

# The Most Interesting Investment In The World: Ethanex Energy

Apr. 1, 2014 8:04 PM ET  
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## Summary

- If you really think you know something then you should do it in a big way.
- Where are the truly undervalued securities? It is in the overlooked, deep dark reaches of the markets. The boomed out, the busted, the complex, and the convoluted.
- Ethanex Energy (EHTEQ) was such an opportunity. Here is the story of how this idea made investors over 2,000% thus far.

I love stock certificates. Long past the era when many investors have ever seen them, I routinely transact in physical certificates. In part, this is due to mutual conversions or odd lot opportunities that can be simplified by physical certificates but in part it is simply because I like them. The most interesting stock certificate that I've ever seen was Ethanex Energy, Inc. ([OTCPK:EHTEQ](#)). It has all of the typical design flourishes as well as the corporate seal that looks like something out of the nineteenth century.

I first learned about this stock from my friend Thomas Braziel. He gobbled up as much of this stock as he could, starting at only a few pennies per share until he owned over twenty percent of the company. The \$0.04 per share has gone to \$0.77 so far. Now that the bankruptcy plan was confirmed on Thursday March 20th, payment will be made within the next few months of somewhere between \$0.80 and \$0.87 per share. There is another 3-13% to go from here. However, it is always that first one or two thousand percent that really makes an investment.



Thomas Braziel saying something amusing.

(click to enlarge)



Here is the short version of Ethanex's business history (there is no long version). Ethanex was founded in 2006, agreed to buy an ethanol plant in 2007, failed to secure financing and was forced to file for bankruptcy in 2008. The end. At least, the end of the beginning.



Ethanex's attorney was one Louis W. Zehil, a partner at the large prestigious firm McGuireWoods.



McGuireWoods partner Louis W. Zehil

Mr. Zehil graduated from Columbia University, served as an associate at White & Case, senior associate at Jones Day, and made partner at McGuireWoods. His biography stated that he was a:

member of the Firm's Corporate Services Group focusing primarily in the areas of mergers and acquisitions and equity capital markets transactions. Practice covers all phases of corporate activity, including the representation of issuers and underwriters, venture capital and private equity, PIPEs and complex corporate finance transactions, mergers and acquisitions, and the negotiation and documentation of all forms of commercial transactions. Primary counsel to eleven public companies.

While working for Ethanex as their outside attorney and corporate secretary, Zehil reaped over \$17 million of illegal profits by selling shares through various firms that he controlled. He sold unregistered shares that should have been restricted. On seven occasions in 2006 and 2007, he sold shares that others were not able to sell. Once caught, he fessed up, pleading guilty to conspiracy and fraud. Ethanex sued his employer, McGuireWoods for damages.

I asked Thomas Brazier to describe what he saw in Ethanex. Here is how he described the opportunity:

Ethanex Energy was a development stage company that went public through a reverse merger. At the same time of the reverse merger, Ethanex raised capital by selling shares to institutional and high net worth investors through a private placement. Afterwards, additional Ethanex shares were sold to the general public in a traditional public offering. At the time, the alternative energy industry, particularly the ethanol industry was experiencing heady times. Unfortunately for Ethanex, not long after they went public, the ethanol industry began a steep and rapid decline. The cost of their input ([CORN](#)) rose above the price they received for their output (ethanol) - which is never a good situation for any business. As a result, investors lost interest in unproven and development stage companies in the sector. Without the ability to raise additional capital, Ethanex was forced to file for bankruptcy protection in 2008 with little to no hope of any recovery for shareholders.

Over the next several years, the bankruptcy appointed trustee went about selling assets and paying off creditors. Things looked pretty hopeless for the equity holders, except for one curious part to the story. Louis Zehil, who was Ethanex's corporate secretary and outside legal counsel, was being indicted for defrauding six companies, including Ethanex, which he and his law firm helped take public through similar reverse mergers. Following his indictment, Mr. Zehil forfeited approximately \$17 million in cash and another \$3 million in other assets to the government. Of these amounts, Ethanex was entitled to approximately \$2.5 million for legal fees charged by Mr. Zehil and his firm and another \$8.5 million related to SEC rules, which prevent corporate insiders from selling stock within a six month period of their original purchase. These payments, in conjunction with the other assets of Ethanex's bankruptcy estate, led to a net recovery of about \$2 million in cash for shareholders.

