

Rating: Sell  
S&P 500: 1122

## **Kinder Morgan Inc.** **High Risk Compensation Model**

<i>Symbol</i>	KMI	<i>Ebitda Next Twelve Months ending 3/31/05 (US\$m)</i>	1,200
<i>Rating</i>	Sell	<i>North American Natural Gas/Ebitda (%)</i>	0
<i>Price (US\$/sh)</i>	59.34	<i>Natural Gas and Oil Production/Ebitda (%)</i>	12
<i>Pricing Date</i>	6/4/04	<i>Adjusted Reserves/Production NTM</i>	12.0
<i>Shares (mm)</i>	125	<i>EV/Ebitda</i>	12.3
<i>Market Capitalization (US\$m)</i>	7,400	<i>PV/Ebitda</i>	8.0
<i>Debt (US\$m)</i>	6,800	<i>Undeveloped Reserves (%)</i>	50
<i>Enterprise Value (EV) (US\$m)</i>	14,300	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	23.78
<i>Present Value (PV) (US\$m)</i>	9,300	<i>Present Value Proven Reserves(US\$/boe)</i>	12.28
<i>Net Present Value (US\$/share)</i>	20	<i>Present Value Proven Reserves(US\$/mcf)</i>	2.05
<i>Debt/Present Value</i>	0.73	<i>Earnings Next Twelve Months (US\$/sh)</i>	4.08
<i>McDep Ratio - EV/PV</i>	1.53	<i>Price/Earnings Next Twelve Months</i>	15
<i>Dividend Yield (%/year)</i>	3.8	<i>Indicated Annual Dividend (US\$/sh)</i>	2.25

Note: Estimated cash flow and earnings at recent quarter rate annualized.

Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

### **Summary and Recommendation**

We continue to recommend sale of the shares of **Kinder Morgan Inc. (KMI)** on the basis of overvaluation, high financial risk and high business risk. Investors are paying 12.3 times cash flow for tenuous participation in properties that change hands in the industry for half that multiple, or less. A high ratio of debt that takes account of partnership debt that is not included on the company's balance sheet points to high financial risk. High compensation of 41% of cash distributions from a partnership creates misplaced incentives to sacrifice maintenance of partnership pipelines and understate the accounting impact. We see some 66% depreciation potential to net present value of \$20 a share subject to the main concern that the market can be slow to recognize overvaluation and environmental jeopardy.

### **Value Business at Eight Times Cash Flow**

Our process of estimating company-specific present value begins with an estimate of next twelve months cash flow. Current projections lead to a healthy level of unlevered cash flow, also known as Ebitda, short for earnings before interest, tax, depreciation and amortization (see table). We choose the next twelve months ending March 31, 2005 as the relevant time period.

For the next twelve months we project operations near the first quarter 2004 level. That is sufficient for our valuation calculation. We assess a multiple of 8.0 times to estimate a present value for all the company's businesses. That is higher than the 6.0 times we assess for the largest publicly-held energy operations in the world. It is lower than the 9.0 times we have assessed in the past for high-quality, utility-type operations.

**Please see disclosures on the final page.**

**Kinder Morgan, Inc.**  
**Next Twelve Months Financial Results**

	<i>Q1</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Next Twelve Months</i>
	<i>3/31/04</i>	<i>6/30/04</i>	<i>9/30/04</i>	<i>12/31/04</i>	<i>2004E</i>	<i>3/31/05</i>	<i>3/31/05</i>
<b>Revenue (\$mm)</b>	353	353	353	353	<b>1,412</b>	353	<b>1,412</b>
Expense	63	63	63	63	<b>251</b>	63	<b>251</b>
<b>Ebitda</b>							
Natural Gas Pipelines	134	134	134	134	<b>537</b>	134	<b>537</b>
Kinder Morgan Energy Partners	156	156	156	156	<b>624</b>	156	<b>624</b>
Total Ebitda	290	290	290	290	<b>1,161</b>	290	<b>1,161</b>
Deprec., Deplet., & Amort.	29	29	29	29	<b>116</b>	29	<b>116</b>
Kinder Morgan Energy Partners	27	27	27	27	<b>108</b>	27	<b>108</b>
<b>Ebit</b>	234	234	234	234	<b>937</b>	234	<b>937</b>
Interest	38	38	38	38	<b>152</b>	38	<b>152</b>
<b>Ebt</b>	196	196	196	196	<b>785</b>	196	<b>785</b>
Income Tax	69	69	69	69	<b>275</b>	69	<b>275</b>
<b>Net Income (\$mm)</b>	128	128	128	128	<b>510</b>	128	<b>510</b>
<b>Shares (millions)</b>	125	125	125	125	<b>125</b>	125	<b>125</b>
Per Share (\$)	1.02	1.02	1.02	1.02	<b>4.08</b>	1.02	<b>4.08</b>
Ebitda Margin	82%	82%	82%	82%	82%	82%	<b>82%</b>
Tax Rate	35%	35%	35%	35%	35%	35%	<b>35%</b>

**Majority of Cash Flow from Partnership**

Ironically, KMI derives its largest cash flow from a partnership that is carried only as an investment on the company's balance sheet. The partnership has three main businesses.

