McDep Associates
Independent Stock Idea
January 22, 2003

Rating: Sell
S&P 500: 888

Kinder Morgan (KMI, KMP, KMR)
Continue Sell on Valuation, Debt and Apparent Deception

Symbol	*Price ($/sh) 21-Jan 2003*	*Shares (mm)*	*Market Cap ($mm)*	*Net Present Value ($/sh)*	*Debt/ Present Value*	*McDep Ratio*	*EV/ Sales NTM*	*EV/ Ebitda NTM*	*P/E NTM*	*Div'd NTM (%)*	*PV/ Ebitda NTM*
KMI	44.25	123	5,400	14.00	0.80	1.42	3.2	12.0	13.5	1.4	8.4
KMP	36.35	141	5,100	14.00	0.47	1.84	3.3	16.0	18.7	6.9	8.7
KMR	33.76	40	1,300	14.00	0.47	1.74	3.1	15.1	17.3	7.4	8.7

McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses
EV = Enterprise Value = Market Cap and Debt:
Ebitda = Earnings before interest, tax, depreciation and amortization:
NTM = Next Twelve Months Ended December 31, 2003; P/E = Stock Price to Earnings
PV = Present Value of energy businesses:

Summary and Recommendation

We continue to recommend the sale of **Kinder Morgan, Inc. (KMI)**, **Kinder Morgan Energy Partners, L.P. (KMP)** and **Kinder Morgan Management, LLC (KMR)** on the basis of excessive valuation, excessive debt and excessive compensation to the general partner. At 12 to 16 times unlevered cash flow, investors are paying too much, in our opinion, for a business that may be worth about 8 to 9 times cash flow. At an average ratio of debt to present value of 0.7 investors are incurring unnecessarily high risk of financial collapse. Kinder Morgan hides debt by keeping the fixed obligations of KMP off the balance sheet of KMI at the same time KMI takes credit for a disproportionate share of the profits of KMP. During the most recent quarter KMI reported a 35% increase in income from KMP while not reporting any of the 43% increase in KMP debt that financed the increase in income. Meanwhile the unitholders of KMP who are fully responsible for the debt saw a 14% increase in distribution per unit. Yet even that distribution exceeds by 50% the cash flow allocable to unitholders after allowing for general partner looting and debt repayment, but not adjusting for fees paid in serial financings. Those financings may be drying up as institutions pull back and competitive partnerships start to offer a better deal. Finally, should the tax treatment of dividends be reduced or eliminated, investors would have less interest in paying excessive compensation to the general partner as a means to avoid paying Uncle Sam.

Business Value of KMP/KMR Less Than Half Stock Price

In our eyes, Kinder Morgan stock is worth no more than its businesses. We start with the format of the company's financial reporting. Since KMP owns no KMI, we'll start with KMP. Then we can use our valuation of KMP in valuing KMI.

It looks like KMP reported cash flow (Ebitda) of about $257 million in the most recent quarter. That is an annual rate of about $1029 million. We suggest, perhaps generously, that a business like that of KMP might have a present value of $8.9 billion, or about 8.7 times cash flow. That value is offset by debt of $4.2 billion, which is just under our maximum ratio of debt to present value of 0.5. Thus, net present value is about $4.7 billion.

Now the valuation becomes less conventional. The unitholders will not get all that net present value. The general partner takes 40% of all cash distributed. Moreover whenever the distribution rate is increased, the general partner gets 50% of the increment. Thus, the general partner's share of future cash flow is probably more than 40%. We use the share of current reported income, 46%, as an indicator of the general partner's share of future cash flow. As a result, we allocate 46% of net present value to the general partner, which leaves 54% for the limited partners.

A case could be made that we should also reduce net present value for financing fees. All of the cash flow distributed is replaced and more by new capital raised in the debt market or the equity market. New investors and lenders expect existing holders to pay the accompanying fees indirectly. Those fees could be 5% or more for equity, a couple percent for debt and a couple percent perhaps for fees in reinvesting the proceeds in an acquisition, for example. Thus if each distribution is going to be offset by new financing, the existing unitholders essentially will be getting that much less in present value as they automatically trade an undivided interest in remaining existing holdings for an undivided interest in new holdings. We will be optimistic and assume that financing fees are a free lunch. After all, we are in the financial business, too!

After adjusting net present value for management, or general partner, fees and ignoring financing fees we are left with remaining net present value of 54% of $4.7 billion, or about $2.4 billion, or about $14 per unit of KMP or KMR. As a result, stock price of more than twice that seems a bit high.

