Goldman Sachs

Enron Corp. (ENE)
Gas & Power Convergence

Conference call transcript

July 12, 2001
Recommended List
Large-Cap Growth
Price: US$49.06
Target price: $68
S&P 500: 1191
United States

We view Enron as one of the best companies in the economy. There are still several misconceptions about Enron that mask the company's strong fundamentals. We therefore hosted an investor conference call on June 27 to clarify Enron's growth prospects and answer investors' questions.

We expect Enron shares to rebound sharply in the coming months

We believe that Enron shares have found their lows and will recover significantly as investor confidence in the company returns and as misconceptions about Enron dissipate. We strongly reiterate our Buy rating on the stock with a $68 price target over the next 12 months. Please see our July 9 company report for more details.

Enron is a world-class company, in our view

We view Enron as one of the best companies in the economy, let alone among our group of diversified natural gas companies. We are confident in the company's ability to grow earnings 25% annually for the next five to ten years, despite its already large base. We believe that Enron investors have the unique opportunity to invest in a high-growth company with improving fundamentals.

Enron Energy Services is on the verge of kicking into high gear

No other company has been able to, or even attempted to, develop the type of retail franchise that Enron has with Enron Energy Services (EES). The business is just now turning profitable, but we expect the earnings curve to be very steep. Based on our discounted cash flow (DCF) valuation, we value EES at $15 per share.

Enron's services-focused marketing capabilities should continue to mushroom

There is no question that Enron has developed a highly profitable trading operation, but the majority of its focus is on designing structured products and risk management services for customers. In our opinion, Enron has developed the best marketing operation in the energy and power sector, and those capabilities are increasingly being applied to other bundled commodities, creating yet another profitable growth platform.

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Goldman Sachs
Global Equity Research

Important disclosures appear at the back of this report.

Stock data	
52-week range	$90.00-$44.05
Yield	1.0%

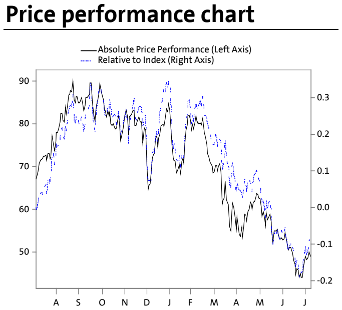
Price performance	1M	3M	12M
Absolute	-6%	-8%	-27%
Rel to S&P 500	0%	-14%	-9%

Capitalization	
Market cap	$42,761mn
Latest net debt/(cash)	9,904mn
Free float	—
Derivatives	—
Shares outstanding	871.6mn

Forecasts/valuation	2001E	2002E
EPS	$1.85	$2.25
P/E	26.5X	21.8X
ROE	13.7%	14.2%

Long-term EPS growth 25%

Price performance chart



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David Fleischer hosted the conference call with investors on June 27, 2001. The prices in this report are based on the market close of July 9, 2001.

Overview: Investors are engaged, but sentiment is still uncertain

Exhibit 1: Forecasts and valuation

Year to December	EBITDA ($mn)	Recurring EBIT ($mn)	EPS ($)	P/E-to-growth (X)	P/E (X)
1999	2,826	1,876	1.18	—	41.6
2000	3,556	2,701	1.47	1.1	33.4
2001E	4,220	3,290	1.85	1.1	26.5
2002E	4,895	3,908	2.25	0.9	21.8

Source: Company data, Goldman Sachs Research estimates.

There are still several misconceptions about Enron that mask the company's strong fundamentals. We therefore hosted an investor conference call on June 27 to clarify Enron's growth prospects and answer investors' questions.

- We expect Enron shares to rebound sharply in the coming months
- Enron is a world-class company, in our view
- Enron Energy Services is on the verge of kicking into high gear
- Enron's services-focused marketing capabilities should continue to mushroom

Valuation

Enron stock is trading at 21.8X our $2.25 2002 EPS estimate. The universe of more than $20-billion market capitalization companies in the S&P 500 with greater than 20% forecast long-term growth trades at an average 1.4X PEG ratio. In this list of 25 companies, very few trade at less than 1X PEG, while Enron trades at 0.9X. We have established a 12-month price target of $68, representing 40% appreciation, based on a 1.2X PEG ratio. Our 25% long-term earnings growth rate is significantly higher than the 16% (First Call) and 17% (Baseline) growth estimates. We believe that this difference represents the opportunity in the shares as our forecasts become more generally embraced by investors. Our sum-of-parts analysis further reinforces our $68 valuation. Based on our DCF analysis, we value Enron Energy Services at $15 per share. We have placed a conservative 28.5X and 13X 2002 P/E multiple on the high growth wholesale business and the pipeline/PG&E businesses, respectively, to arrive at a combined (including EES and assuming zero value from communications) $68 price target. We strongly reiterate our Buy rating on the stock with a $68 price target over the next 12 months.

Key risks

- **Execution.** Execution of the company's aggressive and far reaching strategies remains the major risk. However, we remain confident in Enron's best-in-class capabilities and see this risk as limited.

- **Regulatory risk.** Regulatory issues could delay the deregulating markets that are critical to Enron's growth.

For a further discussion of issues and risks, see the transcript of the conference call.

