

THE FUTURE OF ENERGY

Quants, **Corn** and Bankruptcy

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and KATHERINE BURTON

Illinois farmers put up \$4 million to start an ethanol cooperative and lost every dime when the company went bankrupt. They blame hedge fund mogul Andy Redleaf and his Whitebox Advisors.

Photograph by THOMAS STRAND



Redleaf says his firm spent \$30 million on the plant and made a sincere effort to save it.

A MILE DOWN AN unpaved road on the outskirts of Canton, Illinois, population 14,500, stands a shuttered ethanol plant.

Corn farmers in the area chipped in \$5,000 to \$300,000 each—some even mortgaged their farms—to form the Central Illinois Energy Co-operative. They broke ground on the refinery in 2006, hoping that ethanol would bring higher prices for their corn and more jobs for Canton. The town had been in trouble since 1983, when International Harvester Co. closed its plow factory there.

The ethanol plant was a poor replacement. Central Illinois Energy LLC, the corporation that built the plant, went bankrupt in December 2007 without having produced a drop of fuel, hurt by construction delays and \$40 million in cost overruns. The 260 farmers in the co-op lost every dime.

Some of them blame the flameout on a poker-loving, libertarian math savant named Andy Redleaf, whose Minneapolis-based hedge fund firm, Whitebox Advisors LLC, now controls the plant.

With \$2.7 billion in assets, Whitebox is one of a small group of bottom-fishing hedge funds looking to profit from the ethanol collapse. They're sifting through

the wreckage of a highflying industry that started falling to earth on June 20, 2006. That day, the price of ethanol, the main ingredient in moonshine whiskey, peaked at \$4.23 a gallon on the Chicago Board of Trade, buoyed by a strong economy and former President George W. Bush's pledge to replace 75 percent of the oil the U.S. imports from the Middle East with ethanol by 2025.

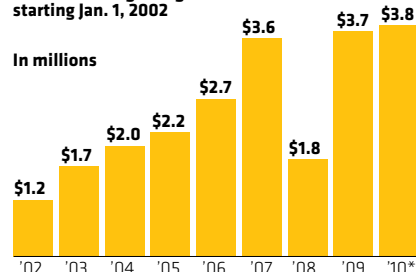
Distillers erected dozens of the plants across the Great Plains, backed by some very smart money. Microsoft Corp. co-founder Bill Gates invested \$84 million in Pacific Ethanol Inc., based in Sacramento, California. Hedge fund managers David Einhorn and Daniel Loeb backed Denver-based BioFuel Energy Corp.

Then the financial crisis hit. Demand waned, and supply surged. BioFuel has

Ethanol Fueled

Investors in the fund that included ethanol have tripled their money.

Value of a \$1 million investment in Whitebox Hedged High Yield Fund starting Jan. 1, 2002



*Through March 31. Source: Investors

made money in just two quarters since going public in June 2007. By December 2008, the price of ethanol had collapsed to \$1.40 a gallon. Pacific Ethanol's plants went bankrupt. "There was too much built too quickly, with too much leverage," says Neil Koehler, the company's chief executive officer.

Redleaf, 52, is an unlikely ethanol speculator. He rails against government bailouts on his blog and in his frequent letters to investors. Ethanol is an easy target for conservatives like Redleaf. The government gives refiners a 45-cent tax credit on every gallon they blend with gasoline and levies a 54-cent-a-gallon

protective tariff on competing fuel made from Brazilian sugar cane. In return, it requires oil refiners to mix more ethanol into their gasoline each year. This year, the quota is 12 billion gallons.

Redleaf isn't normally an energy investor. The core of his hedging strategy is capital structure arbitrage, in which he looks for bonds that pay fat interest rates, then hedges the risk of those bonds by making a separate wager that the issuing company's stock will fall. If the bonds tumble, the stock probably will, too, and the arbitrageur makes enough money on the short sale to cover the bond

The **Canton facility** was bankrupt before it produced a drop of ethanol.



loss—and still collects the interest.

