CS FIRST BOSTON

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Steven A. Parla, C.F.A. 212/909-3145
Vince Salvato 212/909-2518

Enron Corp. ENE LARGE CAP

Announced Merger with Portland General.

Securing PGN's Strategic Electric Generation and Transmission Assets Is the Driving Force Behind the Transaction.

Transaction Should Be Modestly Accretive to Earnings and Cash Flow.

Weakness in ENE Shares Is Unwarranted. ENE Did *Not* Purchase an Electric Utility.

Opinion: BUY.

Price 7/25/96[1]	Target (12 Months)	Dividend	Yield	Mkt. Value (Millions)	52-Week Price Range
39¹/₄	$45	$0.85	2.2%	$9,667.3	44–29

	Annual EPS	Prev. Est.	Abs. P/E	Rel. P/E
12/97E	$2.70		14.7X	98%
12/96A	2.35		16.7	100
12/95A	2.07		19.0	117

	March	June	September	December	Fiscal Year End
1996E	$0.62A	$0.45A[2]	—	—	Dec. 31
1995A	0.72	0.34	$0.39	$0.62	
1994A	0.66	0.30	0.38	0.41	

Common Shares	246.3 mil.	Relative P/E Range	80–120%
Book Value/Share (3/96)	$13.20	Est. 5-Year EPS Growth	15%
Return on Equity (6/96)	15.0%	Est. 5-Year Dividend Growth	5%
Debt/Total Capital (12/95)	46%	Total Debt (12/95)	3.1 bil.

[1]On 7/25/96 DJIA closed at 5422.0 and S&P 500 at 631.2.
[2]Adjusted for a $18.2 million gain on sale of EOG stock and a $16.1 million after-tax litigation reserve.

Viewpoint

We reiterate our Buy recommendation on Enron Corp. The recently announced merger with Portland General (PGN) provides a number of strategic assets necessary for ENE to realize its ambitious wholesale electric marketing and retail natural gas and electric marketing goals. The realization of these goals is a critical component of the company's 15% compound EPS growth target through the year 2000.

As readers of our April 8, 1996, report, *The E·D·Sing of Energy*, are aware, we consider the profit potential in electric wholesale and gas and electric retail marketing to be absolutely huge. The PGN acquisition further solidifies ENE's industry-leading position in these rapidly emerging markets. While the PGN acquisition will not have a major effect on ENE in the short term, and the stock indeed may continue to trade in the $40 plus or minus range for the next few months, we reiterate our long-term Buy rating on Enron based on the company's continuing superior long-term growth prospects and reasonable valuation. Again, Enron Capital & Trade's (ECT) profitability in electric wholesale and gas and electric retail markets is arguably the key component necessary to realize the parent company's growth prospects. *Thus by definition, holders of the shares explicitly or implicitly agree with our assessment of the huge profit potential of ECT in these markets.*

Transaction Description

Enron Corp. and Portland General Corporation, an Oregon-based electric utility, announced plans to merge in a stock swap transaction in which Enron would issue approximately 51 million common shares to PGN shareholders on a share for share basis, and assume $1.1 billion of PGN debt. Based on closing prices for ENE and PGN the day before the merger of $41.75 and $28.125, respectively, the transaction implies a 48% takeout premium for PGN shares. The proposed transaction has a collar structure; the agreement may be terminated by Enron if the price of ENE shares rises above $47.25 for 20 consecutive trading days before shareholder meetings, and can be terminated by PGN if the price of ENE shares falls below $36.25 during the same time period.

The merger, which will be accounted for on a purchase basis to maintain maximum flexibility, is subject to approval by the Federal Energy Regulatory Commission (FERC), the Oregon Public Utilities Commission, and shareholders of both companies. Although the necessary approval process could be both complicated and time consuming (up to twelve months), preliminary indications suggest that ENE will be successful since both the FERC and Oregon PUC are likely to view the merger as pro-competitive.