Financials

We recently raised our 2001 EPS estimate $0.05 to $1.85 and established a well-above consensus 2002 estimate of $2.25. We are confident in the company's ability to grow earnings 25% annually for the next five to ten years, despite its already large base. We are highly confident in Enron's ability to achieve its near-term financial targets, and are equally optimistic about the company's future prospects. Enron management has invested significant resources in new businesses and opportunities in the past few years, such as marketing, EES, and broadband initiatives, and the positive financial impact of these investments is already evident. Marketing has already grown superbly and surpassed all expectations, EES is about to take-off and has progressed nicely, and even though communications has taken longer to develop than management had hoped, its prospects remain strong. We expect to see continued, tangible financial results and high growth from Enron in the near and longer term.

Company profile

Enron has a highly profitable trading operation, but the majority of its focus is on designing structured products and risk management services for customers. In our view, Enron has developed the best marketing operation in the energy and power sector, and those capabilities are increasingly being applied to other bundled commodities, creating yet another profitable growth platform. Enron's diverse business segments represent substantial value:

- **Gas Pipelines**—ownership in four major gas pipeline systems in the United States
- **Portland General**—electric utility in Oregon with over 700,000 customers
- **Wholesale Services**—the leading global energy marketing and trading operation and international project development operation
- **Energy Services (EES)**—"Retail" energy services operation focusing on the $300 billion (in the United States alone) commercial and light industrial market
- **Broadband Services**—bandwidth trading and content delivery businesses

Transcript of investor conference call hosted by David Fleischer

There are still several misconceptions about Enron that mask the company's strong fundamentals, and our June 27 conference call with investors brought out very interesting dialogue and opinions about Enron's prospects. We view Enron as one of the best companies in the economy, let alone among our group of diversified natural gas companies. We are confident in the company's ability to grow earnings 25% annually for the next five to ten years, despite its already large base.

The transcript of David Fleischer's conference call with investors and the question and answer session follow. We have formatted the transcript to highlight the most important points of the call.

We are confident in Enron's prospects and expect 40% share price appreciation

I can hardly contain myself, given the number of conclusions I want to relate to you today, and all the opinions that I have. **First, I'll say what no analyst should ever say, that Enron shares are, in my judgment, very close to or at their low point.** I expect to see a significant recovery in the shares from this level. So, even though one should never say that, and I've been around too long to say such a thing, I'm saying it anyway.

I'm not going to tell you today that the shares have to or will soon shoot up in price; that would be going too far. Stocks usually don't do that after falling 50% in five months. Rather, the upward path of the share price is likely, in my view, to be much more gradual, but still impressive as value and growth-at-a-reasonable-price (GARP)-type investors come back into the shares.

There are many misconceptions out there about Enron, and they will not disappear quickly; however, as they do, the stock should recover. The strong views of top management have come back to bite them, and now many competitors and short sellers are reveling in the opportunity to punish Enron. I hear most of the stories being bandied about, and I can tell you without equivocation that 99 and 44/100ths of them are false, or substantially exaggerated.

The one major truth is that telecommunications—the telecom business—is not progressing nearly to the degree that management had told us in January 2000 that it would. However, this is something that I think everybody knows. I just wish that management would now be forthcoming about where they are, in both bandwidth intermediation and the content business; this would give them a great deal more credibility in what they're saying about the other much more important parts of this company.

It now appears to me that Enron shares incorporate significant negative value for telecom, which is a bit ironic given that there is still significant real value here, and that it has excellent prospects even if they are delayed into the indefinite future.

Enron is likely one of the best-managed companies in the economy, let alone our sector

Let me now backtrack to where I probably should have started in the first place. **In my view, Enron is the clear leader in the energy industry.** I see Enron as dominant in a huge industry where so much is changing and where the profit opportunities are so substantial.

I believe that Enron can and will grow earnings at a 25% annual rate, and not just for a one- or three-year period, but for the next five to ten years. That's an extraordinary statement, and I don't make that lightly. There just aren't many companies where the analyst following them has visibility to growth continuing for any sustained period.

If you could go back in time and pick the companies that would perform in a way that would grow earnings at a substantial 20%-plus—in this case I'm saying 25% growth rate over the long term—that would be how you would really make money. **For example, buying the Pfizers, Mercks, Home Depots, and General Electrics 10 to 15 years ago, is what I think you are doing right here, right now with Enron.**

Let me emphasize that this assumption of a 25% growth rate assumes very little from telecommunications. The growth in profit opportunities are that substantial in the company's wholesale and retail businesses. When we're talking about wholesale, we're talking about Enron wholesale services, and retail means light industrial and commercial—not residential—customers.

I believe that Enron wholesale services, which currently accounts for 77% of earnings, and has grown at a 41% annual rate over the last five years, will be at least a 20% grower over the next five to seven years. I see the opportunity being 20% just from the energy opportunities that exist in the United States right now as the markets open up over the next five to ten years. Then, the opportunities from Europe and other commodities and products should be nicely additive. We believe there's plenty of room for positive surprise in these latter areas.

The segment where I'm probably most different in my expectations, and I mean positive here, is retail—Enron Energy Services (EES). The business is just now turning profitable on a fully allocated basis, but we believe the slope in earnings is going to be very, very steep indeed. Dave Delaney is the new head of this operation. We spent some time with him recently and believe he's absolutely terrific. I think you will too when you hear him and see him and hear what they're doing, and see what the numbers are coming out of this business.

