Rating: Sell
S&P 500: 1196

Kinder Morgan Inc.
Energy Houdini

Symbol	KMI	*Ebitda Next Twelve Months ending 12/31/05 (US$mm)*	1,260
Rating	Sell	*North American Natural Gas/Ebitda (%)*	0
Price (US$/sh)	72.49	*Natural Gas and Oil Production/Ebitda (%)*	11
Pricing Date	1/18/05	*Adjusted Reserves/Production NTM*	12.0
Shares (mm)	125	*EV/Ebitda*	12.7
Market Capitalization (US$mm)	9,100	*PV/Ebitda*	7.5
Debt (US$mm)	7,000	*Undeveloped Reserves (%)*	50
Enterprise Value (EV) (US$mm)	16,100	*Natural Gas and Oil Ebitda (US$/boe)*	19.54
Present Value (PV) (US$mm)	9,500	*Present Value Proven Reserves(US$/boe)*	8.30
Net Present Value (US$/share)	20	*Present Value Proven Reserves(US$/mcfe)*	1.38
Debt/Present Value	0.74	*Earnings Next Twelve Months (US$/sh)*	4.47
McDep Ratio - EV/PV	1.69	*Price/Earnings Next Twelve Months*	16
Dividend Yield (%/year)	3.9	*Indicated Annual Dividend (US$/sh)*	2.80

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

Shares of sell-recommended **Kinder Morgan Inc. (KMI)**, **Kinder Morgan Energy Partners (KMP)**, and **Kinder Morgan Management LLC (KMR)** offer illusory appeal that masks high valuation risk and high financial risk. During 2004 existing limited partners appeared to capture premium value from offerings of new units to investors. Yet the proceeds of the offerings were essentially transferred to the general partner. The limited partnership also borrowed to increase distributions that had the effect of increasing earnings for the general partner without any of the debt showing on the general partner's balance sheet. For a more realistic look, we recombine the separate pieces into a consolidated whole that compares unfavorably with any other energy stock in our coverage. By our analysis, KMI stock has the potential to lose 70% of value to reach estimated net present value of equity of $20 a share in the next few years.

Access to Capital Helps Perpetuate Illusion

Combining the pieces of Kinder Morgan we construct a consolidated entity that we might call KMx (see table Kinder Morgan Matrix). KMx would presumably be valued in the stock market near present value of about $15 billion, near 8 times unlevered cash flow. Indeed the largest, safest and most successful energy stock in the world on a long-term basis, **ExxonMobil (XOM)** is valued at about 7 times unlevered cash flow. Yet KMx commands a premium value with Enterprise Value to cash flow near 14 times.

Perhaps part of the reason KMx enjoys such a premium, twice the unlevered value of XOM, is that aggressive investors may seek leverage. Investors who would not normally buy stocks on margin are getting the effect of the leverage of margin and more in KMx where the total ratio of debt to present value is 0.66 compared to just 0.07 in XOM, for example. For investors who don't have to stretch for high risk stocks, it makes more sense, in our opinion, to own two to three times as much XOM for the same amount of financial risk as in KMx.

Kinder Morgan Matrix

	Kinder Morgan Inc. General Partner	*KM Energy Partners Ltd Partner Units*	*KM Mgt LLC i-Shares*	*Kinder Morgan Consolidated*
Symbol	KMI	KMP	KMR	KMx
Stock Price ($/share or unit)	72.49	45.55	41.43	
Publicly Held Shares/Units (mm)	125	132	41	
Market Cap ($mm)	9100	6010	1710	16820
Debt ($mm)	7000	2120	660	9780
Enterprise Value (EV) ($mm)	16100	8130	2370	26600
Present Value (PV) ($mm)	9500	4100	1280	14880
Net Present Value ($/sh or un)	20	15	15	
Debt/Present Value	0.74	0.52	0.52	0.66
McDep Ratio - EV/PV	1.69	1.98	1.85	1.79
Indicated Annual Distribution ($/sh)	2.80	2.92	2.92	
Distribution Yield (%/yr)	3.9	6.4	7.0	5.1
Ebitda NTM 12/31/05 ($mm)	1260	530	169	1959
EV/Ebitda	12.7	15.3	14.3	13.6
PV/Ebitda	7.5	7.7	7.7	7.6
Earnings NTM ($/sh)	4.47	2.25	2.25	
Price/Earnings NTM	16	20	18	18
Ebitda by Function				
GP Natural Gas Pipelines	529			529
LP Natural Gas Pipelines	182	132	42	357
Products Pipelines	216	157	50	423
CO2 Pipelines	199	145	46	391
Terminals	118	86	27	232

Other investors may not realize how much leverage there really is in KMx. KMP reports leverage near the 0.52 in our 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 debt on KMP's books. 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 for essentially no capital outlay.

Regardless of the explanation, it is clear that the greatest strength of KMx is its stock price. The partnership sold new units in 2004 priced at a premium that was worth about $300 million after fees. That is $300 million of value created for the partnership simply because investors were willing to pay more for the stock than buyers would pay for the partnership's assets.