Initial Market Reaction

The initial market reaction has been modestly negative, with Enron down $2 in early trading. Three key reasons underlie this early market reaction, in our opinion:

(1) The ENE/PGN merger was announced at a higher takeout premium (48%) than most recent electric utility acquisitions, which have entailed more modest takeout premiums of around 20%. Thus, the market may be interpreting that ENE overpaid for an electric utility. Despite the premium, valuation multiples for this transaction appear reasonable, with EBITDA, EBIT, P/E, and other key multiples all within recent takeout ranges for similar transactions.

If one believes that Enron is acquiring a regulated electric utility, the premium *is* large and ENE arguably overpaid. If one believes ENE is acquiring key strategic assets which will further enhance ECT's profit potential in the $90 billion electric wholesale market and $260 billion retail gas and electric market, the premium appears quite reasonable, as the data in Table 1 suggest.

Table 1
ENE/PGN Merger: Takeout Valuation Multiples
averages and range based on 11 recent electric utility M&A transactions

	ENE/PGN Merger	Average	Range
Implied Takeout Premium	48%	22%	11.0 - 48.0%
Price/EPS (Last 12Mos)	14.6X	14.3X	12.2 - 17.1X
Price/Book Value	2.3X	1.7X	1.4 - 2.5X
Adjusted Market Value to:			
EBITDA	7.5X	8.1X	6.5 - 11.9X
EBIT	10.8X	12.1X	9.1 - 18.7X
Revenue	3.1X	2.2X	1.0 - 3.2X

Source. CS First Boston

(2) On the surface, the transaction would appear to slow Enron's earnings growth prospects given that the electric utility industry is a regulated, slow-growth industry with considerable uncertainty regarding the nature of impending deregulation.

(3) Even for those who, like us, believe this is a key strategic step for ECT's wholesale electric and retail gas and electric prospects, these are admittedly intermediate, not near-term benefits.

Enron Is *Not* Buying an Electric Utility!

A ridiculous statement on our part. Of course Enron is purchasing a fully integrated electric utility in Portland General. But we are trying to make a point. Investors should understand that conceptually ENE is *not* purchasing an electric utility. ENE is purchasing four crucially important components that will dramatically enhance its industry-leading position as an independent electricity marketer and further its long-term retail marketing goals.

Electric Generation

ENE is acquiring Portland's low-cost, non-unclear generating assets in the rapidly deregulating West Coast electric market. As discussed at length in our *The E·D·Sing of Energy* report, electric deregulation ultimately will entail the complete separation of the generation, purchase, and sale of electricity from its transportation from point A to point B. *The separation of the generation, purchase, and sale of* *electricity from its transportation will create a new $90 billion, nonregulated, for-profit industry* with even greater inefficiencies (commodity pricing disparities) than existed in natural gas. Portland General has over 2,117 megawatts of electric generation capacity. These assets are appealing to Enron Capital & Trade for a number of reasons, including:

• *Low Cost:* PGN has a mix of non-nuclear power plants, which generate low-cost electricity from hydro, coal, and combustion turbine plants.

Table 2
Portland General: Electric Prices Paid by Customers
cents per kilowatt hour, 1994 data

	Portland General	National Average	% Difference
Residential	5.38¢	8.83¢	39%
Commercial	5.13	7.89	35
Industrial	3.81	4.93	23

Source: CS First Boston.

• *Low Capacity Utilization Factor:* Due to an abundance of hydropowered fuel sources in the Pacific Northwest, Portland purchases a significant amount of off-system electricity to supply Portland General's customers. Over the last five years, PGN's annual capacity factor (utilization of generation capacity) has averaged only 45%. Enron could utilize PGN's excess low-cost generation capacity for nonregulated, off-system sales throughout the Western U.S. This would be particularly appealing for sales into California, where average electricity costs are much higher.

