Kenneth L. Lay
CAR Comments
August 10, 1993

If 75% LTV is exceeded + margin call made, B'er should return near LTV to 70%. MM 8/10

Executive Summary

This CAR requests a $6MM confirmed line of credit to Ken Lay, Chairman and CEO of Enron Corp. The majority of the proceeds of the loan will be used to refinance a loan made by Enron to enable Lay to purchase $5MM in Enron stock. Since this will be a purpose loan under Regulation U, Lay will pledge 185M shares of unrestricted Enron Corp. common stock currently worth $12.6MM for a 50% LTV ($68-1/4 per share as of 8/9/93). Mr. Lay will be required to pledge additional shares or reduce the outstanding balance should the LTV exceed 75% (Regulation U does not require additional monitoring if LTV requirements based on the total commitment are met at closing). Enron is a large capitalization stock with sufficient trading volume on the NYSE to enable Lay to liquidate shares to repay this debt. This underwriting decision is based on the marketability and collateral coverage of the Enron stock securing this facility. Interest will be payable monthly and the outstanding principal will be due at maturity, one year from closing. The facility is priced at NationsBank Prime - 1/2% with no fees. The recommended risk rating is '4' based on the collateral (consistent with Credit Policy guideline for risk ratings on loans secured by readily marketable stock) and the exposure strategy is 'increase'. Lay is not currently a customer of NationsBank and was introduced to the Private Bank by Joe Musolino. The Energy Banking Group has approximately $125MM in credit exposure to Enron on an unsecured basis (risk rating of 5).

Transaction Analysis

- **Credit Policy Exceptions:** 1) Lay's financial statements have not been prepared on NationsBank forms containing certification language and contingent liability disclosure. 2) While Lay's balance sheet is current, cash flow information is 180 days old. Waiver of these credit exceptions is requested based on the marketability and collateral coverage provided by the Enron stock securing this facility. Furthermore, Lay's financial assistant, Sally Keepers, verbally stated to RM that Lay has no contingent liabilities.

- **Use of Proceeds.** Enron advanced Lay $5MM in 1989 for the purpose of acquiring Enron stock. The initial advance under the requested facility would be used to retire this Enron loan, and the shares securing the Enron loan will be transferred to NationsBank. As a result, this facility is a purpose loan under Regulation U and is subject to a maximum initial LTV of 50%. It is assumed that the balance of the loan proceeds will be used to purchase margin stock as well.

- **Repayment Sources.** Although Lay has substantial cash flow generating ability, the primary repayment source for this loan is the timely liquidation of Enron stock by Lay. Enron has recently been trading near its 52-week high of $68-1/2 as a result of strong earnings growth, and average trading volumes should allow Lay to liquidate shares in an orderly manner. Enron is a fully integrated natural gas company whose interests in gas pipelines, exploration and production, natural gas liquids and power generation provide diversification.

  Secondary sources of repayment include Lay's earnings from his employment at Enron and the substantial value of Lay's unexercised Enron stock options.

- **Collateral/Rule 144.** Lay beneficially owns less than 1/2% of Enron's outstanding shares. However, due to Lay's position as Chairman and CEO, he must follow the control restrictions of Rule 144. After satisfying the standard public reporting requirements, the number of shares Lay may sell during any three month period may not exceed the greater of the following:

  1) **1% of the shares of the class outstanding.** There are approximately 119MM shares of Enron Corp. common stock outstanding with a total market value of over $8 billion. *(1% = 1.19MM shares @ 68-1/2 per share = 81MM)*

  2) **Average weekly trading volume as reported on all national securities exchanges during the previous four-week period.** Per Bloomberg reporting system, the average weekly trading volume for the previous four weeks ending 7/30/93 was approximately 1MM shares. *(Avg. Weekly Volume = 1MM shares @ 68-1/2 per share = $68.5MM)*

  3) **Average weekly trading volume reported in the consolidated reporting system during the previous four-week period.** Same as item two above.

<u>Key Critical Issues:</u>

- **Concentration of Wealth/Income.** Lay's wealth is concentrated in Enron common stock and his recurring cash flow is dependent upon his employment at Enron. This risk is mitigated by the strong performance of Enron under Lay's leadership in addition to the conservative advance ratio of 50%. Wall Street has rewarded this performance and Enron's stock is trading near a 52-week high of $68-1/2. The company is expected to continue to perform well due to its diversification across most segments of the natural gas business in addition to the strengthening of natural gas prices.

- **Single Repayment Source.** Given the concentration of Lay's wealth in Enron, liquidation of Enron stock pledged as collateral is the repayment source for this loan. Enron's stock has significantly appreciated over the past year and now trades at a premium to its peer group (Enron's P/E is 23 versus 18-20 for the gas pipeline industry). While the stock has been less volatile than the market (beta is .85), the recent price appreciation makes the stock vulnerable to a potential correction. This risk is mitigated by the conservative 50% advance ratio for this credit facility and the fundamental strengths of Enron that are driving the price appreciation (strong earnings growth, attractiveness of the natural gas industry).

