Ask WHY?

Instructions: So What is this Company Worth—ballpark, estimate?

See Financial Statements. Take all numbers as fair and accurate.

Take no more than 20 minutes:

Determine whether this business is worth investing in. What is it worth? Why? Is this a good business? Why or why not?

What critical information do you need to get or look at if you wanted to fully analyze this company?

To get to the essence of the company I go right to the financial statement or summary of the financial data. A sports writer goes to the video tape; the analyst looks at the numbers first. I read that Warren Buffett prefers not to even know the price of the company before he looks at the financial statements. You have an advantage if you go to the numbers first before even knowing what the company does or the price of its stock. Keep your mind clear of prejudice, noise and stories.

Ask: Is this a good business. What is it?

ITEM 6. SELECTED FINANCIAL DATA (UNAUDITED)

	2000	1999	1998	1997	1996
Operating Revenues (millions)	**$100,78**9	$40,112	$31,260	$20,273	$13,289
Total Assets (millions)	**$ 65,503**	$33,381	$29,350	$22,552	$16,137

Big jump of almost 100% in assets! Financed by debt or stock?

	2000	1999	1998	1997	1996
Common Stock Statistics(a)					
Income before cumulative effect of accounting changes					
Total (millions)	979	1,024	703	105	584
Per share - basic	$1.22	$1.36	$1.07	$0.16	$1.16
Per share - diluted	$1.12	$1.27	$1.01	$0.16	$1.08
Earnings on common stock					
Total (millions)	$896	$827	$686	$ 88	$568
Per share - basic	$1.22	$1.17	$1.07	$0.16	$1.16
Per share - diluted	$1.12	$1.10	$1.01	$0.16	$1.08
Dividends on common stock ***Why?***					
Total (millions)	$368	$355	$312	$243	$212
Per share	$0.50	$0.50	$0.48	$0.46	$0.43
Shares outstanding (millions)					
Actual at year-end	752	716	662	622	510
Average for the year - basic	736	705	642	544	492
Average for the year - diluted	**814**	**769**	695	555	540

About a 5% increase in shares so debt financing for the increase in assets.

	2000	1999	1998	1997	1996
Capitalization (millions)					
Short-term and long-term debt	$10,229	$ 8,152	$ 7,357	$ 6,254	$3,349
Minority interests	2,414	2,430	2,143	1,147	755
Company-obligated preferred securities of subsidiaries	904	1,000	1,001	993	592
Shareholders' equity	11,470	9,570	7,048	5,618	3,723
Total capitalization	$25,017	$21,152	$17,549	$14,012	$8,419

Why no mention of LT Debt? Red flags should be flying. The dog that doesn't bark. Look at what they don't tell you. View terms of debt.

(a) Share and per share amounts have been restated to reflect the two-for-one stock split effective August 13, 1999.

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(a) Share and per share amounts have been restated to reflect the two-for-one stock split effective August 13, 1999.

Net income includes the following:

(In millions)	2000	1999	1998	
After-tax results before items impacting comparability	$1,266	$ 957	$ 698	1.9 ROA, 5% ROE
Items impacting comparability: (a)				
Charge to reflect impairment by xxxxxx	(326)	-	-	
Gain on XXCX, Inc. (The zzzzzzz Company), net	39	-	-	
Gains on sales of subsidiary stock	-	345	45	
VBCX-related charges	-	(278)	(40)	
Cumulative effect of accounting changes	-	(131)	-	
Net income	$ 979	$ 893	$ 703	

(a) Tax affected at 35%, except where a specific tax rate applied.

Diluted earnings per share of common stock were as follows:

	2000	1999	1998
Diluted earnings per share(a):			
After-tax results before items impacting comparability	$1.47	$1.18	$1.00
Items impacting comparability:			
Charge to reflect impairment by	(0.40)	-	-
Gain on cccc zzz fffff cc, net	0.05	-	-
Gains on sales of subsidiary stock	-	0.45	0.07
MTBE-related charges	-	(0.36)	(0.06)
Cum. effect of accting chgs	-	(0.17)	-
Diluted earnings per share	$1.12	$1.10	$1.01

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Corp. Corp. and subsidiaries as of December 31, 2000 and 1999, and the results of their operations, cash flows and changes in shareholders' equity for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

XYZ Accountants

February 23, 2001

XYZ CORP. CORP. AND SUBSIDIARIES CONSOLIDATED INCOME STATEMENT

	Year ended December 31,		
(In millions, except per share amounts)	2000	1999	1998
Revenues			
Products	$ 50,500	$19,536	$13,276
Xxxxxx	33,823	15,238	13,939
zzzzzz	9,234	-	-
Other	7,232	5,338	4,045
Total revenues	100,789	40,112	31,260
Costs and Expenses			
Cost of	4,517	34,761	26,381
Operating expenses	3,184	3,045	2,473
Depreciation, depletion and amortization	855	870	827
Taxes, other than income taxes	280	193	201
Impairment of long-lived assets	-	441	-
Total costs and expenses	98,836	39,310	29,882
Operating Income	**1,953**	802	1,378
Other Income and Deductions			
Equity in earnings of unconsolidated equity affiliates	87	309	97
Gains on sales of assets	146	541	56
Gain on the issuance of stock by TNPC, Inc.	121	-	-
Interest income	212	162	88
Other income, net	(37)	181	(37)
Income Before Interest, Minority Interests and Income Taxes	2,482	1,995	1,582
Interest and related charges, net	838	656	550
Dividends on company-obligated preferred securities of subsidiaries	77	76	77
Minority interests	154	135	77
Income tax expense	434	104	175
Net income before cumulative effect of accounting changes	979	1,024	703
Cumulative effect of accounting changes, net of tax	-	(131)	-
Net Income	979	893	703
Preferred stock dividends	83	66	17
Earnings on Common Stock	**$ 896**	**$ 827**	**$ 686**
Earnings Per Share of Common Stock			
Basic			
Before cumulative effect of accounting changes	$ 1.22	$ 1.36	$ 1.07
Cumulative effect of accounting changes	-	(0.19)	-
Basic earnings per share	$ 1.22	$ 1.17	$ 1.07
Diluted			
Before cumulative effect of accounting changes	$ 1.12	$ 1.27	$ 1.01
Cumulative effect of accounting changes	-	(0.17)	-
Diluted earnings per share	$ 1.12	$ 1.10	$ 1.01
Average Number of Common Shares Used in Computation			
Basic	736	705	642
Diluted	814	769	695