Business Value of KMI Less Than A Third of Stock Price

Now it gets more complicated. We will first look at apparent cash flow reported by KMI and then we will adjust for KMI's share of KMP/KMR.

It looks like KMI reported cash flow (Ebitda) of about $225 million in the most recent quarter. Included in that is $107 of income from KMP/KMR.

KMI not only owns the general partner interest in KMP/KMR that we say is currently worth 46%, it also owns 32 million units of the partnership. KMI's combined interest in KMP/KMR is 56% as it appears to us. As a result, we allocate 56%, or $140 million of KMP/KMR cash flow to KMI. Since $107 of that is already reported by KMI, we add the difference, $33 million to get total quarterly cash flow of $258 million for KMI. That is an annual rate of about $1030 million. We suggest, perhaps generously, that a business like that of KMI might have a present value of $8.7 billion, or about 8.4 times cash flow.

To get net present value we need to know debt. KMI reports debt of about $4.7 billion as we recast it ignoring deferred tax and "free" current liabilities. KMI does not report it's pro rata share of KMP/KMR debt. Thus, we add 56% of KMP/KMR debt, about $1.6 billion, to get total debt of $6.3 billion. That represents a high ratio of debt to present value of 0.8. There is no need for investors to own any stocks of energy companies with a ratio that high.

Now we can estimate net present value by going back to present value of $8.7 billion, subtracting debt of $6.3 billion to get $2.4 billion, or $14 per share. As a result, stock price of more than triple that seems a bit high.

Distribution Growth Model Flawed

In a nutshell, high greed partnerships are promoted as stocks that pay a high dividend that will grow. A prospective investor is encouraged to think that a near 7% distribution yield on KMP is already attractive and if it grows the return increases in direction proportion. Rate of return equals distribution yield plus growth. We see two flaws to applying that model in this case. First, the distribution is artificially high. Second, the growth can't be sustained.

We measure the validity of the level of distribution in comparison to equity cash flow. Start with all cash flow, Ebitda, and consider what would be left if the debt holders asked for their money back. If Kinder Morgan were classified as a junk credit, as could readily occur, certain public pension funds apparently would no longer be able to hold the company's debt. In this case we will be lenient and only apply the KMP ratio of debt in the calculation of equity cash flow. Then we find that KMP/KMR pays a distribution that is 150% of equity cash flow. In contrast, a mega cap energy company paying a 4% dividend yield may only be distributing 20% of equity cash flow.

It takes a lot of growth in the enterprise to generate a little growth in distribution. Debt expanded 43% at KMP/KMR in the past year while distribution per unit expanded 14%.

If Kinder Morgan continues to expand at the pace of the past few years it will soon own the energy industry. As a result, it is not realistic to project distribution growth for more than a few years. In the process financial risk keeps rising and the threat of total collapse becomes increasingly real.

Consolidated Reporting Would Expose Debt Pyramid

The debt ratio we calculate is similar to what management reports for KMP. It is borderline, but not excessive by itself. The debt ratio we calculate for KMI is much higher than what management shows because as we noted, management hides KMP debt from KMI statements. We applied proportional consolidation to recast the debt representation for KMI. Another way to look at the whole picture is to assume that Kinder Morgan is a single, consolidated entity with three classes of shares. In doing so we only include the shares of KMP and KMR that are not owned by KMI in order to avoid double counting.

	Symbol	*Price ($/sh) 21-Jan 2003*	*Shares (mm)*	*Market Cap ($mm)*	*EV/ Ebitda*	*Debt/ Present Value*	*McDep Ratio*
W (wolf) shares	KMI	44.25	123	5,400			
S (sheep) units	KMP	36.35	123	4,500			
D (deer) shares	KMR	33.76	26	900			
				10,800	13.1	0.70	1.55

The three equity classes might be called, light heartedly, W shares, S units and D shares for the animals that identify the preyor, wolf, and preyees, sheep and deer. It is no surprise that the ratio of debt is a high 0.70.

Debt Rating Agencies Should Pull the Plug

After the utility debt pyramids of the 1920s our government created a special status for "independent" agencies to rate the debt of issuers. Yet the raters have an obvious conflict of interest in that the issuers pay them. As a result it is only human nature that the raters are reluctant to clamp down on clients. The raters have been catching up with abuses. Our sense is that the high greed partnerships are essentially on notice that they must come up with more equity. If that does not occur to a sufficient degree, then ratings will be lowered.