In addition to these government payments, the bankruptcy trustee brought a civil suit against the large law firm where Mr. Zehil worked. In June of 2013, the trustee settled the lawsuit for \$6.7 million (before attorney's fees).

As of today, the company is simply a pile of cash waiting to be distributed to equity holders (all creditors have been paid with interest)...

What a perfect hiding place for a bargain. When did you first hear of Ethanex?

I actually found Ethanex while trolling around on a Graham net-net [screen](#) in December 2011. Once I pulled up the SEC documents, I realized the data from the screen was buggy (from the 2007 timeframe) and noticed they filed for bankruptcy protection in 2008. I suppose most investors would have moved on, but given that I had looked at a few bankruptcies in the past, I thought it would be interesting to pull up the bankruptcy docket and see what's going on (pacer.gov for bankruptcy documents). I should say that at the time I was somewhat new (or maybe I should say born again) to the idea of actively looking for investments. I had spent almost ten years generally believing in efficient markets and at the time I was a grad student studying quantitative finance. It just so happened that the school I was studying at also happened to be the home of value investing and Benjamin Graham. I still remember the day I was walking through the university bookstore and came across the 6th Edition of [Security Analysis](#). I bought it. I read it cover to cover and it changed my life. It's as simple as that. I still have a notebook of quotes I wrote down as I read. The accounting and fixed income sections are outdated, but the philosophy is still amazing. This is really the only book one needs to read. Once you have the philosophy and mindset of what you are trying to do, then it's just about learning the mechanics and learning about different businesses and industries. Finding Ethanex was a bit of luck meeting opportunity. I had been learning about Graham, value investing, and distressed investing. I just happen to find and figure out the Ethanex story.

A net net screen is a great starting line for investment research. But how many ideas do you have to go through before finding a gem?

I believe great investments are found, not made. Therefore I look at a lot - emphasis on *a lot* - of ideas before finding something I think is interesting, especially as great of a set up as Ethanex. Also since I am a young guy and don't have twenty years of business experience, I mainly focus on workouts but am always looking to widen my circle of competence in industries and business models. Of course one has to understand if what we are looking at is of note. You have to research research research! I am a real believer in the Buffett punch card test (the rest of the time you should just be happy to make 10-20%). I also believe you have to follow a lot of potential dead ends. This is crucial in my book. **Think about it - where are the truly undervalued securities? It is in the overlooked, deep dark reaches of the markets. The boomed out, the busted, the complex, and the convoluted.** If you have even the smallest reason to keep looking, then keep looking! If you are in a rabbit hole and are not sure if anything is there, then just think you yourself that most people have probably given up by now so if I find something it could really be mispriced. As I said, it leads to a lot of dead ends, but if you could just find five or ten of them throughout your life you'll do great.

Specifically in the case of Ethanex, why did the market misprice it?

Frankly no one had taken the time to do the work. If I would have described the situation to you almost anyone would have thought the idea was amazing. At the initial purchase, the market capitalization of the company was about \$260,000. On the 20th of March, 2014, the bankruptcy plan was just firmed with the estate looking to distribute about \$6 million to equity holders. Now having said that, you had to know enough about investing and bankruptcy law as well as be willing to do the work to come to that conclusion. I remember calling the bankruptcy trustee because I thought I must have made a mistake in my numbers or work and I had him verify every single line item from estate balance sheet. It took a lot of work to figure out and of course the workout has taken some time, but I think it has paid off.

You can include me in "almost anyone"; I thought it was amazing when you told me about it over a year ago. So, it was an amazing opportunity but once you were committed to the idea, how did you think about sizing it?