Whitebox's involvement in the Canton ethanol plant started when it bought a fraction of an \$87.5 million syndicated loan that Credit Suisse Group AG arranged for the farmers' cooperative in April 2006. It was part of a bigger ethanol play. Redleaf also bought \$28.4 million of bonds issued by Pekin, Illinois-based Aventine Renewable Energy Holdings Inc. when it emerged from bankruptcy in March, a right he had as a holder of Aventine's original debt. And he owned bonds issued by bankrupt Sioux Falls, South Dakota-based VeraSun Energy Corp., which raised \$420 million in a 2006 public offering and operated 16 ethanol plants in eight states before it went under.

Another hedge fund firm, New York-based Brigade Capital Management LLC, also bought debt of Aventine and VeraSun.

Unlike those companies, Central Illinois Energy didn't have any shares to short. When the bonds crashed, Redleaf could have taken the loss and moved on. Instead, he took control of the plant in bankruptcy.

That's a source of bitterness in Canton. Before CIE went bust, the farmers sought a new loan from Whitebox. "Whitebox proposed a bridge loan, which was not workable because of onerous terms," says Jay Sutor, a farmer-investor. The interest rate on the loan was about 20 percent, and Whitebox, already a small holder of the plant's equity, was to get 25 percent more as a fee, Sutor says. The farmers balked.

Whitebox also used its equity ownership to block the sale of the plant to other buyers, which could have salvaged some of the farmers' investment, says Dennis Streitmatter, an investor and CIE board member. "It took a 100 percent vote to do anything," Streitmatter says. "And they always voted against it." Whitebox chief operating officer Jonathan Wood says he knows of no offers to buy the plant before it went bankrupt.

Redleaf says Whitebox spent \$30 million to finish the plant—much more than the farmers invested—and made a sincere



The Illinois town had 'high hopes for the ethanol plant,' city attorney **Chrissie Peterson** says.

accused of wrongdoing. Petters is appealing. Sun Country is bankrupt.

Whitebox has sold several private-equity investments to return money to investors who redeemed their Whitebox stake after the 2008 crash. In April, the firm agreed to sell a dozen grain elevators to Toronto-based Ceres Global Ag Corp. for \$74 million in cash and stock. Whitebox made money on the sale, Wood says.

Even so, Redleaf says he's done with running private companies. "We prefer shuffling paper to making widgets," he says in an interview in his office overlooking Minneapolis's Lake Calhoun. His desk is covered with newspapers, and atop the stack rests a magnifying glass that Redleaf, who suffers from macular degeneration—a disease that causes a progressive blurring of vision—uses to read. That problem aside, Redleaf sometimes makes his short commute to work on a Segway scooter.

Redleaf says he has put the Canton

effort to save it. "You can look at what was spent," he says in an interview. "Most of the money wasn't spent by the community."

CIE was one of several private companies that Whitebox invested in over the past few years, a common occurrence among hedge funds in the boom years as they drifted away from publicly traded stocks and bonds in a search for higher returns. One of Whitebox's acquisitions was Sun Country Airlines Inc., which Redleaf bought in 2006 with Petters Group Worldwide LLC, an investment firm run by Thomas Petters, who was sentenced in April to 50 years in prison for orchestrating a \$3.5 billion fraud. Neither Whitebox nor Redleaf was ever

'We prefer shuffling paper to making widgets,' Redleaf says, adding that he will avoid private-equity deals in the future.



Whitebox is making money on **Aventine**, owner of this Illinois plant.

plant up for sale and will avoid private-equity deals in the future.

Redleaf hasn't escaped Canton yet. The Illinois Environmental Protection Agency in March asked the state attorney general to force CIE and a nearby grain handling facility to clean up a discharge of black sludge that killed turtles in a nearby pond. The closed plant contains 2.3 million gallons (8.7 million liters) of toxic soup from the ethanol-making process, says Canton City Attorney Chrissie Peterson. The city has plugged a pipe leading from the plant to make sure none of the material makes its way into the town's water-treatment facility. Wood says Whitebox is cooperating with the Illinois EPA.