Rating agencies apparently are beginning to question whether it is right to allow partnerships to raise new debt, in pyramid fashion, as entities independent of their sponsors. Kinder Morgan makes a mockery of that distinction as we have shown that KMI "owns" 56% of KMP/KMR. Moreover, there is virtually no governance at partnerships except near complete control by the general partner.

We ask, "Why wait?" Why permit, indirectly, the raising of any equity while debt ratings contradict their apparent public purpose?

Institutional Investors Start to Apply a Higher Standard

Institutional investors seem to be looking at Kinder Morgan with more skepticism. That shows up in the spread between KMR and KMP, which should theoretically be priced the same. The spread opened when management dropped the exchangeability feature that guaranteed KMR could be converted to KMP. Thus, we are amused when we hear that management contemplates a buyback of KMR units to narrow the spread. Exchangeability was dropped when management decided that Kinder Morgan was too weak financially to guarantee the spread. That has not changed.

On a more fundamental basis we are reminded that institutional investors are fiduciaries. We do not believe that a fiduciary can rationally justify putting new money into an offering of KMR securities knowing that immediately the general partner would keep at least 40% of cash flow for having put up no capital. Even the most generously compensated managers of public money are capped at 20% of gains, much less than 40% to 50% of all cash flow even before any gains are realized.

Competition on Compensation Likely in New Offerings

There are a host of Kinder Morgan emulators who have done deals with debt and need to reload the equity cannon. One of the largest has decided it no longer wants to emulate Kinder Morgan. Enterprise Products Partners (EPD) has essentially made our case -- 50% incremental compensation for the general partner makes growth in the distribution too difficult to sustain. EPD has limited its top compensation rate to 25%.

Most high greed partnerships have not started collecting yet at the 50% incremental rate. Those partnerships have to ask themselves if investors will increasingly stigmatize high greed compensation in energy partnerships. If so, then why not reform now if the likelihood of realizing the high greed payoff increasingly diminishes.

Thus, individual investors in a saturated market may have a choice between participating in a Kinder Morgan offering where the general partner wants 50% compensation or in an alternative that offers a fairer deal. As a result, visible competition that focuses on general partner compensation may contribute to a more realistic valuation of Kinder Morgan securities.

Reduction of Dividend Taxation Would Diminish Appeal of High Greed Partnerships

Sometimes it seems that investors will do anything to avoid paying taxes. That is a large part of the motivation for the complicated partnerships because there is no income tax paid at the corporate level. We find it ironic that investors are willing to pay more to general partners than would be paid to the government. That shows up as a line item between Ebt, Earnings before tax, and Net Income on the table for KMP on the next page. A little further down in the table we calculate General Partner take as a percentage of Earnings. The takes near 46% are even higher than the normal 35% for corporate tax. Investors seem willing to pay the general partner $1.30 to avoid paying Uncle Sam $1.00.

Public Accountants Should Serve the Public Interest

Certified "Public" Accountants paid by general partners allow their clients to hide the debt of high greed partnerships off the balance sheet of the general partner. That deception, as we call it, stems from the larger problem of the understatement of the equity value of the exploding general partner interest. General partner compensation should appear on the balance sheet as the huge reduction in equity that it is. Under the current system, nearly all computer driven and perhaps some human driven analyses or summaries inadvertently or deliberately overlook the value destruction effect of the general partner interest.

Borrow, Hide Debt, Promote, Reward Management Disproportionately

If Kinder Morgan is as overvalued and overleveraged as we suggest, how can the stocks be holding up as well as they seem to be doing? One answer may be that Enron succeeded for a long time. The chairman of Kinder Morgan was the president of Enron after Enron formed the predecessor of KMP with its general partner compensation scheme. Kinder Morgan may not be Enron, as management protests, but the basic pattern of borrow, hide debt, promote the stock and overpay management seems to apply.

We marvel at Kinder Morgan's mastery of promotion. Reading Kinder Morgan's press releases makes us think that this must be the World's Greatest Management delivering the World's Greatest Performance. To bring ourselves back to reality we see that most of the recent performance comes from deals done primarily with borrowed funds. The promotion seems aimed at driving the stocks up to get off one more equity tranche in order to reload to borrow more money to do more deals.

The whole effort of borrowing, hiding debt, and promoting the stock serves to compensate management disproportionately. Kinder Morgan has exploded the compensation time bomb planted in predecessor Enron Liquids Partners. Management owns about a fourth of the general partner through its ownership of KMI stock.

The shareholders of KMI also share in the excessive compensation. That attracts investors, including institutions, to KMI. Our thesis is that the valuation of KMP/KMR appears unsustainable. If that proves to be the case, then the valuation of KMI, the general partner, also becomes unsustainable.

