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Sell or Merge: Options to Consider in Today's Renewable Energy Industry

by Susan Wyka

The past year has been a volatile time in the renewable fuels industry. The increased demand for ethanol and biodiesel as alternative fuel sources has directly affected the cost of agricultural commodities such as corn and soybeans, which in turn has affected the profitability of renewable energy plants. As a result, business models not accounting for this relatively recent market pressure are struggling to keep pace in this rapidly changing environment. Companies, start-up and mature, must leverage unique capabilities, reduce operating costs and diversify revenue streams in order to position themselves for market success. This most often requires a customized approach for each business and an in-depth understanding of their business and relevant markets.

As outlined in Figure 1, renewable success is the result of understanding how a company's markets, business and capital needs interact.

Figure 1.



SOURCE: ASCENDANT PARTNERS

A timely example of how these factors come together for the owners and managers of ethanol plants is the challenges and opportunities associated with mergers and acquisitions. The ethanol industry is experiencing merger and acquisition activity and many companies are being approached with regard to a merger or sale. This underscores the importance that the owners and board of directors understand the value of their business and, once understood, are positioned to maximize it.

Recent merger and acquisition activity has included Millenium Ethanol's sale of its 100 MMgy plant to U.S. Bioenergy

for \$133 million and ASA Alliance Biofuels' sale of its three 110 MMgy plants to VeraSun for \$725 million. Most recently, VeraSun and U.S. Bioenergy have agreed to merge, subject to Federal Trade Commission and shareholder approval, driven by their record low public valuations. Some privately held ethanol companies have been pursuing mergers and sales as well. Valuations on a per-gallon basis have been wide, from \$1.25 to \$2.50 on actual or projected gallons, depending on the transaction.

Even if a company does not intend to entertain mergers or acquisitions, the board must be able to articulate a clear vision to its investors and demonstrate the ways in which it is continuously focused on protecting and enhancing shareholder value. It is equally important that the board is aligned around a long-term vision for the business. Without clarity and focus around the strategic intent of the company and defining the means as to how business decisions will be made, the board will struggle with how to assess what options meet its strategic and financial requirements.

Therefore, when planning for the future, the board must address whether a sale or merger is an option. A sale or merger may make sense if a project is in financial distress or the company is unable to survive on its own. Shareholders may also want liquidity or to be part of a bigger organization, or they simply want to maximize return on investment and feel the time is right.

If a sale or merger is being contemplated, what will the transaction look like? Several options exist, including a merger, an outright sale of the company either as an asset sale or a stock sale, or a partial sale of the company, which provides some liquidity and brings in a new investor/partner.

A merger is the combination of two companies into one larger company. The goal of the merger is to be accretive where the whole is greater than the sum of the parts. Mergers often occur between similar sized companies, and they must have common values, goals and culture to succeed.

A merger allows the selling company to realize the appreciation potential of the merged entity, instead of being limited to the sale proceeds. It allows shareholders of the smaller company to own a smaller piece of a larger pie, possibly increasing their overall net worth.

The advantages of mergers include succession planning for shareholders and the security of owning a larger organization. No cash is needed as a merger consists of an exchange of stock of the two companies, and it can be structured as a tax-free transaction. On the negative side, many mergers fail due to clashing cultures and the inability to integrate the two firms. Projected synergies often are not realized. Only one management team survives and shareholders are diluted.

The sale of a company consists of one company—the buyer—acquiring another company—the seller. In making the decision to purchase an existing business, it is necessary for the buyer to determine whether he or she is going to seek to purchase the assets of the business or the stock of the business entity.

An asset sale involves selling the company's assets, including facilities, vehicles, equipment and inventory. The buyer buys some or all of the assets of the seller for cash. The seller uses cash to pay off its debt and returns remaining cash to shareholders. An asset sale is usually a less favorable taxable transaction to the seller and is advantageous to the buyer. Several other key points should be considered in an asset sale transaction.

- 1) The buyer may be purchasing assets, not liabilities.
- 2) The buyer can pick and choose assets purchased.
- 3) An asset purchase protects the buyer from unseen liabilities.
- 4) There is a stepped-up basis for depreciation and allocation of purchase price to assets. If the purchase price exceeds the aggregate tax basis of the assets being acquired, the buyer receives a stepped-up basis in the assets.
- 5) The buyer may not experience dilution of ownership that occurs in a merger.
- 6) Purchasing a business through an asset acquisition may be less complicated from a securities law perspective because the parties are not normally required to comply with state and federal securities laws and regulations.
- 7) The closing documents, including conveyance documents, can be more complex.
- 8) There is depreciation recapture by seller.
- 9) It does not qualify for tax treatment as a tax-free reorganization.

A stock sale involves the sale of only the selling company's stock. The buyer buys all of the outstanding shares of the seller for cash or stock and therefore has control over the company and its assets. The buyer replaces selling shareholders as the owner of the company. The seller is acquired intact as a going concern. Liabilities are assumed,

which is added risk to the buyer (skeletons in the closet). Detailed due diligence is a must, and indemnification and escrows from the selling shareholders are common. A stock sale is generally more favorable to the seller. Other key points exist when considering a stock sale.

- 1) It should avoid possible double taxation of the seller.
- 2) The buyer can walk into established credit lines of the seller's corporation.
- 3) If the selling company does not have a large number of shareholders, a stock transaction will normally be less complicated.
- 4) In states that impose sales or transfer taxes on the sale of assets, a stock transaction can avoid some or all of these taxes that apply in the event of an asset transaction.
- 5) The buyer can normally obtain the selling company's non-assignable contracts, permits and licenses without the consent of the other party. 6) Finally, the buyer assumes existing depreciation schedule of assets and the tax status of the corporation.

If the board or owners of the company are ready to consider a merger or sale, it must have a process to follow. The lynchpin for the process is having a strategic plan and intent to move forward with a merger or sale. First, the company must identify potential partners or buyers. Second, the company should put its own house in order. As a potential merger partner or seller it must present itself in its best light, emphasizing its competitive advantages and a value-added business case. This business case should emphasize the ability to:

- 1) generate earnings,
- 2) create a sustainable competitive advantage
- 3) manage risk and
- 4) execute. Third, the company needs to have financial controls in place and financial reports updated.

Lastly, it is important to have realistic business value expectations (today versus tomorrow) and be willing to keep an open mind when entering into merger or sale talks.

Valuation of a company is driven by existing and projected earnings as well as qualitative components that drive success such as management, facility location, feedstock prices, transportation flexibility, industry contracts and relationships. Equally as important are market conditions, which determine earnings multiples or, in the case of an ethanol plant, gallons being produced. Other valuation methodologies include discounted cash flow, internal rate of return targets, and public and private company comparables. In order to protect and enhance the value of the organization and entertain sale or merger opportunities, the board must first be able to define, quantify and support its value.

The board would position its business to maximize the value of the merger or sale by assessing the current state of business performance and making changes in which the company can add value to potential investors. Once the business is positioned to go to market, the board would hire an investment banker to find potential buyers or investors for the plant, help the board evaluate the offers, assist in negotiations to maximize the value for the plant's shareholders and be the owner's representative in closing the transaction. The evolution of the ethanol industry sector continues to move rapidly. Companies need to be positioned, both strategically and operationally, to succeed over time and take advantage of merger and acquisition opportunities as they occur.

*Susan Wyka is a partner with Ascendant Partners Inc. and Ascendant Financial Partners LLC (member FINRA)
Reach her at, swyka@ascendantfp.com, (303) 221-4700 or www.ascendantpartners.com.*