

Rating: Sell  
 S&P 500: 1174

## **Kinder Morgan Inc.** **Our Contrary View**

<i>Symbol</i>	KMI	KMP	KMR	KMx
<i>Rating</i>	Sell	Sell	Sell	
<i>Price (US\$/sh)</i>	74.12	46.39	42.45	
<i>Pricing Date</i>	4/13/05	04/13/05	04/13/05	
<i>Publicly Held Shares (mm)</i>	125	132	41	
<i>Market Capitalization (US\$mm)</i>	9,300	6,120	1,760	17,200
<i>Debt (US\$mm)</i>	7,000	2,120	660	9,800
<i>Enterprise Value (EV) (US\$mm)</i>	16,300	8,240	2,420	27,000
<i>Present Value (PV) (US\$mm)</i>	9,500	4,100	1,280	14,900
<i>Net Present Value (US\$/share)</i>	20	15	15	
<i>Debt/Present Value</i>	0.74	0.52	0.52	0.66
<i>McDep Ratio - EV/PV</i>	1.71	2.01	1.88	1.81
<i>Ebitda Next Twelve Months ending 3/31/06 (US\$mm)</i>	1,270	540	169	1,980
<i>North American Natural Gas/Ebitda (%)</i>	0	0	0	
<i>Natural Gas and Oil Production/Ebitda (%)</i>	11	20	20	
<i>Adjusted Reserves/Production NTM</i>	6.2	6.2	6.2	
<i>EV/Ebitda</i>	12.8	15.3	14.3	13.6
<i>PV/Ebitda</i>	7.5	7.6	7.6	7.5
<i>Undeveloped Reserves (%)</i>	42	42	42	
<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	20.36	20.36	20.36	
<i>Present Value Proven Reserves(US\$/boe)</i>	17.49	17.49	17.48	
<i>Present Value Proven Reserves(US\$/mcf)</i>	2.92	2.92	2.91	
<i>Earnings Next Twelve Months (US\$/sh)</i>	4.53	2.35	2.35	
<i>Price/Earnings Next Twelve Months</i>	16	20	18	18
<i>Indicated Annual Distribution (US\$/sh)</i>	2.80	2.92	2.92	
<i>Distribution Yield (%/yr)</i>	3.8	6.3	6.9	5.0

Reported results may vary widely from estimates.

Estimated present value per share revised only infrequently.

### **Summary and Recommendation**

Shares of sell-recommended **Kinder Morgan Inc. (KMI)**, **Kinder Morgan Energy Partners (KMP)**, and **Kinder Morgan Management LLC (KMR)** offer unlevered depreciation potential along with high risk. On a combined basis the three stocks in the same energy organization are valued at some 14 times unlevered cash flow, almost triple that for the median energy stock in our coverage. Sliced and diced, half the distributions are sent to the general partner, KMI, where they are reported almost entirely as earnings. The remaining partnership distributions are paid in cash to limited partners, KMP, and in additional units that are transformed to shares for KMR. In our opinion, KMI hides debt and exaggerates earnings while KMP/KMR misrepresents general partner compensation. Investors with disproportionate concentration in KMx should be sure to reduce their exposure to a high probability of decline from current price.

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### **High Valuation on Combined Basis**

Combining the pieces of Kinder Morgan we construct a consolidated entity that we might call KMx. The combination would presumably be valued in the stock market near Present Value of about \$15 billion. Estimated Present Value to unlevered cash flow, PV/Ebitda, is 7.5 times. Indeed the largest, safest and most successful energy stock in the world on a long-term basis, **ExxonMobil (XOM)**, has a multiple of Enterprise Value to unlevered cash flow, EV/Ebitda, of less than 7 times. Yet KMx commands a higher value in the stock market with an EV/Ebitda multiple near 14 times.

Income investors seem to be content with the dividend in KMP while overlooking the fact that the general partner gets 50% of incremental cash flow and 42% of average cash flow for practically no capital outlay. Investors in the general partner, KMI, seem happy with the escalating general partner compensation with little concern about how long such an arrangement can last.

