Tuesday, Oct 16, 2007 — An ethanol boom spurred by federal funding, private investment and intense farm lobby support is now quickly fading. And many companies may find themselves bankrupt after the impending shake-up of the ethanol industry, lawyers say.

Last year, corn-based ethanol was seen as the savior of the farm belt, which saw its return from corn products shoot to record levels after decades of declining prices. But now, with higher construction and feedstock costs combined with a drop in ethanol prices, previously profitable facilities are scrambling to make ends meet.

These are the growing pains of the ethanol trade – like many industries before it, it has entered into an economic doldrum after a period of frenzied investment.

Several companies, such as Agassiz Energy in Minnesota and VeraSun Energy Corp. in South Dakota have announced delays in plans to build new ethanol plants. Others, such as Alchem Ltd. in North Dakota, have been forced by market conditions to shut down existing plants, at least temporarily.

Part of the reason the industry is now having trouble is because of simple overproduction. The U.S. has approximately doubled in production capacity since the Energy Policy Act was enacted in 2005, vastly exceeding people’s expectations.

"It seems like a typical bust and boom ... there was a lot of exuberance about building ethanol plants, which lead to excessive amounts of ethanol and the market wasn’t strong enough to be profitable," said Ken Irvin, a partner in McDermott Will & Emery LLP’s energy and derivatives markets and bankruptcy practice groups.

Meanwhile, the special distribution infrastructure ethanol needs has not been able to keep pace with the increased amount of product, said Dan Rogers, a partner at King & Spalding LLP who specializes in energy transactional work.

"Because of the unique characteristics of ethanol, you can’t use regular pipes to distribute it – it corrodes them and becomes easily contaminated ... So you need barges and trains and trucks to take up the distribution ... and that infrastructure is woefully inadequate," Rogers said.

And corn, which is the most popular way of making ethanol in the United States, suffers from competition as an agricultural commodity, which makes prices of the feedstock extremely volatile.

And whether corn ethanol is actually as environmentally friendly as it purports to be has been up for debate. Some scientists have alleged that corn ethanol is a net loss to the environment and a net contributor of carbon dioxide.

"I think ethanol as an alternative energy has a lot of inherent complexities ... it’s not clear that it’s very environmentally friendly ... while it has advantages in today’s market, corn ethanol doesn’t seem to hold the long-term promise of being a source of energy dependence by itself," Irvin said.

As a result, private equity investors have become a lot more cautious with their investments into the ethanol industry.

Edward Schiff, the managing partner of Sheppard Mullin Richter & Hampton LLP’s Washington, D.C., office said that the overall market will see a reduction in the level of activity on financing and private equity investment.

"You have a situation where you’ve seen the demand for ethanol go down while the price of corn used to produce ethanol go up ... and this is subjecting [ethanol companies] to greater scrutinization of whether the industry is worth getting into," Schiff said.

It doesn’t help that the financial troubles of the ethanol industry come at a time when a credit crunch seems to be on the horizon.

"Generally, liquidity is tightening up and so people all over are subjecting their investments to more scrutiny than they have in the past," said Edward Tillinghast, a partner in Sheppard Mullin’s finance and bankruptcy group.

"I believe a lot of these facilities were profitable when the price of debt was lower ... it caused a lot of companies to take on less equity and more debt, but when times are tough, you still have to pay the debt off," Irvin said.

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Tillinghast said that it is the small and medium ethanol companies that are having the most difficulty, since they have the least amount of production capacity. It will mainly be these types of companies that end up declaring bankruptcy, he said.

"Because through a bankruptcy you can sell your assets free and clear of any claims, bankruptcy restructuring may end up being used as a tool to transfer assets in a way they otherwise wouldn’t be able to,” Tillinghast said.

“This may be an opportune time for consolidation within the small and medium industry ... and if they are forced into bankruptcy, you may see larger companies – such as [farming giant] Archer Daniels Midland Co. — swoop in and buy them out,” Schiff said.

Despite the industry’s looming difficulties, ethanol is “here to stay for the near term – it’s the only gas additive today that meets all needed requirements,” Rogers said.

Ethanol has, especially in markets focused on reducing air pollutions, become a replacement gasoline additive for methyl tertiary butyl ether (MTBE), a chemical that was used as an oxygenate to raise the octane number of gasoline.

“MBTE really used to be the additive of choice before we started having problems with things like underground storage tanks leaking into the water supply. Congress, which had previously pushed MTBE, kind of did a turn around on the industry and made ethanol the new additive of choice,” Rogers said.

“There’s still a market for ethanol out there – this recent trouble is more of a market correction.”

Tillinghast agreed that the financial shake-up is indicative of regular market forces: “If you look back at the telecommunications industry 10 years ago ... everyone was popping up with new cell phone capacity and though many companies went bankrupt, the leftovers ended up consolidating pretty substantially.”

Consolidation within the industry, especially among medium- and small-sized companies, could become a way to avoid bankruptcy in the first place, Schiff said.

“You can merge and combine and come together to achieve success through critical mass instead of being a standalone that won’t do as well because of a cost factor you can’t absorb ... if you combine, you may be able to sustain yourself while you ride out the wave that the economy and industry is experiencing today,” he said.

Rogers said that to avoid further troubles, companies that have made significant investments should take a hard look at aspects of their business like infrastructure, logistics, costs and siting.

“That’s what’s killing a lot of these companies. There have been some terrifically bad choices in terms of plant siting, which have upped transportation costs or made it hard to get the product out to the markets that need them,” he said.

Rogers also predicted that there may be more of a push to "get past corn and focus more on the next generation of ethanol – cellulosic.”

Cellulosic ethanol, made from plant waste, such as grass or wood chips, is many times more efficient than corn ethanol. It also does not compete as a food source, making it less subject to market volatilities.

“We’ve seen this cycle in a number of other fields, there will be a financial shakeout, the less efficient operators will file for bankruptcy or go out of business ... then things will get consolidated, strategic buyers will emerge and find good value opportunities by buying up assets from fallen competitors,” Irvin said.

Rogers said: “We’re in for a bumpy ride. ... But markets tend to sort themselves out and ethanol is here to stay.”