

09:02am EDT 25-Oct-01 Salomon Smith Barney (Raymond Niles +1-212-816-2807) ENE  
ENE: --CAUTIOUS OUTLOOK NEAR TERM, CHANGE TO 1S (BUY, SPECULATIVE)

SALOMON SMITH BARNEY

Enron Corporation (ENE)#

ENE: --CAUTIOUS OUTLOOK NEAR TERM, CHANGE TO 1S  
(BUY, SPECULATIVE)

1S (Buy, Speculative)  
Mkt Cap: \$11,890.7 mil.

October 25, 2001

SUMMARY

POWER & NATURAL GAS

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- \* We change our rating on Enron to 1S (Buy, Speculative) from 1H (Buy, High Risk) reflecting our concerns that lingering uncertainty over financial practices may begin to impair Enron's commercial operations. This is the least likely outcome, in our view -- probability 10%-15% -- but one whose likelihood has increased over the last week as questions continue to be asked.
- \* We are long-term believers in the Merchant Energy story and Enron. Should the company make it through its current travails, the unusually low valuation, coupled with their leadership position in the industry, justifies maintenance of our "Buy" rating.
- \* We are confident in the l/t growth prospects of the Merchant Energy industry, and see ENE's peers as recovering, regardless of near-term effects from Enron.
- \* Adjust 12-month price target to \$30, reflecting a target 2002 P/E multiple of 14x. Enron is trading at 1.0x book vs. the 2.3x average for its peers.

FUNDAMENTALS

P/E (12/01E)	9.1x
P/E (12/02E)	7.6x
TEV/EBITDA (12/01E)	NA
TEV/EBITDA (12/02E)	NA
Book Value/Share (12/01E)	\$15.66
Price/Book Value	1.0x
Dividend/Yield (12/01E)	\$0.52/3.2%
Revenue (12/01E)	\$100,789.0 mil.
Proj. Long-Term EPS Growth	23%
ROE (12/01E)	11.5%
Long-Term Debt to Capital(a)	43.0%

ENE is in the S&P 500(R) Index.

(a) Data as of most recent quarter

SHARE DATA

Price (10/24/01)	\$16.41
52-Week Range	\$84.63-\$16.41
Shares Outstanding(a)	724.6 mil.
Convertible	No

RECOMMENDATION

Current Rating	1S
Prior Rating	1H
Current Target Price	\$30.00
Previous Target Price	\$55.00

EARNINGS PER SHARE

FY ends		1Q	2Q	3Q	4Q	Full Year
12/00A	Actual	\$0.40A	\$0.34A	\$0.34A	\$0.41A	\$1.47A
12/01E	Current	\$0.47A	\$0.45A	\$0.43A	\$0.46E	\$1.80E
	Previous	\$0.47A	\$0.45A	\$0.43A	\$0.46E	\$1.80E

12/02E	Current	NA	NA	NA	NA	\$2.15E
	Previous	NA	NA	NA	NA	\$2.15E
12/03E	Current	NA	NA	NA	NA	NA
	Previous	NA	NA	NA	NA	NA

First Call Consensus EPS: 12/01E \$1.81; 12/02E \$2.13; 12/03E NA

## OPINION

We change our rating on Enron to 1S (Buy, Speculative) from 1H (Buy, High Risk). Our concern stems from lingering uncertainty, which may begin to impair Enron's commercial operations. This is the least likely outcome, in our view, but one whose probability has increased over the last week as questions continue to be asked about Enron's financial practices. While we think there is still a low probability at this point of our worst-case scenario occurring -- no more than 10%-15% -- that probability has grown. We maintain a longer-term "Buy" perspective because of a combination of unusually low valuation and, should Enron emerge triumphant from its current travails, what is the industry's dominant Merchant Energy platform.

We think that concerns over Enron are spilling over into the share prices of Enron's peers, who were down 8% yesterday. Further, "sympathy" reductions in share price may occur if Enron tumbles further (obviously, reversing should Enron's shares recover). Longer-term, however, we see Enron's peers recovering, regardless of what happens to Enron. Either they will recover with a recovery in Enron's share price, or in a worst-case scenario, they will gain market share at Enron's expense, although there would likely be near-term impacts from a loss of Enron as a counter-party. Enron currently has approximately 25% market share in the power and natural gas markets, with its next nearest competitors holding market share in the 10%-15% range.

We also base our Buy rating because of what we know about Enron's financial situation. We are unwilling to change this solely because of speculation in the marketplace. What we know suggests to us that Enron has "hidden leverage" on its balance sheet. Attempting to pierce through these known off balance-sheet vehicles, we estimate that Enron is effectively operating at a debt-to-capital ratio in the low 60% range. We think this is manageable, if this is the full extent of Enron's leverage.

## Valuation

Enron is now trading at 1.0x book value, vs. its peers, who are trading at 2.3x. On a 2002 P/E basis, Enron is trading at 7.6x vs. 12.3x for its peers. We think that under our most likely scenario -- of Enron's recovery -- Enron's shares will trade closer to its peers. We also think that the entire group will recover to a higher valuation. Using a target P/E of 14x our 2002 EPS estimate of \$2.15, we derive a new price target of \$30.

## Scenarios

Our worst-case and least likely scenario is that concerns over Enron's financial practices begin to affect their commercial operations because of a reduced willingness by counterparties to do business with Enron. This is the "meltdown" scenario. We think it is within Enron's power to control whether this occurs by fully answering questions related to their use of off-balance sheet financing to fund their operations. Why did they do this? What benefits accrued to the balance sheet and income statement from these practices? What is the magnitude, if any, of "hidden" private off balance sheet transactions? What does their balance sheet look like on a "look through" basis, i.e., if these off balance sheet vehicles were on Enron's books?

We are concerned that because of these concerns we may begin to see signs of a "liquidity crunch" affecting Enron's commercial operations. We are watching for those signs and, to date, liquidity has remained intact.

We have attempted to answer some of these questions and in prior notes where we provide our best estimate of "look-through" leverage arising from Enron's known off balance sheet financings. Based on known off balance-sheet vehicles, we see the "real" leverage as in the low 60% range, a manageable number, in our view. Nevertheless, we see this as the responsibility of Enron's management to answer these questions. Indeed, we see it as in their self-interest to inform interested parties -- investors, counterparties -- to be as forthcoming as possible.

Our best case -- and at this juncture still most likely scenario -- is that Enron recovers. Our estimate of "look-through" leverage is not overly excessive in our view. Enron still has the dominant franchise and market position, and if these were to remain intact, the stock would not recover from its current low valuation.

#### COMPANY DESCRIPTION

NA

#### ADDITIONAL INFORMATION AVAILABLE UPON REQUEST

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