### **Debt Pyramid Not Fully Reported**

KMP reports leverage near the 0.52 in our head table that is still lower than 0.66 for the combined entities. KMI reports leverage near the same level as KMP, but much lower than the 0.74 we attribute to KMI. The explanation is that KMI reports none of the KMP debt on KMI's balance sheet. KMI apparently justifies the omission of partnership debt by ignoring the ownership implication of the general partner's 42% share of limited partner cash flow. In addition KMI has cross-ownership in KMP units and KMR shares that take its effective equity in KMP to more than 50%. Computerized data services miss that important point as the machines simply read and spit back what management discloses. Essentially KMI hides debt in the KMP partnership.

### **Earnings Manufactured with Acquisitions**

KMP is the preferred vehicle for making acquisitions that can then be reported favorably in the KMx accounting system. A recent acquisition of terminals in Texas assures further accounting gains. While the terminal, storage and transportation business can be attractive, the assets do not usually command a very high multiple of cash flow because of the uncertainty of how long the cash flow will last. For a short time the acquisition looks very good because the high rate of current cash flow supports distributions that go half to limited partners. The remainder goes to the general partner where they are reported as earnings because the general partner made no capital outlay.

The manufacturing process works even better when the seller of the acquired asset is the general partner. Late last year the general partner transferred a pipeline asset to the limited partnerships. Not only did the general partnership collect the full price of the transaction, it essentially retains half ownership by virtue of its right to half the distributions.

### **General Partner Compensation Misrepresented**

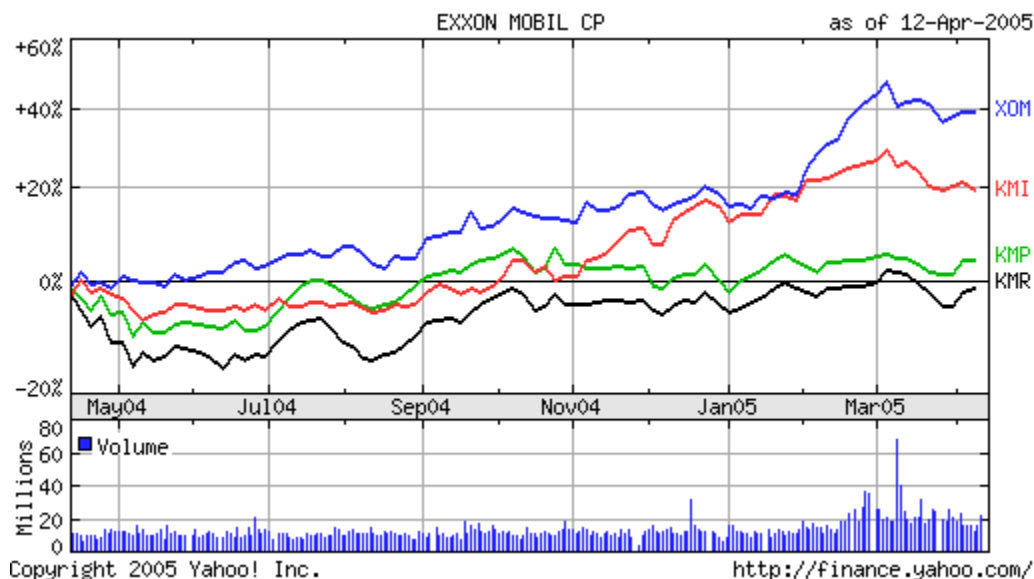
There is no clear provision in the balance sheet of the partnership to show that the general partner effectively owns half the equity. We doubt that owners of KMP fully realize that they are financing 100 percent of acquisitions and immediately are giving up half the value in distributions.

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**Unlevered Performance Waning**

Despite the popularity of KMx in the past, diminishing returns appear to be setting in. On the competitive front, KMx is doing smaller deals. Larger transactions are being done by partnerships that have limited general partner compensation to half the level extracted by KMI. A new Limited Liability Company, LLC, format promises no general partner compensation.

Stock market gains also appear to be diminishing particularly when any adjustment is made for debt. In a good year for energy stocks, KMI showed 20% appreciation while KMP and KMR held about even before counting a dividend yield of about 6% (see chart Exxon Mobil).



