The demand everyone sees, the timing nobody knows

From Emerging Market Debt

Brazil's ethanol industry may be closer to a turning point than it appears

Brazil's Ethanol Moment

For decades, ethanol has been one of Brazil's greatest energy success stories. Born out of the oil shocks of the 1970s, it evolved from a government initiative into a cornerstone of the country's transportation system. Today, millions of Brazilian drivers choose between gasoline and ethanol every time they fill up, a level of fuel flexibility that remains rare elsewhere in the world. Yet despite its long history and environmental advantages, the ethanol industry is facing one of its most challenging periods in years. The paradox is that the long-term outlook has arguably never looked stronger.

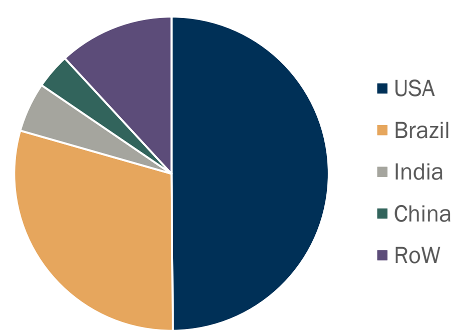
Ethanol in Brazil is a biofuel produced primarily from sugarcane and, increasingly, corn. Sugars and starches are fermented into alcohol and distilled into fuel-grade ethanol, which can either be blended with gasoline or used directly in flex-fuel vehicles. Unlike conventional fossil fuels, ethanol is renewable and generally carries a lower carbon footprint, making it an increasingly important component of the global energy transition.

A tale of two ethanol superpowers: the US and Brazil

Although the United States and Brazil dominate global ethanol production, their markets operate differently. In the US, demand is largely driven by government blending mandates, such as the Renewable Fuel Standard (RFS), that effectively guarantee consumption. Most drivers have little awareness of how much ethanol is in their fuel.

Brazil's system, in addition to the blending mandate, also has a market-driven component. More than 80% of the country's light-vehicle fleet can run on either gasoline or ethanol, allowing consumers to choose whichever fuel offers better value. Ethanol therefore competes directly with gasoline every day at the pump. This dynamic has historically been a major strength of the industry, but recent events have exposed its vulnerability.

Figure 1: Global ethanol production



Source: EIA, 2024

Investment Management

MacKay Shields

The oil rally that ethanol missed

When oil prices rise, ethanol typically becomes more competitive. This year, however, that relationship broke down.

As geopolitical tensions pushed oil prices higher, Brazilian government intervened to limit increases in retail fuel prices. The government swiftly passed a provisory measure in May 2026 so gasoline and diesel producers and importers were compensated for the difference,[1] helping shield consumers from rising costs. Ethanol producers received no timely support. The result was gasoline prices that remained artificially subdued, preventing ethanol prices from fully participating in the energy rally.

The logic was largely political rather than economic. Gasoline prices feed directly into inflation, transportation costs and voter sentiment, making them a sensitive policy issue, particularly during election periods. Ethanol producers, while important to the energy system, have historically been treated more like agricultural commodity businesses than strategic infrastructure providers. As a result, the sector was left to absorb part of the economic shock while gasoline prices remained below international parity.

That said, the story is turning. While ethanol producers largely missed the benefits of the recent oil rally, Brazil's Senate recently approved a biofuels subsidy framework in mid-August 2026 aimed at better aligning incentives for renewable fuel producers with those available to the fossil fuel value chain.[2] The measure reflects growing recognition that prolonged support for gasoline, without corresponding support for biofuels, risks distorting market signals and discouraging investment in a strategically important decarbonisation industry. Although the implementation remains to be seen, the announcement represents one of the first meaningful policy catalysts for the sector in some time and could help narrow the gap between ethanol and gasoline economics going forward.

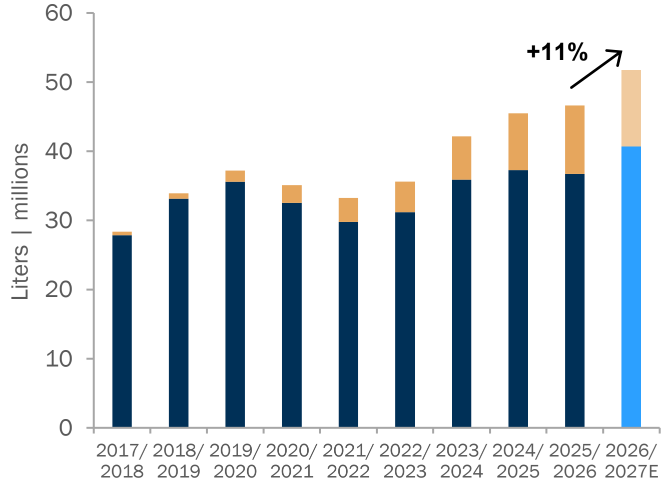
When success becomes the problem

Government intervention explains part of the industry's difficulties. The other challenge is simpler: Brazil has become exceptionally good at producing ethanol.

