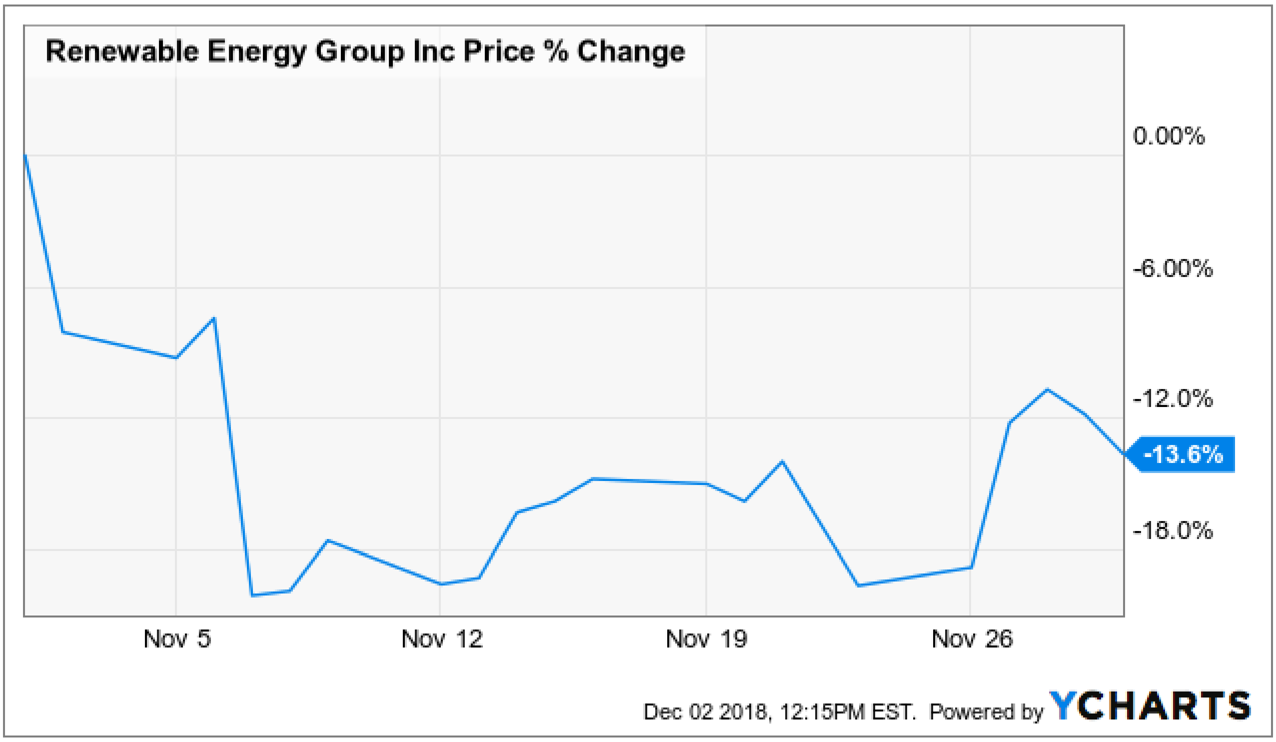
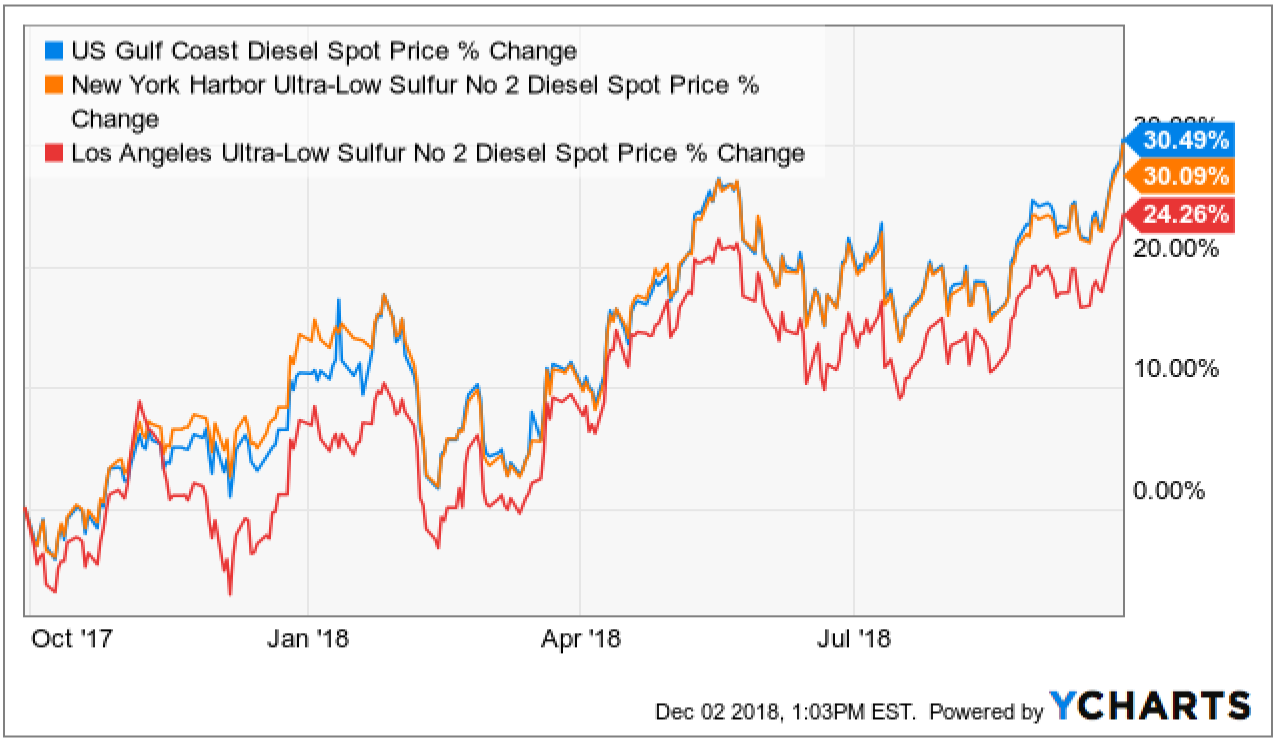
# Renewable Energy Group: A Solid Q3 Even Without The BTC