Kurt H. Wulff, CFA

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

	Q4 12/31/01	***Year 2001***	*Q1 3/31/02*	*Q2 6/30/02*	*Q3 9/30/02*	*Q4 12/31/02*	***Year 2002***	*Q1E 3/31/03*	***Next Twelve** Months 12/31/03*
Revenue ($mm)	564	**2,967**	803	1,091	1,121	1,253	**4,268**	1,253	**5,012**
Expense	368	**2,210**	580	860	874	996	**3,309**	996	**3,983**
Ebitda	196	**757**	223	231	247	257	**959**	257	**1,029**
Deprec., Deplet., & Amort.	39	**142**	41	43	43	46	**173**	46	**184**
Ebit	157	**615**	182	188	204	211	**786**	211	**845**
Interest	36	**172**	40	44	47	48	**179**	48	**192**
Ebt	121	**443**	142	144	157	163	**607**	163	**653**
General Partner	55	**202**	62	65	70	73	**270**	75	**302**
Net Income ($mm)	66	**442**	80	79	87	90	**337**	88	**352**
Units (mm)	166	**154**	166	167	175	181	**172**	181	**181**
Net Income Per Unit ($/un)	0.40	**1.56**	0.48	0.48	0.50	0.50	**1.96**	0.49	**1.95**
Distribution Per L.P. Unit	0.53	**2.00**	0.55	0.59	0.61	0.61	**2.36**	0.63	**2.50**
Distribution ($mm)	140	**491**	148	162	177	183	**670**	188	**753**
General Partner	53	**182**	57	64	70	73	**264**	75	**302**
Limited Partner	87	**310**	91	98	107	110	**407**	113	**452**
General Partner Share									
Earnings	45%	**46%**	44%	45%	44%	45%	**45%**	46%	**46%**
Distribution	38%	**37%**	38%	39%	40%	40%	**39%**	40%	**40%**
Balance Sheet									
Total Assets	6,732		7,495	7,906	8,106	8,346			
Current Assets	568		520	672	651	598			
Deferred Taxes									
Equity	3,159		3,080	3,080	3,407	3,416			
Debt	2,968		3,804	4,081	3,976	4,235			**4,235**

Kinder Morgan, Inc.
Next Twelve Months Financial Results

	Q4 *12/31/01*	***Year*** ***2001***	*Q1* *3/31/02*	*Q2* *6/30/02*	*Q3* *9/30/02*	*Q4* *12/31/02*	***Year*** ***2002***	*Q1E* *3/31/03*	***Next Twelve*** *Montms* *12/31/03*
Revenue ($mm)	289	**1,060**	291	214	225	285	**1,015**	285	**1,140**
Expense	102	**484**	88	36	33	60	**219**	60	**241**
Ebitda	187	**576**	203	178	192	225	**796**	225	**899**
Deprec., Deplet., & Amort.	27	**108**	26	26	26	28	**106**	28	**112**
Ebit	160	**468**	177	152	166	197	**690**	197	**787**
Interest	49	**102**	40	40	41	42	**163**	42	**168**
Ebt	111	**366**	137	112	125	155	**527**	155	**619**
Income Tax	39	**128**	48	39	44	54	**185**	54	**217**
Net Income ($mm)	72	**238**	89	73	81	101	**343**	101	**402**
Shares (millions)	120	**121**	125	123	123	123	**123**	123	**123**
Per Share ($)	0.60	**1.97**	0.71	0.59	0.66	0.82	**2.78**	0.82	**3.28**
Consolidated Ebitda									
Partnership units (mm)	32		32	32	32	32		32	
Share of Partnership (%)	56%		55%	56%	55%	55%		56%	
Share of Ebitda ($mm)	109		122	129	135	140		143	
Partnerhip income included abov	79		90	93	102	107		107	
Consolidated Ebitda	217		234	213	225	258		261	
Ebitda Margin	65%	54%	70%	83%	85%	79%	78%	79%	**79%**
Tax Rate	35%	35%	35%	35%	35%	35%	35%	35%	**35%**
Balance Sheet									
Total Assets	9,538		9,512	9,686	10,055	10,116			
Current Assets	405		386	414	329	405			
Deferred Taxes	2,432		2,434	2,449	2,473	2,473			
Equity	2,260		2,256	2,282	2,326	2,373			
Debt	4,300		4,291	4,397	4,746	4,703			**4,703**
Share of Partnership Debt	1,654		1,621	1,651	1,621	1,618			
Total Debt	5,954		5,912	6,047	6,368	6,321			