The problem with direct stock price comparisons is that they overlook financial risk. When investors buy KMx they are indirectly taking on more debt risk than for the typical energy stock. We illustrate that by calculating the gain in enterprise value, stock price and debt, over the past year. On that basis the 20% gain for KMI drops to 10% (see table Debt-Adjusted Stock Price Change).

**Debt-Adjusted Stock Price Performance**

	Price 4/13/2005	Price 4/12/2004	Price Change	Debt/Share	Stock Price Plus Debt 4/13/2005	Stock Price Plus Debt 4/12/2004	Enterprise Value Change
KMI	74.12	62.75	18%	56.00	130.12	118.75	10%
KMP	46.39	44.41	4%	16.00	62.39	60.41	3%
KMR	42.45	42.61	0%	16.00	58.45	58.61	0%
XOM	59.15	43.11	37%	4.00	63.15	47.11	34%

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A more conservative comparison could be to use ratios of debt to present value to adjust performance. In the end investors can adjust debt in each stock by adjusting the amount owned in a portfolio without actually borrowing any funds. Investors who think KMI is performing well because it was up 20% in the past year may be ignoring risk. The risk-adjusted gain is less and last year was a good one for most energy stocks.

### **Cash Flow Projections Interrelated**

General partner Kinder Morgan Inc. derives most of its growth from its participation in Kinder Morgan Energy Partners (see tables Next Twelve Months Financial Results). The partnership derives cash flow from natural gas pipelines, oil product pipelines, oil production and terminals. The latest acquisition has not been included in projections.

### **Value Disparity Appears Wide**

KMI stock appears to have potential for depreciation in a group of stocks including downstream operations (see table Rank by McDep Ratio). Similarly, KMP and KMR seem uncompetitive in value with income stocks.

Kurt H. Wulff, CFA

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

	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Next Twelve Months</i>
	<i>9/30/04</i>	<i>12/31/04</i>	<i>2004</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005E</i>	<i>3/31/06</i>	<i>3/31/06</i>
<b>Ebitda</b>										
Natural Gas Pipelines	98	201	529	134	97	98	201	529	134	529
Kinder Morgan Energy Partners	174	185	676	184	179	185	191	740	190	745
Total Ebitda	272	386	1,205	318	276	283	391	1,269	324	1,274
Deprec., Deplet., & Amort.	30	30	119	30	30	30	30	120	30	120
Kinder Morgan Energy Partners	30	32	117	32	32	32	32	128	32	128
<b>Ebit</b>	212	324	969	257	214	221	329	1,021	262	1,027
Interest	39	39	154	39	39	39	39	156	39	156
<b>Ebt</b>	173	285	815	218	175	182	290	865	223	871
Income Tax	60	100	285	76	61	64	102	303	78	305
<b>Net Income (\$mm)</b>	112	185	530	141	114	118	189	562	145	566
<b>Shares (millions)</b>	125	125	125	125	125	125	125	125	125	125
Per Share (\$)	0.90	1.48	4.24	1.13	0.91	0.95	1.51	4.50	1.16	4.53
Tax Rate	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%

