BERNSTEIN RESEARCH

WEEKLY NOTES
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Enron: Bruised But Strong, Upgraded to Outperform

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- Enron is likely to overdeliver with its new CEO
- Gas and power volatility ahead supports strong business growth

Our rating codes are:

O = Outperform
M = Market-Perform
U = Underperform

Enron: Bruised But Strong, Upgraded to Outperform

Stock	9/20 Price	SCB Rating	YTD Rel. Perf.	52-Week Range	EPS 2000	EPS 2001E	EPS 2002E	P/E 2001E	P/E 2002E	Current Yield
ENE	$28	O	(41)%	$26 - $90	$1.12	$1.80	$2.40	15.8x	11.8x	1.8%

Overview

We have upgraded Enron to outperform based on short- and long-term valuations. There is plenty of energy-market volatility ahead to support business growth. New economic uncertainties will grow volatility as well as risk management activity — both positive for Enron.

With massive loss of investor confidence, we see focus and discipline, as well as overdelivery on earnings guidance, to $2.40 (14% above guidance), in 2002.

Enron's business model of expandable intermediation in the energy business is sound. The company's share price has overpunished recent problems with legacy assets and now has been doubly punished by the overall market decline.

Love it or hate it, Enron is the market leader and, with Chairman and CEO Kenneth Lay back to continue building on the core, will continue to lead.

The management brain drain that Enron experienced in recent months will be overcome by the company's culture, which has depth to promote from within. While new internal appointments into the office of the CEO are meeting mixed reviews, we are confident that Kenneth Lay will not leave until a strong transition is possible.

Recent attrition and share price weakness have resurrected discussion of a plausible takeover of Enron. The idea that Enron could be rolled into a Shell or a BP is an old one, and we do not think a likely one, as integration of the various cultures would be a fiasco. We expect Enron to remain independent.

We were flabbergasted when investors paid $90 for the shares a year ago but, with a formula rollout of a proven business model ahead, we rate the shares outperform with a 12-month target price of $42.

Back Toward Energy Merchant Core

Enron has gone from trying to be the world's first gas major, to aspiring to be the largest intermediator of all types of commercial transactions, and now is aimed back towards an energy merchant core. This journey has occurred in a short, tumultuous period of growth. Many problems in the past year have hurt the shares, taking them down from an overexuberant $90 per share to an overly cheap $30 per share (see Exhibit 1). With business builder Kenneth Lay back in the driver's seat as chairman and CEO, we see a forceful near-term effort to rebuild investor confidence. At $28, Enron trades at only 13.5 times guided estimated 2002 EPS of $2.10 and 11.8 times what we expect for the year, as we expect them to exceed expectations.

Forget About Some of the Dreams

Broadband valuations, a product of excellent hype and guidance from Enron to the analyst community, are not a material near-term part of the story anymore, except in terms of minimizing ongoing spending. The company suggested $40 per share of broadband NPV, and most analysts went to the beat of the hype. We have never given much credence to share price valuation for broadband or to many of the other ideas before their time that Enron has put forth.

Core Markets Are Where Enron Will Rebuild

With seasonal volatility of gas prices much higher than in the past and the rebuild of the power infrastructure still in progress, we see plenty of volatility of demand and price, as well as continued fear by producers and end users, allowing Enron to grow its core business platform of energy intermediation. Sure, gas prices are unlikely to command winter weather spikes of $10 per mmbtu as they did last year. The overall supply and demand balance for gas, however, leads to a durable link of gas prices to oil products pricing. That means directional support for gas prices at residual fuel oil pricing in the summer, some discounts in the shoulder months, and heating oil support for gas prices in the winter (see Exhibit 2). That creates a price spread of more than $2 per mmbtu between shoulder months and winter months. Next year may be more on the low side in the event of mild winter weather or inadequate industrial gas demand recovery but, long-term, the pattern will emerge and stay. Our assumption of $3.75-per-mmbtu gas pricing in 2002 incorporates a $2 seasonal price spread.

