First National Renewable Fuels

THE DAILY RECORD

Taken from the June 20, 2007 issue of *The Daily Record*

# A Bank's Role in Renewable Fuels

*First in the series is a "Q&A" conducted by Anderson Partners with Mark Baratta, vice president of First National Renewable Fuels Group, a division of First National Bank of Omaha, the nation's leading agribusiness lender. The Renewable Fuels Lending Group currently oversees 40 bio refineries representing over 2 billion gallons of annual production capacity. AP is Anderson Partners (www.andersonpartners.com), an advertising, public relations and marketing consulting firm specializing in agribusiness, food ingredients and renewable energy.*

AP: First National is the largest and oldest lender to the renewable fuels industry. How did First National get started?

BARATTA: In the '90s we made a prospect call on a Midwest, family owned company that was in the process of acquiring an existing ethanol plant. They had just learned their bank financing had fallen through. We were able to respond quickly and made the loan which allowed them to complete the acquisition. Since then we've been able to leverage our knowledge and experience from that transaction to be a leader in the industry. Today we provide financing to over 20% of the country's ethanol plants that are in operation or some stage of construction.

AP: What were the early days in ethanol like?

BARATTA: Through the 90s there were only a handful of plants built, principally by individual farmers and co-ops who saw ethanol as an opportunity to increase the value of their corn crop. As a large ag-lender, First National was a natural partner for many of these investors. We experienced $5 per bushel corn in the mid 90s as well as sub-dollar (per gallon) ethanol prices and learned how to help our customers manage through trying times. This experience has been valuable with today's record high corn prices.

AP: How is the industry different today?

BARATTA: the industry has evolved significantly over the past several years as plants have become larger and ownership more diverse through private equity investors. As margins have compressed due to higher corn costs the ethanol producer's ability to maintain a competitive advantage continues to be key to their long term sustainability. We believe plants situated in the Corn Belt with lower feedstock costs combined with flexible rail access to transport ethanol to the most attractive markets will provide the best opportunity for long term profitability. Certainly passage of the Energy Bill in 2005 and the universal political support for renewable fuels has been instrumental in developing the industry. We've also experienced a move toward consolidation and anticipate more acquisitions in the near term as the market continues to evolve.

AP: Is the co-op model obsolete?

BARATTA: We don't think so. There are several very well managed, profitable co-op plants that have strong ties to their communities. Bigger isn't always better. Consolidating operations in remote locations doesn't automatically generate lower costs and higher profits.

The key is a quality business plan and management team that can execute. We can partner effectively with local community banks to finance the co-op model plant, but we also have the sophistication to work with Wall Street to put together larger projects.

AP: What do you look for in a successful ethanol project?

BARATTA: Basically, as with all lending, it begins with the people behind the project. The ownership and management teams are instrumental in the plant's success.

Beyond that, site logistics are extremely important. Is there enough corn production in the area to support the plant? Is the rail and road infrastructure adequate, utility service, etc. Water is also a major factor that must be analyzed and understood.

Also, the design builder is extremely important. We've been fortunate to develop excellent relationships with well respected contractors in the industry with solid reputations for getting the project completed on time and on budget.

AP: And after construction?

BARATTA: there must be a disciplined approach to managing operations particularly the input costs and marketing of ethanol and distiller's grains, a by-product of the production process which is sold for feed. This really is a function of the quality of the management team and their ability to implement an effective risk management program to reduce price volatility in a commodity based business.

The inherent risk is to manage what we refer to as "crush margin" defined as ethanol and distiller's grain revenue less corn and energy costs, typically natural gas. The most successful management teams have a strategy to aggressively manage the plant to achieve a high crush margin.

AP: Another important commodity is oil.

BARATTA: That's true. At the end of the day, the market price of ethanol tends to be driven by the price of wholesale gas which is ultimately reflected by the price of oil. This is a unique scenario in which ethanol's biggest customer is also its biggest competitor: the oil industry. If you are trying to displace your competitor, you are going to run into some resistance.

AP: What is your long-term perspective on the renewable fuels industry?

BARATTA: The renewable fuels industry has evolved from an attempt to drive increased corn prices to a conscious effort towards energy independence and reduced greenhouse gases. The political support continues to be strong and the future looks bright. We continue to believe there is significant upside opportunities to developers with a good business plan and experienced advisors. We've enjoyed a strong history in the industry and remain committed for the long haul.

AP: What is the total ethanol market now – and where do you see it going in the future?

BARATTA: At the end of last year, the industry had annual production capacity of about five billion gallons. Based on what we believe to be legitimate projects that will most likely move forward there is approximately another six billion gallons in some stage of development or construction. So, we're looking at about an 11 to 12 billion gallon ethanol market in the next 18 to 24 months.

AP: Can you estimate the upper limit of ethanol production?

BARATTA: The United States consumes approximately 150 billion gallons of fuel annually which continues to grow at about 1% per year. Currently a $.51 cent tax credit is available for every gallon of ethanol blended with conventional gasoline up to 10% of the fuel supply. An E-10 blend or 10% ethanol suggests an implied market potential of up to 15 billion gallons per year. However, efforts to increase the blending capacity continue to drive the market potential upward exponentially. Detroit has made a commitment to increase the number of flex fuel vehicles which can run effectively on E-85 blends, or 85% ethanol.

AP: What are the limits to ethanol?

BARATTA: Ethanol produced in the US is made predominantly from corn which produces approximately 2.8 gallons of ethanol from every bushel. If we used 100% of the corn crop we could only produce about 30 billion gallons or 20% of the country's energy needs. Obviously this is an extreme scenario but illustrates the importance of finding improved technologies and alternative feedstocks.

AP: What about cellulosic ethanol?

BARATTA: A real effort has been made to develop alternative feedstocks from corn stover to landfill waste. The Department of Energy recently awarded grants to private businesses to encourage development of these technologies. We are currently working with one of those companies and are anxious to see how the process evolves. The general consensus is we are five years away from commercially feasible production on a scale that would have some impact although several people think the technology may be closer.

AP: Do you see a point in the future where ethanol is making a significant dent in our dependence on foreign oil, like Brazil, for example?

BARATTA: There needs to be a willingness on the part of the auto manufacturers to warranty cars beyond an E-10 blend. Realistically, to have a major impact in using ethanol in the U.S. fuel market, there has to be a willingness to go to an E-20 or an E-30 blend as incremental steps along the way.

AP: What do you think is the biggest risk to ethanol producers at the moment?

BARATTA: Profitability is driven by ethanol revenue and corn costs. With the amount of ethanol expected to enter the market it's reasonable to expect depressed prices at least in the near term. Also, the corn markets have priced an expectation of higher demand which has elevated input costs. The combination of these factors will compress crush margins. The key is to be able to manage in this type of environment. We firmly believe that plants with strong management teams, situated in high corn production areas and good transportation logistics will be effective competitors.

AP: In Nebraska, there is a lot of concern about the water required to run ethanol plants.

BARATTA: In Nebraska, of course, and a lot of Midwestern states, water availability is a major issue. As the number of plants increases this becomes a highly sensitive topic. Availability, quality and discharge requirements are all key issues we consider when a project comes across our desk.

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