**Kinder Morgan Energy Partners, L.P.**  
**Next Twelve Months Financial Results**

	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Next Twelve Months</i>
	<i>9/30/04</i>	<i>12/31/04</i>	<i>2004</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005E</i>	<i>3/31/06</i>	<i>3/31/06</i>
<b>Oil Volume</b>										
Oil (mmb)	3.6	4.0		3.9	3.9	4.0	4.0	16	3.9	16
Oil (mbd)	39	43		43	43	43	43	43	43	43
<b>Oil Price (\$/bbl)</b>										
WTI Cushing	43.89	48.31		49.65	54.24	55.80	55.45	53.79	54.80	55.07
Partnership	26.48	28.12		28.32	28.97	29.18	29.13	28.90	29.05	29.08
<b>Oil Revenue (\$mm)</b>	95	112		110	114	116	116	457	113	460
<b>Ebitda</b>										
Products Pipelines	120	122	475	122	122	122	122	488	122	488
Natural Gas Pipelines	105	107	410	107	95	105	105	412	105	410
CO2 Pipelines	86	114	354	113	115	117	117	462	115	464
Terminals	67	67	263	67	67	67	67	268	67	268
Overhead	(40)	(51)	(184)	(51)	(51)	(51)	(40)	(192)	(40)	(181)
Total Ebitda	338	359	1,318	358	349	360	371	1,439	369	1,449
Deprec., Deplet., & Amort.	74	79	291	79	79	79	79	316	79	316
<b>Ebit</b>	264	280	1,027	279	270	281	292	1,123	290	1,133
Interest	48	54	196	54	54	54	54	216	54	216
<b>Ebt</b>	216	226	831	225	216	227	238	907	236	917
General Partner	100	107	395	107	108	108	109	431	107	431
<b>Net Income (\$mm)</b>	116	119	436	118	108	119	129	475	129	486
<b>Units (mm)</b>	197	203	197	205	206	207	208	206	205	206
Net Income Per Unit (\$/un)	0.59	0.59	2.21	0.58	0.53	0.58	0.62	2.30	0.63	2.35
Distribution Per L.P. Unit	0.71	0.73	2.81	0.73	0.73	0.73	0.73	2.92	0.73	2.92
<b>Distribution (\$mm)</b>	239	254	944	257	258	259	260	1,034	257	1,034
General Partner	99	106	390	107	108	108	109	431	107	431
Limited Partner	140	148	554	150	150	151	152	603	150	603
<b>General Partner Share</b>										
Earnings	46%	47%	48%	48%	50%	48%	46%	48%	45%	47%
Distribution	41%	42%	41%	42%	42%	42%	42%	42%	42%	42%

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**Rank by McDep Ratio: Market Cap and Debt to Present Value**

	<i>Symbol/</i>		<i>Price</i>		<i>Market</i>	<i>Net</i>	<i>Debt/</i>	
	<i>Rating</i>		<i>(\$/sh)</i>	<i>Shares</i>	<i>Cap</i>	<i>Present</i>	<i>Present</i>	<i>McDep</i>
			<i>13-Apr</i>	<i>(mm)</i>	<i>(\$mm)</i>	<i>Value</i>	<i>Value</i>	<i>Ratio</i>
			<i>2005</i>			<i>(\$/sh)</i>		
<b>Producer/Refiners - Large Cap and Mid Cap</b>								
Kinder Morgan, Inc.	KMI	S2	74.12	125	9,270	20.00	0.74	1.71
Imperial Oil Limited (30%)	IMO	B	72.93	105	7,690	64.00	0.11	1.12
Marathon Oil Corporation	MRO	B	45.63	347	15,850	42.00	0.30	1.06
ConocoPhillips	COP	B	105.30	706	74,300	128.00	0.23	0.86
Norsk Hydro ASA	NHY	B	83.50	252	21,070	101.00	0.16	0.85
Petro-Canada	PCZ	B	55.68	264	14,710	70.00	0.17	0.83
Suncor Energy	SU	B	37.53	460	17,260	54.00	0.10	0.72
Lukoil Oil Company	LUKOY	B	143.50	209	30,000	208.00	0.03	0.70
PetroChina Company Ltd (10%)	PTR	B	61.83	176	10,870	94.00	0.05	0.68
	<i>Total or Median</i>				<i>201,000</i>		<i>0.16</i>	<i>0.85</i>
<b>Income</b>								
Kinder Morgan Energy Partners, L.P.	KMP	S3	46.39	150	6,960	15.00	0.52	2.01
Kinder Morgan Management, LLC	KMR	S3	42.45	56	2,390	15.00	0.52	1.88
Pengrowth Energy Trust	PGH		20.02	136	2,720	16.00	0.24	1.19
San Juan Basin Royalty Trust	SJT		36.04	47	1,680	32.00	-	1.13
Enerplus Resources Fund	ERF		33.94	104	3,530	32.00	0.16	1.05
Canadian Oil Sands Trust (US\$)	COSWF	B	67.05	91	6,120	94.00	0.15	0.76
	<i>Total or Median</i>				<i>23,400</i>		<i>0.20</i>	<i>1.16</i>

B = Buy, S2 = Short half unlevered position, S3 = Short quarter unlevered position  
 McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

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