"There were high hopes for the ethanol plant," Peterson says. "It has left a bitter taste."

Redleaf looks more like the late Jerry Garcia, lead guitarist for the Grateful Dead, than a Gordon Gekko-style financier eager to outfox a bunch of

farmers. His white hair floats untamed around his head, and he wears a shaggy goatee. He gives an interview in jeans, a food-stained powder-blue Polo shirt and boat shoes.

Redleaf says he named his firm Whitebox to contrast with most hedge funds, which are black boxes—opaque to investors. He sends regular, detailed letters to his backers. Redleaf became a hero to his clients in 2007 when the market for subprime mortgage bonds collapsed. He had warned that would happen in a letter in December 2006. "Sometime in the next 12 to 18 months, there is going to be a panic in credit markets," Redleaf wrote.

Whitebox bought credit-default swaps on mortgage-backed securities, betting on a decline. As a result, its Hedged High Yield Fund had a 33 percent return in 2007, according to investors. This is the same fund that made Whitebox's ethanol investments. Redleaf then bought back into credit markets too soon during the crisis of 2008. His six funds fell an average of 40 percent. Whitebox recovered in 2009,

with fund returns averaging 80 percent, investors say.

A Minneapolis native, Redleaf has been interested in the markets since he was a child. At 11, he started reading copies of *Forbes* and *Value Line* that his father, an options-trading doctor, brought home. While other kids were delivering the Minneapolis *Star Tribune*, he arranged with a newspaper distributor to get copies of the Sunday *New York Times*, then available at just one newsstand in the city, and charged a premium to deliver it. "I've never believed in the value of having a menial job," he says.

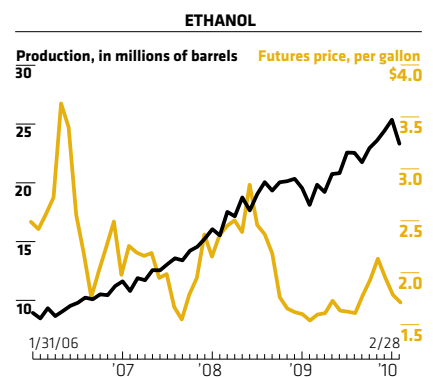
Numbers have always been Redleaf's obsession. They're what sparked his interest in poker, which he plays regularly in Minneapolis-area card rooms. He says he makes fewer mathematical mistakes than most players, although others are better at picking up opponents' weaknesses.

Redleaf completed undergraduate and master's degrees in mathematics at Yale University in just three years, graduating in 1978. While there, he says, he developed a model for valuing stock options similar to the Black-Scholes method. "I'm a little bitter I didn't get the Nobel Prize," he says with a smile. Myron Scholes and Robert Merton won the Nobel Memorial Prize in Economic Sciences in 1997 for developing the formula.

At Yale, he tried to use his math skills to get a summer internship in finance. Wall Street had yet to fall in love with quants, though, and everyone

Too Much Fuel

High prices spurred a boom in ethanol output, which drove down the price.



Source: Bloomberg

BRETT KRAMER

turned him down. Robert Rubin, then a partner at Goldman, Sachs & Co. and later U.S. Treasury secretary, sent him a one-sentence rejection.

After college, Redleaf tried the big accounting firms. No luck. Finally, Gruntal & Co., a small New York brokerage, took a chance, hiring Redleaf to trade the firm's own money. He joined Gruntal's other new hire in trading: Steven A. Cohen, who would go on to found \$12 billion SAC Capital Advisors LP, one of the most profitable hedge fund firms in the world. (See "Steve Cohen's Trade Secrets," April 2010.)

REDLEAF STAYED AT Gruntal for just 18 months before leaving to trade options with his father. "If I had it to do over, I would have stayed longer and tried to do some reverse engineering of Steve," he says.

Redleaf co-founded Minneapolis-based Deeptaven Capital Management LLC in 1994, leaving to start Whitebox five years later.

