Rating: Sell
S&P 500: 1095

Kinder Morgan Inc.
Fallen Star

Symbol	KMI	*Ebitda Next Twelve Months ending 9/30/05 (US$mm)*	1,160
Rating	Sell	*North American Natural Gas/Ebitda (%)*	0
Price (US$/sh)	63.00	*Natural Gas and Oil Production/Ebitda (%)*	12
Pricing Date	10/25/04	*Adjusted Reserves/Production NTM*	12.0
Shares (mm)	125	*EV/Ebitda*	12.9
Market Capitalization (US$mm)	7,900	*PV/Ebitda*	8.3
Debt (US$mm)	7,100	*Undeveloped Reserves (%)*	50
Enterprise Value (EV) (US$mm)	15,000	*Natural Gas and Oil Ebitda (US$/boe)*	19.43
Present Value (PV) (US$mm)	9,600	*Present Value Proven Reserves(US$/boe)*	8.55
Net Present Value (US$/share)	20	*Present Value Proven Reserves(US$/mcfe)*	1.43
Debt/Present Value	0.74	*Earnings Next Twelve Months (US$/sh)*	3.98
McDep Ratio - EV/PV	1.56	*Price/Earnings Next Twelve Months*	16
Dividend Yield (%/year)	3.6	*Indicated Annual Dividend (US$/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

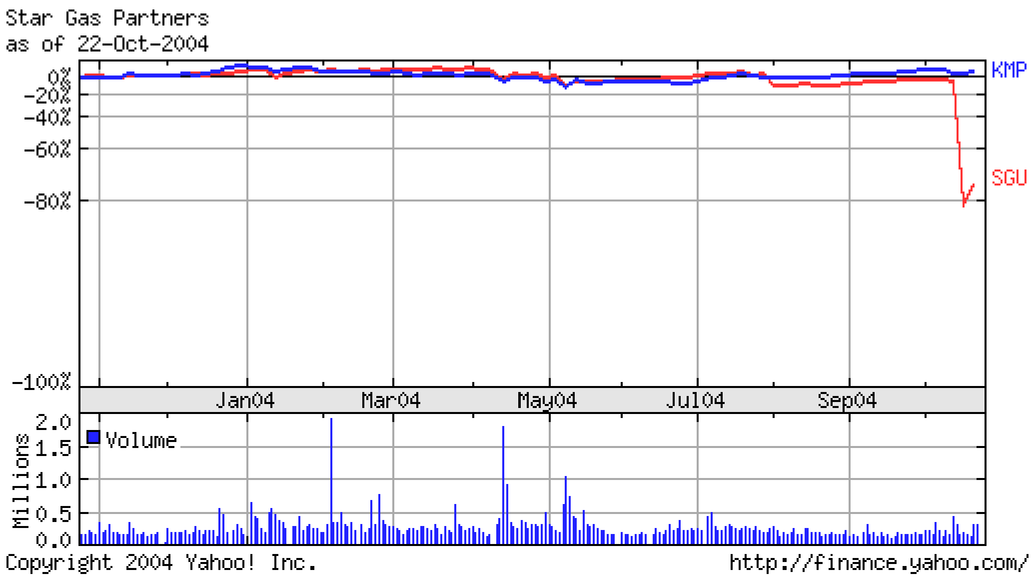
The 80% collapse in stock price for Star Gas Partners LP (SGU) last week attests to the unrecognized risks we see in sell-recommended **Kinder Morgan Energy Partners (KMP)**, **Kinder Morgan Management LLC (KMR)** and **Kinder Morgan Inc. (KMI)**. A highly-leveraged, downstream energy partnership with potentially explosive general partner compensation, Star imploded despite having the active participation of a well-known director, Mr. Thomas Edelman. Only a few months ago the partnership that bills itself as the nation's largest retail distributor of home heating oil enjoyed Wall Street and investor support in an underwriting of new common units. Adding to the risks exposed by Star, Kinder Morgan, in our opinion, understates debt, overstates earnings and compensates the general partner excessively without fully disclosing the negative impact. By our analysis, KMI stock has the potential to lose 68% of value to reach $20 a unit estimated present value of equity in the next few years.