Also during 2004, the partnership made some $600 million of acquisitions including about half from the general partner. When the general partner transfers assets to the limited partner it receives the full purchase price in the non-arms length transaction. Yet it retains 42% of the cash flow from the asset in the form of general partner compensation that requires essentially no capital outlay. As a result the value creation of the public offering of limited partner units at a high price becomes value creation almost entirely for the general partner.

Limited partner distributions also seem to manufacture earnings for the general partner. Keep in mind that distributions approximate cash flow. When the general partner owns an asset the general partner reports earnings after depreciation. When the limited partners own an asset the limited partner distributes earnings and most of the depreciation. The general partner apparently reports its 42% share of distributions as "earnings".

The year would not be complete without more borrowing to support higher distributions. Borrowing is just as illusory as the sale of new units. When the limited partner borrows to buy assets, none of the debt shows up on the general partner's balance sheet. Yet the general partner gets 42% of the distribution from the asset that it reports as earnings. Presto! Earnings from thin air! Houdini would be jealous, as we say.

After stock price, the strongest part of KMx's current business seems to be oil production in West Texas. Oil production from the SACROC unit increased from 27.7 thousand barrels daily (mbd in the third quarter to 32.2 mbd in the fourth quarter 2004 following an investment of $300 million in 2004. While we like that we note that investors can buy the best performing oil and gas producer, **XTO Energy (XTO)**, for 6 times cash flow, not 14 times for KMx.

Acquisitions Contribute to Growth

General partner Kinder Morgan Inc. derives most of its growth from its participation in Kinder Morgan Energy Partners (see table Next Twelve Months Financial Results).

Kinder Morgan, Inc.
Next Twelve Months Financial Results

	Q1 3/31/04	*Q2 6/30/04*	*Q3 9/30/04*	*Q4 12/31/04*	***Year 2004***	*Q1E 3/31/05*	*Q2E 6/30/05*	*Q3E 9/30/05*	*Q4E 12/31/05*	***Next Twelve Months 12/31/05***
Ebitda										
Natural Gas Pipelines	134	97	98	201	**529**	134	97	98	201	**529**
Kinder Morgan Energy Partners	156	161	174	185	**676**	184	178	183	189	**734**
Total Ebitda	290	258	272	386	**1,205**	318	275	281	389	**1,263**
Deprec., Deplet., & Amort.	29	30	30	30	**119**	30	30	30	30	**120**
Kinder Morgan Energy Partners	27	28	30	32	**117**	32	32	32	32	**128**
Ebit	234	200	212	324	**969**	256	213	219	327	**1,016**
Interest	38	38	39	39	**154**	39	39	39	39	**156**
Ebt	196	162	173	285	**815**	217	174	180	288	**860**
Income Tax	69	57	60	100	**285**	76	61	63	101	**301**
Net Income ($mm)	128	105	112	185	**530**	141	113	117	187	**559**
Shares (millions)	125	125	125	125	**125**	125	125	125	125	**125**
Per Share ($)	1.02	0.84	0.90	1.48	**4.24**	1.13	0.90	0.94	1.50	**4.47**
Tax Rate	35%	35%	35%	35%	**35%**	35%	35%	35%	35%	**35%**

Non-Competitive Value among Large Cap and Mid Cap Oil and Gas Stocks

KMI stock appears to have potential for depreciation in a group of stocks including downstream operations (see table of stocks ranked by McDep Ratio). The high valuation investors accord KMI helps make the case for investment in stocks with lower valuation and lower debt.

Our posture is to seek investment growth with inflation protection and deflation resistance. Priced at a high McDep Ratio there is more depreciation than appreciation potential in KMx. With its emphasis on fixed fees, the partnership has little inflation protection. With its high debt, KMx has weak deflation resistance. It seems to us that there are many energy investment alternatives with better combination of potential reward with less risk than KMx.

	Symbol/	Rating	Price ($/sh) 18-Jan 2005	Shares (mm)	Market Cap ($mm)	Net Present Value ($/sh)	Debt/ Present Value	McDep Ratio
Producer/Refiners - Large Cap and Mid Cap								
Kinder Morgan, Inc.	KMI	S2	72.49	125	9,060	20.00	0.74	1.69
Imperial Oil Limited (30%)	IMO	B3	59.46	107	6,350	58.00	0.10	1.02
Marathon Oil Corporation	MRO	B3	38.76	347	13,450	40.00	0.31	0.98
Norsk Hydro ASA	NHY	B1	78.56	254	19,970	90.00	0.17	0.90
ConocoPhillips	COP	B1	90.12	702	63,200	110.00	0.25	0.86
Suncor Energy	SU	B3	34.33	460	15,790	42.00	0.12	0.84
Petro-Canada	PCZ	B3	50.30	269	13,550	68.00	0.18	0.79
PetroChina Company Ltd (10%)	PTR	B2	54.65	176	9,610	82.00	0.06	0.69
Lukoil Oil Company	LUKOY	B2	116.75	209	24,000	208.00	0.03	0.58
Total or Median					*175,000*		*0.17*	*0.86*

B1 = Buy full unlevered position, B2 = Buy half unlevered position, B3 = Alternative buy, H = Hold
S2 = Short half unlevered position, S3 = Short quarter unlevered position
McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses

Kurt H. Wulff, CFA

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