McDep Associates
Stock Idea
January 11, 2002 (updated 1/17/02)

Buy/Sell Rating: 5 – Strong Sell

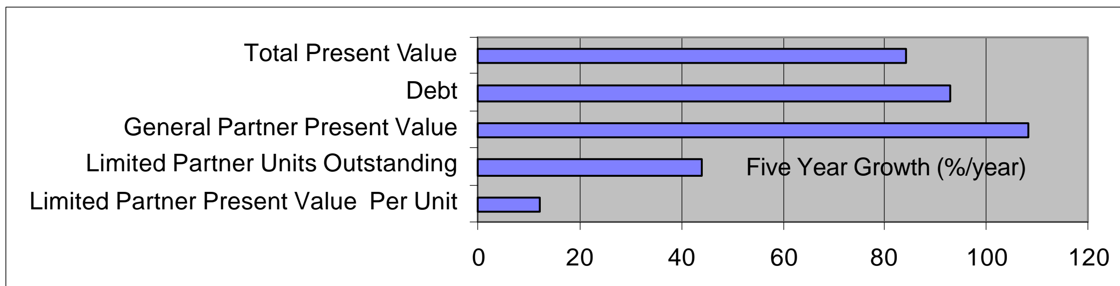
Kinder Morgan Energy Partners, L.P.
Kinder Morgan Management, LLC
It Takes A Universe To Grow A Unit

Symbol	*Price ($/sh) 17-Jan 2002*	*Shares (mm)*	*Market Cap ($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*
KMP	37.70	135	5,100	11.60	0.48	2.16	5.2	19.4	26.4	6.1	9.0
KMR	37.75	30	1,100	11.60	0.48	2.16	5.1	19.4	26.4	6.1	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$mm 8,000
Ebitda = Earnings before interest, tax, depreciation and amortization: US$mm 410
NTM = Next Twelve Months Ended December 31, 2002; P/E = Stock Price to Earnings
PV = Present Value of energy businesses: US$mm 3,710

Summary and Recommendation

We buttress our Strong Sell recommendation for the equity securities of **Kinder Morgan Energy Partners, L.P. (KMP)** and **Kinder Morgan Management, LLC (KMR)** with further analysis to show that growth prospects do not justify high valuation, high risk and a flawed partnership structure, in our opinion. The structure appears so inefficient that to get historical growth in present value per unit of 12% per year, Ebitda, a proxy for total present value, grew 84% per year, Debt grew 93% per year, general partner present value grew 108% per year and limited partner units grew 44% per year. At those rates, Kinder Morgan would have to own the whole universe of publicly held energy and be worth more than $3 trillion before unit value would grow enough to reach current stock price. At the heart of our concern is a compensation scheme originated by Enron that allocates half of the value of the properties to the general partner for no capital outlay. We also discuss specific examples of how the accounting approved by the auditor seems misleading and may be detrimental to the assets of retirement investors.



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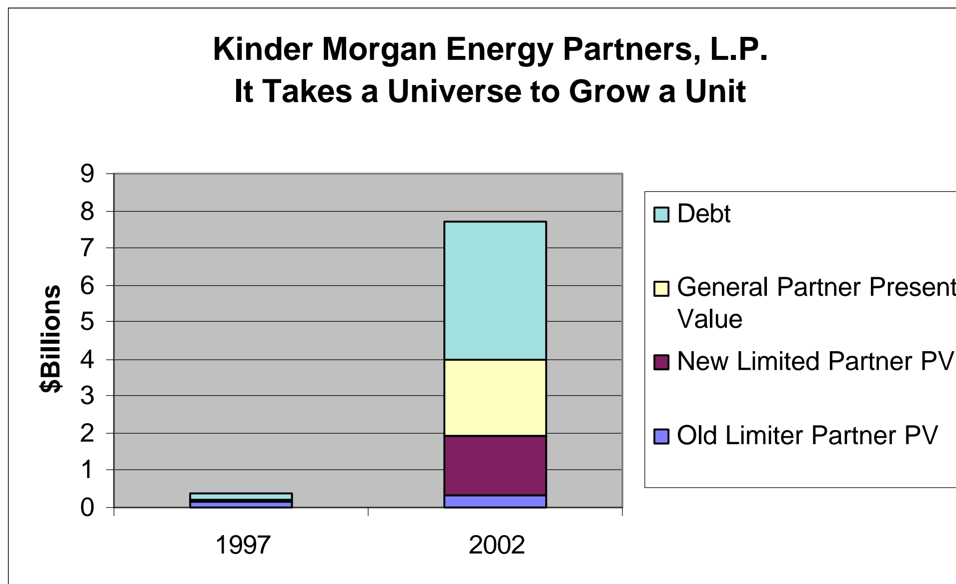
It Takes A Universe To Grow a Unit

Unitholders of KMP seem happy with the growing distribution and the price action in the stock. Naturally, the assumption is that such experience will continue. Looking at the historical record we are struck by how little the units benefited considering the rapid pace of deal making (see Chart).



