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Trusts Keeping Enron Off Balance

By **Peter Eavis**
 Senior Columnist
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Enron (ENE:NYSE - news - commentary - research - analysis) stock plunged 20% last week after the energy giant revealed that a complex financing deal caused a \$1.2 billion hit to its equity. But other big deals that have yet to receive much public scrutiny could further damage the company's balance sheet.

In the spotlight last week were transactions done with investment partnerships called LJM2 and LJM Cayman. An examination of the LJM2-related equity writedown [can be found here](#).

However, the LJM deals make up only part of Enron's sophisticated financing arrangements. Also at issue are two large trusts that contain assets Enron shifted from its balance sheet. These are the \$1 billion Marlin Water Trust II and the \$2.4 billion Osprey Trust, usually known as Whitewing.

The key risk for investors is how Enron chooses to repay these trusts if they don't unwind as planned. The company may end up issuing stock to repay money borrowed through the trusts. This would dilute existing shareholders. Alternatively, Enron could resort to using cash raised through sales of on-balance sheet assets. But this would hamper efforts to reduce debt and deprive the company's profitable business lines of much-needed capital.

Whitewing and a Prayer?

Though set up by Enron, Marlin II and Whitewing are legally distinct from the company. Institutional investors bought notes issued by the trusts. The \$3.4 billion in proceeds from the notes flowed to Enron.

Both trusts are scheduled to unwind in 2003. Originally, Enron had hoped to repay them by selling the trusts' underlying assets. This repayment method would have had a minimal impact on Enron's balance sheet.

However, there's a potential problem brewing with this approach. The value of the assets may be too low to raise sufficient funds to pay back the trust investors. Hence Enron's two unenviable options: issuing stock, or raising cash from its own balance sheet.

Enron treasurer Ben Glisan concedes that assets in Marlin II won't be sufficient to pay it back. But he

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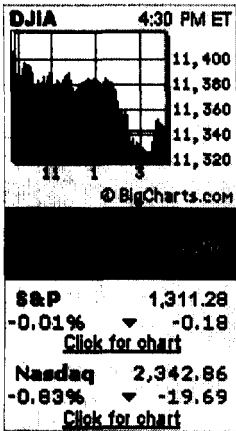
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adds that proceeds from planned sales of on-balance sheet assets will provide Enron with the necessary funds for Marlin II. When asked if Whitewing's assets are adequate for repayment, Glisan replied: "We believe so."

In reference to the two trusts, Enron CEO Kenneth Lay said on a conference call Tuesday: "We anticipate the sale of assets will be the primary source of repayments."

Sterling Marlin

TheStreet.com hasn't seen offering documentation for Whitewing; Enron didn't provide it when requested. But *TSC* has reviewed the Marlin II prospectus. Here's how Marlin II works. Enron took water assets, primarily based in the U.K., off its balance sheet, and the Marlin II trust took a stake in them. Meanwhile, Marlin II issued senior debt to investors, the proceeds of which went to Enron. The company didn't have to recognize these notes as debt on its balance sheet, due to the structure of the trust. Marlin II replaced a similar trust called Marlin that was set to mature at the end of this year.

Ideally, the aim was for Enron managers to maximize the value and profitability of the assets over the life of Marlin and Marlin II so it could sell them off and pay down the trusts. To cover the risk that asset sales wouldn't raise enough money, Enron also pledged to issue as much new convertible preferred stock as might be needed to pay off the notes.

As it happened, the water assets didn't perform well. In fact, Enron set up Marlin II in July to succeed the original Marlin because it wanted to avoid paying off the first Marlin with convertible stock, or with cash from its own balance sheet. This move risked angering the rating agencies that had agreed not to treat Marlin as debt because of Enron's pledge to backstop it with preferred stock. Suddenly, it seemed Enron was wriggling out of its commitment to make good with stock.

Enron's Glisan responds that many of the investors in the first Marlin also invested in Marlin II, illustrating that investors weren't upset by the maneuver.

Glisan says Enron almost certainly won't decide to issue stock to pay off Marlin II. Instead, he adds, money from pending asset sales can be used to pay it off when it matures in July 2003. When asked if Enron might use the expected \$1.9 billion in proceeds from selling Portland General, the utility based in Portland, Ore., Glisan replied: "That's a good one."

But using the Portland General windfall would run counter to Enron's frequently stated strategy of selling off low-yielding assets and investing the proceeds in higher-yielding businesses. Portland General is almost certainly a more profitable business than the U.K.'s Wessex Water, which is the dominant asset in Marlin II. In addition, doing so would mean Enron couldn't use all the Portland proceeds to pay off debt. Enron aims to get its debt-to-total-capital ratio down to 40%, from the current 50%.

Maturity

What about Whitewing, which matures in early 2003? Glisan lists Whitewing's assets as: Central American gas distribution assets; turbines destined for European power stations; interests in European power stations; and various debt and equity participations in energy investments. Glisan says these assets can be sold to pay off the \$2.4 billion in notes issued by the trust.

But what would happen if the Whitewing assets can't fetch the necessary price? Enron could sell off more on-balance-sheet assets. But, again, this wouldn't help debt-reduction efforts, and it may be running short of large assets that it can quickly sell.

Whitewing is backed with Enron convertible stock. But Enron may be reluctant to issue paper when its stock is so far below recent highs, and current shareholders may begrudge the prospect of further dilution.

Investors also need to keep their eyes on the early-repayment triggers of the trusts. In fact, the stock

price-related element of the triggers has already been set off. For Whitewing, the stock has to fall below \$59.78; for Marlin II, the stock has to be under \$34.13. However, something else has to happen before the trust investors can claim their money back through asset sales and stock issuance. Enron's credit rating must fall below investment grade. That looks to be a long shot, since its rating is currently three notches above subinvestment grade. But it is something the market will watch after Moody's said last week that it was putting Enron on review for a possible downgrade.

Despite all the questions stemming from the trusts, Enron still seems keen to use the structure. Last week, Barclays Capital was inviting investors to subscribe to an Enron-related entity called the Besson Trust. This is being set up to enable Enron "to monetize substantially all of its interests in EOTT Energy Partners," an Enron affiliate that markets and transports crude oil. Expected proceeds from the deal are \$227 million, according to the prospectus. Could Enron be setting up new trusts to pay off damaged old trusts?

Due to off-balance sheet financings like Marlin II and Whitewing, it's clear that uncertainty could weigh on Enron's battered stock for some time.

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