<u>A good business?</u>

If we take the operating income from the income statement of $1,953 and divide by the total assets of 65,503 we have a pre-tax return of a whopping 2.98%. Not good.

Perhaps the return on assets is skewed by the addition of assets at the end of the year, but a quick glance to calculate the return on assets for 1999 indicates that operating income (Ebit) of $802 million divided by assets of $33.4 billion is even worse at 2.4%. With $33 to $65 billion in assets this company is not a start-up so we can't expect huge increases in growth and despite the company's huge asset base, there seems to be no economies of scale. Why can't the company's assets earn at least a pre-tax return of 8% to 10%? Also, the company will have to use more and more debt to fund its growth, but growth is not profitable at sub 3% returns. Long-term government bonds in 2000 are yielding about 6% so who would lend to this company? Since the business is in a commodity business of natural gas and telecom, the obvious question would be how can <u>any</u> company have a competitive advantage. Why would Enron be better at commodity trading than J Aron, of Goldman Sachs? And even if they had the best and the brightest, the best and the brightest can leave at any time.

What is it worth—well this is NOT a franchise and it is heavily asset based. From the balance sheet showing telecom equipment, natural gas facilities, etc. book value of $14.09 per share ($11.47 bil. equity divided by 814 million outstanding shares). Unless the company has trough earnings due to an economic slowdown (1999-2000, no sign of a recession, in fact, a nominal boom) the company is not earning an economic return on its assets so at 1/3 to ½ the cost of its assets I think the company is worth AT BEST $5 to $7 a share. The company reported $1.12 per share. The company's growth is not profitable so who cares if it grows. No growth multiple would be $9 to $11 but to have a margin of safety, you would need a $6 to $7 stock. Earnings do not seem sustainable with dividends being paid out of capital while debt is increasing massively. The next step would be to look at the terms and structure of the debt, but a glance at the complexity would leave you saying, why bother unless I am a short seller. The second hurdle to stop you dead in your tracks would be the complexity of Enron's off balance sheet debt structures. If a company doesn't want you to understand what it is doing, then walk away. Yet, Wall Street analysts with CFAs and MBAs justified investing even though in their words, Enron was a "black box."

The bottom line is that the numbers show a POOR business. Don't solve tough problems, move on and forget this company unless you are a short seller.

Time is precious, so eliminate quickly, poor businesses unless that is what you seek to short.

But to <u>continue</u> looking at Enron since we are thick-headed, the price in August 2001 is $42. If you paid that price, you would have a sub 1% return since you are paying 3x book value and the book value return is 2.98%. Can anyone justify paying such a price? And if growth is not profitable with assets generating sub-three percent returns, then why spend any more time on this investment?

Even though $42 was an absurdly high price for Enron, the stock traded at $90 a share in August 2000. Efficient market where are you? When investors are swayed by hype (Enron was the king of Broad-band trading, etc.) and prices are rising, then markets can temporarily become inefficient. Investors in Enron can complain about the fraud and greed, the use of mark-to-market accounting where Enron would sign a long-term contract for energy trading, then make generous assumptions on returns while booking ALL of the profits UPFRONT, but EVEN using the company's numbers at face value, this was a poor business. Since management was incentivized by stock, could there be any possibility of gaming the accounting? As the 1999 10-K read, "The market prices used to value these transactions reflect management's best estimates." (Translate: management's license to print money!). A careful reader would immediately know that the quality of earnings would be suspect. You could keep digging, but smart investors would have walked away after a cursory glance at the financials.

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Bethany McLean asked a simple question: How does Enron make money?

She reports, "Details are hard to come by because Enron keeps many of the specifics confidential for what it terms 'competitive reasons.' And the numbers Enron does present are often extremely complicated. Even quantitatively minded Wall Streeters who scrutinize the company for a living think so.". Actually, analysts don't seem to have a clue what is in Assets and Investments or, more to the point, what sort of earnings it will generate". The lack of clarity raises red flags about Enron's pricey stock.

Even when reports follow the essential guidelines for covering the economy by being skeptical, thinking counter-intuitively and fighting a tendency to follow the pack, stories don't always make a difference.

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Let's look at what a professional short-seller, Jim Chanos of Kynikos Associates thought of Enron in 1999 to 2001.

If we look at page 320 of *The Smartest Guys In the Room*, Chanos says, Enron's return on invested capital (1999) was abysmally low, around 7%--and that figure didn't even include the billions upon billions of off-balance-sheet debt. "They were chewing up capital," says Chanos. He was struck by a three paragraph disclosure in Enron's third-quarter 2000 filing about its dealing with a related party. No matter how many times he read it, he still couldn't understand what it said. He showed it to derivatives specialist, corporate layers and other experts; they couldn't figure it out either. Chanos thought: They must by trying to hide something." And then there were the insider sales. Lay was consistently selling about 2,500 shares a day. Skilling was also selling in big chunks.

Chanos and the others who shorted Enron's stock didn't have any special information that wasn't available to the bulls. "As soon as **anyone looked**, they could see the stuff we saw," says Chanos today. At first, he adds, "We didn't think it was some great hidden fraud. We just thought it was a bad business." By November of 2000, he had begun taking a big short position in Enron stock.