The original limited partnership units from 1997 that represented ownership in almost half of the partnership assets at that time would account for only 4% of partnership assets in 2002. Many factors affected historical performance that could have turned out differently. One factor that seems swamped with all the deals is operational improvement. Whether or not there has been any is difficult to see.

For the sake of illustration we look at the implications of future trends along the lines of the past. In particular we were interested in how soon the present value per unit that grew from about $7 in 1997 to about $12 in 2002 would become $38. At 12% per year, that would occur in 2012. Corresponding growth in total present value over the next ten years would take the partnership to $3.3 trillion in assets, an amount that makes today's $8 billion invisible by comparison (see Chart).

The whole publicly traded energy industry today including the Mega Cap International Oil companies has less than $2 trillion of present value. If that grew at 4% per year for ten years it would still be less than $3 trillion. Thus it would take more than the universe of the energy industry to grow the present value per unit of KMP to its current stock price.

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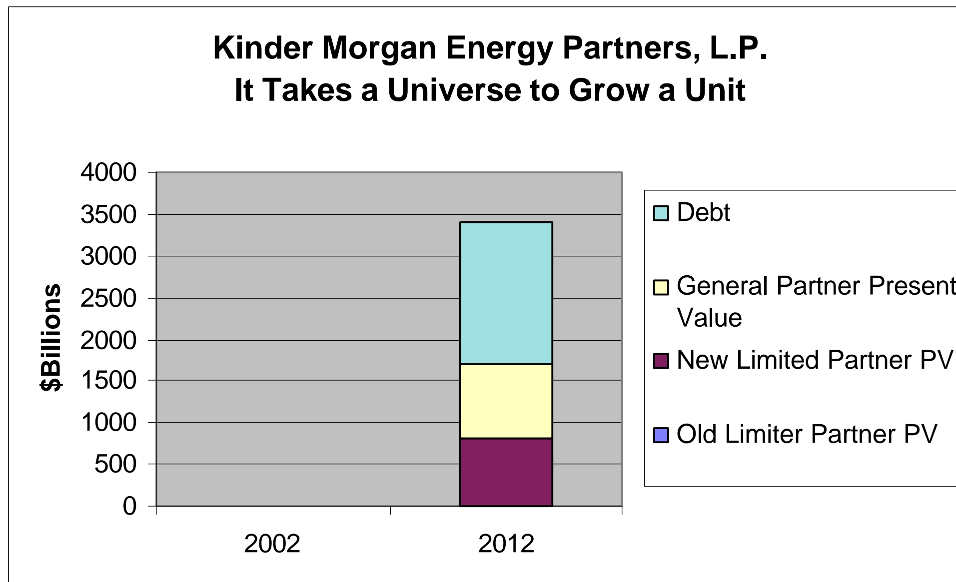

Growth Depends On New Debt Financing

Practically half of value growth is matched by increased debt obligation. For a stable business a ratio of debt to present value of a half is close to the comfortable maximum. Should equity financing become less readily available, the use of debt instead could quickly reach its limits.

Before long Kinder Morgan may run out of stable businesses to acquire. That may already be happening, as the Tejas Pipeline may not be as stable as the natural gas utility properties that came with the acquisition of KN Energy. As shorter life businesses are acquired, the capacity to support debt declines.

General Partner Has Half of Net Present Value

The remarkable arrangement that Enron built into Enron Liquids Pipeline, L.P. that became the predecessor of Kinder Morgan gives the general partner a cash payback for declaring higher distributions. Initially the general partner received only 2% of cash distributions. Then as the amount declared surpasses $0.15 per unit the general partner gets an increasingly larger share (see Chart). Above $0.23 per unit, the general partner gets half of the cash distributed. At the current payout of $0.55 per unit, the general partner's overall share is about 38%. (In our original analysis we mistakenly stated that number at 14%. While we admit to the error, the fact of it supports our point that disclosures downplay the real economic implications of the compensation structure. It has taken us considerable effort to understand what seems to be going on. We are sure that most retirement investors are not able to put the same effort into understanding the Kinder Morgan securities.)

