Illinois ethanol company must adapt to evolving industry

by Bridget Macdonald
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Flagging federal support for cornstarch-based ethanol has created an ultimatum for producers like Pekin-based Aventine Renewable Energy Holdings Inc. to pursue new technologies as demand grows for more sustainable energy sources.

An eleventh-hour change to the stimulus package signed into law by President Obama Tuesday weakened critical support for the ethanol industry, slashing $200 million slated for retrofitting cornstarch ethanol facilities to produce fuel from inedible plants, called cellulosic ethanol.

Pekin-based Aventine, which produced an estimated 10 percent of the nation's cornstarch-ethanol supply in 2007, reported a 66 percent gain in revenues for the third quarter 2008, up to $599.5 million from $360.7 million in the year-earlier period, on record-breaking sales of ethanol.

But earnings for the quarter slipped to $2.5 million, or 6 cents per diluted share, from $3 million, or 7 cents per diluted share in the 2007 period. And for the nine months ended Sept. 30, the company reported a loss of $10.2 million, or 24 cents per diluted share, compared with a profit of $30 million, or 73 cents per diluted share, in the year-earlier period.

Analysts expect the company to report another loss for the fourth quarter.

In 2008, the industry surpassed the federally mandated volume of cornstarch-based ethanol by 3 billion gallons, forcing companies to idle production and watch their margins dwindle. Because retailers must adhere to blending restrictions set by the EPA for the ratio of ethanol to gasoline that can be used in a normal engine, the slowdown in overall fuel sales in recent months has undermined the need for ethanol.

The current blending limit is a ratio of 10 percent ethanol to 90 percent gasoline, referred to as E10.

Conceding that the company's margins will be "breakeven at best" in the inundated corn-ethanol market, Aventine's CEO Ron Miller said in a conference call in October he believes the industry will not fundamentally recover until "supply and demand balance becomes more known and certain."

According to the company, the average gross sale price of ethanol for the third quarter was $2.47 per gallon, while corn costs amounted to $5.78 per bushel.

One bushel of corn translates into 2.63 gallons of ethanol.

The U.S. Department of Agriculture projected 3.6 billion bushels of corn will be siphoned into the ethanol industry in 2009, 70 percent more than the 2.1 billion bushels in 2007. The estimate for Illinois, second only to Iowa in corn production, is 530 million bushels for 2009, enough to produce 1.5 billion gallons of ethanol, equivalent to 30 percent of the state's fuel supply.

Ian Horowitz, an analyst with Soleil Securities Group Inc., said he thinks many producers in the cornstarch ethanol industry are "in over their heads." He said large agricultural companies like Archer Daniels Midland Co., the Decatur, Ill.-based grain processor that is one of the leading global ethanol producers, have the security of diverse business portfolios. But Horowitz has a "sell" rating on Aventine, whose sole business is ethanol.

The Energy Independence and Security Act of 2007 stipulated that the amount of renewable fuel in the domestic gasoline supplies reach 36 billion gallons by 2022, from 9 billion gallons in 2008. The law caps cornstarch-based ethanol at 15.6 billion gallons, a target expected to be met by 2013, while cellulosic ethanol is mandated to account for 16 billion gallons.

Although the cellulosic process is still being developed, producers are under pressure to invest in the evolving technology in order to cut back on fossil fuels and operate more efficiently.

Many companies have started to lose their footing in the fragmented industry, particularly those that cannot keep up with the pace of transition. But Miller said Aventine is well positioned to take advantage of any disruptions: "We may see other market participants cease production, helping to ease prices on corn and making ethanol prices better as supply tightens."

On Feb. 3, grain company MGP Ingredients Inc. of Atchison, Kan. announced it was severing ties with ethanol. Later in the same week, San Antonio oil refiner Valero Energy Corp. bid on five of the 11 facilities put up for sale by bio-fuels producer VeraSun Energy Corp. The Sioux Falls, S.D-based company filed for bankruptcy protection in October.

"Whoever buys the rest, it will certainly prompt more consolidation, and that will be good for the industry," said Jinming Liu, an analyst with Ardour Capital Investments LLC, who has a "hold" rating on Aventine. The viable companies, he said, are those that can stay afloat during the downturn.

Aventine has been endeavoring to steady the ship since the third quarter. In November, the company temporarily suspended construction of ethanol facilities in Aurora, Neb. and Mount Vernon, Ind., a move Liu said was wise.

Monte Shaw of the Iowa Renewable Fuels Association said there is no certain answer about the potential costs of adding cellulosic capacity to existing plants because "nobody has done it yet." He said "the notion that plants are going to have to move forward with new technology is an absolute," but he added that it is unrealistic to think the industry will abandon corn, given its abundance. Shaw explained that new technology would allow producers to utilize the entire corn plant, rather than just the shelled kernels, as well as other biomass materials.

However, criticism has mounted against the corn-fed industry on the grounds that it competes with food supply and because it consumes substantial energy in the production process. While acknowledging the declining popularity of cornstarch ethanol, Miller said, "We remain positive about growth and economics of ethanol and view the current negative sentiment toward the industry as excessive and temporary."

In January, the Environmental Working Group, a public-health organization focused on sustainable development, reported that ethanol accounted for three-quarters of the tax benefits and two-thirds of all government subsidies allotted for renewable energy sources in 2007.

The organization's efforts to lobby against federal support for corn-based ethanol production are backed by members of the Food Before Fuel campaign, who oppose the use of food crops for energy.

Mark Lambert of the Illinois Corn Growers Association dismissed Food Before Fuel's stance, saying there is plenty of corn to go around, "And it's going up." Despite a price spike last year, which he attributed to inflated concerns about weather conditions, Lambert said 2007 and 2008 were both record-breaking years for corn production in Illinois.

In light of oil supply tensions and the environmental impacts of global warming, the argument for the U.S. to diversify its energy supply is virtually uncontested, but Scott Irwin, a professor of agriculture and consumer economics at the University of Illinois, said he thinks lawmakers need to address whether the long-term benefits of pursuing cornstarch ethanol as a component of a revised energy portfolio are worth the costs today.

He said the inherent risk in commodities pricing "is why these companies are going out of business." Irwin said VeraSun made "outrageous" bets. "They bought corn high and let ethanol prices go un-hedged, so when corn and ethanol prices fell, they took losses directly on corn, and implicitly on prices of ethanol."

But, he said, the inevitable consolidation in the industry "will weed out undercapitalized and foolish." The remaining producers will reap the benefits of the continued mandates as the industry evolves to incorporate changing bio-fuels technology.

Shaw agreed that capital is necessary for companies to move forward, but said small, efficient operations can hold their ground. Right now, he said, nobody has cash: "The pause button has been pushed on expensive new technologies." In October, Aventine said it expected to spend approximately $109.9 million on capital projects during the first half of 2009.

Shaw said ethanol will begin to recover once crude oil rises from its recession price of around $30 per barrel. "When we return to profitability and a functioning credit market, you're going to see an explosion of innovation," he affirmed.

But as Liu said, "For the coming year, it's all about survival."

Aventine's stock marked a 52-week low of 26 cents on Wednesday. The high was $8.89 last February,

For comparison, the S&P 500 Index's 52-week range peaked at 1,440.24 on May 19, while its low was 741.02 on Nov. 21.

The consensus analysts' estimate for Aventine's fourth-quarter performance is a loss of 24 cents per diluted share, according to Zacks Investment Research Inc. The company will report its earnings on Feb. 24.