Biomass-based diesel producer **Renewable Energy Group** (REGI) reported Q3 earnings last month that were largely in-line with analyst expectations. Revenue came in slightly above the consensus at $598 million, down 5% YoY, while non-GAAP diluted EPS came in $0.05 below the consensus at $0.43, up from -$0.29 YoY. The large increase in profits over the period reflects the strong operating conditions that the company has benefited from over the previous year, which in turn drove its share price to a 145% gain over the year prior to the Q3 report's release. Despite this, though, investors punished Renewable Energy Group's share price in response to the report and, while it has regained some ground of late, it remains below its October highs (see figure).



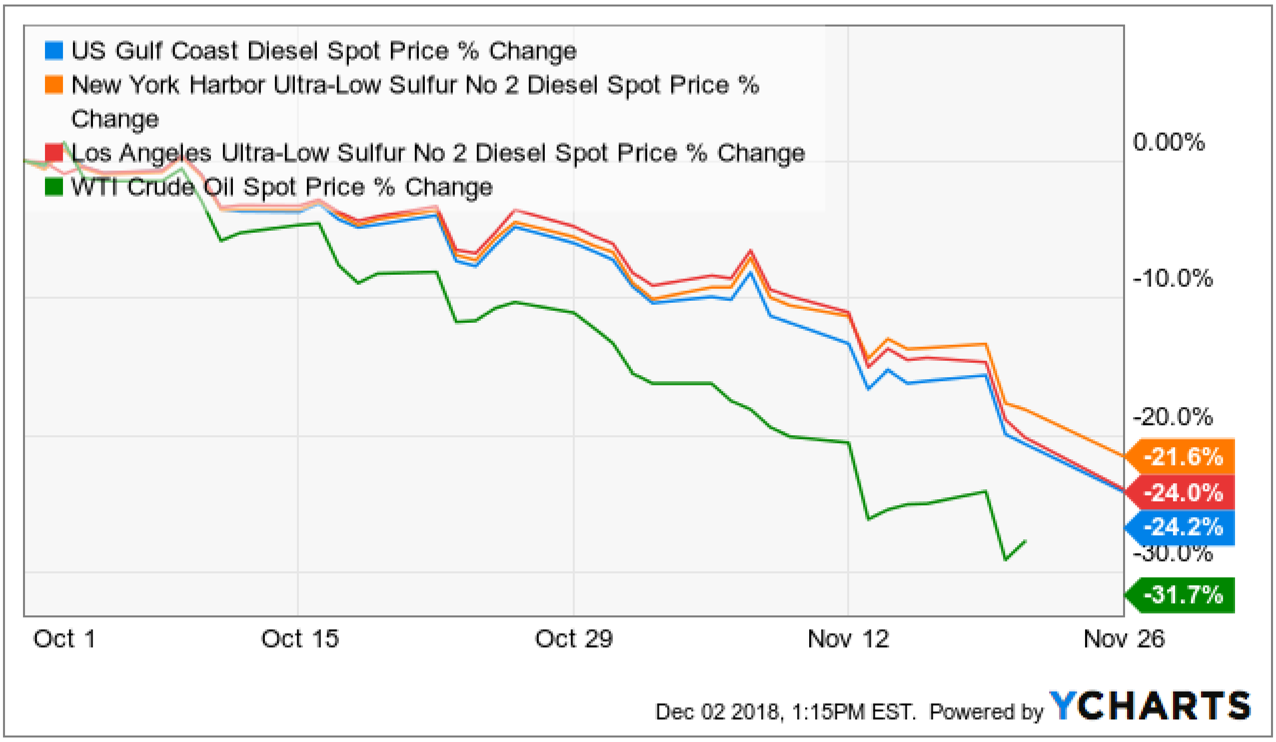
REGI data by YCharts

The Q3 earnings report contained quite a bit of good news for the company's investors to cheer. Gallons produced and gallons sold in Q3 were 16% and 18% higher than in Q3 2017, respectively. While the increased production volume on its own was impressive, it is also notable that the company had little difficulty finding customers for all of those additional gallons. Diesel prices charged higher between Q3 2017 and Q3 2018 (see figure) and, while Renewable Energy Group's revenue per gallon struggled to keep up due to the expiration of last year's biomass-based diesel Blenders' Tax Credit [BTC] and a sharp decline to D4 RIN prices over the same period, national demand for diesel fuel supported the company's biomass-based diesel margins. Renewable Energy Group reported Q3 adjusted EBITDA of $34.6 million, or $0.25/gallon of production, compared to -$1.5 million, or -$0.01/gallon, YoY. (This excludes the impact of the BTC on 2017's results to permit a like comparison.) If Congress moves forward with proposals to retroactively reinstate the BTC for 2018 then the company estimates that EBITDA in its latest quarter, inclusive of the tax credit, would have instead been $104.6 million, or $0.75/gallon, compared to $55 million and $0.46/gallon in Q3 2017.