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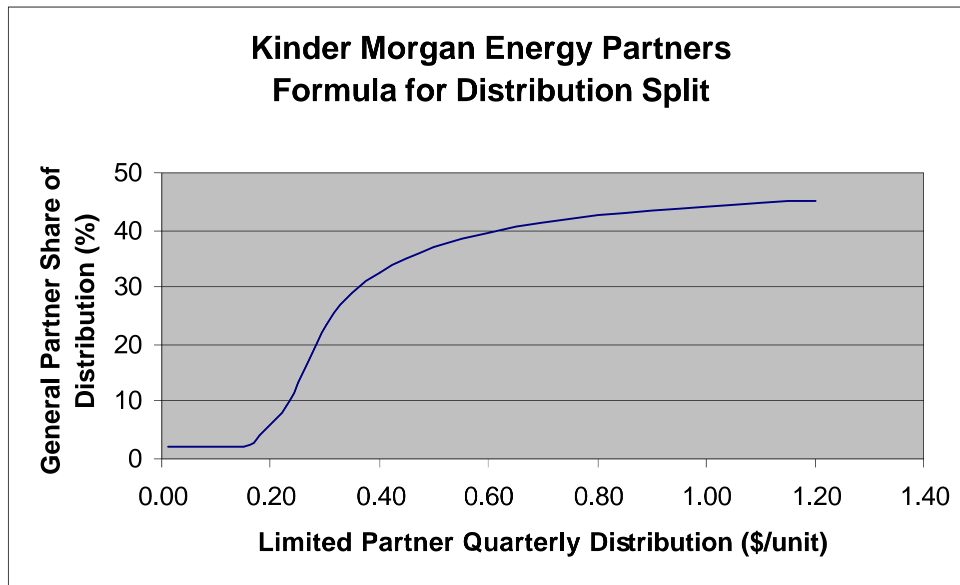
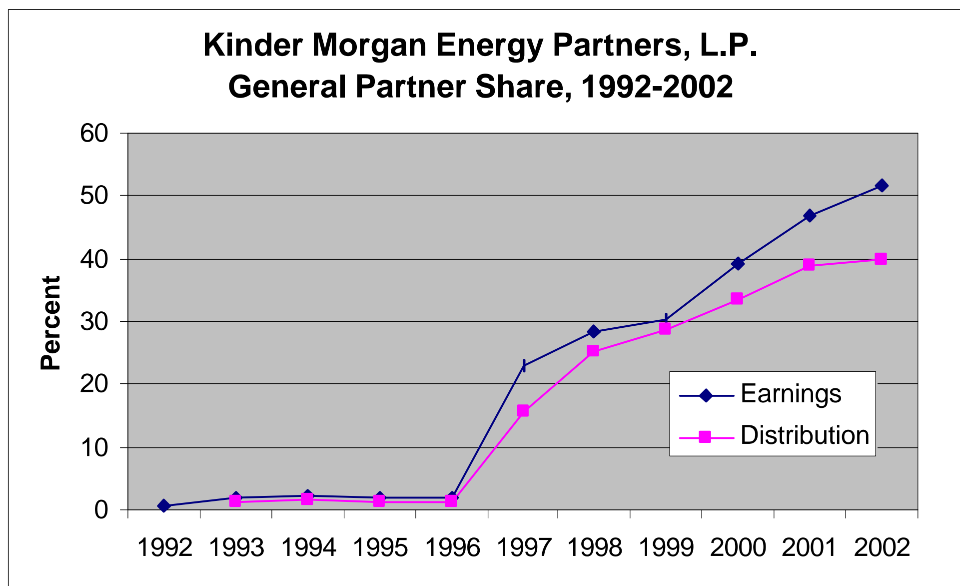


Here is how the formula to split the cash distributions worked out over the years (see Chart). The cumulative general partner distribution take appears to be crossing 40% in 2002.

One element of the disclosure we have found helpful is the allocation of earnings to the general partner. Apparently those earnings are equivalent to the cash that would be distributed to the GP. It looks to us that the GP share of earnings is just now crossing the 50% mark in 2002 (see Chart again). Absolute, not just relative, LP earnings may now be declining because of the increasing GP share.



Theoretically, the general partner cannot just declare higher distributions on a whim. Practically, with long life assets, it could be relatively easy to disguise a payout that is too high to be sustained indefinitely. Yet it could be a long time before investors catch on.

General Partner's Take Causes Misleading Interpretations of Value

When we first started looking into Kinder Morgan last month we knew that the general partner's compensation scheme did not seem equitable. Yet it has taken us a few weeks to understand it better. The difficulty in understanding it may stem from the changing payoff as distribution increases. Conventional interpretation of accounting statements doesn't handle dilution, conversion, options and other contingent payoffs well.

The statements do make the point that distribution per unit exceeds earnings per unit. That implies some of the distribution is a return of capital. Taxable investors claim even more return of capital on their returns to defer taxation.

Those investors who check book value may be getting false assurance if they rely on secondary sources that simply divide limited partner equity by units outstanding. The accounting statements don't show any significant book value for the general partner even though the GP is now getting half the earnings and half the incremental distributions.

