

Rating: Sell
 S&P 500: 1214

Kinder Morgan Energy Partners Unlevered Underperformer

<i>Symbol</i>	KMI	KMP	KMR	KMx
<i>Rating</i>	Sell	Sell	Sell	
<i>Price (US\$/sh)</i>	82.62	50.33	45.56	
<i>Pricing Date</i>	6/22/05	06/22/05	06/22/05	
<i>Publicly Held Shares (mm)</i>	124	133	44	
<i>Market Capitalization (US\$m)</i>	10,200	6,710	1,980	18,900
<i>Debt (US\$m)</i>	7,100	2,110	690	9,900
<i>Enterprise Value (EV) (US\$m)</i>	17,300	8,820	2,670	28,800
<i>Present Value (PV) (US\$m)</i>	9,600	4,110	1,340	15,100
<i>Net Present Value (US\$/share)</i>	20	15	15	
<i>Debt/Present Value</i>	0.74	0.51	0.51	0.66
<i>McDep Ratio - EV/PV</i>	1.81	2.15	1.99	1.91
<i>Ebitda Next Twelve Months ending 6/30/06 (US\$m)</i>	1,250	560	180	1,990
<i>North American Natural Gas/Ebitda (%)</i>	0	0	0	
<i>Natural Gas and Oil Production/Ebitda (%)</i>	11	21	21	
<i>Adjusted Reserves/Production NTM</i>	6.0	6.0	6.0	
<i>EV/Ebitda</i>	13.9	15.9	14.7	14.5
<i>PV/Ebitda</i>	7.7	7.4	7.4	7.6
<i>Undeveloped Reserves (%)</i>	42	42	42	
<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	21.88	21.88	21.88	
<i>Present Value Proven Reserves(US\$/boe)</i>	18.65	18.65	18.66	
<i>Present Value Proven Reserves(US\$/mcf)</i>	3.11	3.11	3.11	
<i>Earnings Next Twelve Months (US\$/sh)</i>	4.26	2.25	2.25	
<i>Price/Earnings Next Twelve Months</i>	19	22	20	20
<i>Indicated Annual Distribution (US\$/sh)</i>	2.80	3.04	3.04	
<i>Distribution Yield (%/yr)</i>	3.4	6.0	6.7	4.7

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)** may have recently favorable stock price momentum, but continue to lag energy stocks on an unlevered basis that adjusts for balance sheet risk. The unlevered underperformance probably reflects the high valuation risk measured by an unlevered cash flow multiple three times that of the median energy stock in our coverage. There are many lower risk alternatives among energy investments that also promise more return for the amount of risk taken. Nor is it necessary for investors to take the risk of questionable accounting that Kinder Morgan practices.

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Unlevered Performance Explained

How can we say that stocks that went up 39%, 24% and 23% in the past year, as KMI, KMP and KMR did, underperformed? The answer lies in the adjustment for balance sheet risk. The pioneers in finance demonstrated years ago that leverage adds no value by itself. Nor is leverage, by definition, necessarily good or bad. Yet, it is a sufficiently important investment variable that we believe it should be controlled in a portfolio. Paying attention to leverage levels the playing field and helps avoid the worst disasters.

The simple relationship to keep in mind is that an investor would normally own less of a high debt stock and more of a low debt stock presuming that each issue had equal prospects otherwise. In the case of most of our energy stock recommendations, debt is low and might be ignored for practical purposes. It makes a huge difference when comparing high-debt stocks with low-debt stocks as we shall see.

We start a debt-adjusted comparison with the suggestion that a full unlevered position in Kinder Morgan might be made up of a half position in KMI, and quarter positions each in KMP and KMR. That combined full position might be compared with any other full position, **ExxonMobil (XOM)**, the largest energy stock, for example (see table Equal Present Value Position Comparison).

Equal Present Value Position Comparison

	Unlevered Weight	Debt/PV 6/21/2004	Levered Weight	Price 6/22/2005	Price 6/21/2004	Price Change	Unlevered Gain
KMI	0.50	0.73	0.14	82.62	59.40	39%	5%
KMP	0.25	0.49	0.13	50.33	40.43	24%	3%
KMR	0.25	0.49	0.13	45.56	37.00	23%	3%
							11%
XOM	1.00	0.09	0.91	59.67	44.73	33%	30%

Next, we recall the Debt/PV ratio that we print regularly. Then we convert unlevered weight to levered weight. The calculation involves multiplying unlevered weight by 1.0 minus the Debt/PV ratio. Finally we calculate the unlevered gain as Price Change times Levered Weight.

As a result, the favorable performance of the Kinder Morgan securities becomes considerably less positive when adjusted for risk. A long/short portfolio might make money on the underperformance. Meanwhile the past year was good for energy investment. We expect that to continue, but we could have a negative surprise at any time. High risk stocks are more vulnerable.