Years of investment, particularly in corn ethanol, have pushed supply well ahead of demand. Inventories have risen, margins have contracted, and the sector is experiencing a classic commodity cycle in which capacity arrived before the market was ready to absorb it.

For corn ethanol producers, the pressure has been amplified by rising feedstock costs. Corn prices have moved higher just as ethanol producers so far have struggled to participate in the broader energy rally, squeezing crushing spreads from both sides.

Figure 2: Brazil's ethanol production



Source: Unica, August 2026

Yet the seeds of a recovery may already be emerging. The same sugar market that helped create today's ethanol surplus could help solve it. Weak sugar prices over the past year encouraged sugarcane mills to maximise ethanol production, flooding the market with additional supply. As sugar prices begin to recover, producers are likely to redirect more cane back into sugar, naturally slowing ethanol output growth.

With moderating supply growth, domestic consumption continuing to expand, exports gradually increasing, sugar economics improving, and new biofuel support measures now emerging, ethanol prices and crushing spreads may be approaching a cyclical floor. The industry still faces challenges, but for now, some of the key drivers that created the downturn are beginning to move in the opposite direction.

Three paths through the downturn

This environment is creating clear differentiation among agricultural companies.

The most vulnerable are pure growth stories that rely heavily on debt. These producers continue pursuing aggressive expansion plans despite weak market conditions, betting that future demand will absorb today's surplus. That may ultimately prove correct, but for now they face compressed margins, elevated leverage and delayed free cash flow generation.

At the other end of the spectrum are diversified agricultural businesses. With exposure spanning crops, fertilizers, farmland and sugar processing, these companies can offset ethanol weakness with strength elsewhere. Some can even shift production between sugar and ethanol depending on market conditions, providing valuable flexibility when prices move against them. One such

1. Source: https://news.bloomberglaw.com/international-trade/brazil-govt-publishes-decree-with-gasoline-subsidy
2. Source: https://valorinternational.globo.com/politics/news/2026/08/13/chamber-and-senate-approve-fuel-tax-bill.ghtml

company has benefited significantly from a well-timed acquisition in the fertilizer sector, with its fertilizer earnings more than compensating for weakness in sugar and ethanol markets.

Between these extremes sit large grain merchants that have recently entered the ethanol space. Historically these corporates typically enjoy scale advantages, strong logistics networks and substantial market positions in agricultural exports. For them, adding ethanol to the profile offers attractive long-term exposure to renewable fuels, but it also introduces new risks. Investors who once focused on the stability of their grain-trading franchises must now assess exposure to an industry wrestling with oversupply and rising leverage, while their credit ratings have also come under pressure.

The next demand wave

Despite current challenges, the long-term demand story remains compelling. Countries across Asia are increasing blending mandates, Europe continues to evaluate higher ethanol usage, and new maritime decarbonisation regulations could create an entirely new source of demand. South Korea already demonstrates ethanol's potential beyond transportation, importing substantial volumes from Brazil for petrochemical applications

Brazil also retains an enduring competitive advantage. Thanks to favourable growing conditions, established infrastructure and decades of operational experience, it remains one of the world's lowest-cost ethanol producers. While the US benefits from stronger policy support, Brazil arguably possesses the more attractive long-term export opportunity.

The real investment question

This leaves Brazil's ethanol industry in an unusual position. The long-term opportunity remains intact, but the near-term economics are challenging. For investors, the debate is no longer whether ethanol demand will grow. It is which corporates have the balance sheet strength, operational flexibility and financial discipline to bridge the gap between today's oversupply and tomorrow's opportunity.

Some of the forces behind the downturn are already beginning to reverse. Sugar prices are improving, biofuel support is strengthening, and global demand continues to build through blending mandates, exports and decarbonisation initiatives. Demand is not the hard part. The timing is. As the cycle begins to turn, the biggest winners may simply be the corporates that could afford to wait.

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