I was a poor grad student. I put every single dollar I had into it. I sold every other investment I had. Understand though that there were two parts to the story. The first part was the stipulated government payments which were going to lead to the equity having a workout value of about \$1.4-2 million. Meanwhile, I was buying at a \$250-300,000 market value. I bought almost 20% of the company for that valuation, and would have bought more but I didn't have any more money. The other part of the investment was the enormous lawsuit the estate was pursuing. This in my mind was all gravy. In the end the Ethanex bankruptcy trustee settled the case for \$6.8 million before attorneys' fees. Frankly I am just starting to learn about portfolio management and position sizing which I think are important for any investor, but most of the thought on these topics is complete garbage. I'll put it this way: **If you really think you know something then you should do it in a big way, however if you think you know something every other week, then you**

**should probably diversify heavily.**

So you stumbled on an amazing opportunity and you went all in. What could have gone wrong and if something did, what would it have cost you?

The government could have backed out of the stipulated deal as it related to the payments from the forfeiture action. This was an extremely low probability but I held my breath until the check cleared. The real risk in my mind as the Ethanex bankruptcy estate trustee burning all of the government payments on pursuing the large lawsuit. I don't like risk, and I was always worried he was spending too much money on the litigation. In the end it was fine, but I'm a bird in the hand kind of guy.

What was the process for buying shares like?

The process was difficult. I first thought that I would just buy shares in the open market, but I really could not buy enough shares. I therefore tried reaching out to my broker who thought they could get me shares for four times the market price so that was a "no thank you". I also tried reaching out to Wellington Management which at the time had a 10% position, however they claimed it was sold in a private placement swap. I also remember a fund manager friend of mine telling me that Wellington was pretty sharp, and that if there was anything there that they probably would have figured it out. So I googled and used the bankruptcy court documents to find the large block holders, most of which were former directors. In the end I bought an approximately ten percent block from the former chairman of the board.

How did you go about contacting and negotiating with the former director for his shares?

I just called them all up. The former chairman who sold me his shares thought they were worthless. I told him otherwise and wanted to buy them. He was a very nice guy and we had about a two hour chat. He was happy to wash his hands of the shares. The gentleman was a respectable and upstanding guy and Ethanex was a bankrupt company that was associated with fraud. I still talk to most of the directors. To transact, I write up a one page contract, he signed it and endorsed the physical stock certificate over to me, and I wired the money.

I hope the story goes to show that little guys can perform just as well, if not better, research than big and deep pocketed institutional. It is not about Bloomberg and expert networks. It is about preparation, putting in the work, following a sound process, looking under a lot of rocks, and most of all being patient.

What was the percentage return on this investment and how much did you make relative to the risk?

From my initial investment, I stand to make about 22-23x my money, but remember that was over a 2.5 year period. I would say that about 4-5x was a lock and this was the entire reasoning for the making the investment. The name of the game in my opinion is "free options". Winning the lawsuit led to a terrific outcome but I would have *never* paid for the option, and while I'm happy with the outcome, I'm more proud of the fact that I think the process was sound. I'd like to think Graham or Buffet would have been proud of the process, would have smiled, and since I don't really have an investment mentor that is how I judge myself and that means a lot to me. To quote the great Michael Price "buy the steak, get the sizzle for free!" which is something I like to remember when thinking about investing.

It was a great steak. Where are you hunting for the next meal?

I really try to look everywhere. I do like voluntary liquidations and bankruptcies for some reason. Busted securities and companies have a special place in my heart. I just like finding something no one else has found. Areas I like to look are pretty much the same as most intelligent value investors. The fishing holes would include:

- bankruptcies
- liquidations
- spin-offs
- rights offering
- non-reporting operating companies (call for annual reports or use state corporate law to demand financial statements)
- mergers (and CVRs)
- litigation
- general complex securities or situations (my favorite area, which of course overlaps into another areas).

If it is difficult to understand/buy/or find information on it is probably a good place to be looking.

Thomas, thanks for taking the time to answer my questions. I hope that we can discuss many more such ideas through the years.

Thanks Chris for letting me share the story.

Editor's Note: This article covers a stock trading at less than \$1 per share and/or with less than a \$100 million market cap. Please be aware of the risks associated with these stocks.

**Additional disclosure:** Chris DeMuth Jr is a portfolio manager at Rangeley Capital, a partnership that invests with a margin of safety by buying securities at deep discounts to their intrinsic value and unlocking that value through corporate events. In order to maximize total returns for our partners, we reserve the right to make investment decisions regarding any security without further notification except where such notification is required by law.

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