High McDep Ratio

Even with the seemingly strong stock price performance for the Kinder Morgan securities, it is not a surprise that the unlevered performance is relatively weak. That is what the McDep Ratio is

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supposed to anticipate. The numerator of the ratio represents the unlevered enterprise value and the denominator the unlevered present value of the business. High McDep Ratio stocks tend to underperform low McDep Ratio stocks though not necessarily in every time period. The McDep Ratio for KMI is high compared to peers in the oil and gas production, transportation, storage, refining and marketing industry. Similarly the McDep Ratios are high for KMP and KMR in the energy income stock category (see table Rank by McDep Ratio). The idea behind ranking in descending order with high ratio entities at the top of the list and low ratio entities at the bottom of the list is “buy low, sell high”.

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

	Symbol/ Rating		Price (\$/sh) 22-Jun 2005	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio
Producer/Refiners - Large Cap and Mid Cap								
Kinder Morgan, Inc.	KMI	S2	82.62	124	10,240	20.00	0.74	1.81
Imperial Oil Limited (30%)	IMO	B	83.48	105	8,750	64.00	0.10	1.27
Marathon Oil Corporation	MRO	B	54.05	349	18,840	42.00	0.30	1.20
Petro-Canada	PCZ	B	65.29	263	17,200	70.00	0.19	0.95
Suncor Energy	SU	B	46.40	461	21,400	54.00	0.10	0.87
ConocoPhillips	COP	B	58.41	1,420	82,900	70.00	0.21	0.87
Norsk Hydro ASA	NHY	B	87.60	251	21,980	110.00	0.13	0.82
PetroChina Company Ltd (10%)	PTR	B	72.60	176	12,760	94.00	0.05	0.78
Lukoil Oil Company	LUKOY	B	35.30	834	29,000	52.00	0.03	0.69
	<i>Total or Median</i>				<i>223,000</i>		<i>0.13</i>	<i>0.87</i>
Income								
Kinder Morgan Energy Partners, L.P.	KMP	S3	50.33	153	7,700	15.00	0.51	2.15
Kinder Morgan Management, LLC	KMR	S3	45.56	58	2,650	15.00	0.51	1.99
Pengrowth Energy Trust	PGH		22.03	153	3,370	16.00	0.19	1.31
San Juan Basin Royalty Trust	SJT		41.90	47	1,950	32.00	-	1.31
Enerplus Resources Fund	ERF		37.45	105	3,920	32.00	0.16	1.14
Canadian Oil Sands Trust (US\$)	COSWF	B	76.16	93	7,050	94.00	0.16	0.84
	<i>Total or Median</i>				<i>26,600</i>		<i>0.17</i>	<i>1.31</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

High Cash Flow Multiple

The McDep Ratio incorporates our estimate of relative value while the cash flow multiple may be considered more objective. Here, too, the valuation gap is wide. KMI has an unlevered market cash flow multiple, EV/Ebitda, of some 14 times, three times the median of 4.4 times for peers (see table Rank by EV/Ebitda). Similarly, KMP and KMR have unlevered market cash flow multiples, EV/Ebitda, of some 16 and 15 times, compared to 9 times for income peers.

There may be reasons why stocks might be valued at different multiples, mainly how long might the cash flow last? We give KMI the benefit of the doubt with an estimated present value multiple, PV/Ebitda, higher than for peers. For KMP and KMR the estimated present value multiple, PV/Ebitda, is near the median for peers.

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Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	Symbol/ Rating		Price (\$/sh) 22-Jun 2005	Adjstd Resrvs/ Prod NTM	PV/ Ebitda NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)
Producer/Refiners - Large Cap and Mid Cap								
Kinder Morgan, Inc.	KMI	S2	82.62		7.7	13.9	19	3.4
Imperial Oil Limited (30%)	IMO	B	83.48	9.9	6.3	8.0	15	0.8
Suncor Energy	SU	B	46.40	20.1	8.5	7.4	16	0.4
Marathon Oil Corporation	MRO	B	54.05	7.5	3.9	4.7	8	2.1
Petro-Canada	PCZ	B	65.29	5.4	4.7	4.4	8	0.7
PetroChina Company Ltd (10%)	PTR	B	72.60	13.7	5.7	4.4	8	4.4
ConocoPhillips	COP	B	58.41	11.6	4.9	4.3	7	4.2
Norsk Hydro ASA	NHY	B	87.60	8.2	4.7	3.8	8	3.5
Lukoil Oil Company	LUKOY	B	35.30	20.0	4.3	3.0	5	2.8
	<i>Median</i>			<i>10.7</i>	<i>4.9</i>	<i>4.4</i>	<i>8</i>	<i>2.8</i>
Income								
Kinder Morgan Energy Partners, L.P.	KMP	S3	50.33		7.4	15.9	22	6.0
Kinder Morgan Management, LLC	KMR	S3	45.56		7.4	14.7	20	6.7
San Juan Basin Royalty Trust	SJT		41.90	12.0	8.1	10.6	12	8.6
Pengrowth Energy Trust	PGH		22.03	7.4	5.0	6.6	10	10.0
Canadian Oil Sands Trust (US\$)	COSWF	B	76.16	20.0	7.5	6.3	7	2.1
Enerplus Resources Fund	ERF		37.45	9.4	5.2	6.0	10	8.9
	<i>Median</i>			<i>10.7</i>	<i>7.4</i>	<i>8.6</i>	<i>11</i>	<i>7.6</i>

