McDep Associates
Stock Idea
December 12, 2001

Buy/Sell Rating: 5 – Strong Sell

Kinder Morgan Entities
High Debt, High McDep, Questionable Structure

	Symbol	*Price ($/sh) 12-Dec 2001*	*Shares (mm)*	*Market Cap ($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*
Kinder Morgan, Inc.	KMI	49.40	121	6,000	9.10	0.88	1.52	6.8	13.7	25.2	0.4	9.0
KM Energy Partners, L.P. (43%)	KMP	35.64	135	4,800	12.80	0.43	2.02	5.5	18.2	24.1	6.2	9.0
KM Management, LLC	KMR	35.45	30	1,100	12.80	0.43	2.02	5.5	18.2	24.1	6.2	9.0

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: US$mm 21,800
Ebitda = Earnings before interest, tax, depreciation and amortization: US$mm 1,460
NTM = Next Twelve Months Ended December 31, 2002; P/E = Stock Price to Earnings
PV = Present Value of energy businesses: US$mm 13,120

Summary and Recommendation

We strongly recommend the current sale of the equity securities of the Kinder Morgan entities because of high financial and valuation risk and a partnership structure with self-destructive tendencies. Financial risk is highest in **Kinder Morgan, Inc. (KMI)** where the ratio of Debt/Present Value at 0.88 is extraordinary, allowing for no disappointment as the energy economy moves through a difficult period. Valuation risk as measured by the McDep Ratio appears highest in **Kinder Morgan Energy Partners, L.P. (KMP)** and **Kinder Morgan Management, LLC (KMR)**. That high valuation implies that those investors are expecting higher distributions that can come only from acquisitions because all of existing cash flow is paid out. Yet KMI gets half of the cash flow from incremental acquisitions while KMP and KMR must support almost all of the new capital. The downside, if stock price fell to our estimated present value, is some 80% for KMI and more than 60% for KMP and KMR.

Capital Investment Must Be Financed Externally

Kinder Morgan Energy Partners, L.P. (KMP) distributes practically all of its cash flow in meeting a promised distribution currently at the rate of about 6% a year. The cash is generated primarily from natural gas and oil pipelines including systems otherwise known as KN Energy and Natural Gas Pipeline Company of America. Such capital-intensive businesses usually need more capital to grow. In fact existing assets eventually become less productive. If all of cash flow is being paid out, the new capital has to come from external sources. If new capital can be raised at a cheaper price than historical capital, the assets financed by the new capital throw off a little extra cash flow that can be paid to the holders of historical capital and make it appear temporarily that the distribution is growing or that it will last longer at the current level.

The problem is that the capital markets are fickle. If stock price declines, issuing new shares is less attractive and may even be dilutive. If debt is substituted for stock, the risk of default rises and debt gets more costly as well. Moreover in the limited partnership structure there is no tax deduction at the partnership level to defray the cost of debt.

Incremental Cash Flow Diverted Disproportionately to the General Partner

In the last half dozen years we have seen the creation of a new wave of limited partnerships that offer a graduated incentive to the general partner if the distribution is raised. The scale starts low and soon reaches the point where the GP gets 50% of the incremental distribution. Kinder Morgan has reached that point.

The self-destructive tendency we see is that the GP has such a strong conflict of interest that it could be driven to do deals at the expense of the limited partners. The GP gets half the economic benefit of incremental transactions for almost none of the economic cost. Conversely the limited partners take almost all the risk of new transactions for only half the benefit. Moreover in the partnership structure the GP has less accountability to unitholders than does management to shareholders in the typical publicly held corporation.

We fear that one or more of the new wave partnerships may fail as a result of misdirected actions and/or a surprise change in industry conditions. When that happens the market will likely penalize all similar entities, Kinder Morgan included.

Rewards of KMI Depend on Healthy KMP and KMR

Unitholders can hedge a disproportionate division of benefits by owning KMI. Though that may be reassuring, the current high valuation of KMI still depends on raising new capital.

The creation of Kinder Morgan Management, LLC generated a billion dollars of new capital in 2001. KMR offers identical economic interests as Kinder Morgan Energy Partners, L.P. Among the differences in appearance, KMR holders get their distribution in units, or shares, while KMP holders get their distribution in cash. The structure of KMR is designed to produce different tax consequences. As a result, primarily institutional investors own KMR, while primarily taxable individual investors own KMP. KMR and KMP are further linked by the ability to exchange KMR units for KMP units.

