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Ethanol Making Comeback as Valero Sees Profit Where Gates Lost
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By Mario Parker

March 9 (Bloomberg) -- Ethanol, the commodity that cost Bill Gates more than $44 million the last time prices collapsed, is poised to rally as much as 20 percent as the fastest drop since 2008 spurs demand.

Falling corn prices and record ethanol supplies have driven the price down 17 percent in three months to $1.634 a gallon, its worst run since 2008’s fourth quarter. It will average $1.96 a gallon at the peak of the U.S. summer driving season as refiners from Valero Energy Corp. to Sunoco Inc. mix more into gasoline made from increasingly pricey oil, according to the median of 10 analyst estimates compiled by Bloomberg.

Four years after George W. Bush made ethanol a centerpiece of his presidency’s push to cut dependence on foreign oil, three of the biggest producers have sought bankruptcy protection and prices have fallen 61 percent from their mid-2006 record. Now demand is rebounding because ethanol is almost 66 cents cheaper than gasoline, the biggest discount in 14 months. The potential gains prompted Valero and Sunoco to buy failed distilleries.

“Margins today are better than a year ago, absolutely,” said Todd Becker, the chief executive officer of Green Plains Renewable Energy Inc., the fourth biggest producer, in an interview. “The industry is on pretty good footing for 2010.”

The Omaha, Nebraska, company reported a record fourth- quarter profit of $23.1 million last month, up from a $1.85 million loss a year ago. Green Plains sold new shares in March, the first producer to do so in almost two years. The stock closed at $14.48 yesterday, up from $1.32 a year ago, its best 12 months since going public in 2006.

Crack Spread

Producing gasoline became less lucrative as the worst recession since World War II cut fuel demand. After selling for a record $37.48 a barrel more than crude oil in May 2007, gasoline now goes for $14.276 more. The 62 percent decline in that so-called crack spread is being exacerbated by rising oil prices, which have almost tripled since February 2009’s low of $33.98 a barrel.

Using more ethanol can improve profits for refiners who get a 45-cent tax credit for each gallon they blend. The incentive has effectively been more than doubled by falling corn prices, which account for 70 percent of the alternative’s cost. Corn has plummeted to $3.75 a bushel from a record $7.9925 in June 2008.

Corn has fallen 17 percent from its 2009 high in June as oil rose 19 percent. Ethanol has been depressed further by increased production, which averaged an unprecedented 788,000 barrels a day in December, 20 percent higher than a year ago.

Stockpiles that month totaled a record 16.7 million barrels, Energy Department data show.

Record Supplies

The result: a 65.5-cent difference between gasoline and ethanol that producers can combine with the tax credit, for a total discount of $1.11. Production of conventional gasoline mixed with ethanol ballooned 22 percent to a record 4.4 million barrels the week ended Feb. 19.

“Considering what we see in gasoline, there will be a formidable amount of resiliency for ethanol,” said John Kilduff, a partner at Round Earth Capital, a hedge fund in New York that focuses on food and energy commodities.

Ethanol is made by fermenting starches from corn to create an alcohol that’s indistinguishable from moonshine. The fuel has been a staple of U.S. energy policy since President Jimmy Carter’s administration in the late 1970s.

Gates Gamble

Gates, Microsoft Corp.’s founder, completed his bet on ethanol four months after Bush declared the U.S. “addicted to oil” and vowed to increase use of the alternative in his Jan.
31, 2006, State of the Union address. The billionaire’s Cascade Investment LLC purchased an $84 million stake in Sacramento, California-based Pacific Ethanol Inc. for the equivalent of $8 a common share. Gates originally bought preferred shares that were later converted to common.

About eight weeks later, ethanol started an unprecedented three-month, 60 percent slide as supply outpaced demand.
Production soared 27 percent that year.

By the time Cascade signaled intent to sell its stake on Nov. 16, 2007, ethanol had fallen 56 percent. It unloaded shares in a series of transactions the next year as ethanol fell 32 percent, Securities and Exchange Commission filings show.
Pacific Ethanol closed yesterday at $1.94, down 95 percent since its May 2006 high.

Cascade sold 8.06 million Pacific shares for $25.6 million at an average price of $3.18 each from April 21 to June 13, 2008, for a loss of $38.9 million, SEC records show. As of June 13, 2008, it held 2.58 million shares, then worth $2.31 each, for an additional $14.6 million hit. That means the investment’s value dropped by at least $53.5 million as of that date, offset by dividends of $7.9 million in cash and $1 million in preferred shares, for a total loss of at least $44.6 million.