Doug Millett, Chief Operating Officer of Kynikos, told *Fortune* writer Bethany McLean that Enron was a hedge fund sitting on top of a pipeline. Would you put your money in a hedge fund earning a 7% return?" Chanos said, "Read the 10-K and see if you can figure out how they are making money." The two men also noted that Enron was a speculative trading ship, which meant that, at an absolute minimum, its outsize price-to-earnings multiple made no sense. "You don't give these things a 50 multiple even if it's the Goldman Sachs of the energy business," said Chanos.

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In summary, all you have to do is ask simple questions like, "Is this a good business?" And do you understand how the company makes money? If either of those two questions is a *no* or unclear, then WALK AWAY.

At a minimum, look at the primary documents—the 10-K and read it. (See article below).

Good investors feed good businesses capital and starve bad businesses of capital—therefore performing a useful service to society.

Yes, we as investors are not saving the Manatee, but we are helping make society richer through improving the productivity of capital investment.

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How Can Investors Spot an Enron?

Jan. 22, 2002 (ABCNews.com) — Hindsight is everything when it comes to Enron, but if the Securities and Exchange Commission and company shareholders carefully read Enron's annual reports, disaster might have been averted.

By law, publicly traded companies like Enron must mail all shareholders an annual report disclosing all relevant financial information and business happenings. Public companies also send their investors proxy statements seeking shareholder approval for certain business activities.

Yet the Enron debacle demonstrates that most shareholders aren't reading the annual reports. Even the SEC, which oversees 12,000 registered companies, recently admitted not having read Enron's annual reports for the last three years.

A review of Enron annual reports and proxy statements for the last three years (found on the company's own Web site) shows signs of trouble.

Currently 37 million Americans have $1.8 billion invested in 401(k) plans. How can average investors spot the red flags that led to the Enron disaster?

Language in the Annual Reports
Look at the language in the report's summary. Is it easy to understand? Are the company's objectives clear? If not, it could be a red flag about the business's operations.

Enron's **1998 annual report** included a simple two-page document, which clearly summarizes a fairly simple business strategy. The company describes itself as a "global energy franchise,' and goes on to say that its "unparalleled ability to deliver on these three words will propel Enron to become THE 'blue chip' electricity and natural gas company of the 21st century." Its stocks show a near 40 percent return, versus 28 percent for the S&P 500, and 2.9 for their peers in the business.

In 1999, the company's strategy gets murky. Its opening statement said: "Enron is moving so fast that sometimes others have trouble defining us." Its business summary is also shifting and less well defined. "But we know who we are," the report says. "We are clearly a knowledge-based company, and the skills and resources we used to transform the energy business are proving to be equally valuable in other businesses."

The report says that the company has evolved into a series of global networks, each of which is a leader in its specific region. The networks work its "physical assets harder and drive more high-return products and services into the market." What does this mean? Did anyone know? Still, the company's stock performance was impressive, with a 58 percent return, eight times higher than its peer group and almost triple the S&P 500 return.

By 2000, the annual report contains more and more hype, though stock earnings are up even more: "89 percent, compared with negative 9 percent for the S&P 500."

The report summary says, "Enron hardly resembles the company we were in the early days," adding that "we have metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people."

Financial Statements: Do the Math
The very first page of Enron's financial statement -- its income statement -- shows dramatic revenue growth. From 1998 to 2000, the company revenues jump from $31 billion to $100 billion, a 220 percent increase. At first blush, one would think this is a fantastic business and perhaps become mesmerized by the reported revenue growth.

However, over that same period, the cost to generate that revenue growth grew at an even greater rate. More specifically, operating income (revenues less costs and expenses to generate those revenues) only increased from $1.378 billion in 1998 to $1.953 billion in 2000, or a 42 percent increase. It is worth noting, that by any measure 42 percent is a healthy growth rate, however, there is a disconnect between this number and the topline growth.

You can also look at the actual profit margins on the business, which can be determined through simple math: divide the operating income by the revenues.

In 1998, the margins are ***4.4 percent*** ($1.378 billion divided by $31.26 billion), but by ***2000, margins are just 1.9 percent.*** ($1.953 billion divided by $100.789 billion) These margins don't justify an ***89 percent*** surge in the stock price in 2000.

The Fine Print of Footnotes
Footnotes are both the fine and the revealing print in financial statements, providing a wealth of information about a company's accounting policies. In the case of Enron, the footnotes showed a growing number of partnerships, which Enron was apparently using to hide its growing debt level.

If you own more than 50 percent of a company it must be consolidated on the parent company balance sheet, but if you own less than 50 percent, it typically stays off the balance sheet as an unconsolidated affiliate. Even if the parent owns less than 50 percent, if the owner company exercises some form of control it is no longer deemed independent and therefore should be consolidated.

Why the partnerships? **In order to fund its explosive growth, Enron's debt grew at a very rapid pace.** The risk of the growing debt level is that it can harm a company's investment grade rating, meaning it would have to pay higher interest rates on borrowed money. It is similar to what an individual does if he or she can't get a bank loan: they max out their credit cards, or go to a loan shark.

So, to avoid this possibility, Enron established partnerships that enabled them to move some of their debt into affiliate companies that should have been independent but weren't. Ultimately, the partnerships were doing the borrowing, which protected Enron's credit ratings. The opening paragraph of the "Related Party Transactions" footnote says it all:

"In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior office of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated parties."

In the 1998 financial statement, there is no "Related Party Transactions" footnote. In 1999, this footnote is less than one column. By 2000, the footnote length has ballooned. The longer the footnote, the more questions should be raised.

Mellody Hobson, president of Ariel Capital Management in Chicago, is Good Morning America's personal finance expert. Ariel associates Matthew Yale and Anne Roche contributed to this report.

