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Independent Research Report

MORNINGSTAR

Kinder Morgan Energy Partners

Morningstar Rating	Last Price	Fair Value	Consider Buy	Consider Sell	Business Risk	Economic Moat	Industry	Sector	Ticker
★★★	$44.68	$46.00	$35.50	$57.60	Average	Wide	Pipelines	Energy	KMP

We're boosting our fair value estimate for KMP.

by Paul Larson
Stock Analyst
Analysts covering this company do not own its stock or those of its closest competitors.

Report updated on December 13, 2004.
Data and Rating updated as of December 13, 2004.

Thesis 12-13-04

We would not hesitate to buy Kinder Morgan Energy Partners if it got cheap enough.

It is not just the high, tax-advantaged yield that has attracted our attention. KMP owns stable assets that generate substantial free cash flow largely insulated from swings in commodity prices. We've given KMP a wide-moat rating because pipelines are expensive to duplicate. They are also largely regulated businesses, with the regulators setting rates and keeping competition at levels that maintain industrywide health. No new pipelines are built without regulators' approval. And since rates are regulated, once a well, refinery, or power plant is hooked up to a pipeline, there is little incentive to switch providers. As a result, service contracts tend to be several years long.

KMP is the premier "roll-up" in the energy transportation and storage industry. Beyond acquisitions, significant opportunities for internal growth exist, as demand for moving energy should grow as the economy expands. KMP expects it can increase its partnership distributions 8%-10% per year from internal opportunities alone.

We like Kinder's management. Enron would've been much better off had it not strayed from its core businesses after parting ways with Richard Kinder. CEO Kinder does not receive any compensation beyond his $1 annual salary. He got his stake in KMP the old-fashioned way--he bought it--and makes money purely from increasing per-share cash flow and distributions. We are extremely impressed by how well top management's interests are aligned with public owners' interests.

While there is much to admire about KMP, we'd be careful not to overpay for the shares because of the structure of the partnership agreement. At current cash-flow levels, limited partners split all additional cash flow 50-50 with the general partner, owned by parent Kinder Morgan. Combined with its nearly 20% economic interest in KMP, KMI has a claim on roughly half of KMP's cash flow. We don't think this spread is onerous today, given management's success in expanding and running the company, but this structure makes long-term unit distribution growth harder. The upshot to this cash-flow split with KMI is that it reduces risk. This is because limited partners would only bear half the downside on anything but the most severe cash-flow interruption.

Regardless, KMP's core business is predictable, stable, and generating copious free cash flow. It is also very well managed. Investors looking for handsome yields should keep an eye on KMP.

Valuation

After adjusting our discounted cash-flow model, we're raising our fair value estimate by $2. We now think KMP is worth $46 per unit. The largest change in our model came courtesy of the company's recently announced acquisitions, which we anticipate will be mildly accretive to per-unit cash flow and distributions. Raising our oil price and production assumptions for the firm also helped. We now assume the limited partners' interest in net income goes from $2.00 per unit in 2003 to $2.55 in 2008, a very realistic target, given the firm's history. Before buying KMP, we'd look closely at related company Kinder Morgan Management, which has a more attractive valuation. At the current distribution rate, KMP would yield 6.4% at our fair value estimate, though we think further increases in distributions are all but a given.

Risk

Kinder's primary risks are regulatory, since regulators set the rates it can charge its customers. Making an acquisition with poor returns is also a risk, as are spills and other environmental concerns.

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Close Competitors	Market Cap $Mil	TTM Sales $Mil	Oper Income $Mil	Net Income $Mil
Kinder Morgan Energy Partners	6,257	6,950	868	745
Williams Companies	8,311	14,735	854	44
Enterprise Products Partn	6,193	8,072	249	123
Enbridge Energy LP	2,749	3,473	208	114

Morningstar data as of December 13, 2004.

Bulls Say

- Companies in the pipeline industry generally enjoy wide economic moats. Pipes are expensive to duplicate, and new ones are not built without regulatory approval.
- The company's assets--the infrastructure of the energy industry--generate substantial positive free cash flow.
- The master limited partnership structure nearly eliminates corporate income-tax exposure as long as the company pays out a minimum percentage of its cash flow to shareholders each year.
- Kinder Morgan's partnership distributions are large and growing. The current quarterly distribution rate is $0.73 per unit ($2.92 annually), implying an annual yield of 6.4% at our fair value estimate.
- Kinder Morgan is not Enron, and the guilt-by-association accusation does not hold water. The firm has none of the energy-trading operations that have bankrupted others.

Bears Say

- The structure and relationships among the various parts of the Kinder Morgan empire are highly complex. Understanding this firm is no small feat.
- The current partnership agreement calls for the general partner to get 50% of incremental "available cash" at today's distribution rate, which will make completing acquisitions that boost cash flow for both the general partner and unitholders very difficult.
- Debt has risen with each acquisition and is near the company's target level. Any large acquisition would require going back to the well to raise more capital, which the company has done several times during the past few years.
- The recently passed legislation that eases dividend taxes does not benefit owners of partnerships like KMP. On a relative basis, this makes other investments that pay regular dividends more attractive than they once were.
- There are more-attractively priced parts of the Kinder empire, namely Kinder Morgan Management.

Financial Overview

Growth: Growth has been astonishing in the past few years, but nearly all of it came from numerous acquisitions. Though we expect future purchases, growth should slow considerably. We forecast internally generated distribution growth of 6%-8%.

Profitability: Return on invested capital has been lackluster for the past three years; last year it was 6.1%, after general partnership fees paid to parent company KMI. Absent these fees, KMP's ROIC would be closer to 10%.

