

Is Enron Overpriced?

It's in a bunch of complex businesses. Its financial statements are nearly impenetrable. So why is Enron trading at such a huge multiple?

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In Hollywood parlance, the "It Girl" is someone who commands the spotlight at any given moment--you know, like Jennifer Lopez or Kate Hudson. Wall Street is a far less glitzy place, but there's still such a thing as an "It Stock." Right now, that title belongs to Enron, the Houston energy giant. While tech stocks were bombing at the box office last year, fans couldn't get enough of Enron, whose shares returned 89%. By almost every measure, the company turned in a virtuoso performance: Earnings increased 25%, and revenues more than doubled, to over \$100 billion. Not surprisingly, the critics are gushing. "Enron has built unique and, in our view, extraordinary franchises in several business units in very large markets," says Goldman Sachs analyst David Fleischer.

Along with "It" status come high multiples and high expectations. Enron now trades at roughly 55 times trailing earnings. That's more than 2 1/2 times the multiple of a competitor like Duke Energy, more than twice that of the S&P 500, and about on a par with new-economy sex symbol Cisco Systems. Enron has an even higher opinion of itself. At a late-January meeting with analysts in Houston, the company declared that it should be valued at \$126 a share, more than 50% above current levels. "Enron has no shame in telling you what it's worth," says one portfolio manager, who describes such gatherings as "revival meetings." Indeed, First Call says that 13 of Enron's 18 analysts rate the stock a buy.

But for all the attention that's lavished on Enron, the company remains largely impenetrable to outsiders, as even some of its admirers are quick to admit. Start with a pretty straightforward question: How exactly does Enron make its money? Details are hard to come by because Enron keeps many of the specifics confidential for what it terms "competitive reasons." And the numbers that Enron does present are often extremely complicated. Even quantitatively minded Wall Streeters who scrutinize the company for a living think so. "If you figure it out, let me know," laughs credit analyst Todd Shipman at S&P. "Do you have a year?" asks Ralph Pellecchia, Fitch's credit analyst, in response to the same question.

To skeptics, the lack of clarity raises a red flag about Enron's pricey stock. Even owners of the stock aren't uniformly sanguine. "I'm somewhat afraid of it," admits one portfolio manager. And the inability to get behind the numbers combined with ever higher expectations for the company may increase the chance of a nasty surprise. "Enron is an earnings-at-risk story," says Chris Wolfe, the equity market strategist at J.P. Morgan's private bank, who despite his remark is an Enron fan. "If it doesn't meet earnings, [the stock] could implode."

What's clear is that Enron isn't the company it was a decade ago. In 1990 around 80% of its revenues came from the regulated gas-pipeline business. But Enron has been steadily selling off its old-economy iron and steel assets and expanding into new areas. In 2000, 95% of its revenues and more than 80% of its operating profits came from "wholesale energy operations and services." This business, which Enron pioneered, is usually described in vague, grandiose terms like the "financialization of energy"--but also, more simply, as "buying and selling gas and electricity." In fact, Enron's view is that it can create a market for just about anything; as if to underscore that point, the company announced last year that it would begin trading excess broadband capacity.

But describing what Enron does isn't easy, because what it does is mind-numbingly complex. CEO Jeff Skilling calls Enron a "logistics company" that ties together supply and demand for a given commodity and figures out the most cost-effective way to transport that commodity to its destination. Enron also uses derivatives, like swaps, options, and forwards, to create contracts for third parties and to hedge its exposure to credit risks and other variables. If you thought Enron was just an energy company, have a look at its SEC filings. In its 1999 annual report the company wrote that "the use of financial instruments by Enron's businesses may expose Enron to market and credit risks resulting from adverse changes in commodity and equity prices, interest rates, and foreign exchange rates."