• *No "Stranded Cost" Issue:* Unlike many electric utilities, Portland General is not straddled with extensive "stranded" generation assets, such as uneconomic nuclear power plants. Stranded costs and the uncertainty surrounding them could become a serious problem as the electric industry is deregulated. PGN's modest stranded costs potential also further justifies the transaction's valuation.

The equivalent of gas reserves in natural gas marketing, the control of generation assets will afford electric marketers a number of key attributes exploited by many successful gas marketers. Included among them are a base return on the generation assets, credibility and reliability in the marketplace and, most importantly, a commodity source that allows them to provide high-margin, value-added products and services such as longer-term and fixed-price commodity supplies.

Electric Transmission

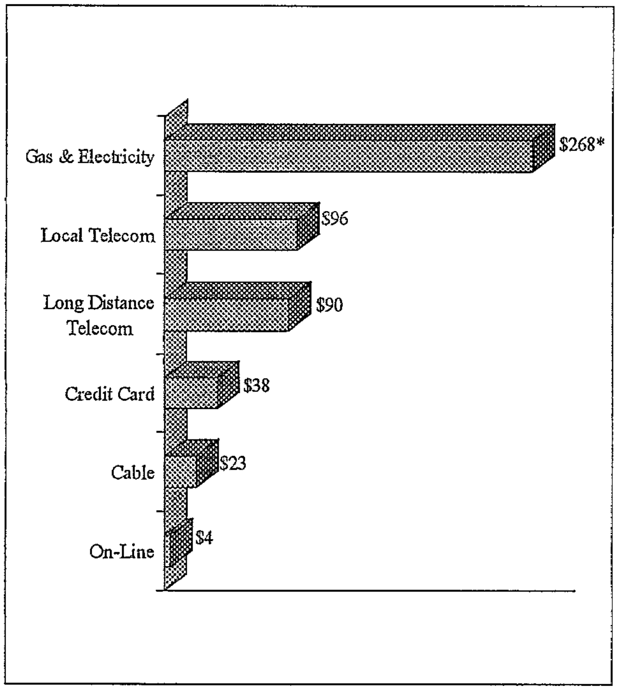
ENE is acquiring PGN's extensive electric transmission system, with over 1,957 miles of electric lines throughout the Western U.S., including substantial transmission capability into California. Included are three key 1,600 MW electric transmission lines running north-south through the West Coast. One of the lines runs south to the Los Angeles basin through Nevada, bypassing northern California and Pacific Gas and Electric completely. While FERC open access rules clearly apply, Portland General has the contractual rights to about 25% of this strategic transmission capacity.

ENE is acquiring strategic transmission capacity to the California-Oregon Border (COB) delivery point where physical electricity can be delivered against electricity futures contracts. Investors familiar with ENE's strategic purchase of Louisiana Resources, which provided the similar capability to physically deliver against natural gas futures contracts, understand the critical importance of being able to physically deliver against futures contracts. For those less familiar, this capability has provided ECT enormous arbitrage profit opportunities at (the many) times when cash and futures markets have diverged. This capability has also substantially enhanced ECT's ability to provide higher-margin value-added risk management products and services to both producers and consumers of natural gas. *We thus consider the COB delivery capability backed by Portland General's low-cost generating capacity (remember electricity is instantaneous, it cannot be stored) a critical component of ENE's attraction to PGN.*

Retail Distribution

Enron *is* acquiring an electric utility! PGN has 658,000 retail customers around the Portland, Oregon, area. Located in a fast-growing, economically robust area, Portland General has been a market leader in retail energy marketing and management. While we consider this perhaps the least strategic piece of the acquisition, it is important nonetheless. In addition to providing ENE a steady stream of modestly growing regulated earnings, PGN's distribution system will provide significant knowledge and experience in retail distribution. As important, it will serve as a real-time testing ground as ENE begins to implement its retail gas and electric marketing strategy. The $260 billion retail natural gas and electric market (Figure 1) represents classic inefficiency in the form of an historical cost-plus monopoly in both gas and electric—i.e., a substantial profit opportunity as barriers to entry fall in the next few years.