The ethanol cooperative Redleaf later invested in was the dream of Mike Smith, an executive at MidAmerica National Bank in Canton. Smith convinced 260 farmers and about 100 other investors to pony up \$4 million to form the co-op, according to farmers who invested. About 70 signed letters of credit for another \$5 million. Smith didn't return telephone calls.

The \$4 million was barely enough for a down payment on the 37-million-gallon-per-year ethanol plant. The farmers went to Zurich-based Credit Suisse, which offered its \$87.5 million syndicated loan. Canton officials were eager to help, too. The town sold \$26 million in bonds to upgrade its water system, partly to supply the 200 million gallons of water the plant would need each year.

Math is what attracted Redleaf to ethanol, he says. The price of corn determines much of its cost, while the price of gasoline, with which it is blended, helps determine the ethanol price. "It's a series of complex options on inputs and outputs," Redleaf says.

The investment became more

Redleaf uses his math skills to construct options trades. **He saw the mortgage meltdown coming in 2006.**

interesting in 2007, when ethanol prices plunged and the Canton plant suffered construction delays. The Credit Suisse debt dropped to just pennies on the dollar. Whitebox bought more.

The Whitebox portfolio manager handling the investment, Nick Swenson, had experience analyzing distressed assets at Varde Partners Inc., another Minneapolis fund.

Swenson, who left Whitebox in February 2009 to found his own firm, Groveland

dispute with the company providing technology, delaying construction by months, according to the farmers. Lurgi, now a unit of Paris-based Air Liquide SA, declined to comment.

After the co-op had run through the cash provided by the Credit Suisse loan, Smith went to Whitebox looking for more money. Swenson assured co-op members that Whitebox would help, the farmers say.

"There were several times when they would offer to give us some money, and it



Capital LLC, declined to comment.

Ethanol has been around since ancient times—not as fuel but as spirits. Ethanol as fuel is distilled from grain the same way whiskey and vodka are: by crushing the grain; extracting the starch; mixing it with water, enzymes and yeast; then heating it.

Henry Ford designed the Model T, first sold in 1908, to run on either ethanol or gasoline. Ethanol fell out of favor during Prohibition. The Canton facility was part of its revival.

Trouble started almost immediately. Lurgi GmbH, the German contractor, had to switch designs because of a

'It wasn't going to fly right from the start,' farmer **Verlyn Vaughn** says.

wouldn't come through," says CIE board member and farmer Tim Wagenbach, who says he put up \$63,000, including \$48,000 via a letter of credit, and lost it all. "They wanted to own the company."

Redleaf says he never expected to own the plant.

In November 2007, with weeks to go before the plant had to make a payment to Credit Suisse, Swenson offered a \$15 million bridge loan at 20 percent, the farmers say. They rejected the terms, and

CIE declared bankruptcy in Illinois federal court on Dec. 13, 2007. Whitebox Chief Legal Officer Mark Streffling says he doesn't know the terms of any proposed bridge loan.

On April 24, 2008, a group of creditors led by Whitebox won permission from the bankruptcy judge to take over the ethanol plant. The creditors held \$80 million in CIE debt, 80 percent of it owned by Whitebox.

Whitebox renamed the facility Riverland BioFuels LLC, finished construction and, in late 2008, fired it up. It halted production in March 2010 after a new slide in ethanol's price, to \$1.53 a gallon on March 25 from \$2.14 on Nov. 30, 2009. A Whitebox executive named Bruce Nordin came to town and fired 31 of the 41 workers. Redleaf says the plant is now for sale.

REDLEAF'S ETHANOL investments haven't been a total bust. Aventine is in much better shape. Whitebox, Brigade and other investors won rights to most of the new equity in the company when it emerged from bankruptcy in March by agreeing to buy \$105 million in new bonds.

As of early May, Aventine shares traded at \$43.25 on the over-the-counter market. Houlihan Lokey, the Los Angeles-based investment bank that valued Aventine in



Michael Welsh and other investors were wiped out in the Aventine bust.

bankruptcy, estimated that the new shares would be worth just \$25.