New capital comes at the expense of new risk. We have made a balance sheet reinterpretation of KMI that heightens our concern. KMI carries its largest asset, its ownership in KMP, as an investment without noting the debt in KMP. We think a proportional consolidation of KMP into KMI provides a better reading. Our adjustments add more than a billion dollars to raise KMI's debt to more than $8 billion. That compares to little more than $9 billion of estimated present value. We make no attempt to measure off balance items, leases, derivatives or other instruments that may magnify leverage further.

Where is the Cash Flow?

Consolidating the three KM entities we measure about $1.5 billion a year in Ebitda, or cash flow. Impressive though that may seem, it is not enough, in our opinion to justify $22 billion in Enterprise Value, EV, or market cap and debt. The EV/Ebitda multiple is some 15 times compared to a median 9 times for Large Cap Power stocks and 7 times for Large Cap Natural Gas and Oil stocks.

Our cash flow projections merely carry forward the latest quarter's experience. We realize that investors expect some growth and that may very well be the case. At the same time expectations are coming down for energy companies and who is to say that Kinder Morgan is immune to industry developments.

Analyze KM Energy Partners In Three Pieces

KM Energy Partners has roughly three classes of owners. KMI owns 47%, KMP unitholders own 43%, and KMR stockholders own 10%. The breakdown conforms to the split of distributable income in the most recent quarter. Because the split of risks and rewards is different, the economic interests could be quite different eventually from the current breakdown of distributable income. KMI's ownership is further divided into a general partner's stake and a limited partner's stake. The general partner's stake is growing and is already higher than at September 30. On the basis of the $2.20 annual distribution implied by the recent declaration for the quarter, the general partner appears entitled to more than 14% of the distribution in return for an apparent 2% capital contribution.

Mr. Kinder Has a Remarkable Record

Owning 21% of KMI put Rich Kinder on the Forbes 400 for the first time in 2001 where he ranked as the 145th richest American. College roommate, Morgan, and other managers own 4% of KMI while the rest is publicly held. From 1980 to 1996 Mr. Kinder worked for **Enron**, the last several years as president and chief operating officer.

Kurt H. Wulff, CFA

Kinder Morgan, Inc.
Next Twelve Months Financial Results

	Q3 *9/30/01*	*Q4E* *12/31/01*	*Q1E* *3/31/02*	*Q2E* *6/30/02*	*Q3E* *9/30/02*	*Q4E* *12/31/02*	***Next Twelve*** *Months* *12/31/02*
Revenue ($mm)	527	527	527	527	527	527	**2,107**
Expense	265	265	265	265	265	265	**1,059**
Ebitda	262	262	262	262	262	262	**1,048**
Deprec., Deplet., & Amort.	27	27	27	27	27	27	**108**
Kinder Morgan Energy Partners, L.P.	91	91	91	91	91	91	**363**
Ebit	144	144	144	144	144	144	**577**
Interest	53	53	53	53	53	53	**212**
Ebt	91	91	91	91	91	91	**365**
Income Tax	32	32	32	32	32	32	**128**
Net Income ($mm)	59	59	59	59	59	59	**237**
Shares (millions)	121	121	121	121	121	121	**121**
Per Share ($)	0.49	0.49	0.49	0.49	0.49	0.49	**1.96**
Ebitda Margin	50%	50%	50%	50%	50%	50%	**50%**
Tax Rate	35%	35%	35%	35%	35%	35%	**35%**

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

	Q3 *9/30/01*	*Q4E* *12/31/01*	*Q1E* *3/31/02*	*Q2E* *6/30/02*	*Q3E* *9/30/02*	*Q4E* *12/31/02*	***Next Twelve*** *Months* *12/31/02*
Revenue ($mm)	638	638	638	638	638	638	**2,552**
Expense	445	445	445	445	445	445	**1,779**
Ebitda	193	193	193	193	193	193	**773**
Deprec., Deplet., & Amort.	37	37	37	37	37	37	**148**
Other Non Cash							
Ebit	156	156	156	156	156	156	**625**
Interest	41	41	41	41	41	41	**164**
Ebt	115	115	115	115	115	115	**461**
Income Tax		-					**-**
Net Income ($mm)	115	115	115	115	115	115	**461**
Shares (millions)	311	311	311	311	311	311	**311**
Per Share ($)	0.37	0.37	0.37	0.37	0.37	0.37	**1.48**
Ebitda Margin	30%	30%	30%	30%	30%	30%	**30%**
Tax Rate	0%	0%	0%	0%	0%	0%	**0%**

