ASAlliances Biofuels Ethanol portfolio

Simon Ellis

09/03/2006

Ethanol has long been seen as the country cousin of conventional fuels such as petroleum and diesel, but things are changing fast

A political consensus on cutting the US's 'Addiction to Oil' from the Middle East and reducing vehicle pollution has led to a slew of favourable policies and incentives for the fuel.

The new emphasis on ethanol has quickly got the attention of Wall Street, but with no new plant built since the 1970s - the industry has been in dire need of a large and viable deal.

The US$423 million financing for ASAlliances Biofuels ethanol portfolio, which closed last month, marks the largest step to date to achieving this.

The deal is the first commercial bank financing of a US ethanol deal, the first completely greenfield ethanol deal and most importantly the first grouped financing of ethanol plants.

For a corn-to-energy project, the financing is surprisingly sophisticated calling on several layers of sophisticated financiers - private equity, institutional investors and commercial banks.

Finally, the deal is also one of the first tests of the US' controversial emissions strategy.

While European nations have focused on building renewable power capacity and cutting emissions from existing plants, the US has focused on cleaning the vast emissions generated by its vehicle fleet.

Drivers - Riding the policy wave

Investors have traditionally stayed away from ethanol, but the combination of spiking oil prices, the decline of rival fuel MTBE and solid policy support have created a paradigm shift in favour of the fuel.

National politics have always been of crucial importance to ethanol. The Corn Belt contains four election swing states - including the key primary Ohio - and has enjoyed an estimated US$12 billion in tax credits for ethanol since 1980.

The October 2004 American Job Creation Act extended the 51 cents per gallon ethanol tax credit until the end of 2010 - a tenor that America's wind energy industry can still only dream about.

The 2005 Energy Policy Act cemented federal support by adding the security of a national commitment to increase fuel consumed as ethanol to 7.5 million gallons per year by 2012.

Ethanol is protected from foreign imports by a 54 per cent per gallon premium on ethanol imported from overseas - with the exception of some parts of the Caribbean which have a capped tax-free allowance.

A more short-term spark for the rise in ethanol is the elimination of a similar fuel additive methyl tertiary butyl ether (MTBE) after it was linked to contaminating water supplies - MTBE is now banned in 25 states.

The drivers got the attention of big finance with CSFB providing a US$185m B loan to the Hawkeye plant in Indiana and a further US$90m B loan for Spanish firm Abengoa's US$166m facility in Ravenna, Nebraska.

Meeting the risk challenge

Private equity firm Americas Strategic Aliances (ASA) also read the signs of gathering political momentum early in 2004 and determined to go a step further by launching a vehicle that could build own and operate a number of biofuels plants.

However, the venture would have to succeed in a market shallow in expertise, loaded with commodity mismatch risk and virtually unknown to the financial markets.

The major risk in the market is commodity pricing, there is a lack of correlation between the grain supply price (which takes 55 per cent of a plant's running costs) and the ethanol output price (85 per cent of a plant's profits).

Another factor is oil, ethanol is only viable as a commodity when oil is over US$30 a barrel, yet high oil prices impact upon the price of natural gas which is used to power the plants.

To make matters worse, these risks are difficult to offset on the financial markets. It is only possible to get a six-month hedge on ethanol prices in the tiny Chicago-based market.

Finally while policy support is currently strong, a level of uncertainty remains about the future of the excise tax credit expires and the future of the tariff wall which protects the market from cheaper Brazilian imports.

Green giant - the project portfolio

To control these risks ASA needed to involve experienced players and, more ambitiously, attempt to secure a vertically integrated project from scratch.

ASA responded by striking a partnership with agricultural supplier Cargill, experienced ethanol plant engineering specialist Fagen and services provider United Bio Energy.

In a fragmented industry with little recent pedigree it was an impressive team.

Fagen has built two thirds of the ethanol plants in the US over the past five years and United Bio was one of the few specialised operators around the Corn Belt.

Agricultural and foodstuffs conglomerate Cargill - would along with ADM - provide gas and corn to the project pre-arranged prices for a ten-year period - effectively covering its exposure to anything but the oil price.

With their combined experience the consortium partners were determined to create a project on a more ambitious scale than even those CSFB has financed

ASAlliances Biofuels set out to create a portfolio of three one hundred gallon ethanol plants on the extremities of the Corn Belt near to the large population centres of the east and west United States.