Simply put though, we don't believe any other company in America has built the capabilities that Enron has, and the market opportunity here appears just tremendous. We're talking about potentially multi-hundreds of billions of dollars of revenue opportunity in this business per year. I'll come back to more fully discuss this business opportunity, and I promise not to overdo it, in a few minutes. I'll do the same for wholesale, and I won't overdo that either.

Conservative valuation analysis suggests 40% price appreciation—$68 price target

I want to talk valuation first and hit the misconceptions that are out there right now about Enron:

- First—today, I'm raising my 2001 EPS estimate 5¢ to $1.85. So here's a company that has come down 50% in price, and I'm raising estimates. **We believe that fundamentals are getting better and absolutely not getting worse.**

- Second—I'm initiating a $2.25 estimate for 2002, and that's well above the consensus number; I see the 2002 estimate as one that could actually be exceeded. This is absolutely not a stretch target. We believe the second-quarter EPS will beat the 42¢ consensus number. I'm using 43¢ now, and it'll be a very nice comparison with 34¢ of last year.

  This is after what is clearly very substantial reserving in California. **Enron shares are currently trading at 21.8X our year-ahead earnings, which is 90% of the company's earnings growth rate.** The average large-cap company in the S&P 500 with greater than 20% EPS growth is trading at 140% of its growth rate. That's still after all the declines in the marketplace, and the compression of multiples.

  Now, if I'm right about Enron's growth rate, and I believe that I am, then there's a lot of upside here—and that doesn't include the impact of other growth companies coming back to higher multiples. So there are many ways you can make money here, with what I believe is very limited risk at these levels.

- Third—**we're setting a $68 one-year price target, which is based on 120% P/E-to-growth (PEG) rate over next year's earnings.** A year from now, this price target would actually represent a share price trading only at the growth rate of the then-year-ahead results. So once again, that $68 seems like a big number, up about 40% from where it is now—but in many ways, I think it's a very attainable number that will and can be very easily exceeded. Over a multi-year period, I see Enron as not a $68 stock but a $200 stock.

Non-core setbacks have pressured Enron shares

My view is that an investment in Enron shares right now represents one of the best risk/reward opportunities in the marketplace. Energy shares certainly have declined sharply of late, and the premium multiple has been removed from Enron. However, we believe that Enron remains the premium company. That's a very key point. When—as we expect—energy shares rebound, when one by one the misconceptions about Enron fade away, and when Enron reports strong second-quarter earnings and future earnings, the shares should simply rebound—and I believe substantially.

The psychology toward the company is probably as bad as it can be, given that fundamentals are so good. That should be my next point. I visited with virtually all of the top management recently and am convinced that the company's strategy is intact, execution remains excellent, and morale remains high at the company. I earlier mentioned that telecommunications is the one partial exception.

Let me now hit these major issues I keep talking around, and that you hear so much about. Let me just tell you why I think there is so much ado about so little, and why they likely have little real investment significance over the intermediate and longer term. I'll hit these issues really quickly, and in the interest of time, I won't spend a lot of time on anything else here. We'll try to wrap-up to take your questions when I think I've made my points. Let me run through several issues first:

- **On California.** Enron owns no significant assets in California, but they are a major marketer in the state. There is no question that they've earned some money there, but California is not where they've made a substantial portion of earnings. For those who think that, "gosh, they've been just capturing all these billions of dollars in California," that simply isn't the case. Enron has heavily reserved against revenues, and we see very limited risk at Enron from California. We view Enron as actually part of the solution, not part of the problem in California.

- **On Dabhol, India.** There have just been so many stories thrown out there in the press, particularly the international press. Enron's total investment in that plant is $850 million. Their commitment, if they were to complete the plant would have added another $150 million to that, so there's a very large investment there. The contract that's been written—I think a lot of you know this from past tests of the contract in London and in arbitration—has extraordinary protections for Enron. **Enron is exceedingly unlikely to experience any losses here. In fact, we think they're going to come out ahead, and maybe nicely ahead in this project.** This contract calls for Enron to receive the future value of all the profits that they're supposed to if the contract is repudiated. That's exactly what the government has done here. Enron also has the right to grab any Indian assets up to the amount of guarantee, which is at the federal government level, about $750 million. So Enron can grab any 747 that lands out here at JFK if it gets to that. However, it won't; they will negotiate a settlement. They'll likely end up selling this asset to the Indian government, and that'll be a source of capital that they'll likely reinvest in higher-returning businesses.

- **The Portland General sale has fallen apart right now because of California.** There are interested parties, so a sale is likely. It's not a negative to earnings in the short run, and I don't see this as being a longer-term issue either. They needed the Portland General asset several years ago. The key point here is that they bought it when they needed it to jump-start their electricity and marketing business in the western region. Now they don't need it, so they plan to sell it. Maybe that's the broader point here when you look at this longer list of major international assets that they've talked about selling. Just going back in January, they said they would sell three major international assets this year. They are newly motivated to sell these assets. The weak euro has been part of the problem with a lot of the potential buyers being European companies. Andy Fastow, CFO, is the man responsible for selling these assets now, and he knows he's going to be measured on his results. We expect Enron to extract substantial cash out of these assets over the next two years. They may not race to do it; however, I don't think it's an overhang. I just think it's essentially a pending positive. They plan to take the capital—substantial capital—out of under-earning and non-earning assets, and reinvest it in growth businesses that are growing. Enron absolutely doesn't need to sell any more equity, and actually the company is a regular buyer right now, and will probably continue to be, and maybe even a substantial one.