Analyzing Enron can be deeply frustrating. "It's very difficult for us on Wall Street with as little information as we have," says Fleischer, who is a big bull. (The same is true for Enron's competitors, but "wholesale operations" are usually a smaller part of their business, and they trade at far lower multiples.) "Enron is a big black box," gripes another analyst. Without having access to each and every one of Enron's contracts and its minute-by-minute activities, there isn't any way to independently answer critical questions about the company. For instance, many Wall Streeters believe that the current volatility in gas and power markets is boosting Enron's profits, but there is no way to know for sure. "The ability to develop a somewhat predictable model of this business for the future is mostly an exercise in futility," wrote Bear Stearns analyst Robert Winters in a recent report.

To some observers, Enron resembles a Wall Street firm. Indeed, people commonly refer to the company as "the Goldman Sachs of energy trading." That's meant as a compliment. But the fact that part of Goldman's business is inherently risky and impenetrable to outsiders is precisely the reason that Goldman, despite its powerful franchise, trades at 17 times trailing earnings--or less than one-third of Enron's P/E. And as Long Term Capital taught us, the best-laid hedges, even those designed by geniuses, can go disastrously wrong. "Trying to get a good grip on Enron's risk profile is challenging," says Shipman.

Nor at the moment is Enron's profitability close to that of brokerages (which, in fairness, do tend to be more leveraged). While Wall Street firms routinely earn north of 20% returns on their equity--Goldman's ROE last year was 27%--Enron's rate for the 12 months ended in September (the last period for which balance sheet information is available) was 13%. Even less appealing is Enron's return on invested capital (a measure including debt), which is around 7%. That's about the same rate of return you get on far less risky U.S. Treasuries.

Enron vehemently disagrees with any characterization of its business as black box-like. It also dismisses any comparison to a securities firm. "We are not a trading company," CFO Andrew Fastow emphatically declares. In Enron's view, its core business--where the company says it makes most of its money--is delivering a physical commodity, something a Goldman Sachs doesn't do. And unlike a trading firm, which thrives when prices are going wild, Enron says that volatility has no effect on its profits--other than to increase customers, who flock to the company in turbulent times. Both Skilling, who describes Enron's wholesale business as "very simple to model," and Fastow note that the growth in Enron's profitability tracks the growth in its volumes almost perfectly. "People who raise questions are people who have not gone through [our business] in detail and who want to throw rocks at us," says Skilling. Indeed, Enron dismisses criticism as ignorance or as sour grapes on the part of analysts who failed to win its investment-banking business. The company also blames short-sellers for talking down Enron. As for the details about how it makes money, Enron says that's proprietary information, sort of like Coca-Cola's secret formula. Fastow, who points out that Enron has 1,217 trading "books" for different commodities, says, "We don't want anyone to know what's on those books. We don't want to tell anyone where we're making money."

In addition to its commodities business, Enron has another division called Assets and Investments that is every bit as mysterious. This business involves building power plants around the world, operating them, selling off pieces of them, "invest[ing] in debt and equity securities of energy and communications-related business," as Enron's filings note, and other things.

Actually, analysts don't seem to have a clue what's in Assets and Investments or, more to the point, what sort of earnings it will generate. Enron's results from that part of its business tend to be quite volatile--profits fell from \$325 million in the second quarter of 1999 to \$55 million in the second quarter of 2000. In written reports, Morgan Stanley chalked up the decline to the poor performance of Enron's "significant number of investments" in telecom stocks; Dain Rauscher Wessels blamed it on a lack of asset sales.

In any event, some analysts seem to like the fact that Enron has some discretion over the results it reports in this area. In a footnote to its 1999 financials, Enron notes that it booked "pretax gains from sales of merchant assets and investments totaling \$756 million, \$628 million, and \$136 million" in 1999, 1998, and 1997. "This is an enormous earnings vehicle, which can often be called upon when and if market conditions require," notes UBS Warburg analyst Ron Barone. Not everyone is so chipper. "We are concerned they are liquidating their asset base and booking it as recurring revenue, especially in Latin America," says analyst Andre Meade at Commerzbank--who has a hold rating on the stock. At the least, these sorts of hard-to-predict earnings are usually assigned a lower multiple.

