In the volatile business of biofuels, the phrase ‘know when to hold ’em, known when to fold ’em’ is as true in biofuel plant ownership as it is in a game of poker. Some plants have been transitioned by luck, a few by strategic hard work, but more by forced circumstances.

**Know when to hold ’em or fold ’em**

There are four factors that drive project transition. These are feedstock pricing and availability, operational proficiency, margin management strategy, and available capital.

Many biofuel plants were built on low-price feedstocks and high biofuel prices. As shown in chart 1, the price of corn, which generally is over 80% of the cost of ethanol production, has ranged from $3 (£2.4) per bushel to $8 per bushel since 2006, and volatility has increased dramatically.

From 2006 through 2008 a number of biodiesel plants using soyabean feedstocks became unprofitable due to high soyabean prices. Plants based on waste oil feedstocks found that, as a waste, the oil could be procured cheaply; then, with more biodiesel refineries being built, direct competition and brokers increased the ‘opportunity’ or cost of waste oil feedstocks to commodity price status.

Most biofuel plants operate well, and there are many consultants and engineers who can provide advice on how to operate better. In competitive markets the plants that operate in the top 25%, based on operational efficiency factors, are the businesses most likely to survive and command a premium price in a merger or acquisition.

In the biofuels industry many businesses are challenged to employ expertise in process engineering and supply chain and marketing logistics, as well as to have a programme of active capitalisation of technological improvements to compete with multi-plant businesses. Some single to triple plant operators do so, but it is difficult without regular access to the right personnel who are driven to perform at the top of the industry.

Every biofuel business has a profit margin strategy and usually it is aligned with the business capitalisation. On the conservative end, plants purchase feedstock and sell product simultaneously to ‘lock’ in a margin based on the processing costs. That strategy has served many plants well. It does not tend to capture the highest margins, but it tends to avoid disastrous losses.

The other end of the profit margin strategy is to purchase quantities of feedstock when the operator believes feedstock prices are low and then sell when the operator believes product prices are high. When the relative lows of feedstock prices and highs of product prices do not correlate in a financeable period, the results can be disastrous. Many operators, large and small, have learned expensive lessons from the market, which is never wrong.

Feedstock volatility, operational inefficiencies, and profit margin losses can be lessons rather than terminable events if the biofuel business has enough capitalisation in current permanent...
and working capital and access to new capital.

Many biofuel businesses are capitalised on an income model (single capitalisation of plant to generate income stream to owners) rather than a growth model (initial capitalisation and reinvestment of profits to capitalise growth or stability). Limited access or no access to new capital increases the need to have substantial equity and little debt.

Sales considerations

Biofuel plants are being sold, merged and transitioned on a regular basis. Since 2008, over 45 ethanol plants and many biodiesel plants have transitioned ownership. When should a board hold versus be sold?

A sale or merger should be considered when a biofuel business is at risk for feedstock volatility, operator efficiency, and inadequate capitalisation levels or lack of access to capital. Short of a sale or merger, a company may consider a business structure change to mitigate risk and volatility.

For example, companies such as Tenaska Biofuels have contracted with biofuel plants to provide feedstock, energy, market fuel and other products. This arrangement has a multi-billion dollar company managing feedstock and volatility risk and providing a service that is similar to toll processing arrangements, where the owner focuses on operations and receives returns based on the plant’s efficiency combined with the market value of feedstock and energy cost versus the final product sale revenues.

Management should also consider transition when there is investor fatigue (tired of the investment or business) or investor expectations of income or liquidity are not being met. Operational or actual mergers may allow economies of scale to retain top management teams without new capital for acquisitions.

If the biofuel business has owner fatigue – in other words, owners who are aging but not investing and not strategically engaged in the business – a restructured business may allow tired investors to exit and active owners to realign. Tax equity financing in a restructured business can realign some owners with tax benefits and other owners with long-term growth.

Preparing for a buyer

For biofuel plant owners, the best sales occur when buyers see an opportunity they can leverage or capitalise upon, particularly if the seller cannot capitalise on the opportunity.

Millennium Ethanol sold its 100 million gallon a year ethanol plant, represented by US law firm Stoel Rives, when the owners became strategically concerned about feedstock and market volatility. The buyer was driven to increase scale through acquisition of large plants.

Similarly, Midwest Grain Processors, whose management saw expansion as critical but lacked the capital, sold a majority of its business for $95 million to Global Ethanol, which was raising money from capital markets to expand to a large-scale plant.

A biofuel business seller should expect a merger or acquisition transaction to have the characteristics of a project finance transaction – in other words, buyers expect to purchase a new car and discount the price for a used car (or plant) for risk or conditions that do not meet that expectation.

The structure of a typical transaction is deal structure (timing, purchase price, merger or sale conditions, and merger consideration), representations and warranties (seller’s statements about the business, plant, property, site, and risks to operations), covenants (commitments of buyer and seller until closing), and indemnities and holdbacks (the amount of the purchase price or merger consideration reserved for representations and warranties that are not true and covenants that were not performed, all typically to the detriment of the acquirer).

The tenor of those provisions will depend on the relative leverage of buyer and seller. Sellers can save time and money by taking predictable issues off the table with an informed review of how a prospective purchaser would view the business in advance of a transaction.

In a typical transaction, the buyer and seller try to agree on deal strategy terms in a non-binding manner through a letter of intent (LOI) or indication of interest. While typically non-binding, the LOI conveys expectations, which if properly drafted can carry a deal, and if not, can result in walking away from a deal. A properly negotiated LOI leads to better deals. The art is in disclosing enough information to arrive at solid deal points knowing that due diligence almost always reveals issues or risks not contemplated when the LOI was negotiated.

In selling a biofuel business, knowing the buyer helps the seller impact price. For 45 commercial ethanol plants sold since 2008, 19 were sold to oil companies, 15 were sold to multi-plant aggregators and 18 were sold to independent buyers.

Chart 3 shows that oil companies acquired plants in 2009 and 2010 and focused on 100+ million gallon plants. Large aggregators purchased plants in 2008 and 2009, with some limited activity since that time. Independent acquisitions occurred throughout the 2009 to 2012 period.

Good business owners review their company’s risk and business plan on a regular basis and consider the conditions to exit.

When their success or sustainability is threatened by volatility, operational expertise, or capital constraints, or they have investor fatigue, the best business plan is to solidify the strengths of the business and plan an exit strategy or to restructure the business to a sustainable model.

Just as selling a product is different from marketing a product, strategically transitioning a business is different from selling one under forced or stressed conditions.

For more information
This article was written by Mark Hanson, partner, Stoel Rives; +1 (612) 373-8823; mhanson@stoel.com

Chart 3. Mark J. Hanson analysis of Renewable Fuels Assn. reports