Stock Price and Income Nightmare

SGU stock traded in a stable pattern and then dropped 80% instantly (see chart). For comparison purposes we note that that the stock price pattern leading up to the collapse was nearly indistinguishable from KMP, for example.

The drop in unit price coincides with the suspension of the distribution. One week income investors thought they were getting a $2.30 per unit annual distribution, the next week their income vaporized.

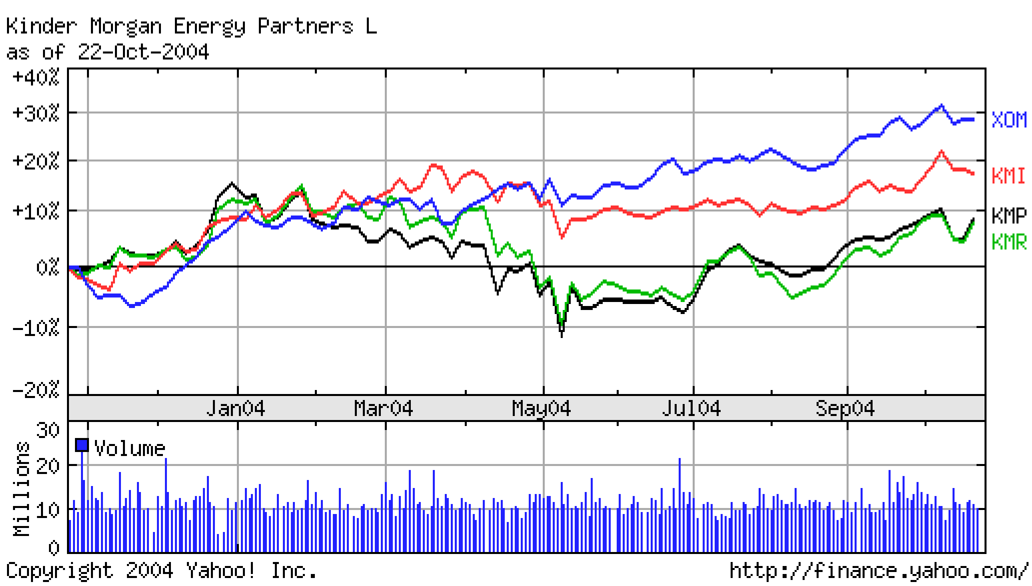
Management attributes Star's difficulties to the inability to pass on heating oil price increases and to customer attrition. In one of its gambits to convince investors of the stability of its cash flow, management used weather insurance. Unfortunately, Star could not weather all contingencies. Moreover, being a highly leveraged partnership that used debt to finance distributions, Star had no long underwear. The Star example illustrates a type of risk that may not show up right away, but is catastrophic when it occurs. Investors need to recognize such vulnerability and avoid it, in our opinion.



Kinder Morgan Underperforms

Though Kinder Morgan stock has not collapsed in the past year, it has underperformed the energy industry. We compare the three KMx stocks with the largest, lowest risk energy stock, **ExxonMobil (XOM)** (see chart).

The difference widens when one adjusts for financial risk. For example, XOM has a ratio of debt to present value of 0.08; KMI 0.74. Equal positions in unlevered present value would have the amount invested in XOM stock 3.5 times the amount invested in KMI stock (1-0.08)/(1-0.74). Alternatively, one could say that the unlevered return in XOM was 27% (29% times (1-.08)) compared to KMI at only 5% (18% times (1-.74)).



