Goldman Sachs

# Enron Corp. (ENE)
## Neg. Perceptions Hit Bottom and Catalysts Appear at Hand; Strongly Reit. RL

**Analyst Comment**

7:30 AM - October 3, 2001

Recommended List

Large-Cap Growth

Price: US$30.61

S&P 500: 1051

United States

**Investors have virtually given up on ENE (down 63% ytd), & its prospects as a long list of extremely neg stories have swirled around about the co and its financial cond; the co's limited transparency to its sources of earnings, its cash flow and financials in gen. has worked against percep as mgmt has declined to be more specific in refuting even outrageous claims that have assumed a life of their own. We see major catalysts in Q3 reporting and disclosure and more in coming months as credibility is partially restored. We are strongly reiterating our RL rating, and our conviction in the high and sustained growth prosp at ENE, even as we are cutting our 02 est. to $2.15 and growth expect. and our price tgt to $48**

| Stock data | |
|---|---|
| 52-week range | $86.44-25.15 |
| Yield | 1.6% |

| Price performance | 1M | 3M | 12M |
|---|---|---|---|
| Absolute | -13% | -37% | -65% |
| Rel to S&P 500 | -5% | -22% | -38% |

| Capitalization | |
|---|---|
| Market cap | $23.0bn |
| Latest net debt/(cash) | - |
| Free float | - |
| Shares outstanding | 750mn |

| Forecasts/valuation | 2001E | 2002E |
|---|---|---|
| EPS | $1.85 | $2.15 |
| P/E | 16.6 | 14.2 |
| Next quarter EPS | 0.43 | - |

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Important disclosures appear at the end of this note.

## Full details

PERCEPTIONS TOWARD ENRON HAVE TUMBLED FAR BELOW REALITY
Perceptions toward Enron have fallen as dramatically over the past 18 months as we have seen for any major company. However, the major disconnect is that unlike many technology and other (former) high growth companies, Enron continues in our view to be the far-and-away best-in-class company in its major business segments, and to have company-making growth prospects, with a high probability of success, in huge new markets. Only 18 months ago Enron was perceived as a company that could do no wrong. It's wholesale marketing operation (currently 77% of earnings) was viewed as having virtually limitless potential and its retail marketing business was just beginning to emerge as a business that could even surpass wholesale. Management presented its telecommunication strategy to Wall Street in January 2000 to great fanfare. It was this raising of expectations to (in hindsight) unreasonable levels and management's failure to reset expectations for telecommunications when this business clearly was falling far short of the objectives set by management that set the stage for investors to lose trust in management and to discount other statements because disclosure and transparency of information was so limited.

PERCEPTIONS HAVE HIT BOTTOM AND ARE LIKELY TO TURN WITH COMING DISCLOSURES We believe perceptions have gone to such a negative extreme that a major uptick is likely in the near and intermediate term given actions we expect to be taken by management and new disclosures we expect with the Q3 report and at year end. We are decreasing our previous price target from $63 to $48, still representing 57% appreciation, based on an 18 multiple of forward earnings; we see this target as one that could easily be exceeded.

We view the current period as an extremely rare opportunity to purchase shares of a company that remains extremely well positioned to grow at a substantial rate and earn strong returns in the still very young and evolving energy convergence space. We do not intend to totally dismiss the concerns of investors and even certain of the negative stories that are circulating about Enron. Some appear to have validity. However most appear to us to represent major exaggeration or misinformation to an extreme; even these are difficult to effectively debunk given Enron's limited financial disclosure.

WE SPOKE RECENTLY WITH MOST OF TOP MANAGEMENT; OUR CONFIDENCE LEVEL IS HIGH We spoke recently with top management including the CEO, CFO, Chief Accounting Officer and the head of Wholesale Services. We challenged top management on the wide range of accusations and concerns that have been repeatedly bandied around by investors and have weighed heavily on the shares. We are convinced that the great bulk of the negative stories being told about Enron are false or without substantial merit. Most others appear exaggerated in their claims. We strongly believe that ENE shares have fallen to discount these worst fears of investors and that as they are debunked in coming months, as we fully expect, that the shares will rise substantially. We will review the major concerns that investors have expressed and present our response/conclusions:

Market Speculation: Enron uses fair value accounting and has 'created' the bulk of its earnings in recent years by writing up assets to market (and above market in today's world) and now faces huge charges as it attempts to sell these assets.
Response: Enron does use fair value accounting, but only in its merchant investment portfolio. This portfolio totaled as much as $2 billion at its peak and is currently valued at approximately $1 billion. Earnings and losses from this portfolio have appeared in the asset and investment category of Wholesale Services, the (by far) smallest piece of Wholesale's earnings in recent years. Any net gains in our view have been a modest portion of earnings over the years and a negative in 2001. This criticism of Enron's past earnings, which some have used to discount past and current levels of earnings as proper numbers to use to value the company, appears to be totally off base. We believe that some small portion of past earnings can be categorized by investors as non-recurring, but that the great bulk of past earnings are real and recurring and the proper starting point in forecasting future earnings.

