Is scramble to buy ethanol based on rush to fool's gold?

By David Nicklaus
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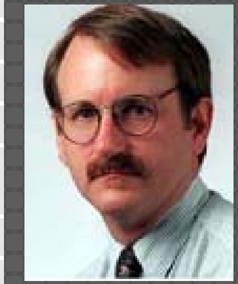

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A young company sells stock to the public, raises more money than it expected and watches the shares soar 30 percent in a single day. Several competitors are waiting in the wings to grab their own pieces of the IPO bonanza.

The dot-com industry, circa 1999? No, we're talking about the ethanol industry in 2006. The gold-rush mentality is almost the same.

The second-largest U.S. ethanol producer, VeraSun Energy, made its initial public offering last week, raising $420 million, and its shares jumped from $23 to $30 on the first day of

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trading. The No. 3 and 4 companies, Hawkeye Holdings and Aventine Renewable Energy Holdings, have IPOs pending. The No. 1 producer, agribusiness giant Archer Daniels Midland, has seen its shares rise 83 percent in the last year.

And that's the established end of the market. Pacific Ethanol, a company that plans to supply the West Coast market and has yet to produce fuel, has seen its shares double in a year and quadruple in two years.

"We're really having the silly season again," said Juli Niemann, a veteran energy analyst at Smith Moore & Co. in Clayton. "If you look at the economics, it's not there."

Ethanol itself commands a premium at the moment, so the distillers are earning fat profit margins. That's partly because high oil prices have created a clamor for almost any form of alternative energy. It's also because gasoline companies are scrambling to replace MTBE, an additive that is being phased out because of environmental concerns and replaced with ethanol.

The average U.S. price of ethanol hit a record $3.64 a gallon this week, up 50 percent in just the last three months. But, flush with investors' money, the industry has embarked on a building boom that could bring prices back down.

The nation's 97 ethanol plants currently have a production capacity of 4.5 billion gallons a year. Construction projects already under way will bring that to 6.7 billion gallons within two years. That is likely to put supply well ahead of demand, a recent Standard & Poor's research report says.

"As expected, the ethanol industry is responding to increased demand quickly, but the result could be an oversupplied market and depressed prices," S&P analyst Elif Acar writes.

Here's another concern: What will the scramble for ethanol do to corn prices? Today's relatively low corn prices, about $2.30 a bushel, are fattening the distillers' profit margins. If corn gets more expensive €" it reached $3 a bushel as recently as 2004 €" the margins could shrink quickly.

Of course, today's ethanol industry wouldn't exist without support from the government, in the form of a 51-cent-a-gallon tax credit and a renewable-fuels mandate that was part of last year's federal energy bill. However, public policy can be fickle, and investors can't be sure that the tax credit will be renewed before it expires in 2010.

"I don't think of ethanol in normal supply and demand terms," said Robert Wilder, chief executive of WilderShares LLC in Encinitas, Calif. His firm has created an index and an exchange-traded fund made up of alternative-energy stocks. "The markets are having a tough time determining a fair value for these ethanol stocks. The unknown and the unknowable are enormous when it comes to ethanol."

In investing, an unknown risk is usually a bad thing. At the moment, hype and hope seem to have trumped risk in the ethanol industry.

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