END

Why Enron Went Bust

Start with arrogance. Add greed, deceit, and financial chicanery. What do you get?
A company that wasn't what it was cracked up to be.

FORTUNE, December 24, 2001 By Bethany McLean

"Our business is not a black box. It's very simple to model. People who raise questions are people who have not gone through it in detail. We have explicit answers, but people want to throw rocks at us."

So said Enron's then-CEO, Jeff Skilling, in an interview I had with him last February. At the time--less than ten months ago, let's recall--Enron's market capitalization was around **$60 billion**, just a shade below its all-time high, and its status as a Wall Street darling had not yet begun to crumble. I was working on a story that would ultimately raise questions about **Enron's valuation**, and I'd called with what I considered fairly standard queries in an effort to understand its nearly incomprehensible financial statements. The response from Enron was anything but standard. Skilling quickly became frustrated, said that the line of inquiry was "unethical," and hung up the phone. A short time later Enron spokesperson Mark Palmer called and offered to come to FORTUNE's New York City office with then-CFO Andy Fastow and investor-relations head Mark Koenig. "We want to make sure we've answered your questions completely and accurately," he said.

Now, in the wake of Enron's stunning collapse, it looks as if the company's critics didn't throw enough rocks. The world is clamoring for those "explicit answers," but Skilling, long gone from Enron--and avoiding the press on the advice of his lawyers--is in no position to provide them. As for "completely and accurately," many would argue that the men running Enron never understood either concept. "One way to hide a log is to put it in the woods," says Michigan Democrat John Dingell, who is calling for a congressional investigation. **"What we're looking at here is an example of superbly complex financial reports. They didn't have to lie. All they had to do was to obfuscate it with sheer complexity--although they probably lied too."**

Until recently Enron would kick and scream at the notion that its business or financial statements were complicated; its attitude, expressed with barely concealed disdain, was that anyone who couldn't understand its business just didn't "get it." Many Wall Street analysts who followed the company were content to go along. **Bulls, including David Fleischer of Goldman Sachs, admitted that they had to take the company's word on its numbers--but it wasn't a problem, you see, because Enron delivered what the Street most cared about: smoothly growing earnings.** Of course, now that it's clear that those earnings weren't what they appeared, the new cliché is that Enron's business was incredibly complicated--perhaps even too complicated for founder Ken Lay to understand (something Lay has implied since retaking the CEO title from Skilling last summer). Which leads to a basic question: **Why were so many people willing to believe in something that so few actually understood?**

Of course, since the Enron collapse, there are other basic questions as well--questions for which there are still no adequate answers. Even today, with creditors wrangling over Enron's skeletal remains while the company tries desperately to find a backer willing to keep its trading operations in business, outsiders still don't know what went wrong. Neither do Enron's employees, many of whom expressed complete shock as their world cratered. Was Enron's ultimate collapse caused by a crisis of confidence in an otherwise solid company? Or were the sleazy financial dealings that precipitated that crisis--including mysterious off-balance-sheet partnerships run by Enron executives--the company's method of covering up even deeper issues in an effort to keep the stock price rising? And then there's the question that's been swirling around the business community and in Enron's hometown of Houston: Given the extent to which financial chicanery appears to have take place, is someone going to jail?

A Culture of Arrogance

If you believe the old saying that "those whom the gods would destroy they first make proud," perhaps this saga isn't so surprising. "Arrogant" is the word everyone uses to describe Enron. It was an attitude epitomized by the banner in Enron's lobby: the world's leading company. There was the company's powerful belief that older, stodgier competitors had no chance against the sleek, modern Enron juggernaut. "These big companies will topple over from their own weight," Skilling said last year, referring to old-economy behemoths like Exxon Mobil. A few years ago at a conference of utility executives, "Skilling told all the folks he was going to eat their lunch," recalls Southern Co. executive Dwight Evans. ("People find that amusing today," adds Evans.) Or how about Skilling's insistence last winter that the company's stock--then about $80 a share--should sell for $126 a share? Jim Alexander, the former CFO of Enron Global Power & Pipelines, which was spun off in 1994, once worked at Drexel Burnham Lambert and sees similarities. "The common theme is hubris, an overweening pride, which led people to believe they can handle increasingly exotic risk without danger."

To be sure, for a long time it seemed as though Enron had much to be arrogant about. The company, which Ken Lay helped create in 1985 from the merger of two gas pipelines, really was a pioneer in trading natural gas and electricity. It really did build new markets for the trading of, say, weather futures. For six years running, it was voted Most Innovative among FORTUNE's Most Admired Companies. Led by Skilling, who had joined the company in 1990 from consulting firm McKinsey (he succeeded Lay as CEO in February 2001), Enron operated under the belief that it could commoditize and monetize anything, from electrons to advertising space. By the end of the decade, Enron, which had once made its money from hard assets like pipelines, generated more than 80% of its earnings from a vaguer business known as "wholesale energy operations and services." From 1998 to 2000, Enron's revenues shot from $31 billion to more than $100 billion, making it the seventh-largest company on the Fortune 500. And in early 2000, just as broadband was becoming a buzzword worth billions in market value, Enron announced plans to trade that too.

But that culture had a negative side beyond the inbred arrogance. Greed was evident, even in the early days. "More than anywhere else, they talked about how much money we would make," says someone who worked for Skilling. Compensation plans often seemed oriented toward enriching executives rather than generating profits for shareholders. For instance, in Enron's energy services division, which managed the energy needs of large companies like Eli Lilly, executives were compensated based on a market valuation formula that relied on internal estimates. As a result, says one former executive, there was pressure to, in effect, inflate the value of the contracts--even though it had no impact on the actual cash that was generated.