- **The last issue I'll mention is share sales by top management.** These share sales are the result of long-term sell programs. They have set them up in advance and have very narrow windows to sell shares. Jeff Skilling has indicated to me that he's terminated his share sale program. It's not that management believes that the stock is expensive at this level—very much to the contrary.

There is visible growth in wholesale and retail

Let me backtrack and mention a couple of facts and thoughts I have on wholesale and retail.

Wholesale

I just want to emphasize that many people look at the wholesale business and say, "oh well, they're just a big trading shop, and they deserve a trading multiple like an investment bank." I absolutely disagree with that thought. **I view Enron as a great trading operation; however there's no question that the majority of what they make is in structured products and risk management services.** They are much, much more than a trading operation, and it is critical to recognize that.

Enron is taking a lot of these skill sets that they've developed and are transferring them to other commodities as well. They're making the bulk of their money right now in energy, and over 90% of their current earnings in the sector are from energy. Yet, that's a business opportunity that without question is going to continue to develop.

This is a major growth business, because the markets in the United States are probably just 25% open to competition. **Over the next five to ten years, the market opportunity itself should triple. Therefore,** I absolutely believe that this business is a 20%-plus grower over the long term, and I see Enron as having extraordinary capabilities in this business. I'll leave it at that for now.

Retail

Moving on to retail, my one-liner that tells the entire story is: "they're winning a game that no one else is even playing." They have built, over the last seven years, an extraordinary company. No one else has built these capabilities, and they signed $16 billion worth of contracts last year alone. They are absolutely confident where they are and that they are going to be able sign over $30 billion worth of contracts this year. Enron will make, by our numbers, $250 million of EBIT this year in retail, and we believe this is a 50% grower over the next seven, eight, or ten years.

These numbers start going up very, very rapidly. **Even using lower numbers than I just gave you, this earnings stream has a discounted cash flow (DCF) valuation that is in excess of $15 per share.** You can assume almost whatever value you want; if you give them as little as $10 of value, take $10 off the current price because it's earning virtually nothing. When you look at the modest earnings of Enron Energy Services, and the losses at telecom, they're breaking even essentially between those two this year, maybe even losing a smidgen on a fully allocated basis.

If you take $10 off $45, you're left with $35 for a company that, on a forward-year basis, is making $2.25 per share—this appears to be an awfully undervalued stock. Setting these two (EES and telecom) aside for a moment, and looking at it using sum-of-the-parts, you've got a stock trading at 15X earnings, not the 21.8X I gave you before. That works as long as you like these businesses, and I think they're great. **EES could be Enron's single best business because it is so capable, and they have so little competition.**

Telecom and content are not dead, but have a ways to go

Let me just make a final comment on telecom. **The telecom story is not dead.** It's not terrible. It may not be great at the moment, but they have this bandwidth platform, and we absolutely expect intermediation to happen. However, because of the absence of good counterparties, it's not happening now. It's not moving along very rapidly, but it will likely become a business of some importance at some point in the future.

Similarly, the content business is not dead either. They got rid of Blockbuster, and they are actually signing deals with studios currently. The economics and the business opportunity actually look better to me than I thought only a few months ago. There are interesting things going on here. Their Modulus technology and Enron Intelligent Network give them tremendous capabilities; however, we don't give them any credit for it currently. No one wants to give them credit now. That's fine. **It's a free call option, and it's a free call option that could turn into something pretty nice at some point in the future.**

So let me just stop there, and see if there are any questions. I'd be happy to take them. I know a lot of people like to talk individually, so let me just give you my office phone number. It's 212-902-6018. But let me take some questions now.

Q&A session: Addressing investor concerns

Heavy investments in opportunities . . . and returns appear imminent

Investor 1

If you look at the cash flow statement from last year, skimming the table from the Analyst Day, we'd expect to see a big increase in cash flow from operations, which we did, and it was all in working capital and other. Net income plus depreciation, which is traditionally what you'd want to see make up the bulk of cash flow from operations, had a very modest increase and is not a very big portion of the cash flow from operations. Now maybe it shouldn't be, but what should the cash flow statement for this company look like? Should it really be a bunch of working capital swings that is generating the working cash flow from operations?

David Fleischer

Well, let me make a couple statements there, and probably give you a less than complete answer to your question.

- **First, I think the transparency with Enron is pretty low.** This makes it very difficult for us to really know what's going on at the company. Unfortunately this is the situation, and it's probably a situation that's going to continue.
- **Second, Enron has been indifferent to cash flow as it sought to build businesses, at least until about a year ago.** Jeff Skilling told me five years ago that he would spend whatever it took to build these businesses because this was a once-in-a-lifetime opportunity. They have done that. We've seen the money going out, and a lot of it's been invested in assets that have not as yet had good cash flow and returns. I thought the next thing you were going to ask was, "why is return on equity so low?" That's the other side of it. For a company with these kinds of high returns and a lot of intellectual capital businesses, return on equity for the whole is also low.