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended June 30, 2006; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

Cash Flow Projections Interrelated

The denominator of the multiples is the cash flow projected for the next twelve months ended June 30, 2006. 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.

Debt Pyramid is “Conservative”?

KMP reports leverage near the 0.51 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%. While KMI hides debt in the KMP partnership, management represents its capital structure as “conservative”.

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Kinder Morgan, Inc.
 Next Twelve Months Financial Results

	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</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>6/30/06</i>	<i>6/30/06</i>
Ebitda											
Natural Gas Pipelines	98	201	529	139	97	98	135	468	139	97	468
Kinder Morgan Energy Partners	174	185	676	190	194	196	196	775	195	195	782
Total Ebitda	272	386	1,205	329	290	293	331	1,243	334	292	1,250
Deprec., Deplet., & Amort.	30	30	119	29	29	29	29	116	29	29	116
Kinder Morgan Energy Partners	30	32	117	36	37	38	40	151	40	40	158
Ebit	212	324	969	264	225	226	262	977	265	223	976
Interest	39	39	154	41	41	41	41	164	41	41	164
Ebt	173	285	815	223	184	185	221	813	224	182	812
Income Tax	60	100	285	78	64	65	77	285	78	64	284
Net Income (\$mm)	112	185	530	145	119	120	144	528	146	118	528
Shares (millions)	125	125	125	124	124	124	124	124	124	124	124
Per Share (\$)	0.90	1.48	4.24	1.17	0.96	0.97	1.16	4.26	1.18	0.95	4.26
Tax Rate	35%	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>Q1</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</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>6/30/06</i>	<i>6/30/06</i>
Oil Volume											
Oil (mmb)	3.6	4.0		4.0	4.1	4.1	4.1	16	4.0	4.1	16
Oil (mbd)	39	43		45	45	45	45	45	45	45	45
Oil Price (\$/bbl)											
WTI Cushing	43.89	48.31		49.65	53.83	59.85	60.92	56.06	60.53	59.80	60.27
Partnership	26.48	28.12		29.73	30.35	31.20	31.34	30.66	31.29	31.20	31.26
Oil Revenue (\$mm)	95	112		120	124	129	129	502	126	127	512
Ebitda											
Products Pipelines	120	122	475	126	126	126	126	504	126	126	504
Natural Gas Pipelines	105	107	410	124	105	105	105	439	105	105	420
CO2 Pipelines	86	114	354	123	126	129	130	507	127	128	514
Terminals	67	67	263	74	74	74	74	296	74	74	296
Overhead	(40)	(51)	(184)	(79)	(54)	(54)	(54)	(241)	(54)	(54)	(216)
Total Ebitda	338	359	1,318	368	377	380	381	1,506	378	379	1,518
Deprec., Deplet., & Amort.	74	79	291	85	85	85	85	340	85	85	340
Ebit	264	280	1,027	283	292	295	296	1,166	293	294	1,178
Interest	48	54	196	59	59	59	59	236	59	59	236
Ebt	216	226	831	224	233	236	237	930	234	235	942
General Partner	100	107	395	112	115	116	116	460	117	117	467
Net Income (\$mm)	116	119	436	112	117	120	120	470	117	118	475
Units (mm)	197	203	197	208	209	210	211	209	212	213	211
Net Income Per Unit (\$/un)	0.59	0.59	2.21	0.54	0.56	0.57	0.57	2.24	0.56	0.55	2.25
Distribution Per L.P. Unit	0.71	0.73	2.81	0.74	0.76	0.76	0.76	3.02	0.76	0.76	3.04
Distribution (\$mm)	239	254	944	265	274	275	277	1,091	278	279	1,109
General Partner	99	106	390	111	115	116	116	459	117	117	467
Limited Partner	140	148	554	154	159	159	160	632	161	162	642
General Partner Share											
Earnings	46%	47%	48%	50%	50%	49%	49%	49%	50%	50%	50%
Distribution	41%	42%	41%	42%	42%	42%	42%	42%	42%	42%	42%

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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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