- **Negative Cash Flow.** As detailed in the attached cash flow worksheet, Lay had negative cash flow on a recurring basis in 1992. This cash flow shortfall ($1.9MM) was covered through the exercise of stock options for $6MM. The risk of negative recurring cash flow is mitigated by the following:

  1) Lay's unrestricted ownership of Enron stock is currently worth $24MM, representing a significant source of liquidity to meet potential cash flow shortfalls.

  2) A large portion of Lay's reported cash uses is discretionary in nature and could be reduced if necessary.

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3) Lay holds Enron stock options with a current value of $28MM; approximately half of these options are currently exercisable. While the value of these options fluctuates with the price of Enron's stock, the options represent another significant source of funds for Lay given the current outlook for Enron's stock.

- **Multiple Creditors/Margin Calls.** In addition to this proposed credit facility, Lay also has notes payable to Charter Bank and Texas Commerce in the amount of $3.1MM and $1.6MM, respectively. These notes are secured by Enron stock and other marketable securities based on a 75% LTV. Lay has approximately 88M shares available to meet margin calls. Enron's stock price would have to decline by 40% (to $40/share) before Lay's ability to meet margin calls would be diminished. Given the strong performance of Enron, a stock price decline of this magnitude is unlikely.

- **Regulation U Compliance.** Although the initial LTV will not exceed 50%, a margin call for this facility will not occur below a 75% LTV. Regulation U states that if the 50% margin requirement based on the total commitment is met at closing, then no additional monitoring of the LTV is required going forward unless the Borrower requests a withdrawal or substitution of collateral. The 75% margin call is therefore allowable under Regulation U and is justified based on the marketability and trading volume of the Enron stock pledged as collateral.

Relationship Summary

- Ken Lay is a high profile executive who leads one of the largest fully integrated natural gas companies in the world. The requested credit facility represents an excellent opportunity to begin a relationship with this important member of Houston's business community. Lay currently has banking relationships with Texas Commerce Bank and Charter Bank.

Cash Flow:

- Mr. Lay's recurring sources of cash totaled $3,958M through January 13, 1993, consisting primarily of his salary ($900M), incentive bonus ($1,665M), deferred income ($404M), long term incentive bonus ($1,453M), and deferred salary ($885M). The incentive bonus is paid to Mr. Lay based on the results achieved by Enron during each year. In addition, Enron provides for a long term incentive bonus in the form of deferred income, based on the performance of the company generally over a four-year period, to compensate the officers of the company for achieving certain results. Mr. Lay also received dividend income of $263M from his Enron stock, rental income of $102M from his investments (primarily apartments) in Houston, Missouri, and Austin, and directors fee income of $57M.

- Recurring uses of cash ($4,474M) consist of estimated taxes ($3,189M), living expenses ($1,213M), and alimony payments ($72M). Mr. Lay's debt service totaled $1,349M of which $607M was for his homes in Houston, Aspen, and Galveston. In addition, interest expense for the note payable to Enron (for the purchase of Enron stock) was $533M, debt service for Mr. Lay's investment properties was $168M, and other debt service (cars/boats) was $41M. The recurring cash uses exceeded recurring sources by $1.9MM, however, this shortfall was covered by exercised stock options as discussed below. It should be noted that living expenses and children expenses are discretionary items that Mr. Lay could reduce if necessary.

- Enron Corporation stock options of $6,026M (a non-recurring source of cash) resulted in positive net cash flow of $4,161M. Although recurring cash earnings were unable to cover debt service, Mr. Lay's stock options provided positive net cash flow. It should be noted that the Enron stock options generally provide for a vesting period of four years and an additional six years before expiration. Lay's remaining Enron stock options have a current value of roughly $28MM, of which approximately half are currently exercisable.

Liquidity:

- As of 6/21/93, Mr. Lay's liquid assets totaled $25,100M of which Enron Corporation stock accounted for $22,761M, or 90.7%, (only 6% is restricted stock) of total liquid assets. Marketable securities accounted for $1,503M (6%) consisting of Compaq stock ($1,009M) and various other publicly traded stock. In addition, Enron Oil and Gas stock accounted for $632M (2.5%) of total liquid assets. The remaining liquid assets consist of an IRA ($147M), cash ($42M), CVLI ($12M) and savings bonds ($2M). Although Mr. Lay's liquid assets are concentrated in Enron stock (90.7%), his liquidity remains strong due to the marketability of this stock.

Leverage:

- As of 6/21/93, total liabilities were $17,022M consisting primarily of a note payable to Enron Corporation ($7,450M) for the purchase of Enron Corp. stock; a note payable to Charter National Bank ($3,106M); the mortgage on his residence in Houston ($2,606M); and a note payable to TCB-Houston ($1,532M). The mortgages on his vacation homes in Aspen and Galveston accounted for $1,320M and $292M of total liabilities, respectively. The remaining liabilities consist primarily of notes payable on his investment properties ($716M). Mr. Lay did not report any contingent liabilities at 6/21/93. It should be noted that total liquid assets of $25,100M covered total debt of $17,022M 1.5 times. As of 6/21/93, Mr. Lay's net worth was $20,569M, while his adjusted net worth was $10.2MM.

James H. Shelton
Relationship Manager
(713) 247-6497

James C. Ehrlich
Credit Analyst
(713) 247-7744