differentiate itself include:

- > Feedstock control through its own crushing assets and strong grower alignment, long-term supply contracts or other captive supply arrangements
- > Feedstock flexibility
- > advantaged location
- > Transportation flexibility
- > Sustainable cost advantage
- > Existing asset leverage (e.g., brownfield sites)
- > Superior margin management with offtake and origination contracts with credible partners

- › Credible project development and management team
- › Capacity to expand scale and scope of operations to reduce unit costs and/or diversify risk.
- › Sustainable incentive structure beyond the federal tax incentive.

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 upon 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 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 50 percent to 55 percent debt-to-total capital range with equity investors funding the remaining project costs with equity of 45 percent to 50 percent. Equity dollars are required to be the first into the project.

While commercial and agricultural banks tighten their lending standards, 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. In addition, new funds are being formed to invest in the 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 lifecycle of the business. The various scenarios that biodiesel plant directors and owners should consider include:

- › Vertical integration to reduce feedstock and/or marketing risk
- › Horizontal diversification into other business areas (such as ethanol processing) to reduce risk
- › Innovative and sustainable feedstock strategies
- › Acquire or merge with other companies
- › Improve efficiencies through energy and operational optimization
- › Refinance debt to improve long-term cash flow
- › Recapitalize the company to provide liquidity to existing shareholders and reduce risk
- › Sell part or all of the company.

An exit strategy is an important part of overall capital strategy planning. As the industry matures and shifts from construction to growth, liquidity and operation of existing plants, one will have the opportunity to be an acquirer or be purchased, in full or in part. Protecting and enhancing shareholder value should be an ongoing goal when considering partial and whole restructure or exit strategies.

Company 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. The prevailing marketing conditions also determine the multiples of earnings being paid. While current market conditions are indeed tough, a well-managed and well-positioned company always has better long-term options.

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 key 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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