That said, the cash flow answer is: we believe the numbers will look very different in two or three years from now. They've been investing a lot of money in businesses that are not yet generating the substantial free cash flow that they will in the future. We're beginning to see wholesale get to what we might call a "take-off and cash generation stage" and leave the investing stage behind.

They are absolutely not there yet with Enron Energy Services, where cash is concerned. I believe they've actually invested more money there than they've acknowledged publicly because they don't want to reveal how important they see that business as being.

EES is investing a great deal in its operations, and they're not close to generating cash. Enron has sold substantial equity in the past to fund growth. All this is going to change and soon.

Investor 1

Let me ask you one more thing while I can. Is there anything that's happening in the last six or seven months that has made you question the idea that Jeff Skilling is really a fantastic CEO? Some of the stuff he's said strikes me as kind of erratic if you look at press releases and comments he's made on conference calls and things.

David Fleischer

Well, I would prefer that a CEO be a little more humble than Jeff has been. Jeff is brilliant and is exceedingly capable, and he's very well regarded and respected within the company. **He's very involved with so many parts of this company, but I think he's sometimes been caught in the heat of battle and has said things that he knows afterwards he shouldn't have said—and in the way he said them.**

I think he's learned, though. He's grown dramatically. When I look back just four years ago, and I probably shouldn't be saying this on a conference call, I'm just astounded at how he's changed. Usually people don't change that much, but he has, and I think he's continuing to grow and change. He knows he's made some mistakes, and let's hope that he can correct them. I for one believe he can.

The situation in California should not have a material impact on Enron

Investor 2

David, I don't want to accuse anyone of glossing over the negatives too much, but I still can't quite get my hands around the legal costs that they might be facing from the FERC hearings and the California actions. Could you try to flush out a worst-case scenario, and how that stands relative to what they've reserved?

David Fleischer

What I would say first of all is that the issue is probably a lot more broad than Enron. I think it relates to any company that owns assets—IPP assets or pipeline assets out in California—and the marketers. Then the question is: what's been going on out there? Like a lot of people, I have spent a lot of time trying to keep track of what's going on in California.

I don't believe that anyone has done anything legally wrong, but I think that there is a concern about certain companies in terms of how much money they made when Californians had to pay higher prices in these very visible commodities. I don't believe that anyone is going to prove that these companies did anything wrong—but unfortunately when politicians are involved it isn't that simple.

I'm not going to tell you that I'm also an insider and that I know all the details here. However, **my strong belief from everything I know, and I probably get into it more than most of you, is that these companies have actually been part of the solution, not part of the problem.** They've helped bring liquidity to the markets. Do they make more money when they bring power in at the peaks in demand? Yes, but these actions actually drive prices down, and we've seen prices come down in California in the last month more than anyone ever thought they would see, and I'm convinced it's not because of some of the things Governor Gray Davis has been saying. I think it's because these companies have been working hard at trying to make more money. That's how the prices come down, when everyone tries to make more money, which is the irony of what California's been doing.

Do I think that everyone gets off scot-free and collects all the receivables? No, but that said, all these companies privately have been indicating that they've been reserving heavily against these receivables and against earnings that they otherwise had been booking out there.

I would tell you that Enron is not making all that much money in California. It's a single-digit percentage of their earnings that they've been booking. Whether it's 5% or some other number, I don't know. I don't know if they even know given all the different moving parts in these transactions.

This is a small piece of their earnings, and the earnings for a lot of these other companies. This is a very broad and big energy marketplace in the United States and worldwide. So, yes, when California becomes such a big issue in talking about a company like Enron, I believe it's overdone. I don't intend to totally sweep it under the table, if that's what it sounded like to you, but I am convinced that when a stock comes down 50%, and their earnings are undiminished, and they're not really coming from this source that, yes, it is overdone.

Broadband is inching its way to profitability; power portfolio remains intact

Investor 3

Dave, I've got two questions, something that if you could take a stab at regarding some of the speculation out there. First, when do you think that they could eke out a profit on broadband?

Also, could you take a stab at one other story that I've been hearing circulating around? Is it true that they were unhedged on a significant part of their power portfolio, took a bet on the long side, and now, because of the decline in the forward price for power, they're going to be taking some big back-charge in that regard?

David Fleischer

Let me address both of those in turn.

- **On broadband,** I think the surprise is going to be that they are going to cut their costs in telecom more than they've said, and they're going to take those losses down more than they had indicated earlier. In my model, you'll see that I've taken a $100-million loss this year and cut it in half for next year, and I think that the losses could actually be less than that. **I believe we've seen the worst in telecom in terms of the numbers there—and they're absolutely working hard to make that the case.**

  Intermediation is the portion of the business that's going to make them the money soonest. The problem has been that there aren't good creditworthy counterparties. That's the reason they haven't done more transactions. However, this marketplace appears to me as one that has to develop and will be substantial. That said, it's currently growing at a slow rate compared with what it can and likely will be, and there is no visibility to strong profitability.

So when do I think this business will be profitable? I don't think it's going to be significantly profitable over the next two years, but I think it will be two to four years from now. Bandwidth intermediation will likely be an important business for them; it just seems to be a question of when.