Figure 1
U.S. Retail Market Sizes as of 1994
$ in billions



* $289 billion in the U.S. & Canada, Source. Enron Corp.

Strategic Direction Strengthened

Once again, Enron Corp., in general, and ECT head Jeffrey Skilling, in particular, are so early in implementing critical strategic plans as to be genuinely visionary. Having virtually pioneered wholesale gas marketing and industry-leading value-added products and services, Mr. Skilling established ECT's wholesale electric marketing organization two to three years ago. The PGN acquisition now adds the full complement of west-of-the-Rockies assets ECT needs for its wholesale and retail electricity marketing ambitions.

In our opinion, strategically located generation and transmission assets in the Gulf Coast and Northeast will be acquired over the next few years. Beyond that, Mr. Skilling is again years early in focusing the majority of his attention on building the organization and emerging skills necessary to realize the huge profit potential that exists in the $260 billion retail gas and electricity market.

Within the next three to five years retail energy marketers will offer customers a choice of gas and electric supplies similar to their choice of AT&T, MCI, or Sprint for long-distance service. The service will work in much the same fashion as in the telephone business, but the commodity will be marketed by a third party, with transportation and billing services provided by the local carrier.

Again, the profit potential appears huge, particularly if a way to replicate enormously expensive firm delivery charges, paid 365 days a year, use it or lose it, can be found. This is an important point since the overwhelming portion of the delivered price of natural gas, for example, is for delivery charges, not the commodity. *The bigger profit potential exists if marketers with enough firm transportation capacity, secondary capacity, storage, and "liquidity" in gas and eventually electric supplies can replicate the enormously expensive firm delivery charges* for natural gas and eventually electricity.

Clearly, the challenges in retail gas and electric marketing will be different. In addition to providing the commodity and its delivery, there are other products and services, sales and marketing, customer service, brand name, telemtry (real time metering), and back-office functions to be dealt with. However, the profit opportunities in an inefficient $260 billion market should provide retail marketers such as Enron with sufficient incentive to accept these challenges.

Earnings/Cash Flow Accretive

The transaction should be both earnings and cash flow accretive immediately, thus adding to ENE's ability to meet its 15% earnings growth target. More importantly, PGN's asset base should allow ECT to grow even faster in nonregulated electric wholesale and gas and electric retail markets, allowing ENE to meet its ambitious long-term growth targets.

Management has indicated that PGN should be able to generate $450-500 million in EBITDA on a normalized basis. Due to PGN's strong cash flow generation capabilities and credit strength, the transaction should result in a slight improvement in ENE's credit quality. Management indicated that roughly $0.08-0.10 per share of goodwill will be amortized annually; thus we estimate the transaction will result in the addition of roughly $1.0 billion in goodwill to Enron's balance sheet. Table 1 shows our estimates for a fully incorporated Portland General into Enron's 1997 estimated income statement.

(Note: These estimates are preliminary and somewhat theoretical since they assume the full incorporation of Portland General into ENE for the entirety of 1997. A more likely scenario would entail incorporation of PGN's financials during the later half of 1997.)

AT&T (T, 51 1/4, Strong Buy)*
Enron Corp. (ENE, 39 1/4, Buy)
MCI (MCIC, 23 1/8, Buy)*
Pacific Gas & Electric (PCG, 20 1/8, Hold)
Portland General (PGN, 34 7/8, Not Rated)
Sprint (FON, 35 1/4, Buy)*

*Followed by a different CS First Boston analyst.