The shares rose after Aventine reported to the bankruptcy court that its business had improved. The company had net income of \$27 million in the second half of 2009, according to a regulatory filing. "They've been making money like crazy," says Michael Welsh, who has been climbing around Aventine's Pekin plant for 16 years as a consulting engineer.

The old shareholders, wiped out in the bankruptcy, are incensed. Welsh, who says he bought 430,000 Aventine shares before it went bankrupt, says the hedge funds forced the bankruptcy filing in order to take control. Redleaf responds that his actions in Aventine were proper. Wood, his COO, says Whitebox is in the

money in Aventine. "It's a very good trade," he says.

The still-unanswered question for Whitebox is whether the firm can make enough on its Aventine shares to cover potential losses on CIE.

At least one farmer is patting himself on the back for avoiding

the whole debacle. Verlyn Vaughn, 79, farms 550 acres (220 hectares) of corn and soybeans around Canton. He says the co-op solicited his investment in the ethanol plant. He passed because he didn't get a good feeling from the project, he says. "It wasn't going to fly right from the start," Vaughn says he predicted. And he was right. "They were open, and then they were closed," he says.

Redleaf wasn't as lucky. He learned the hard way that there's more to making money from ethanol than plugging numbers into an options equation. **B**

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Tracking Whitebox's Holdings

You can use the Holdings Search (HDS) function to monitor the shares held by Andy Redleaf's Whitebox Advisors, including stock of ethanol producer Aventine Renewable Energy Holdings, which emerged from bankruptcy in March. **Type AVRW US <Equity> HDS <Go>** to view institutional holders of Aventine, led by Whitebox. Click on Whitebox and then on Reported Holdings to view all of the hedge fund's reported stock holdings on another Bloomberg Professional service screen. To sort Whitebox's equity holdings by the percentage of outstanding shares held by the firm, click on the arrow to the right of Sort By and select % Outstd. The screen shows that by this measure, Whitebox's Aventine stake was among the firm's biggest equity holdings as of March 31.

BETH WILLIAMS

BLOOMBERG TIPS

Rank	Security	Source	Shares	Latest Chg	% Out	Mkt Val	Date
1	EPIC CAPITAL GROUP INC	13D	30,967,415	+27.12M	68.19	2M	5/10/10
2	STRATEGIC RESERVE ADVISORS	13D	6,658	0	12.17%	9/22/09	
3	SILICONIX INC	13D	146,643,329	0	43.41	146,643,329	3/31/10
4	AVENTINE RENEWABLE ENERGY INC	13D	1,053,216	0	12.32	46M	3/31/10
5	AVANTAGE TECHNOLOGIES INC	13G	711,420	0	10.38	42,440,000	12/31/08
6	PHOSPHATE HOLDINGS INC	13G	776,572	0	10.14	7M	12/31/09
7	OMNICARE CAP TRUST II	13F	651,295	-50,000	9.76	24M	3/31/10
8	LLZ CLAIRBORNE INC	13G	9,105,274	0	9.64	59M	12/31/09
9	GENCORP INC	13G	5,050,286	+1.58M	8.63	29M	12/31/09
10	ADAMANT POLYBENZENE CORP	13G	9,378,479	0	8.14	68,030	3/31/10
11	UWENK INC	13G	1,000,000	0	7.88	9000	12/31/07
12	FRANCONIA MINERALS CORP	SED	5,343,200	-187,500	7.21	2M	3/31/10
13	DVI INC	13G	1,092,274	0	7.19	1092	12/31/08
14	TWO HARBORS INVESTMENT	13F	1,841,537	-183,895	7.07	16M	3/31/10
15	VCG HOLDING CORP	13F	1,180,263	-200,235	6.52	2M	3/31/10
16	FAMOUS DAVE'S OF AMERICA	13F	538,423	-198,913	6.12	5M	3/31/10

The list of Whitebox's equity investments shows the hedge fund owned 12 percent of Aventine's shares as of March 31.

BRETT KRAMER