

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		Price performance		
52-week range	\$86.44-25.15	1M	3M	12M
Yield	1.6%	Absolute	-13%	-37%
		Rel to S&P 500	-5%	-22%
			-38%	
Capitalization		Forecasts/valuation		
Market cap	\$23.0bn	2001E	2002E	
Latest net debt/(cash)	-	EPS	\$1.85	\$2.15
Free float	-	P/E	16.6	14.2
Shares outstanding	750mn	Next quarter EPS	0.43	-

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

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Important disclosures
appear at the end of
this note.

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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