Market Speculation: Enron has indicated that many billions of dollars of assets that earn low returns are for sale and investors are concerned about major write-offs that some believe could run in the billions of dollars.
Response: Management does not deny that certain assets when sold could incur losses. However, others are likely to be sold at gains. No assets on the balance sheet are classified by accountants as impaired, which would require that write-offs be taken. Rumors of an $850 million charge at the company's Dabhol, India power project appear far off base and we expect Enron to suffer no loss given its strong contract position. Although certain Brazilian assets could be sold at losses, Enron does not have the problem of having financed the Brazilian assets with U.S. debt; all were financed with local currency. We doubt that major charges are likely on any assets to be sold and expect management will better define this issue on October 18th with its earnings release. Concerns of multi-billion dollar charges in telecommunications and elsewhere also appear grossly inaccurate. The sale of various assets including the long awaited sale of Portland General will likely create substantial cash proceeds (close to $1.5 billion of net cash proceeds from the PGN sale alone) which will be accretive to earnings almost regardless of how the proceeds are used (we expect debt paydown and share repurchases). Enron is committed to selling some billion of dollars of assets over the next two years.

Market Speculation: Capital requirements are substantial in the company's marketing operations and both customers and competitors are concerned about credit exposure to Enron.
Response: Moody's upgraded Enron's credit earlier this year to BAA1 and rating agency discussions have been routine according to management, given Enron's best ever funds flow ratios. Management indicated that speculation of certain counterparties not extending credit are 'absolutely false.'

Market Speculation: Cash flow from operations has lagged earnings and the company has been a consumer of cash.
Response: Management indicates that it will be cash positive in the second half of 2001 and in

future years. This is perhaps the most difficult or inpossible claim to confirm. Management claims that margin activity distorted cash flow in 1H01; in 2000 there was $1.8 billion of customer inflows to cover margin requirements and in 1H01 $2 billion of deposits were returned. Enron has made many billion of dollars of investment in past years as it sought to build its various businesses. Financial discipline did not appear in the past to be a top priority as the company spent whatever it took to rapidly build its industry leading capabilities.
It now appears that financial discipline is dramatically improved at Enron.

Market Speculation: A. California generated huge profits for Enron.
B. California represents substantial potential liabilities.
Response: This is another difficult topic to prove or disprove.
Detractors can (and have) made many unsubstantiated claims. The recent agreement for SoCalEdison to avoid bankruptcy appears to confirm the validity of contracts and likelihood of Enron being paid for past power sales. Enron earlier identified nearly $600 million of receivables and has indicated, similar to other convergence companies, that it has recognized limited profits in California and has created substantial reserves.

Market Speculation: Disclosure is sketchy. The company must be hiding something.
Response: Enron had substantially more complete disclosure a decade ago when it was forming its natural gas business and found that competition intensified and margins were held down as competitors took advantage of the information. Management has steadily reduced the disclosure of information even as the company's businesses and its products have become dramatically more complex. Investors have begun to call Enron's earnings a 'black box' as they began to doubt their ability to analyze and predict future earnings. When management began to lose credibility with investors this turned into a total loss in confidence in reported and potential future results, a very high price to be paid. Enron management is now committed to improving disclosure, even at the expense of competitive issues. (The number of true competitors has already declined dramatically). We expect some additional disclosure with the Q3 report, but substantially more beginning at year-end as management now recognizes the cost in ENE share price of the limited disclosure and loss of confidence.

Market Speculation: Recent 10K and 10Q disclosure of transactions may require substantial new share issuance, given the current weak share price, that will appear in fully diluted shares.
Response: These shares represent collateral to backstop off-balance transactions. Net exposure and the transactions themselves are not well defined and disclosed. Management has indicated to us that the company is working to restructure these transactions and that investors will see results on this score 'fairly soon.'

Market Speculation: Businesses are not doing as well as the numbers make them appear to be doing.
Response: Our trade checks convince us that Enron remains an extremely well respected and capable competitor with broad and deep capabilities.
Competitors do like to throw criticism at Enron because of the company's aggressiveness and perceived arrogance, perhaps creating some of the uncertainty in investors. Customers find Enron's service and products to be top flight and, in many cases, unique. Following the tragic events of September 11th, business at both Wholesale and Retail has, according to management, returned to the prior levels.

Market Speculation: Earnings can not continue their past rate of growth.
Response: Although we are lowering our long term growth rate to 23% from 25% (we are lowering our expectations for all convergence shares because of the more uncertain economic environment), and reducing our 2002 earnings estimate by $0.10 to $2.15, we believe that the market opportunities in Wholesale and Retail are undiminished. Telecommunications appears likely to not contribute positively over the next year; however, neither do we expect it to be an incremental drag on earnings. We expect the telecommunications loss to shrink in the year ahead as costs are reduced.
A renewed financial discipline is likely to be the major positive surprise as asset sales are completed and the proceeds applied to debt reduction and/or share repurchases. We do not believe that Enron will complete substantial new investments.

Market Speculation: Many top managers have left, leaving a vacuum at the senior levels of Enron.

- *Insiders have been heavy sellers on ENE shares.*
Response: For the first time in Enron's 16 year history, a number of executives have left in the past year. However, in each case an extremely capable successor has stepped in to fill the hole. The departure of CEO Jeff Skilling in our view is related to credibility issues he had with investors and the very weak share price. His departure is a significant loss as it was his vision that created the wholesale natural gas and electricity marketplace as it exists today. However, Enron as a company could do even better over the next several years with its new found financial discipline since his departure. The CEO and CFO have recently become net buyers of shares.

Goldman, Sachs & Co. or an affiliate has rendered significant corporate finance services to the *following companies or one of its affiliates* within the past 12 months: Enron Corp. *An affiliate of Goldman, Sachs & Co.* has acted as dealer in the commercial paper of the following companies and/or affiliates thereof within the past 12 months: Enron Corp. Goldman, Sachs & Co. or an affiliate has managed or comanaged a public offering of the following companies' securities in the past several years: Enron Corp. Goldman Sachs & Co. or an affiliate may deal as principal in any of the securities mentioned.