The largest partnership business, product pipelines, is showing its age. Last year an old gasoline line failed in Arizona causing consternation for consumers in several states. More recently an old underwater line failed in California.

The next partnership business, natural gas pipelines, transmits natural gas mainly intrastate Texas. That is a competitive business with ties to controversy. Recall Coastal States Gas which promised long-term natural gas supply at fixed prices that it could not honor. Recall Texas Oil and Gas which was successfully sold to U.S. Steel that soon could not find the value that it thought it acquired. Recall Houston Natural Gas, a less controversial operation that became a vehicle to launch Enron.

The partnership's third business, labeled carbon dioxide pipelines, is essentially an oil producing business with promising prospects in a higher oil price environment. The partnership has succeeded to ownership of half the Yates oil field, once the jewel of Marathon Oil. Remaining oil-in-place attributable to the partnership is more than a billion barrels. While the partnership does not report reserves, we suggest that only about 50 million of that might be classified as proven recoverable.

### **Company Operations Concentrated on Aging Natural Gas Pipelines**

Most of the remaining cash flows from Natural Gas Pipeline of America (NGPL), a mainline from Texas to Chicago. The pipeline generates stable cash flow after a challenging transition from wellhead price regulation to deregulation.

Regional patterns of transportation are in constant flux. Chicago may get more of its future gas from Canada or Alaska or indirectly from imported liquefied natural gas. Gas landed at the coast may not need to be transported through NGPL or it may back out other sources that find a new outlet in NGPL.

The company had the idea of installing electric generating facilities along its line as a way of using potentially idle capacity. Those investments were written off when a surplus of generating capacity developed.

### **Financial Leverage Understated**

When we look at the company's balance sheet we measure "debt" of \$4.4 billion. To that we add \$2.4 billion for a 41% share of partnership debt to match the 41% of partnership cash flow we allocate to the company. In a distorted representation, the company reports practically none of that extra debt on its balance sheet while reporting most of the cash flow on its income statement. As a result, we calculate a ratio of debt to present value of 0.73, well above the maximum debt we would like to see in an energy stock. In our experience a ratio above 0.50 has often pointed to distress. Investors who like more leverage might be better advised to add it at the portfolio level by owning more of lower debt companies. That way control of the extra leverage remains in the hands of the investor rather than a management that may not have the same flexibility when faced with distress.

If one were to assume that the shares of the company were just another form of ownership in a consolidated entity that included the operations of the partnership and operations of the general partner the ratio of debt to present value would be 0.65. That is an average of the higher ratio we calculate for a proportionally consolidated general partner and the lower ratio for a "self-standing" partnership. In a distress situation creditors are likely to look to both entities to satisfy claims. Further confounding the appearance of separation, the general partner guarantees some of the debt of the partnership.

### **Compensation Model Increases Business Risk**

In an escalating pattern, the general partner currently receives 41% of the distributions from the partnership. Thus, we allocate 41% of present value to the general partner. On that basis, KMI, the company, looks like a less overvalued stock than that of the partnership.

The market neutral allocation to the general partner may be about 30% of value of the partnership. On that assumption, if we modeled accurately enough, the market cash flow multiple of both the partnership and the company would be about 13 times, in between the high multiples the market accords each entity.

One source of business risk is that the regulatory authorities eventually may require the general partner's compensation to be more fully reflected in the accounting statements. For example, the partnership is too important for its debt not to show on the company's balance sheet. Similarly because the cash flow the company receives is described as compensation rather than ownership it is all reported as profit to the company. That is a nice trick that turns expenses into profits.

Among the regulators, the Securities and Exchange Commission has been under staffed until recently. At the same time the company is well-connected politically.

Another source of business risk is environmental and legal in connection with safer pipeline operation. Accidents will happen and we can be sympathetic. It is harder to accept when the partnership facilities are operated by a general partner whose high compensation encourages undermaintenance and potential threat to safety and the environment. For example, the partnership's pipelines are as old as single hull tankers. Perhaps the most sensitive should be upgraded to "double hull" standards.

Finally, the company's high valuation seems to depend on high valuation of the partnership that in turn appears to depend on continued access to the capital markets. The conditions appear delicately balanced for now, but an unexpected upset would likely have a magnified impact.

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