Cascade’s Stake

The firm no longer holds Pacific shares, said Laurie Smiley, a Cascade attorney, declining to say when the remaining stake was sold or at what price. Since mid-2008, the price has averaged 89 cents, so the additional sales likely increased the loss.

Telephone messages to Paul Koehler, Pacific’s spokesman and vice president of corporate development, weren’t returned.

Three publicly traded producers who provided 11 percent of 2008 U.S. supply have sought bankruptcy court protection.

VeraSun Energy Corp., once the largest American distiller, went first, in October 2008, followed five months later by Aventine Renewable Energy Holdings Inc. as wrong way bets on corn led to a shakeout. Pacific Ethanol's refining units succumbed in May 2009 as a rebound in prices the previous year gave way to a 50 percent rout.

Cheap Refineries

Valero, Sunoco and Murphy Oil Corp. found bargains in the meltdown.

In July 2007, VeraSun paid ASAlliances Biofuels LLC $725 million for three plants that can produce 330 million gallons a year, or $2.20 per gallon of distillation capacity. Valero, the U.S.'s largest independent refiner, bought two of them at 91 cents per gallon of capacity in December 2009, making the San Antonio, Texas, company the third-largest U.S. ethanol producer behind closely held Poet LLC in Sioux Falls, South Dakota, and Archer Daniels Midland Co.

Philadelphia-based Sunoco and Murphy in El Dorado, Arkansas, bought plants at similar discounts from Northeast Biofuels LP and AgStar Financial Services in Mankato, Minnesota. AgStar Financial was a VeraSun creditor. Fulton, New York-based Northeast Biofuels also filed for Chapter 11 protection. Green Plains also acquired two VeraSun refineries.

"Valero gets a big positive from what's going on in ethanol," said Paul Resnik, an analyst at Olympia Capital Markets Group in New York. "If you want to bet on ethanol prices rising, Archer Daniels Midland, Valero and Green Plains are it, and if I just wanted to have a rifle shot on ethanol I choose Green Plains."

Stock Forecasts

Resnik has a buy recommendation on Green Plains' stock, with a target price of $22.50, 55 percent more than yesterday's $14.48 close.

He's also bullish on Decatur, Illinois-based ADM, along with eight other analysts surveyed by Bloomberg; five have hold recommendations. The average of a dozen predictions for the stock is $37.42, up 22 percent from $30.57 yesterday. Eight analysts recommend buying Valero, 10 say hold and three say sell. The average target price is $20.17, a 2.8 percent gain from yesterday.

Wagering on ethanol with futures on the Chicago Board of Trade is risky because there are relatively few buyers and sellers. The market opened in May 2005 with 96 contracts traded in the first week. Less than 4,000 changed hands in the week ended Feb. 26, compared with 122,335 gasoline futures.

Futures traders are less bullish than forecasters, with ethanol for July fetching $1.676 a gallon yesterday, 2.6 percent more than now.

Corn Prices

Higher corn prices would squeeze refiners' profits. Corn prices are forecast to jump 20 percent to $4.64 a bushel by Dec. 31, according to the median of eight forecasts.

A loss of political support also would undercut ethanol. The 45-cent tax credit and a 54-cent tariff on imports from Brazil, the biggest exporter, will expire at the end of this year if they're not extended. Production of biodiesel, a diesel additive, has ground to a near halt since its $1-a-gallon tax credit ended on Dec. 31, said the National Biodiesel Board, a trade group in Jefferson City, Missouri.

Ethanol got a boost from President Barack Obama's administration when the Environmental Protection Agency concluded last month that it produces 20 percent less greenhouse gases than gasoline, clearing the way for more use.

Blending Limits

Under a 2007 law, gasoline refiners must use 12 billion gallons of ethanol this year, up from 10.5 billion gallons last year. The EPA plans to determine by mid-year if it will raise the 10 percent blend limit for cars made after 2001. The industry is lobbying for 15 percent. The U.S. requires refiners to have at least 8.3 percent of renewable fuels in their gasoline.

Kevin Book, an ethanol analyst and managing director of Clearview Energy Partners LLC in Washington, said the administration is likely to approve higher blends as it pushes to create more "green-collar" jobs.

American distillers also are benefiting from the highest sugar prices in almost three decades, which are driving up costs for Brazilian competitors that make ethanol from sugarcane. The country reduced domestic blending requirements to 20 percent from 25 percent because of shortages.

"I'm not sure there's a lot of extra capacity or extra ethanol in Brazil really coming into the U.S. anyways," said Green Plains CEO Becker. "It is an underlying factor that is favorable to the industry overall."

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