Should archer daniels midland buy verasun energy?

The ethanol industry producers in this case considering only three industries: Aventine Renewable (AVR), U. S. BioEnergy (USBE) and VeraSun, have market caps of between $500million and $ 1Billion. The stocks have lost averagely 40% each, in recent times. The more sell-offs have been due to higher corn prices and the resulting pressure (Zacks Investment Research Real Risks Facing Ethanol industry).

The industry revenues are highly dependant on the product prices, while profit distribution is highly dependent on the price spread between gasoline and ethanol. The stock performance in 2007 indicated that (Year in Review 19). More than 50% of their revenues are derived from seed sales. In 2006 the Vera sun total accumulated fund was $ 700, 766 as compared with 2005 (United States department of Agriculture research report 16).

The five forces include: Potential competitors; the entry barrier in the market is relatively high, as the ethanol industry has no outstanding distribution systems, locations, brand names, and financial capital to outdo its competitors. It has an absolute cost advantage over the oil industry.

Rivalry among Established companies; as at present there are not many companies that exist in the same market. All of these companies target to command most of the retail(Wal-Mart; Industry Analysis Example 1). The targets have experienced tremendous growth in their domestic markets and yet they have not defined their areas of operation quite effectively.

The bargaining power of buyers; the individual users of ethanol have little pressure on the industry. Their pricing techniques are not transparent hence arousing complains amongst the consumers. This has made the convenience power of ethanol to be lost hence switch to comparable prices of oil companies.

The Bargaining Power of Suppliers is low on the Ethanol industry since they do not hold so much of the market share. The substitute Products like petroleum products, natural gas and unleaded gasoline do not offer any convenience when it comes to pricing (Wal-Mart; Industry Analysis Example 1)

The ethanol firm plans to build design firms to offer one-stop ethanol shops, this will increase the supplies by hand-holding producer investors and providing operational contracts through marketing partnerships for ethanol and distiller grains.

The securing of contracts for feedstock, energy, and inputs. Considering the competitors in the market the management will set agreements for operations, process benchmarking and trading, risk mitigation and finally on market analysis (United States department of Agriculture research report 11).

Competitive Advantage

The major cause of the equilibrium that exists among the mid-sized and the largest firms is the result widespread adoption of the contemporary information technologies that enhance cheap access to markets and help in the diminishing of vertical coordination activities.

The formulation and implementation of new policies that focuses towards emission of non-air pollutants is beneficial, since it makes the industry to escape unnecessary ban under the clean Air act and also exempts the industry from the Federal excise tax which is an advantage to its profit margin (Informa Economics The Role of Information Availability and Technology in the Ethanol Industry)

The formation of the farmer-owned ethanol plant also plays a role in the development of the ethanol industry. This is because it serves to distribute the investment risk over the entire group of investors and this obliges them to perform extra works.

The industry should also adopt the elements necessary for price transparency of ethanol which is the differential between the referenced index and the privately negotiated transportation arrangement. The transparency function gives traders a way to develop a forward price curve (Informa Economics The Role of Information Availability and Technology in the Ethanol Industry)

The company estimated third quarter loss of $63 to $103 million based on input and output prices. The company’s market share might be established after the Obama win on November 4th since it’s still struggling under liquidity crisis.

Vera Sun has fourteen plants with two more soon to start operating in the different regions (Damas VeraSun Energy; Buyout candidate, if Obama wins.)The VeraSun only has 16 state-of-the-art ethanol plants. The profit margin per gallon of the already manufactured ethanol will still remain in certain value even after the combined market share; this will remain even after the fluctuation of corn prices.

The range will be in the $2. 90 to $3. 32 per bushel for the third quarter (Damas VeraSun Energy; Buyout candidate, if Obama wins)

They will change the pricing structure and make it capable of absorbing the rising cost of corn and at the same time still keeping their margins inside the band. The VeraSun had run up its credit facilities due to the corn market squeeze and delays in collecting receivables from the Gulf refiners.

The combination of the two companies will lower its liquidity problems, and also they will be advantaged by the Obama presidential platform which will reduce subsidies to corn ethanol producers This will also ensure a large asset base which will support additional borrowing (Damas VeraSun Energy Buyout candidate, if Obama wins)

Strategic Options

As stated earlier in the beginning, the issue that is being investigated here is the options that are available for Archer Daniels Midland (ADM) and Verasun Energy. As is the practice in many financial decisions, ADM is grappling with the uphill task of finding the best financial decision to make with regards to her future operational activities (Archer Daniels Midland, Dividend Stock Analysis)

This is heightened more by the fact that the United States is currently undergoing an electioneering period which will definitely affect the strategic options of many business organizations come January next year (Damas, VeraSun Energy: Buyout Candidate, If Obama Wins).

The outcome of the US election is particularly very important to these two companies because of the nature of their business. ADM deals in ethanol energy. Given that the leading presidential candidates have kind of indicated various reactions with regards to the use of ethanol fuel, Verasun Energy, a producer of ethanol has justified concerns about her future which will depend on the outcome of the elections (Damas, VeraSun Energy: Buyout Candidate, If Obama Wins).