Investors who are skeptical of our analysis might point to book value of $18 or $19 dollars from a secondary source and ask how our present value could be only $12? Isn't present value usually more than book value? Yes.

Thus one idea for improving disclosures might be to introduce fully diluted book value. There will be disagreement on how to measure dilution. We used the current earnings split of about 52% for the general partner in 2002. That implies fully diluted book value of less than half widely disseminated numbers. Although most investors know about fully diluted earnings, how many investors have thought about fully diluted book value? One might also ask, "If book value is only half what it seems, aren't there some losses somewhere?"

We also did a double take when we saw an Ebitda per share estimate by a respected Wall Street source. Ebitda per share is already a potentially misleading concept because it has interest in the numerator and no debt in the denominator. Nonetheless some find it a useful shorthand indicator with the understanding that debt must be considered as well. The misleading indicator of Ebitda per share is compounded in its potential deception when for KMP only the LP units are used in the denominator. Thus our respected source portrayed KMP as being a cheap stock on Ebitda per share. <u>We have to conclude that overstated valuation measures derived from incomplete and likely misleading disclosures are contributing to the potential fleecing of retirement investors.</u>

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Tax Collector Surpassed by Take Collector

A critic might fault us for ignoring the tax benefits of the limited partnership structure. Don't tax benefits justify a premium valuation? We consciously omit adding such an adjustment because it may not be as important as some perceive it.

The first point to remember on taxes is that the partnership benefit is a deferral, not avoidance. Those who sell the stock early would give up any future tax benefits.

Tax deferral may actually discourage long time holders from selling and thereby possibly contribute to the overpricing of the units. All the return of capital that sheltered taxes in the past is reversed when a partnership unit is sold for more than the adjusted cost basis. Moreover, as we understand it the "recaptured" capital is taxed at ordinary income rates and not lower capital gain rates.

There is also the nuisance of partnership tax reporting and the potential obligation to file returns in several states where the partnership has operations. Our advice on partnerships has usually been to own enough to justify the extra accounting effort.

Potential tax savings pale in comparison to the general partner take. The GP is taking 50% of cash flow without much allowance for return of capital to the LP's. Moreover should cash flow weaken, the GP apparently is not obligated to repay what in hindsight could be proven to be too high a take. In contrast, taxes are assessed only on income and losses can be used to reduce the obligation.

To repeat, the GP's marginal "take" rate is 50%. "Takeable" income appears to be defined as any cash distributed irrespective of return of capital or future losses. Investors in KMP appear to have traded some deferral of tax collection for "take" collection far more onerous than full tax collection.

Concerns About KMP Apply Directly To KMR And Indirectly To KMI

Remember that KMR is essentially a derivative security that allows tax-exempt institutional investors to bet on the willingness of individual investors to continue to pay a high price for KMP. KMI is on the other side of the high compensation that we think will ultimately bring down KMP. Yet, in the end the high valuation of KMI depends on the high price of KMP. Each of the three security issues with the name Kinder Morgan is vulnerable to sharp loss, in our opinion.

Kurt H. Wulff, CFA

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Growth Model

	1997	*Growth (%/yr)*	*2002E*	*Growth (%/yr)*	*2012P*
Ebitda ($mm)	41		856		
Deprec., Deplet., & Amort.	10		164		
Ebit	31		692		
Interest	13		204		
Ebt	18		488		
Income Tax					
Net Income					
General Partner	4		252		
Limited Partner	14		236		
Total Net Income	18		488		
Net Income Per Unit ($/un)	0.51		1.43		
Units (mm)					
General Partner Equivalent	8		176		
Limited Partner	27		165		
Total Units	35		341		
Distribution					
General Partner	4		243		
Limited Partner	22		380		
Total Distribution	26		622		
Distribution/Net Income + D.D.&	0.93		0.95		
General Partner Take (%)					
Net Income	23%		52%		
Distribution	15%		39%		
Distribution Per Unit ($/un)	0.82		2.30		
Balance Sheet					
Total Assets	313		7,437		
Current Assets	22		447		
Working Capital	(3)		(102)		
Non Current Assets	291		6,990		
Debt	138		3,719		
Deferred Tax					
Equity	150		3,169		
Valuation					
Present Value @ 9 x Ebitda	367	84%	7,704	84%	3,391,000
Debt	138	93%	3,719	85%	1,700,000
Net Present Value	229	77%	3,985	83%	1,691,000
General Partner Net Present Value	53	108%	2,058	84%	900,000
Limited Partner Net Present Value	176	61%	1,927	83%	791,000
LP Net PV/Unit	6.60	12%	11.70	13%	38.00

Source: Company Disclosures, McDep Associates

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