Independent of the new higher seasonal price swings we see developing, the absolute volatility of power demand (see Exhibit 3) and gas demand (see Exhibit 4) assure a continued market for risk management by Enron. New uncertainties in the broader economy also support increased risk management and likely volatility. This volatility supports growth of Enron's wholesale services segment (see Exhibit 5). Our downside EPS scenario of extreme revenue and margin declines in the wholesale sector still makes Enron look cheap, trading at 11.5 times normalized earnings.

Little Guys Get to Be Scared Too

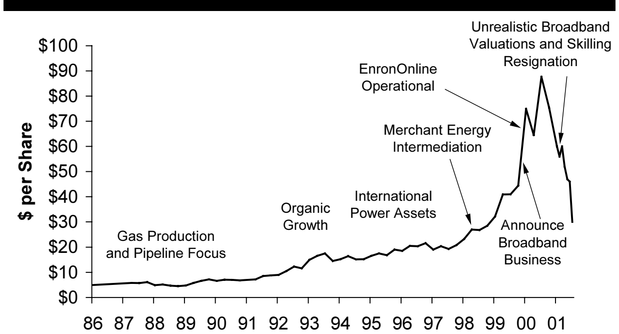
We have always liked Enron's retail energy services model. With an end to certainty of low gas and electricity prices, a heightened awareness by medium- and large-scale end users of the complexity of energy pricing, and a track record of expertise where Enron defines the market, Enron's retail services sector is a winner. We see the growth of the business continuing, as energy policy continues to be part of the national dialog, and facility managers realize they are amateurs at energy cost risk management. Enron's approach is to take control of a third-party facility to the point of controlling equipment operation and replacement. Enron can guarantee a cost saving to a facility for a fee or for a split of the savings. This business, with real earnings now, is an adjunct to Enron's risk management expertise. We see the opportunity for long-lived formula rollout of the concept, both in North America and internationally, with limited downside risk.

Energy services should contribute $275 million of EBIT in 2002. That is a 7% contribution to total EBIT (see Exhibit 5), holding steady in the growing environment to 2005, and our estimates beyond 2002 could prove to be conservative.

Some Growth Ideas Will Be Abandoned

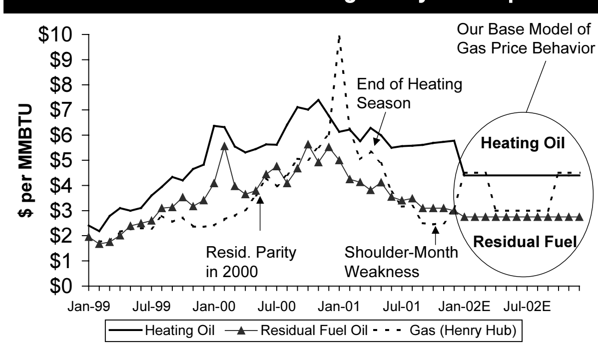
We think Enron, in its thrust to do business without physical assets, has burned bridges in two sectors — LNG supply and international power. This is a net benefit for other competitors in the space, like El Paso, but mars the credibility of Western investment in those markets. Enron's growth will be less focused on physical assets in the future, partly because of bad experiences in this space and sometimes as a result of Enron's aggressive approach. Announced asset sales of $4 billion to $5 billion are likely to be seriously pursued to emphasize Enron's asset-light philosophy, and as a result of past negatives in dealing with ongoing operations. Our model assumes little asset investment going forward.

Exhibit 1 Enron: Share Price



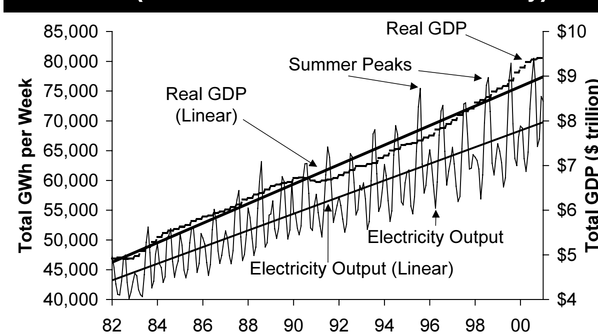
Source: Corporate reports.