High Valuation, High Financial Risk and High Business Risk

We like the energy business, but we believe it is unwise for investors to pay a double digit cash flow multiple, EV/Ebitda, for the KMx entities when the largest and best energy stocks in the world are priced at mid-single digit multiples. Moreover, the combined KMx with high debt and questionable accounting have little ability to withstand a change in financial conditions. Finally, we do not believe that paying 42% of average and 50% of incremental distributions to the general partner, who makes essentially no capital contribution, can be a viable, long-term, healthy business.

Commodity Price Helps Incremental Cash Flow

In the low oil and gas price environment of the 1990s, KMx attempted to minimize commodity uncertainty with its emphasis on fixed price business. In the extreme case more recently, KMx bought half the Yates oil field in West Texas, an asset jewel, and apparently sold the oil forward for years at about $25 a barrel, half the current price. Investors were encouraged to pay a high multiple for KMx cash flow because it was growing steadily independent of commodity price.

Now it is ironic that KMx get some current positive news from commodity price. We have added a commodity section to our quarterly model that illustrates potential revenue gains from oil price advances. It appears that the natural gas liquids portion of KMx's oil production is unhedged. If so and if actual oil prices follow futures, it would add some $6 million to next quarter's revenue, $4 million to quarterly cash flow and match about half the $9 million increase in quarterly distribution (see table <u>Next Twelve Months Financial Results</u>).

Partnership Continues to Hide Debt

It was amusing to read that KMI has "reduced" its debt in the past quarter. We see an increase in ratio of debt to present value for KMP from 0.49 to 0.52. Our ratio of debt to present value for KMI rises from 0.73 to 0.74 in the latest quarter. We believe that KMI misleads investors when it does not report KMP debt on the KMI balance sheet.

Compensation Milestone

With the latest increase in distribution, the general partner's average share rises to 42% from 41% rounded. That is the highest we know of in the energy industry.

We question whether investors get fair presentation of general partner compensation. We believe the general partner fees are equivalent to an equity interest that should be disclosed as a reduction of limited partner equity on the balance sheet of KMP. In fact, KMI calls its proceeds from KMP "equity earnings". We further believe that KMI overstates its earnings from KMP when it reports an amount two-thirds of what KMP reports and it claims that is does not own enough KMP to require consolidated reporting.

Kinder Morgan, Inc.
Next Twelve Months Financial Results

	Q1 *3/31/04*	*Q2* *6/30/04*	*Q3* *9/30/04*	*Q4E* *12/31/04*	***Year*** ***2004E***	*Q1E* *3/31/05*	*Q2E* *6/30/05*	*Q3E* *9/30/05*	***Next Twelve Months*** ***9/30/05***
Ebitda									
Natural Gas Pipelines	134	97	98	134	**463**	134	98	98	**464**
Kinder Morgan Energy Partners	156	161	174	174	**665**	174	174	174	**695**
Total Ebitda	290	257	272	308	**1,127**	308	272	272	**1,159**
Deprec., Deplet., & Amort.	29	30	30	30	**119**	30	30	30	**120**
Kinder Morgan Energy Partners	27	28	30	30	**115**	30	30	30	**119**
Ebit	234	200	212	248	**894**	248	212	212	**920**
Interest	38	38	39	39	**154**	39	39	39	**156**
Ebt	196	162	173	209	**740**	209	173	173	**764**
Income Tax	69	57	60	73	**259**	73	60	60	**267**
Net Income ($mm)	128	105	112	136	**481**	136	112	112	**496**
Shares (millions)	125	125	125	125	**125**	125	125	125	**125**
Per Share ($)	1.02	0.84	0.90	1.09	**3.85**	1.09	0.90	0.90	**3.98**
Tax Rate	35%	35%	35%	35%	35%	35%	35%	35%	**35%**

Star Gas Reminds Investors of the High Risk of Partnerships with Misplaced Incentives

Star Gas reminds us of the low financial quality of partnerships with exploding compensation agreements. The misplaced incentives seem to drive the partnerships to unsound practices such as using debt to finance distributions. Along the way, there appears to be inadequate communication of financial risks and results.

Kurt H. Wulff, CFA

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