Table 1
1997 Outlook Before and After Merger Announcement
$ in millions, data assumes incorporation of Portland General into Enron for the entirety of 1997

Without Portland General

	1997E
Operating income	
ENE Operations	465.0
ENE Capital & Trade	**325.0**
Intl G&P Services	215.0
Explorat & Production	260.0
Other	40.0
Total	1,305.0
Interest expense, net	290.0
Subsid Preferred Div	31.0
Minority Interest	45.0
Pretax income	939.0
Income taxes	262.9
Effective Tax Rate	28.0%
Net income	676.1
Preferred dividends	15.0
Net to common	661.1
Average shares	245.0
EPS	$2.70
Fully Diluted EPS	$2.47
DD&A	550.0
Deferred taxes	60.0
Other	100.0
Total Cash Flow	$1,371.1
Cash flow per share	$5.60
Fully Diluted	$5.40
Common dividends	188.2
Capital expenditures	1,000.0
EBITDA	$1,779.0
Internal cash flow rate	118%

With Portland General

	1997E	Notes:
Operating income		
ENE Operations	465.0	
ENE Capital & Trade	**325.0**	
Portland General	**325.0**	**$475 in EBITDA minus $125 in depreciation and $25 in goodwill amortization.**
Intl G&P Services	215.0	
Explorat & Production	260.0	
Other	40.0	
Total	1,630.0	
Interest expense, net	369.2	**$80 million from PGN which has a 7.2% embedded cost of long term debt.**
Subsid Preferred Div	40.0	
Minority Interest	45.0	
Pretax income	1,175.8	
Income taxes	352.7	
Effective Tax Rate	30.0%	
Net income	823.1	
Preferred dividends	17.0	
Net to common	806.1	
Average shares	296.0	**245 + 51 from PGN swap.**
EPS	$2.72	**Modest ($0.02 per share) accretion.**
Fully Diluted EPS	$2.53	
DD&A	700.0	
Deferred taxes	80.0	
Other	100.0	
Total Cash Flow	$1,686.1	
Cash flow per share	$5.70	**$0.10 per share accretion.**
Fully Diluted	$5.29	
Common dividends	260.5	
Capital expenditures	1,170.0	**$1,000 + $170 of PGN Cap. Ex.**
EBITDA	$2,245.0	
Internal cash flow rate	122%	

CS First Boston

Americas

Park Avenue Plaza
55 East 52nd Street
New York, NY 10055, U.S.A.
(1) 212 909 2000

Atlanta	(1) 404 656 9500	Mexico City	525 202 6000
Boston	(1) 617 556 5500	Philadelphia	(1) 215 851 1000
Buenos Aires	(1) 541 394 3100	Portland	(1) 207 780 6210
Chicago	(1) 312 750 3000	San Francisco	(1) 415 765 7000
Houston	(1) 713 220 6700	São Paulo	(55 11) 822 4862
Los Angeles	(1) 213 253 2000	Toronto	(1) 416 947 2600

Europe

One Cabot Square
London E14 4QJ, England
44 1 71 516 1616

Amsterdam	(31) 20 575 4444	Paris	(33) 1 40 76 8888
Budapest	(36) 1 202 2188	Prague	(42) 2 248 10937
Frankfurt	(49) 69 7534 0	Vienna	(43) 1 512 3023
Geneva	(41) 22 707 0130	Warsaw	(48) 2 630 5656
Madrid	(34) 1 595 9988	Zug	(41) 41 726 1020
Milan	(39) 2 77702 1	Zurich	(41) 1 335 7220
Moscow	(7) 501 967 8200		

Pacific

Shiroyama Hills
4-3-1 Toranomon
Minato-ku, Tokyo 105, Japan
813 5404 9000

Auckland	(64) 9 302 5500	Seoul	(82) 2 399 7355
Beijing	(86) 10 501 4508	Singapore	(65) 226 5088
Hong Kong	(852) 2847 0388	Sydney	(61) 2 394 4400
Melbourne	(61) 3 280 1666	Wellington	(64) 4 474 4400
Osaka	(81) 6 243 0789		