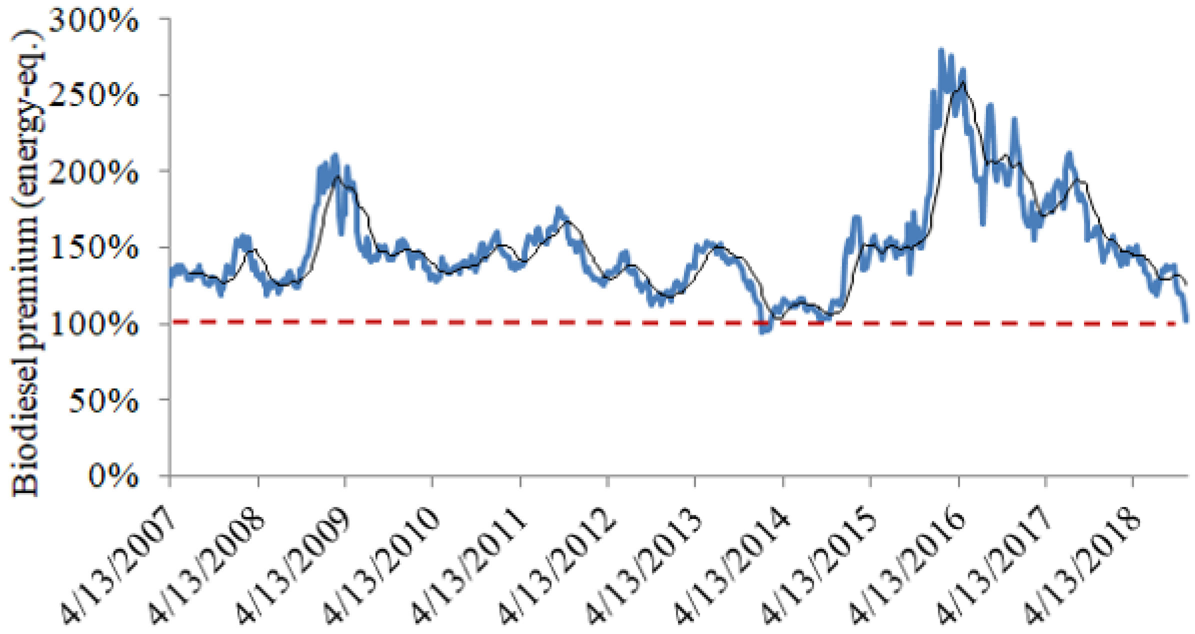

U.S. Gulf Coast Diesel Spot Price data by YCharts

Q3 was a very good quarter that will ultimately turn out to have been an excellent quarter if the BTC is retroactively reinstated for 2018. Where investors turned sour was on Renewable Energy Group's Q4 outlook. First, diesel fuel prices have tumbled in Q4 to date as the price of WTI crude has fallen rapidly (see figure). Biomass-based diesel producers have not been as exposed to lower crude prices as their peers in the ethanol sector due to diesel fuel's relative resilience compared to the price of gasoline but, even after accounting for that difference, the value of biomass-based diesel as a fuel has come under pressure in recent weeks.



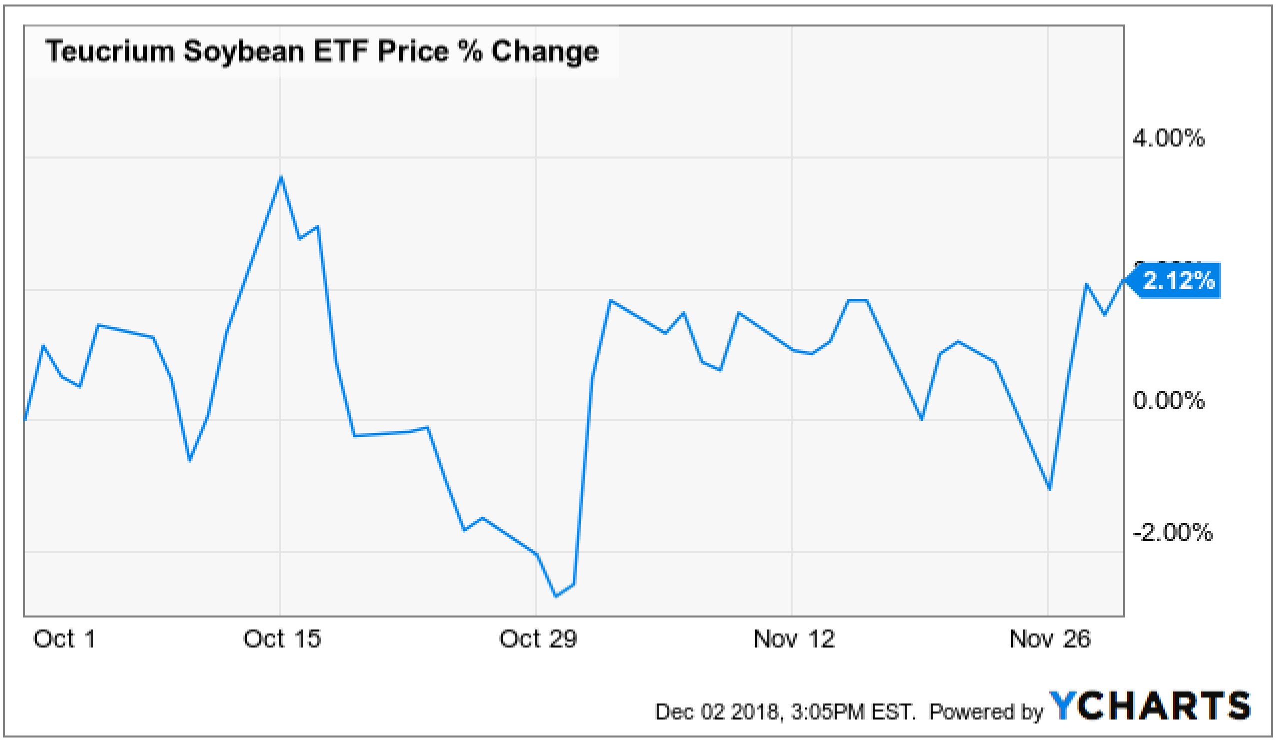
U.S. Gulf Coast Diesel Spot Price data by YCharts