Exhibit 2 Natural Gas Pricing Parity vs. Liquids



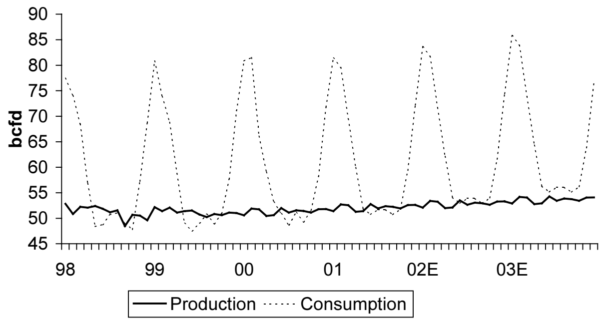
Source: AGA, EIA, Bloomberg L.P. and Bernstein analysis.

Exhibit 3 Electricity Output Versus Real GDP (Weather Creates Extreme Volatility)



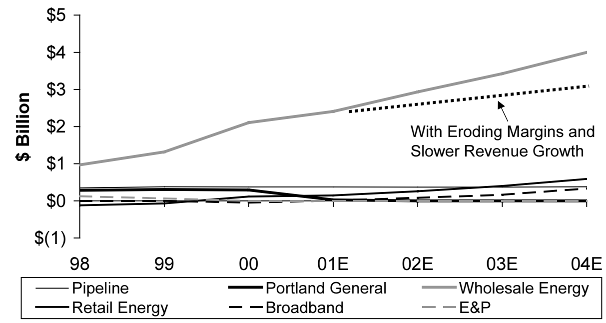
Source: EEI, EIA, DRI and Bernstein estimates.

Exhibit 4 U.S. Monthly Production Versus Consumption



Source: EIA and Bernstein estimates.

Exhibit 5 Enron: EBIT Segment



Source: Corporate reports and Bernstein estimates.

At $30, Does Someone Take Over Enron?

As Enron crafted the merchant energy space, early speculation, including a prominent article in *The Economist* several years back, was that a Shell or a BP would merge with Enron. The lukewarm results of Shell's Coral unit and the yet-to-behold significance of BP's effort revive this idea. We believe that a merger with Enron would be a disaster due to difficult cultural integration. Integration of upstream, midstream and merchant energy functions along the gas value chain has succeeded where core commercial thinking of pipeline managers has led the way, and has failed where upstream has led the way. Meanwhile, Enron continues to grow its own managers, with an active MBA recruitment effort, as well as a tenacious commercial culture that will survive the recent management brain drain.

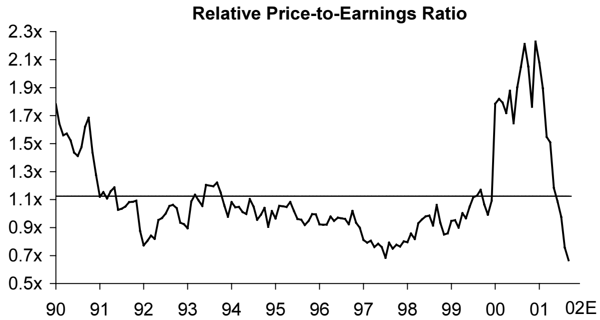
As Enron extracted economic rent from the gas marketing part of the chain, many upstream companies, including Shell, Unocal and Texaco, built up business segments to do global trading. None took off to the degree that the pipeline-led efforts of Enron, El Paso and Williams did. We believe that the upstream attempts to break into the effort failed, as those managements were not committed to the idea of energy merchanting and neither had the commercial background of the pipeline business nor supported appropriate trader incentives to have energy merchanting work in a company dominated by upstream investment.