Because Enron believed it was leading a revolution, it encouraged flouting the rules. There was constant gossip that this rule breaking extended to executives' personal lives--rumors of sexual high jinx in the executive ranks ran rampant. Enron also developed a reputation for ruthlessness, both external and internal. Skilling is usually credited with creating a system of forced rankings for employees, in which those rated in the bottom 20% would leave the company. Thus, employees attempted to crush not just outsiders but each other. "Enron was built to maximize value by maximizing the individual parts," says an executive at a competing energy firm. Enron traders, he adds, were afraid to go to the bathroom because the guy sitting next to them might use information off their screen to trade against them. And because delivering bad news had career-wrecking potential, problems got papered over--especially, says one former employee, in the trading operation. "People perpetuated this myth that there were never any mistakes. It was astounding to me."

Trading Secrets

"We're not a trading company," said Fastow during that February visit. "We are not in the business of making money by speculating." He also pointed out that over the past five years, Enron had reported 20 straight quarters of increasing income. "There's not a trading company in the world that has that kind of consistency," he said. "That's the check at the end of the day."

In fact, it's next to impossible to find someone outside Enron who agrees with Fastow's contention. "They were not an energy company that used trading as a part of their strategy, but a company that traded for trading's sake," says Austin Ramzy, research director of Principal Capital Income Investors. "Enron is dominated by pure trading," says one competitor. Indeed, Enron had a reputation for taking more risk than other companies, especially in longer-term contracts, in which there is far less liquidity. "Enron swung for the fences," says another trader. And it's no secret that among non-investment banks, Enron was an active and extremely aggressive player in complex financial instruments such as credit derivatives. Because Enron didn't have as strong a balance sheet as the investment banks that dominate that world, it had to offer better prices to get business. "Funky" is a word that is used to describe its trades.

But there's an obvious explanation for why Enron didn't want to disclose the extent to which it was a trading company. For Enron, it was all about the price of the stock, and trading companies, with their inherently volatile earnings, simply aren't rewarded with rich valuations. Look at Goldman Sachs: One of the best trading outfits in the world, its stock rarely sells for more than 20 times earnings, vs. the 70 or so multiple that Enron shares commanded at their peak. You'll never hear Goldman's management predicting the precise amount it will earn next year--yet Enron's management predicted earnings practically to the penny. The odd mismatch between what Enron's management said and what others say isn't just an academic debate. The question goes to the heart of Enron's valuation, which was based on its ability to generate predictable earnings.

Why didn't that disconnect seem to matter? **Because like Enron's management, investors cared only about the stock price too.** And as long as Enron posted the earnings it promised (and talked up big ideas like broadband), the stock price was supposed to keep on rising--as, indeed, it did for a while. Institutions like **Janus, Fidelity,** and **Alliance Capital** piled in. Of course, earnings growth isn't the entire explanation for Wall Street's attitude. There were also the enormous investment-banking fees Enron generated. Nor was asking questions easy. **Wall Streeters find it hard to admit that they don't understand something.** And Skilling was notoriously short with those who didn't immediately concur with the Enron world-view. "If you didn't act like a light bulb came on pretty quick, Skilling would dismiss you," says one portfolio manager. "They had Wall Street beaten into submission," he adds.

Where Are the Profits?

Although it's hard to pinpoint the exact moment the tide began to turn against Enron, it's not hard to find the person who first said that the emperor had no clothes. In early 2001, Jim Chanos, who runs Kynikos Associates, a highly regarded firm that specializes in short-selling, said publicly what now seems obvious: **No one could explain how Enron actually made money. Chanos also pointed out that while Enron's business seemed to resemble nothing so much as a hedge fund--"a giant hedge fund sitting on top of a pipeline,"** in the memorable words of Doug Millett, Kynikos' chief operating officer--it simply didn't make very much money.

Enron's operating margin had plunged from around 5% in early 2000 to under 2% by early 2001, and its return on invested capital hovered at 7%--a figure that does not include Enron's off-balance-sheet debt, which, as we now know, was substantial. "I wouldn't put my money in a hedge fund earning a 7% return," scoffed Chanos, who also pointed out that Skilling was aggressively selling shares--hardly the behavior of someone who believed his $80 stock was really worth $126.

Not only was Enron surprisingly unprofitable, but its cash flow from operations seemed to bear little relationship to reported earnings. Because much of Enron's business was booked on a "mark to market" basis, in which a company estimates the fair value of a contract and runs quarterly fluctuations through the income statement, reported earnings didn't correspond to the actual cash coming in the door. That isn't necessarily bad--as long as the cash shows up at some point. But over time Enron's operations seemed to consume a lot of cash; on-balance-sheet debt climbed from $3.5 billion in 1996 to $13 billion at last report.

Skilling and Fastow had a simple explanation for Enron's low returns. The "distorting factor," in Fastow's words, was Enron's huge investments in international pipelines and plants reaching from India to Brazil. Skilling told analysts that Enron was shedding those underperforming old-line assets as quickly as it could and that the returns in Enron's newer businesses were much, much higher. It's undeniable that Enron did make a number of big, bad bets on overseas projects--in fact, India and Brazil are two good examples. But in truth, no one on the outside (and few people inside Enron) can independently measure how profitable--or more to the point, how consistently profitable--Enron's trading operations really were. A former employee says that Skilling and his circle refused to detail the return on capital that the trading business generated, instead pointing to reported earnings, just as Fastow did. By the late 1990s much of Enron's asset portfolio had been lumped in with its trading operations for reporting purposes. Chanos noted that Enron was selling those assets and booking them as recurring revenue. In addition, Enron took equity stakes in all kinds of companies and included results from those investments in the figures it reported.