Making matters worse, biomass-based diesel's value as a biofuel has also come under pressure following the Trump administration's decision over the summer to weaken the U.S. biofuels blending mandate. While the ethanol sector has been the primary victim of this policy change, it has also reduced demand for biomass-based diesel under the mandate. As a consequence the price of biodiesel has declined in recent weeks even relative to the spot price of diesel fuel: whereas the biodiesel price was on average 131% that of diesel fuel on an energy-equivalent basis in Q3, this value has averaged only 116% in Q4. In fact, the two prices have been trading at close to parity on an energy-equivalent basis in recent trading (see figure), biodiesel’s lowest premium in almost five years.



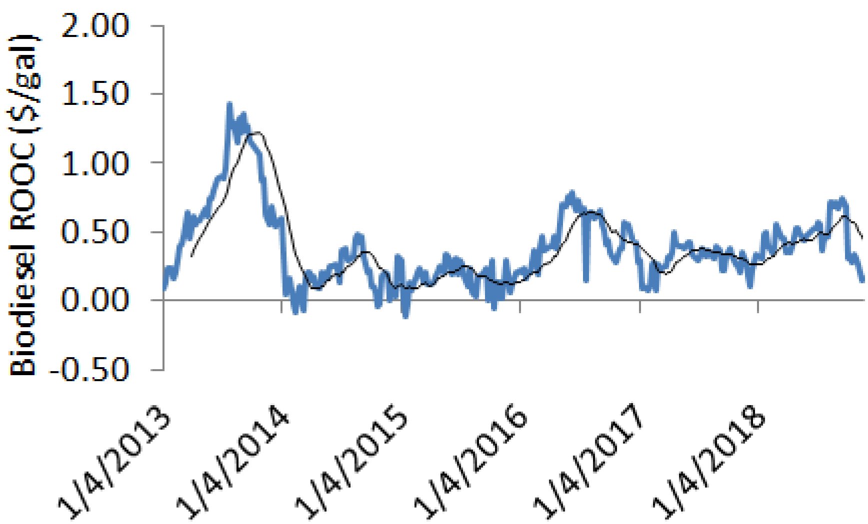

*Sources: CARD, EIA (2018).*

A further complication is that the prices of soybeans (see figure) and methanol have both moved against biomass-based diesel production margins in recent weeks. The former is admittedly still much lower than where it was in the first half of the year, but it moved higher in November even as the price of biodiesel moved lower. The price of methanol has been high in 2018 to date, and its November price was the highest reported monthly price since June 2014. Soybean oil drives the price of lipid feedstocks while methanol also serves as an important production input for biodiesel (renewable diesel, which uses natural gas as an input in the form of hydrogen, has also been at a disadvantage in recent months), so input costs have also put pressure on biomass-based diesel production margins.