As far as the content side, they are signing deals there, but the numbers don't work until they get much bigger. I don't think that business will be profitable for them over the next two to three years either.

- **On hedging, let me, absolutely, throw cold water on your hint that they might have been unhedged, and lost money.** I can tell you that, in a somewhat lengthy conversation this Monday (June 25) when I was at Enron, they indicated that they had expected the prices to come down in the California market. So they were absolutely not expecting that prices would rise and may have been on the profitable side of this transaction, even though they generally tried to be hedged.

  I would also tell you that Enron appears to be the most perfectly hedged company. They try to be, and I believe they are the most perfectly hedged company out there. So if you're worried, my belief is that you probably need to worry more about everybody else than Enron. I can also tell you that, given what's gone on over the last month, management is very comfortable with their profit objectives—I absolutely believe they know their position, and they are very comfortable in saying they have no such liabilities, no such losses there.

Enron's quality of earnings are consistently improving

Investor 4

Hi, David. Appreciate your comments. To kind of take the gloves off and get to the core of the matter, I believe—and I'm long some of the generators—basically you're saying that they have an earnings growth rate, and a lot of the bears are saying that as much as 30%-40% of their earnings are related-party transactions. So let's not worry about growth rates, let's meditate a little bit on the earnings. I don't know if you've seen those arguments, but I'm just curious how you think about them—I mean this is not innuendo, this is stuff out of their 10-Q. So are these related-party transactions done with an intent to make earnings, or aren't they?

David Fleischer

Enron—much more in the past than in the present—has booked returns on sale of assets for as long as I've been following this company, which goes back literally 16 or 17 years when this company was formed. There have long been questions about the quality of the earnings. **In every report I put out on Enron, I have a page of adjustments to the reported earnings, so I'm not going to disagree with the statement that there are issues and questions about the quality of earnings because there have been, and there continue to be.** So the first thing I'd say is that it's not a new statement.

What I would say is that when I go back in time, my earnings adjustments were huge. Back 10 and 15 years ago, I showed they were losing money on an adjusted basis when the company was reporting some strong earnings gains.

The next statement I would make to you is that the quality variance has been getting steadily better. I think substantially better. You throw out a 30%-40% of earnings figure from related-party transactions; I don't believe the number is anything close to that. Yet, the lack of transparency in a lot of these numbers makes it difficult to know exactly what the right numbers are. However, when you go make adjustments and look year-by-year at the numbers, the quality of earnings has been getting substantially better.

The other side of this is that, as I look at some of these earnings, maybe 10%-15% of the total earnings range are from related-party transactions. That has been an integral part of their business strategy. One of their businesses has been to develop projects and sell them down; recently they've been selling off their power portfolio. I think it's an absolutely great strategy.

I happen to think that owning power assets in this country is not the best use of funds going forward. There's likely to be a cliff out there in two years or so when all of a sudden everybody wakes up and realizes that there isn’t a shortage of generating capacity. I expect the surprise will be when the United States goes from the current tight markets to having more than enough capacity.

Enron has been developing generation sites and then selling them off, booking profits, and probably capturing four or five years worth of excess or strong returns through this strategy. This has been part of their business strategy. If you don't like that kind of earnings, and I can understand why you might not, and if you don't think they can continue with that, then you should probably make some adjustments there.

All that said, Enron has had a track record of earning money off of these international projects in the past (more in the past) and more recently domestic projects. **I actually think the transition that's taking place right now is exactly the kind of earnings that you're asking for.**

Although this wasn't your question, I look at the future earnings stream that I believe is going to come out of Enron Energy Services as being huge, and one that you probably would view as high-quality earnings, and I don't think anyone's paying for that. I don't know if that is a good enough answer for you, but that's my answer.

Investor 4

I guess I have two quick follow-ups: What are your data points that the earnings quality is getting better? Why don't they just say what these transactions were? I mean—they book a huge gain off that, and that's not a power portfolio.

David Fleischer

My data points are going back over the very long term and making adjustments, as best I have been able. I have one page after the earnings model where I've made adjustments each year. I've tried to do it consistently, and the adjustments have been getting smaller. So maybe, that'd be the first answer.

I will agree with you 100% on the second part of the question. One of the major points I made with Jeff Skilling and with Ken Lay was, "please give us more transparency, give us more data, give us more information." I think we all would like that, and would feel a lot better with that. Unfortunately, it's not nearly as transparent as we'd like.

We arrived at a $68 price target by assuming a 1.2X PEG ratio on 2002 estimates

Investor 5

Just a quick question because I jumped on in the middle. Could you just go over the different components of your $68 price target?

David Fleischer

Well, what I basically said is that I've got an earnings estimate for this year of $1.85, after raising it a nickel today, and I've initiated a $2.25 estimate for 2002. As we look at the broad list of S&P 500 companies that grow at 20% or greater, they're trading right now at 140% of their P/E-to-growth rate on average. I assume a 120% P/E-to-growth rate for Enron to get to a $68 price target, based on one-year forward earnings right now, which will essentially get you to a P/E-to-growth of 1X a year from now.

Enron spared little expense to build a world-class business

Investor 6

When I hear a CEO say "we'll spend whatever it takes," I don't think that's very prudent. Do you think the company's expenses and investments are justified?