Chanos was also the first person to pay attention to the infamous partnerships. In poring over Enron documents, he took note of an odd and opaque mention of transactions that Enron and other "Entities" had done with a "Related Party" that was run by "a senior officer of Enron." Not only was it impossible to understand what that meant, but it also raised a conflict-of-interest issue, given that an Enron senior executive--CFO Fastow, as it turns out--ran the "Related Party" entities. These, we now know, refer to the LJM partnerships.

When it came to the "Related Party" transactions, Enron didn't even pretend to be willing to answer questions. Back in February, Fastow (who at the time didn't admit his involvement) said that the details were "confidential" because Enron "didn't want information to get into the market." Then he explained that the partnerships were used for "unbundling and reassembling" the various components of a contract. "We strip out price risk, we strip out interest rate risk, we strip out all the risks," he said. "What's left may not be something that we want." The obvious question is, Why would anyone else want whatever was left either? But perhaps that didn't matter, because the partnerships were supported with Enron stock--which, you remember, wasn't supposed to decline in value.

Skilling Sends a Signal

By mid-August enough questions had been raised about Enron's credibility that the stock had begun falling; it had dropped from $80 at the beginning of the year to the low 40s. And then came what should have been the clearest signal yet of serious problems: Jeff Skilling's shocking announcement that he was leaving the company. Though Skilling never gave a plausible reason for his departure, Enron dismissed any suggestion that his departure was related to possible problems with the company. Now, however, there are those who speculate that Skilling knew the falling stock price would wreak havoc on the partnerships--and cause their exposure. "He saw what was coming, and he didn't have the emotional fortitude to deal with it," says a former employee.

What's astonishing is that even in the face of this dramatic--and largely inexplicable--event, people were still <u>willing</u> to take Enron at its word. Ken Lay, who stepped back into his former role as CEO, retained immense credibility on Wall Street and with Enron's older employees, who gave him a standing ovation at a meeting announcing his return. He said there were no "accounting issues, trading issues, or reserve issues" at Enron, and people believed him. Lay promised to restore Enron's credibility by improving its disclosure practices, which he finally admitted had been less than adequate.

Did Lay have any idea of what he was talking about? Or was he as clueless as Enron's shareholders? Most people believe the latter. But even when Lay clearly did know an important piece of information, he seemed to be more inclined to bury it, Enron-style, than to divulge it. **After all, Enron's now infamous Oct. 16 press release--the one that really marked the beginning of the end, in which it announced a $618 million loss but failed to mention that it had written down shareholders' equity by a stunning $1.2 billion--went out under Lay's watch.** And Lay failed to mention a critical fact on the subsequent conference call: that Moody's was considering a downgrade of Enron's debt. (Although Skilling said last February that Enron's off-balance-sheet debt was "non-recourse" to Enron, it turns out that that wasn't quite true either. Under certain circumstances, including a downgrade of Enron's on-balance-sheet debt below investment grade, Enron could be forced to repay it.)

Indeed, facing a now nearly constant barrage of criticism, Enron seemed to retreat further and further from Lay's promises of full disclosure. The rather vague reason that Enron first gave for that huge reduction in shareholders' equity was the "early termination" of the LJM partnerships. That was far from enough to satisfy investors, especially as the Wall Street Journal began to ferret out pieces of information related to the partnerships, including the fact that Fastow had been paid millions for his role at the LJMs. As recently as Oct. 23, Lay insisted that Enron had access to cash, that the business was "performing very well," and that Fastow was a standup guy who was being unnecessarily smeared. The very next day Enron announced that Fastow would take a leave of absence.

We now know, of course, that Enron's dealings with its various related parties had a huge impact on the earnings it reported. On Nov. 8, an eye-popping document told investors that Enron was restating its earnings for the past 4 3/4 years because "three unconsolidated entities should have been consolidated in the financial statements pursuant to generally accepted accounting principles." The restatement reduced earnings by almost $600 million, or about 15%, and contained a warning that Enron could still find "additional or different information."

And sophisticated investors who have scrutinized the list of selected transactions between Enron and its various partnerships are still left with more questions than answers. The speculation is that the partnerships were used to even out Enron's earnings. Which leads to another set of questions: If Enron had ceased its game playing and come completely clean, would the company have survived? Or did Enron fail to come clean precisely because the real story would have been even more scandalous?

The Last Gasp

On the surface, the facts that led to Enron's Dec. 2 bankruptcy filing are quite straightforward. For a few weeks it looked as if Dynegy (which had long prided itself on being the anti-Enron) would bail out its flailing rival by injecting it with an immediate $1.5 billion in cash, secured by an option on Enron's key pipeline, Northern Natural Gas, and then purchasing all of Enron for roughly $10 billion (not including debt). But by Nov. 28 the deal had fallen apart. On that day Standard & Poor's downgraded Enron's debt below investment grade, triggering the immediate repayment of almost $4 billion in off-balance-sheet debt--which Enron couldn't pay.

But even this denouement comes with its own set of plot twists. Both companies are suing each other: Enron claims that Dynegy wrongfully terminated the deal, "consistently took advantage of Enron's precarious state to further its own business goals," and as a result has no right to Enron's Northern Natural pipeline. Dynegy calls Enron's suit "one more example of Enron's failure to take responsibility for its demise." No one can predict how the suits will pan out, but one irony is clear: Enron, that new-economy superstar, is battling to hang on to its very old-economy pipeline.

To hear Dynegy tell it, a **central rationale for abandoning the deal was what might be called the mystery of the missing cash.** General counsel Ken Randolph says that Dynegy expected Enron to have some $3 billion in cash--but an Enron filing revealed just over $1 billion. "We went back to Enron and we asked, 'Where did the cash go? Where did the cash go?' " says CEO Chuck Watson. "Perhaps their core business was not as strong as they had led us to believe," speculates Randolph. Dynegy also claims that Enron tried to keep secrets to the last. Enron's lack of cash was revealed to the world in a filing on the afternoon of Monday, Nov. 19. Watson says he got the document only a few hours earlier--but that Lay had a copy on Friday. "I was not happy," says Watson. "It's not good form to surprise your partner."