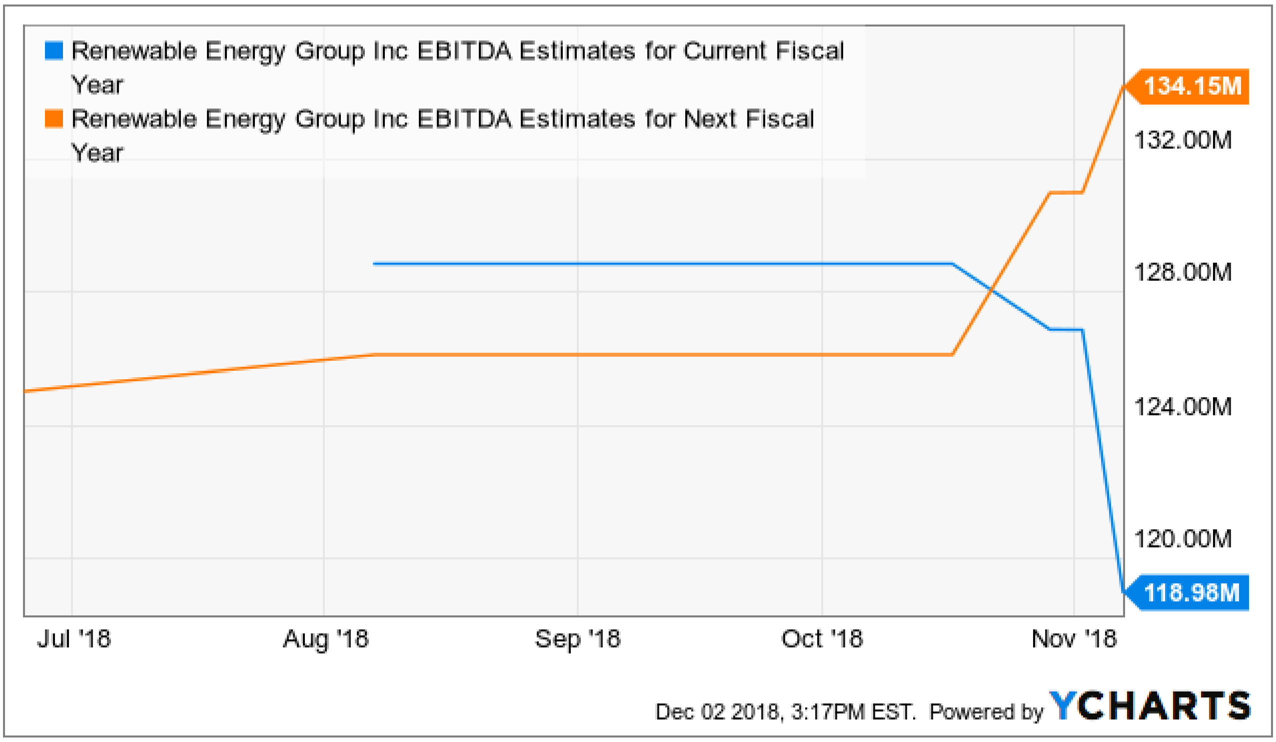

SOYB data by YCharts

The combination of falling fuel prices and rising input costs has caused biodiesel margins to decline sharply from an average of $0.62/gallon in Q3 to only $0.27/gallon in Q4 to date (see figure). Some of this move can be explained by seasonal factors such as increased demand for natural gas (an important methanol feedstock) in heaters and reduced demand for biodiesel in cold weather locations. On average, though, the change from Q3 to Q4 to date has been one of the steepest margin declines since at least 2016 and possibly since 2013.