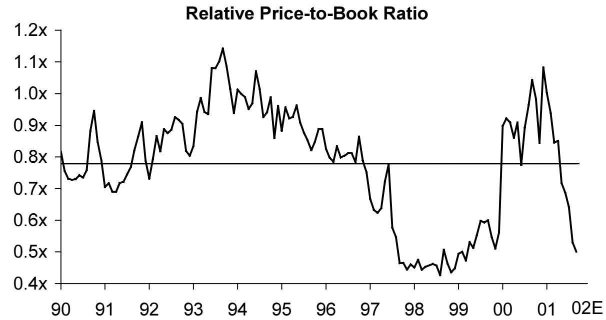
Similarly, as many of the upstreamers ultimately saw the merchanting activity as distracting and cut commitments to the effort, Enron did the same, jettisoning the upstream segment of its model. Our theory is that great merchanting comes from a core pipeline business acumen and that upstream-dominated managements are unwilling to give enough rope to merchanting risk management, which is much different than exploration and production risk management. Thus, while bringing a world-class merchant like Enron into a BP or a Shell is a somewhat appealing idea, it would be disruptive and, without a scorched-earth approach to integrating the assets, would likely fail. So we do not assign any value to a takeover of Enron, but it is a small upside if you disagree with us. Enron currently is trading weakly versus the merchant group, particularly on a price-to-book and price-to-cash flow basis. Enron is also trading at a steep discount versus the S&P 500 (see Exhibit 6). We believe in power growth and gas price volatility and, thus, Enron's business model is a way to invest in relatively certain growth in the uncertain macro environment.

Risks

The departure of CEO Jeff Skilling alters Enron's persona. It also leaves the nagging sense that there is an accounting time bomb waiting for investors. In California, the company has been threatened with contempt charges, and now it is being forced to provide documentation related to California profits during the state's crisis. The company says it is protecting commercially sensitive insight. More logically, the company is taking an approach that recognizes that what is not exposed cannot be subject to potential litigation. With repeated guidance that any problems in California have been reserved for on the receivables side, and that there are no excess profits that the state might be chasing, we are satisfied. Similarly, we see limited reason to discount the company for an accounting time bomb. However, if we are wrong, the company is at risk of both a monetary issue of unknown proportion and a credibility discount with investors. We believe Enron's current low price is an attempt to discount the potential for a negative surprise. If credibility is further hurt, we think there is only room for the shares to erode another 10-15% versus current levels. It is this

Exhibit 6 Enron: Relative to S&P 500





Source: FactSet, corporate reports and Bernstein estimates

asymmetric risk/reward profile that in part underpins our upgrade.

Investment Conclusion

Enron's shares now reflect 13.5 times guided 2002 EPS. We expect a redoubling of effort by reinstalled Chairman and CEO Kenneth Lay and $2.40 of 2002 EPS as a result, putting the share price at only 11.8 times our estimate. Volatility of gas and power prices will continue, and the middle market for energy cost risk management is being grown by Enron with no visible competitors. The company has alienated some business segments, like LNG supply and international power production. The core energy trading, pipeline and retail energy segments, however, are performing well. Investors paid too much for broadband. But now they overpunish the firm for missteps and lingering issues of the water business, Portland General, Dabhol and, notoriously, California, where the company has been the bad boy of noncooperation with state officials. Former CEO Jeff Skilling, who personified the New Age cowboy approach of the company, is gone. The father of Enron, Chairman and CEO Kenneth Lay, is back in the saddle, and we believe he will incent and lead Enron to outperformance to re-establish Enron's credibility, partly motivated by personal pride, as he indeed is a captain of industry and the stuff of Harvard Business School case studies. A strong management culture, strong energy markets and formula rollout of successful approaches lead us to believe in our EPS forecasts plus upsides. We rate the shares outperform with a 12-month target of $42, a 50% upside.

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