Sagas like this one inevitably wind up in the courts--and Enron's is no exception. Given that credit-rating agency Fitch estimates that even senior unsecured-debt holders will get only 20% to 40% of their money back, the battles among Enron's various creditors are likely to be fierce. Nor has Enron itself conceded yet. The company's biggest lenders, J.P. Morgan Chase and Citigroup, have extended $1.5 billion of "debtor in possession" financing to Enron, which will enable it to continue to operate at least for a while. And Enron is still searching for a bank that will back it in restarting its trading business.

In the meantime, the courts will also be trying to answer a key question: Who should pay? Enron's Chapter 11 filing automatically freezes all suits against the company itself while the bankruptcy is resolved. But while Enron may seek the same protection for its executives, lawyers predict that the attempt will fail and that the individuals will have to fend off a raft of suits. Some think that criminal charges are a possibility for former executives like Skilling and Fastow. But such cases require proof of "knowing, willful, intentional misconduct," says well-known defense attorney Ira Sorkin. And a criminal case requires a much higher standard of proof than a civil case: proof beyond a reasonable doubt rather than a preponderance of the evidence. That's a high bar, especially since Enron executives will probably claim that they had Enron's auditor, Arthur Andersen, approving their every move. With Enron in bankruptcy, Arthur Andersen is now the deepest available pocket, and the shareholder suits are already piling up.

In any conversation about Enron, the comparison with Long-Term Capital Management invariably crops up. In some ways, it looks as if the cost of the Enron debacle is far less than that of LTCM--far less than anyone would have thought possible, in fact (see next story). But in other ways the cost is far greater. Enron was a public company with employees and shareholders who counted on management, the board, and the auditors to protect them. That's why one senior Wall Streeter says of the Enron saga, "It disgusts me, and it frightens me." And that's why, regardless of how the litigation plays out, it feels as though a crime has been committed.
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The article below shows how even famous firms like Alliance Bernstein were "duped" into recommending Enron's stock for their clients.

Lesson: Don't trust the experts. Do your own work and thinking.

Lawsuit against Alliance Capital's Purchase of Enron's Stock

"The Enron purchases by Alliance were negligent from the start and became reckless over time," said the 34-page lawsuit filed in Leon County Circuit Court. "As a result of Alliance's negligent and reckless purchases of Enron stock, the Florida Retirement…

To see more of the Tallahassee Democrat, or to subscribe to the newspaper, go to **http://www.Tallahassee.com**

May 8--The state filed suit for more than $300 million against a New York investment firm Tuesday, accusing the company of ignoring "red flags" and pouring Florida's pension money into Enron's plummeting stock.

A spokesman for Alliance Capital Management said the company was duped by Enron, relying on market research and financial statements audited by Arthur Andersen Co. Public affairs director John Meyers said Florida's investments out-performed the market by more than $1 billion during the 17 years that Alliance managed them.

"The Enron purchases by Alliance were negligent from the start and became reckless over time," said the 34-page lawsuit filed in Leon County Circuit Court. "As a result of Alliance's negligent and reckless purchases of Enron stock, the Florida Retirement Fund suffered damages in excess of $300 million." The State Board of Administration demanded repayment with interest, attorney fees and unspecified punitive damages.

The suit said Alliance, the nation's largest publicly traded investment firm with more than $400 billion under management for several states, was paid more than $26 million for its advice under a contract with the SBA. **Since April of 1998, the suit said Enron stock rose from about $26 to $90 a share, then fell to 28 cents when the state finally dumped it Nov. 30 and fired Alliance in December.**

Gov. Jeb Bush, Comptroller Bob Milligan and Insurance Commissioner Tom Gallagher, who make up the SBA, authorized the agency to sue Alliance when the company refused to settle the state's damages claim. SBA Director Tom Herndon said he was in New York just last week, seeking a settlement, but Meyers said an Alliance attorney unsuccessfully sought a meeting with Bush's lawyers this week. "We're disappointed that Florida has filed suit, but will defend ourselves vigorously," he said. "The suit really ignores the fact that Alliance, along with thousands of investors and rating agencies, was misled by what appears to be a massive fraud by Enron."

The state's lawsuit said the SBA contract with Alliance required the company to do thorough market research and be prudent in making investments for the $100 billion-plus Florida Retirement System. "All told, Alliance (through Enron purchases) bet big on a 'faith stock' without the 'rigorous research' required by the agreement -- and lost," said the suit. "As a result of the actions and omissions of Alliance, the SBA has suffered damages in excess of $300 million."

No active or retired public employees will lose any money because of the Enron collapse. The pension fund has ample surpluses and is a "defined benefit" plan, with guaranteed monthly payments to retirees -- regardless of ups and downs in its investments.

But the lawsuit said Enron went far beyond simple bad luck in the market. It said the company's financial statements and news reports in the Wall Street Journal and Dow Jones News Service documented Enron's outside partnerships, but that Alliance ignored warnings. "There were numerous 'red flags' concerning Enron that were readily available before and during Alliance's purchase of Enron stock for the Florida Retirement Fund," the suit said. Florida lost more than any other state in Enron's collapse. Georgia's pension fund lost $127 million and Arizona took a $35 million hit.

"Alliance is doing the rope-a-dope on us," Bush said of the settlement talks. "I've been an advocate of (suing) for a while. I've shown more patience that I normally do."

Milligan said "it doesn't look like these folks are willing to come to the table" and Gallagher added, "I think we ought to move on with it."