With this clearly in mind, Verasun is grappling with either the option of acquiring or merging with other companies such as ADM among others (Aniston Jennifer, Archer Daniels Midland Co. (ADM) is in the Food Industry).

It thus implies that one strategic option available for ADM is to acquire Verasun. This is more given the fact that VeraSun Energy (VSE) only recently offered herself for sale having lost out in the business of corn (Archer Daniels Midland, Dividend Stock Analysis).

The loss out occurred because the company had been in the practice of purchasing corn requirements at the right time. Currently, the company projects a loss of $63- $103 in the third quarter of her trading period. This is founded on both input as well as output (Damas, VeraSun Energy: Buyout Candidate, If Obama Wins).

According to Damas, the loss of VeraSun will be $100-$200. However this does not mean that the company is undergoing a crisis of liquidity. Therefore ADM equally has the strategic option of merging with VSE. All the same, the company offers a very good buyout opportunity.

The implication here is that with net earnings for the period ending June 30, 2007 of $665 million and with a market price per share of $1. 01. This was further strengthened by the 59% increase in operating income of $44 billion during the period June 30, 2008 (PR Newswire, 1). ADM therefore has the strategic opportunity of either acquiring or merging with VSE following the impressive financial performance of the company (Damas, VeraSun Energy: Buyout Candidate, if Obama Wins).

Recommendation

According to me, I would strongly recommend that ADM buys VSE. This is informed by several factors. First, it is evident from the given financial statements that ADM has enough capital enough to acquire AVE. The given financial statements point to the fact that ADM is a string company with a solid financial base. For instance the increased net sales as well as other operating income of $21. 8billion which represented a 78% increase while the 59% increase represented $69. 8 billion for the period ended June and December 2008 respectively (PR Newswire, 1).

The implication here is that ADM has the potential of actually completely acquiring VSE. This would give the company total control as opposed to if the two companies were to merge in which case then two companies will be operating as equal partners. The option of total acquisition would equally be more appropriate owing to the fact that VSE is actually facing a tight financial situation.

For instance, VSE currently projects that it could record a $35. 5 million in incomes before tax following their quarterly disclosure (PR Newswire, 1). Acquisition would give ADM total control thereby enabling her to further consolidate her market share in the market (Damas, VeraSun Energy: Buyout Candidate, if Obama Wins).

Financial Evaluation

A financial evaluation of the company reveals that the net earnings of ADM for the period ending 6/30/08 were $372 while that of 6/30/07 was $ 955. At the same time, the net earning for the period ended 6/30/08 was $1, 802 while for the period ending 6/30/07 was $2, 162. Equally the net sales revenue together with other operating income for the period ending 6/30/2008 was $69. 8billion.

This was a 59% increase from the $44 billion of the year 2007. This was further reinforced by the $3. 4 billion operating profit for the year ending 2008 up from $280 million for the fiscal year 2007(PR Newswire, 1).

This would imply that if ADM were to buy VSE, definitely the amount which would be needed to accomplish that transaction would have to be more than the total financial worth of VSE. For instance VSE only had about $28 million for the period ending June 30 2008. However, it should be noted that the company has a large base of assets as well as a strong advisor Morgan Stanley (Damas, VeraSun Energy: Buyout Candidate, if Obama Wins).

These factors coupled with the fact that it has 16 ethanol plants fully equipped with state of the art technologies. The implication is that with a total of the 16 plants ands at a cost of transaction of $1. 25/galloon, the total with of the company could be valued at $2. 05 billion. Simply put the amount of capital that would be needed to buy and integrate VSE is over $2. 1 billion (Imielinski, VeraSun’s Corn Costs- Another Bearish Sign for Ethanol Stocks).

Conclusion

In conclusion, the net present value NPV of each of the strategic options, what can be noted is that acquisition would give a higher NPV as compared top a merger. In the case of an acquisition, all that would needed is summation of all the future earnings as well as the projected outflows. In this case the major outflow would be the money spent towards the acquisition which would be $2. 1 billion.

The total of the projected inflows would be $(372+955+1802+2162) = $ 5, 291billion. The outflow would be the equivalent of $2. 1 billion which would be paid as the outflow. In this case, each of the inflows will be discounted at a given rate. That is the PVIFi, n where i is the discount rate and n is the number of periods (Panell, Avoiding simplistic assumptions in discounting cash flows for private decisions).

That is NPV will be given by {372/(1+i)1 + 955/(1+ i)2 + 1802/(1+i)3 + 2162/ (1+ i)4 } - { 2. 1/(1+i)0 }. The implication here is that all the future cash inflows would be discounted at a discount rate i after which the summation will be subtracted from C0, which represents the total outflows, which in this case is $2. 1billion. The balance will be the Net Present Value, NPV.

The key assumptions which could underlie the calculation of the above NPV such as the fact that the discount rate is constant and known, the cash flows will be constant and are known. At the same time, taxation is irrelevant in this case as well as the fact that the growth of productivity over time is zero (Panell, Avoiding simplistic assumptions in discounting cash flows for private decisions).

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