The consortium decided to place two plants to serve the Chicago market at Bloomingberg, Ohio and Linden, Indiana and one to serve a Californian market hit heavily by the phaseout of MTBE at Albion, Nebraska.

All would be on greenfield sites adjacent to railway lines and existing Cargill food processing plants.

According to ASA President David Black, the portfolio would stand up without either protection or subsidisation.

'We did want to have any reliability on incentives in producing the highest economic business model for the long term. There were a lot of incentives at the local level, a few at the state level but none that materially steered us to a site.'

Financing - Strength in depth

As the risk was spread as widely as possible, the financing risk would have to be spread vertically to accommodate a number investors with different appetites.

To appeal to high risk investors, Challenger Capital raised a further US$148 million in equity and sub-debt.

The equity was largely sourced from existing ASA backers American Capital Strategies, DE Shaw, First Midwest and US Renewables - to complete finance the project on a 78:22 debt:equity ratio.

West LB was engaged to provide a bulk of financing through a US$275m two-tranche eight-year senior secured debt facility.

The deal was split into US$175m senior loan and US$100 B loan priced at 250bps above LIBOR and 450bps above LIBOR respectively.

The senior loan was syndicated by 17 banks while the B loan was marketed at institutional investors. After an enthusiastic reception, the debt was two times oversubscribed.

Tom Murray, co-head of West LB's loan and capital markets group claims the bank felt comfortable that the senior was adequately protected,

'What are really in place right now are conservative financing structures on the debt side which require significant equity and equity-like sub debt to cushion the senior debt.

'Deals also require quick de-leveraging. There are mandatory cash sweeps which have these facilities repaid in five years, notwithstanding the fact that the useful life of the asset is more like 20 or 25 years.'

Conclusion - Harvest boon

Also to attract four layers of sophisticated financing in an industry previously dominated by hayseed banks is impressive.

As is the scale, more than double the size of any previous deal, and ostensibly hedged against anything but the global oil price.

Also at a time when spreads have compressed to new lows in the rest of the project finance world, the portfolio stands out for its wide margins despite negligible country risk and a record of consistent policy support.

The success of the deal on its own is not a vindication of US renewable fuels policy.

Even if ASAlliances does expand its portfolio to the planned billion gallons per day of ethanol before the end of the decade that, will still represent less than one per cent of the US's total fuel consumption at the current petroleum growth rate.

But the deal does put in place a powerful precedent for financing independent ethanol ventures, and with liquidity in the financial markets burning a whole in banks' pockets, the only difficulty may be backing the right contractors.

The project at a glance

Project Name	ASAlliances Biofuels ethanol portfolio
Location	Bloomingburg, Ohio; Linden, Indiana and Albion, Nebraska
Description	Three corn-to-ethanol plants producing a total of 300 million gallons of ethanol, 321 tons of distillers' grain and 223,000 tons of CO2 per year
Sponsors	ASAlliances Biofuels, American Capital Strategies, Laminar Direct Investments (DE Shaw), Midwest First Financial and US Renewables Group
Operator	United Bio Energy
EPC Contractor	Fagen
EPC Sub Contract 1	ICM (plant technology)
Project Duration (Including construction)	Construction period: 18 months per plant Operational period: Indefinite
Construction Stage	November 2005 to May 2007 (Linden, Indiana and Albion, Nebraska) March 2006 to late 2007 (Bloomingburg, Ohio)
Total Project Value	US$423m
Total equity	US$94m
Equity participants	Included ASAlliances Biofuels, American Capital Strategies, Laminar Direct Investments, Midwest First Financial and US Renewables Group
Subordinated debt	US$54m

Subordinated debt participants	ASA Biofuels, American Capital Strategies, Laminar Direct Investments, Midwest First Financial and US Renewables Group
Total senior debt	US$275m
Senior debt breakdown	Tranche 1: US$175m underwritten by West LB Tranche 2: US$100m B loan underwritten by West LB
Senior debt pricing	A loan: LIBOR + 250 bps B loan: LIBOR + 450bps
Debt:equity ratio	78:22
Government subsidies/ credits	0.54 cents per gallon Volumetric Ethanol Excise Tax Credit
Supply agreements	10-year contract with Cargill to provide corn and natural gas
Sales agreements	10-year contract with Cargill to market and sell project ethanol
Mandated lead arranger	West LB
Participant banks	Syndicate of 17 banks
Equity and sub-debt arranger	Challenger Capital Group
Legal adviser to banks	Chadbourne & Parke
Date of financial close	7 February 2006