David Fleischer

I think Jeff said that to me five years ago or six years ago. A statement is a statement—he wasn't the CEO at that point either, and I'm sure there were people like Rich Kinder (president and chief operating officer) at that time who didn't give unlimited budgets. It was a statement of intent that he saw this as a once-in-a-lifetime opportunity to create some major businesses, and that's exactly what Enron has done here.

I think that one of the major statements made by me and, hopefully, appreciated by you, is that this company has built—not "is building"—the absolute leading franchise here, in both wholesale and retail, and that's pretty extraordinary.

Did they spend too much money? Did they waste money in the process? I think everyone can have their answer to that. Maybe they could have been more disciplined with their capital expenditures, and I think we see that with some of the returns that aren't as high right now. That's part of what's penalizing the stock price right here, right now.

There's a follow-up that I should give, which is that I believe that an incredible financial discipline has returned to this company, or has come to this company just in the last six months. Maybe this stock price decline has not been the worst thing that's ever happened to the company. Maybe they've learned from it, and they've somewhat changed their ways. I don't think that this change has been stated very publicly, but I think it is the situation.

Investor 7

If it is a great investment for us, why wouldn't they be buying back a lot of their shares down here? Or why wouldn't we be able to get our hands on a reasonable net present value, or net asset value?

David Fleischer

I would ask you to pass that question onto them because I ask a lot of those same questions.

Enron does not need to hold physical assets to grow its communications business

Investor 8

I just had a quick question regarding the telecom division. I had heard a story, this is a while back, that Enron was shopping around their network. Could you make any comments on that? What have you heard?

David Fleischer

Well, I can't respond specifically to that except to say that they don't believe they need to own all these assets in order to execute their business strategy. They believe that the value of bandwidth will keep going down and down sharply.

If there's any way they could be short bandwidth, they'd love to be short bandwidth. If that means they can sell their network to someone who will pay real money for it and still have access to assets, they would love to do that.

They can still build a network without having any assets, or they can have a major network capability as they have right now with only modest amounts of assets because of the tremendous capability that they've created from Modulus, the Enron Intelligent Network, and the BOS system. I think that they are trying not to be so asset-intensive. This is a brand-new and very focused change in the company.

Investor 8

OK, but I would guess that this wouldn't be a great time to shop around a network?

David Fleischer

It depends. I suppose the answer is that you haven't seen any big sale of a network because no one can afford to buy one. Even if Enron wanted to sell it, I don't think they could right now. That said, they don't have a lot invested in their network. We're talking about essentially a billion dollars, or slightly under, which given the size of Enron, is not that huge. **I would just reiterate that I think there's negative value in the stock right now for telecommunications and certainly, not positive value of any sort.**

Enron is not a pure trading operation

Investor 8

Thank you. I just wanted to point out what I think is an anomaly in terms of your statement that you don't believe Enron should be valued on the same multiple as an investment bank. You say that Enron can do a lot of sophisticated things.

I think it's often pointed out that Enron has a cyclical asset base, which sets them apart from just a pure trading operation/corporate finance operation. At the moment, it seems if anything they're looking to sell off their physical assets, and that seems to be an anomaly in the portfolio optionality and the physical asset base. I can't quite get my hands around that.

David Fleischer

Well, I'm absolutely not going to disagree with your general premise. As I look at Enron and I look at the businesses that they have, I believe Enron is a much faster grower, and that is the simple bottom line; we're talking about 25% growth prospects.

Now, you could disagree with that, and I'm surprised no one actually did here on the call because the consensus expectation out there is more like 17%. I absolutely believe that this company is a much faster grower than 17%. Maybe the difference in expectation is not so substantial. **If we were to just look at the wholesale side of Enron, we might say that Enron and an investment bank were an awful lot closer and more similar, actually.**

However, on top of that, you have Enron Energy Services, which right now has essentially not been making money and has been for the most part ignored by investors. Enron has been investing in this business and building its capabilities over the last seven years. I would argue that this is a major growth business that must be layered on top of the wholesale operation. There are a lot of similarities between Enron and an investment bank, yet they have some pieces on top of what an investment bank would have, and a higher growth rate. That would be my answer to you.

Investor 8

OK, but you'd concede that when the stock was trading on 50X next year's earnings, that was slightly entering the realms of science fiction in terms of the steady-state multiple?

David Fleischer

Well, I look back and ask myself why I wasn't smarter back then. A year ago and 18 months ago there were a lot of stocks trading at 50X and 500X earnings. Enron was probably the last, or one of the last, of the high P/E stocks to come down in price. As I look at this company today, I'm trying to not make excuses for the past, but look at the present and value it going forward.

That's all the questions we have time for today. You can always call me at my office on 212-902-6018 if you have any follow-up questions.