There are other concerns: Despite the fact that Enron has been talking about reducing its debt, in the first nine months of 2000 its debt went up substantially. During this period, Enron issued a net \$3.9 billion in debt, bringing its total debt up to a net \$13 billion at the end of September and its debt-to-capital ratio up to 50%, vs. 39% at the end of 1999. Nor does Enron make life easy for those who measure the health of a business by its cash flow from operations. In 1999 its cash flow from operations fell from \$1.6 billion the previous year to \$1.2 billion. In the first nine months of 2000, the company generated just \$100 million in

cash. (In fact, cash flow would have been negative if not for the \$410 million in tax breaks it received from employees' exercising their options.)

But Enron says that extrapolating from its financial statements is misleading. The fact that Enron's cash flow this year was meager, at least when compared with earnings, was partly a result of its wholesale business. Accounting standards mandate that its assets and liabilities from its wholesale business be "marked to market"--valued at their market price at a given moment in time. Changes in the valuation are reported in earnings. But these earnings aren't necessarily cash at the instant they are recorded. Skilling says that Enron can convert these contracts to cash anytime it chooses by "securitizing" them, or selling them off to a financial institution. Enron then receives a "servicing fee," but Skilling says that all the risks (for example, changes in the value of the assets and liabilities) are then transferred to the buyer. That's why, he says, Enron's cash flow will be up dramatically, while debt will be "way down, way down" when the company publishes its full year-end results, which are due out soon.

That's good, because Enron will need plenty of cash to fund its new, high-cost initiatives: namely, the high-cost buildout of its broadband operations. In order to facilitate its plan to trade excess bandwidth capacity, Enron is constructing its own network. This requires big capital expenditures. So broadband had better be a good business. Both Enron and some of the analysts who cover it think it already is. Included in the \$126 a share that Enron says it's worth is \$40 a share--or \$35 billion--for broadband. Several of Enron's analysts value broadband at \$25 a share, or roughly \$22 billion (and congratulate themselves for being conservative). But \$22 billion seems like a high valuation for a business that reported \$408 million of revenues and \$60 million of losses in 2000. Not all analysts are so aggressive. "Valuing the broadband business is an "extremely difficult, uncertain exercise at this point in time," notes Bear Stearns' Winters, who thinks that broadband, while promising, is worth some \$5 a share today.

Of course everything could go swimmingly. Enron has told analysts that it plans to sell between \$2 billion and \$4 billion of assets over the next 12 months. The bullish scenario for Enron is that the proceeds from those sales will reduce debt, and as earnings from new businesses kick in, the company's return on invested capital will shoot upward. Along with broadband, Enron has ambitious plans to create big businesses trading a huge number of other commodities, from pulp and paper to data storage to advertising time and space. Perhaps most promising is its Enron Energy Services business, which manages all the energy needs of big commercial and industrial companies. Skilling has told analysts that its new businesses will generate a return on invested capital of about 25% over the long run.

But all of these expectations are based on what Wolfe, the J.P. Morgan strategist, calls "a little bit of the China syndrome"--in other words, if you get x% of y enormous market, you'll get z in revenues. For instance, Enron says the global market for broadband and storage services will expand from \$155 billion in 2001 to somewhere around \$383 billion in 2004. "Even a modest market share and thin margins provide excellent potential here," writes Ed Tirello, a Deutsche Bank Alex. Brown senior power strategist. The problem, as we know from innumerable failed dot-coms, is that the y enormous market doesn't always materialize on schedule. And Enron isn't leaving itself a lot of room for the normal wobbles and glitches that happen in any developing business.

In the end, it boils down to a question of faith. "Enron is no black box," says Goldman's Fleischer. "That's like calling Michael Jordan a black box just because you don't know what

he's going to score every quarter." Then again, Jordan never had to promise to hit a certain number of shots in order to please investors.

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SOME PEOPLE liken Enron, with its massive trading operation, to a Wall Street securities firm.

COLOR PHOTO: AFP

ENRON still has plenty of old-economy iron and steel assets like this one, but it has been selling them off at a steady clip.

COLOR CHART: FORTUNE CHART

Enron's stock is soaring

Enron

S&P 500

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JEFF SKILLING, a former consultant, has taken over the reins from chief executive officer Kenneth Lay.