Alliance's Meyers responded that "based on information available at the time, we believed our investments in Enron were <u>reasonable</u>." ***(Editor: I would PAY to have him tell me WHY?)***

EXCERPTS FROM THE STATE'S LAWSUITP: "The SBA retained Alliance not to follow the herd

mentality on Wall Street but, instead, to capitalize on Alliance's claimed research excellence ..."
"On Nov. 6, 2000, after watching Enron shares triple in price that year, **Alliance first purchased 150,300 shares of Enron stock at $78.74 per share on behalf of the Florida Retirement Fund.** By the end of that month, Alliance had already purchased 1,331,700 shares of Enron at a cost of nearly $100 million."

"During the following 12 months, ... Alliance continued to purchase Enron stock ..., ultimately amassing a position of 7,583,900 shares at a total cost of nearly $300 million."

"... on Nov. 30, 2001, Alliance finally sold the SBA's entire position in Enron, 7,583,900 shares, at 28 cents per share***."*** ***(Living in a delusion)***

"The character of Alliance's negligence was gross and flagrant ..."

Lesson: Don't listen to stock analysts.

Analysts and Enron

To see more of the Austin American-Statesman, or to subscribe to the newspaper, go to http://www.austin360.com

Feb. 28--WASHINGTON--Continuing what has become a theme in congressional Enron hearings, Wall Street analysts said Wednesday they gave bad advice to investors because they were misled by Enron Corp. executives.

"I recommended Enron stock because I believed in the company's business model and believed in the company's management," said *Raymond Niles, a Salomon Smith Barney* analyst. Niles never issued a "sell" recommendation on Enron, even when its price plummeted late last year.

Other analysts, from J.P. Morgan Chase, Lehman Brothers Holdings Inc. and Credit Suisse First Boston, also said they believed the company's optimistic assessments of its future. But many senators weren't buying the analysts' we-were-duped defense.

"It now seems clear that too many analysts failed to ask `why' before they said `buy,' " said Sen. Joseph Lieberman, D-Conn., chairman of the Senate Governmental Affairs Committee. Ten of the 15 analysts following Enron were still recommending its stock as a "buy" or "strong buy" as late as Nov. 8, two weeks after the Securities and Exchange Commission said it was investigating the company's accounting practices, he noted. That day, the stock closed at $8.41 a share, down from $79.90 at the beginning of 2001.

Even as the company's stock crashed to less than $1 last year, Lehman Brothers didn't drop its "strong buy" rating until Dec. 6, five days after the company filed for bankruptcy. Critics contend that analysts, caught between conflicting interests, fail to give candid assessment of stocks because their firms want investment banking business from the companies. The four analysts denied that they were pressured.

"I have complete freedom with respect to the recommendations that I make concerning any (stock), and my compensation is not tied to the recommendations that I make," said Anatol Feygin, an analyst at J.P. Morgan Securities Inc.

The analysts said Congress has no need to legislate changes on Wall Street, such as forcing firms to sell off their analysts' operations or at least forcing them to make broader disclosures about possible financial conflicts.

Sen. George Voinovich, R-Ohio, said that while analysts may claim their views are unclouded by conflicts of interest, investors may no longer believe them. "You have an appearance problem," he said. Howard Schilit, president of the Center for Financial Research and Analysis, said Enron's problems should have been obvious to the analysts.

Schilit said he spent just an hour going over Enron's financial reports from last year and immediately could see trouble ahead. The reports were peppered with phrases such as "non-cash sales" and "related-party revenue, which would set off alarms for unbiased analysts, he said.
In related developments Wednesday:

-- Enron's pension plan is seriously underfunded and the government might have to step in to pay guaranteed benefits, the executive director of the Pension Benefit Guaranty Corp. told Congress.
The government's pension insurance program "has not taken over any Enron plans, but we are closely monitoring the situation," said Steven Kandarian, executive director of the program. Enron's pension plan is underfunded by at least $125 million, Kandarian said. The plan has about 20,000 participants and about $220 million in assets.

-- The Securities and Exchange Commission is meeting with lawyers for Arthur Andersen LLP, Enron's former auditing firm, which is trying to settle its part of shareholder lawsuits involving Enron.
The agency is trying to help reach a settlement that would allow Andersen to survive to maintain competition in the accounting industry.

-- David Duncan, who led the Enron audit team at Andersen, reportedly has offered to help the Justice Department investigation.

Duncan approached the Justice Department even before the firm said in January it would fire him. He has since met with federal investigators under a limited immunity arrangement.

-- A federal judge in New York rejected Enron's request to allow at least $30 million in insurance proceeds to be paid for company executives' mounting legal costs.

"The Enron purchases by Alliance were negligent from the start and became reckless over time," said the 34-page lawsuit filed in Leon County Circuit Court. "As a result of Alliance's negligent and reckless purchases of Enron stock, the Florida Retirement…
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The lessons can go on and on…..Many market professionals are too riven with conflicts, lack of time, sloth and misunderstanding to analyze companies.

APPENDIX

To dig deeper go to the following links:

Enron's 2000 Annual Report: http://www.scribd.com/doc/66581243/En-Ron-Annual-Report-2000

Enron's Moral Hazard Study: http://www.scribd.com/doc/66580950/Enron-Moral-Hazard-Case-Study

For a brief corporate history of Enron: http://www.scribd.com/doc/66581537/Enron-EDF-Credit-Ratings

How beginning investors approached analyzing Enron: http://www.scribd.com/doc/66581472/Cornell-Students-Research-Story-on-Enron-1998

Cornell Students' Research on Enron: http://www.scribd.com/doc/66581472/Cornell-Students-Research-Story-on-Enron-1998

A Professional Research Firm, Off-Wall Street's *In-depth* Research on Enron: http://www.offwallstreet.com/reports/NEW_ENE_5.6.01.pdf This is worth reading for how the analyst breaks apart Enron's businesses for a short sale recommendation.