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Investment ratings:

RL: Recommended List	**LL:** Latin America Recommended List	**TB:** Trading Buy
MO: Market Outperformer	**MP:** Market Performer	**MU:** Market Underperformer

Legal/Policy ratings:

NR: Not Rated	**CS:** Coverage Suspended	**NC:** Not Covered

Enron earnings model, 1994-2005E
US$ millions except per-share data

	Full Year						2000				Full Year	2001		Full Year				
Income bef.int.,taxes&min.int.	1994	1995	1996	1997	1998	1999	1Q	2Q	3Q	4Q	2000	1Q	2QE	2001E	2002E	2003E	2004E	2005E
Exploration & Production	$194	$241	$200	$183	$128	$65	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Transportation and Distribution																		
Gas Pipeline Group	367	375	416	364	351	380	128	77	83	103	391	133	80	405	430	443	456	470
Portland General Electric	--	--	--	114	286	305	105	62	74	100	341	60	60	290	300	309	318	328
Wholesale Energy Operations & Services																		
Commodity Sales and Services	376	399	348	249	411	610	256	420	407	539	1,622	785	700	2,805	3,086	3,703	4,443	5,332
Energy Assets and Investments	128	140	263	565	709	850	220	55	305	309	889	59	100	460	550	550	550	550
Unallocated Expenses	(132)	(138)	(145)	(160)	(152)	(161)	(47)	(60)	(82)	(70)	(259)	(89)	(90)	(360)	(400)	(440)	(484)	(532)
Total Wholesale Energy Ops & Services	372	401	466	654	968	1,299	429	415	630	778	2,252	755	710	2,905	3,236	3,813	4,509	5,349
Enron Energy Services	--	--	--	(107)	(119)	(50)	6	46	27	32	111	40	55	250	417	669	987	1,350
Broadband Services	--	--	--	--	--	--	0	(8)	(20)	(32)	(60)	(35)	(30)	(100)	(25)	50	200	400
Corporate & Other	(8)	(35)	(22)	(31)	7	(17)	(44)	17	(128)	(134)	(289)	(158)	(100)	(460)	(450)	(495)	(545)	(599)
Non-recurring items	19	183	178	(612)	(39)	13	--	--	--	(264)	(264)	--	--	--	--	--	--	--
Income before interest, taxes & minority int.	944	1,165	1,238	565	1,582	1,995	624	609	666	583	2,482	795	775	3,290	3,908	4,788	5,926	7,298
Interest expense (net)	(273)	(284)	(274)	(401)	(550)	(656)	(161)	(196)	(247)	(234)	(838)	(201)	(210)	(870)	(960)	(1,050)	(1,106)	(1,106)
Dividends on preferred stock	(20)	(32)	(34)	(69)	(77)	(76)	(18)	(21)	(20)	(18)	(77)	(18)	(20)	(80)	(80)	(80)	(80)	(80)
Minority interest	(31)	(44)	(75)	(80)	(77)	(135)	(35)	(39)	(35)	(45)	(154)	(40)	(40)	(170)	(170)	(170)	(170)	(170)
Total income before taxes	620	805	855	15	878	1,128	410	353	364	286	1,413	536	505	2,170	2,698	3,488	4,570	5,941
Income tax expense	167	285	271	(90)	175	104	72	64	72	226	434	130	126	543	674	872	1,143	1,485
Net inc. from cont.ops before extra. Items	453	520	584	105	703	1,024	338	289	292	60	979	406	379	1,628	2,023	2,616	3,428	4,456
Change in accounting principle	--	--	--	--	--	(131)	--	--	--	--	--	19	--	19	--	--	--	--
Net income	453	520	584	105	703	893	338	289	292	60	979	425	379	1,647	2,023	2,616	3,428	4,456
Dividends on preferred stock	(15)	(16)	(16)	(17)	(17)	(66)	(20)	(21)	(21)	(21)	(83)	(20)	(21)	(84)	(84)	(80)	(80)	(80)
Net income avail.to common	$438	$504	$568	$88	$686	$827	$318	$268	$271	$39	$896	$405	$358	$1,563	$1,939	$2,536	$3,348	$4,376
Diluted adjusted EPS	$0.83	$0.91	$0.91	$0.87	$1.00	$1.18	$0.40	$0.34	$0.34	$0.41	$1.47	$0.47	$0.43	$1.85	$2.25	$2.75	$3.52	$4.47
Non-recurring items	$0.02	$0.06	$0.17	($0.71)	$0.01	($0.08)	$0.00	$0.00	$0.00	($0.36)	($0.35)	$0.02	$0.00	$0.02	$0.00	$0.00	$0.00	$0.00
Diluted: EPS cont. ops.	$0.85	$0.97	$1.08	$0.16	$1.01	$1.10	$0.40	$0.34	$0.34	$0.05	$1.12	$0.49	$0.43	$1.88	$2.25	$2.75	$3.52	$4.47
Wtd. avg. shares outstanding (fully diluted)	531.8	536.0	540.2	591.6	695.3	769.0	851.9	862.2	869.5	787.7	813.9	871.6	875.0	878.0	900.0	927.0	954.8	983.5
Dividends paid per common share	$0.382	$0.407	$0.431	$0.457	$0.482	$0.500	$0.125	$0.125	$0.125	$0.125	$0.500	$0.125	$0.125	$0.500	$0.500	$0.500	$0.500	$0.500
Book value per common share	$5.15	$5.65	$6.64	$9.27	$9.95	$12.28	--	--	--	--	$13.94	--	--	$15.47	$17.99	$21.02	$24.79	$29.47
Return on avg.com.eqty (adjusted)		17.5%	15.4%	11.7%	11.5%	11.9%	--	--	--	--	12.3%	--	--	13.7%	14.2%	14.8%	16.0%	17.0%

Source: Goldman Sachs Research estimates and company data.