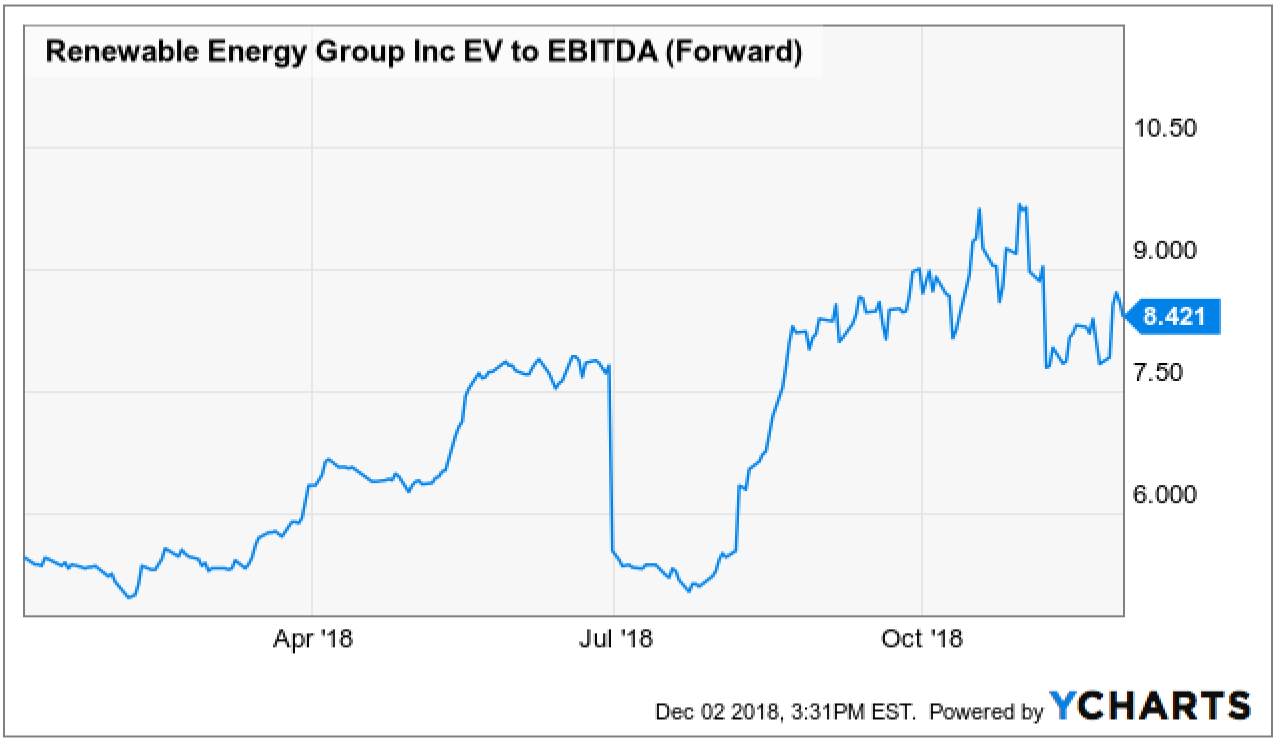

*Sources: CARD, EIA (2018).*

There is still much that could go right for Renewable Energy Group moving into 2019 despite a recent period of low production margins. The powerful chair of the House Ways and Means Committee proposed last week to retroactively reinstate the BTC for 2018 while also extending it through 2021 at $1/gallon as part of technical corrections to last year's tax reform legislation. Renewable Energy Group possessed cash and liquid assets worth $210 million compared to total debt of $204.4 million at the end of Q3, leaving it with a solid balance sheet even if the BTC is not extended. Looking further out, the EPA recently finalized the volume of biomass-based diesel that must be blended in 2020, locking in a 16% YoY increase to 2.43 billion gallons in that year. While the consensus analyst estimate for Renewable Energy Group's EBITDA in 2018 has declined in Q4 as margins have fallen (see figure), the current annual average for 2018 and 2019 of $126.6 million is in-line with the company's current performance without the BTC; investors can expect the consensus to move sharply higher if the BTC is reinstated, let alone retroactively.




REGI EBITDA Estimates for Current Fiscal Year data by YCharts

Whether or not investors view Renewable Energy Group's shares as being overvalued therefore depends on the status of the BTC. The decline to the company's share price since October has outpaced the reduction to the consensus EBITDA estimate for FY 2018, causing its forward 2018 EV/EBITDA ratio to decline from almost 10x to 8.4x. While high compared to the 5x ratio that prevailed at the beginning of the year (see figure), the company estimated in its Q3 earnings report that its FY 2018 adjusted EBITDA result will be at least $200 million higher if the BTC is retroactively reinstated. In that case the company's annual result is estimated to be closer to $320 million, resulting in a forward EV/EBITDA ratio of 3.1x instead of 8.4x (based on an EV of $1 billion at the time of writing). While the BTC's future remains far from certain, Renewable Energy Group's share price will likely move substantially higher if the latest House proposal becomes law.



REGI EV to EBITDA (Forward) data by YCharts

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