Rating: Sell
S&P 500: 1106

Kinder Morgan Inc.
Momentum Challenge

Symbol	KMI	*Ebitda Next Twelve Months ending 6/30/05 (US$mm)*	1,100
Rating	Sell	*North American Natural Gas/Ebitda (%)*	0
Price (US$/sh)	61.00	*Natural Gas and Oil Production/Ebitda (%)*	12
Pricing Date	9/1/04	*Adjusted Reserves/Production NTM*	12.0
Shares (mm)	125	*EV/Ebitda*	13.1
Market Capitalization (US$mm)	7,600	*PV/Ebitda*	8.5
Debt (US$mm)	6,800	*Undeveloped Reserves (%)*	50
Enterprise Value (EV) (US$mm)	14,400	*Natural Gas and Oil Ebitda (US$/boe)*	24.07
Present Value (PV) (US$mm)	9,300	*Present Value Proven Reserves(US$/boe)*	12.10
Net Present Value (US$/share)	20	*Present Value Proven Reserves(US$/mcfe)*	2.02
Debt/Present Value	0.73	*Earnings Next Twelve Months (US$/sh)*	3.75
McDep Ratio - EV/PV	1.55	*Price/Earnings Next Twelve Months*	16
Dividend Yield (%/year)	3.7	*Indicated Annual Dividend (US$/sh)*	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 high valuation, high financial risk and high business risk. More than half the cash flow and most of the growth for the company come from its ownership of **Kinder Morgan Energy Partners (KMP)** and **Kinder Morgan Management (KMR)**. The partnership continues to report incremental progress in natural gas pipelines, oil products and enhanced oil recovery and has increased its quarterly distribution. In particular, we believe the partnership has a valuable asset in its 50% ownership of the Yates oil field in West Texas. Yet as the stock appears to be trading without momentum on its 200 day average, we reaffirm our concerns.

Investors are Paying More than the Value of the Businesses

Projected cash flow of about $1100 million for the Next Twelve Months ended June 30, 2005 appears somewhat less than we projected it for the period ended three months earlier. We had apparently overlooked a seasonal decline in summer quarters. Actual results will reflect industry conditions, investment decisions and operating actions that might be anticipated in more detail, but the illustration is sufficient for valuation perspective (see table Next Twelve Months Financial Results).

About 125 million shares are projected to be outstanding for the period. The current share price implies an equity market value of $7.6 billion. Add $6.8 billion of debt and the Enterprise Value becomes $14.4 billion as stated above. The debt requires some explanation because it is more than the company reports for reasons discussed below. By our standard translation the company's latest balance sheet shows debt of $4.3 billion. To that we add $2.5 billion as the company's 51% proportionally consolidated share of partnership debt.

Kinder Morgan, Inc.
Next Twelve Months Financial Results

	Q1 *3/31/04*	*Q2* *6/30/04*	*Q3E* *9/30/04*	*Q4E* *12/31/04*	***Year* *2004E***	*Q1E* *3/31/05*	*Q2E* *6/30/05*	***Next Twelve Months* *6/30/05***
Ebitda								
Natural Gas Pipelines	134	97	97	134	**461**	134	97	**461**
Kinder Morgan Energy Partners	156	160	160	160	**637**	160	160	**640**
Total Ebitda	290	257	257	294	**1,098**	294	257	**1,102**
Deprec., Deplet., & Amort.	29	30	30	30	**119**	30	30	**120**
Kinder Morgan Energy Partners	27	27	27	27	**109**	27	27	**108**
Ebit	234	200	200	237	**870**	237	200	**873**
Interest	38	38	38	38	**152**	38	38	**152**
Ebt	196	162	162	199	**718**	199	162	**721**
Income Tax	69	57	57	70	**251**	70	57	**252**
Net Income ($mm)	128	105	105	129	**467**	129	105	**469**
Shares (millions)	125	125	125	125	**125**	125	125	**125**
Per Share ($)	1.02	0.84	0.84	1.04	**3.74**	1.04	0.84	**3.75**
Ebitda Margin	82%	108%	108%	83%	93%	83%	108%	**93%**
Tax Rate	35%	35%	35%	35%	35%	35%	35%	**35%**

Now we can calculate a ratio of Enterprise Value to unlevered cash flow, EV/Ebitda, of 13.0 times. In contrast, we assess the value of the businesses at 8.5 times. On August 31, the partnership announced a $100 million pipeline acquisition it asserted would produce $18 million annually in distributable cash flow. The purchase price translates to 5.6 times cash flow though we may never know all the details. If incremental transactions are priced that low, it tends to confirm that the mix of existing operations are not likely worth much more on average.

The ratio of Enterprise Value to Present Value or business value is our McDep Ratio. At 1.54 it prompts us to consider whether the stock is overvalued. How can investors justify paying the premium to business value? Most likely the investors in the stock are impressed at how profitable it is for the general partner. We have to agree that the partnership is a money machine for the general partner. Yet, we still would not want to pay a McDep Ratio of 1.54. In addition there is the nagging uncertainty about how much longer the money machine can go.

Financial Risk Appears Understated

Kinder Morgan, Inc. receives 41% of the distributed cash of the partnership as general partner compensation. It also owns units or i-shares that increase its ownership to the point where the combined interest is about 51% of the partnership. Under normal circumstances a 51% owned entity would be consolidated on the balance sheet of the owner. Yet KMI does not count most of the general partner share of distribution as ownership and thus claims that it owns less than 20% of the partnership. Therefore it is not required to show the debt of the partnership on KMI's balance sheet. As a result, KMI can say it has only about 50% debt and KMP has only about 50% debt when the reality is that the combined entities have about 65% debt. Some investors may applaud KMI for being so clever. Others may consider it a red flag when a company hides debt in a partnership. In the end the risks of the general partner and the partnership are linked.

Compensation Creates Misplaced Incentives

The third distinctive feature and risk factor is the 41% general partner compensation. While individuals are free to pay any compensation to managers that they wish, institutions have a fiduciary responsibility. In fact few institutions seem to own KMP. Yet KMR is designed for institutions. We see a problem for most institutions to justify owning that stock because each new dollar invested essentially puts $.41 into the pocket of the general partner who makes essentially no capital outlay. Private equity and hedge fund compensation at 20% of gains appears institutionally acceptable. 41% compensation to a general partner regardless of gains appears to be pushing the envelope. It may not be a problem as long as it works, but it could be indefensible if it doesn't.

Kurt H. Wulff, CFA

Research Methodology/Ratings Description: McDep Associates is an independent research originator focused on oil and gas stocks exclusively. The firm applies the thirty years of experience of its analyst to estimate a present value of the oil and gas resources and other businesses of covered companies. That value is compared with a company's stock market capitalization and debt. Stocks with low market cap and debt relative to present value tend to outperform stocks with high market cap and debt relative to present value. Buy recommendations are expected to deliver a total return better than 7% per year above inflation. Hold recommendations assume the attributes of the underlying business are reflected in the current price of the stock. Sell recommendations are expected to deliver a negative total return less than 7% per year including the effects of inflation.