Financial Health: Thanks to asset purchases, debt has been growing and now stands at $4.6 billion against a capital base of $8.1 billion. The firm aims to keep its debt/capital ratio near 50%, and a recent secondary offering will help here.

Company Overview

Profile: Kinder Morgan Energy Partners (KMP) is a master limited partnership that consolidates fixed assets used to

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transport energy commodities. It owns and operates more than 25,000 miles of pipelines for oil and gas transport. It also owns nearly 100 processing terminals that can handle and store liquids, gases, and dry bulk materials such as coal. As a partnership, KMP pays no corporate income tax, but its tax burden flows through to individual stockholders.

Strategy: Aiming to leverage its tax-advantaged status, KMP is the leading roll-up in the business of transporting and processing energy commodities. It aims to buy (roll up) cash-flow-generating assets, such as pipelines, from other energy companies at discount prices and then increase their utilization and efficiency. Its ultimate goal is to increase cash flow and partnership distributions.

Management: We think founder Richard Kinder is one of the best CEOs in energy, and he has often been a finalist for Morningstar's CEO of the Year award. This may sound strange, considering that Kinder was president of Enron until 1996, but he left well before the funny business began. We admire that Kinder is the lowest-paid CEO of any major public corporation. Since the firm's founding, his only compensation has been his $1 annual salary. As the largest shareholder, his personal fortune rises and falls with those of the firm's limited partners. All other executives have their base salary capped at $200,000, and cash bonuses in 2003 were all under $1 million. The only major ding on our fiduciary grade comes via the characteristics of the master limited partnership structure that limits limited partners' rights.

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Kinder Morgan Energy Partners

Morningstar Rating	Last Price	Fair Value	Consider Buy	Consider Sell	Business Risk	Economic Moat	Industry	Sector	Ticker
★★★ Hold	$44.68	$46.00	$35.50	$57.60	Average	Wide	Pipelines	Energy	KMP

Analyst Notes

07-22-04

No Surprises in Kinder's Earnings

There were no major surprises when Kinder Morgan and related company Kinder Morgan Energy Partners reported earnings Wednesday night. Our opinions and fair value estimates are unchanged. At KMP, all four of the company's business segments showed modest year-over-year profit growth, aided both by internally generated growth and previous acquisitions. The bottom-line impact was earnings of $0.51 per limited partner unit, up three cents from last year. As a result, KMP raised its quarterly cash distribution rate yet again, this time to $0.71 per unit. At KMI, transport volume increases across all of its systems, combined with contributions from KMP, helped earnings grow 9% year-over-year to $0.84 per share. Although KMP and KMI's businesses are performing well, we continue to believe that Kinder Morgan Management remains the best value among the three publicly traded firms in the Kinder empire.

Morningstar® Stock Report

All pricing data thru 12-13-04

Fiscal year-end: December

Kinder Morgan Energy Partners KMP

Last Close $	Sales $Mil	Mkt Cap $Mil	Industry
$44.68	$6,950	$6,257	Pipelines

Kinder Morgan Energy Partners (KMP) is a master limited partnership that consolidates fixed assets used to transport energy commodities. It owns and operates more than 25,000 miles of pipelines for oil and gas transport. It also owns nearly 100 processing terminals that can handle and store liquids, gases, and dry bulk materials such as coal. As a partnership, KMP pays no corporate income tax, but its tax burden flows through to individual stockholders.

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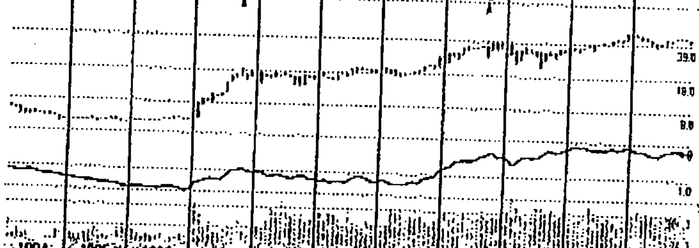
Morningstar Rating	Business Risk	Fair Value	Economic Moat	Style	Sector
★★★ Hold	Average	$46.00	Wide	Medium Value	Energy

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	YTD	
8.63	8.72	7.28	20.63	19.06	22.81	28.88	39.65	38.89	49.95	49.27	Annual Price High
5.75	5.97	6.09	6.84	14.28	16.50	18.19	25.19	24.00	33.51	37.65	Low
			2:1				2:1				Recent Splits



1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	YTD	Stock Performance
-16.1	9.2	24.7	160.6	14.4	22.6	46.4	42.4	-0.7	50.1	-3.5	Total Return %
-17.4	-28.3	1.8	127.2	-14.2	1.6	55.5	54.3	21.4	21.4	-12.0	+/- Market
-6.4	-21.8	-20.7	118.3	11.2	26.4	-19.6	54.5	13.2	-15.1	-22.8	+/- Industry
10.2	10.3	9.1	4.8	6.6	6.7	5.7	5.4	6.7	5.2	6.2	Dividend Yield %
139	159	180	478	1770	2044	3616	4908	4548	6638	6757	Market Cap $Mil

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	TTM	Financials
55	64	71	74	323	429	816	2947	4237	6624	6950	Revenue $Mil
69.6	61.8	55.6	62.4	71.1	66.6	59.3	29.2	25.2	18.7	19.6	Gross Margin %
18	18	17	24	140	187	316	564	724	807	868	Oper Income $Mil
33.0	28.2	24.0	32.8	43.4	43.7	38.7	19.1	17.1	12.2	12.5	Operating Margin %
11	11	12	18	104	182	278	442	608	697	745	Net Income $Mil
0.47	0.43	0.45	0.51	1.05	1.32	1.34	1.56	1.96	1.98	2.03	Earnings Per Share $
0.63	0.63	0.63	0.82	1.19	1.39	1.60	2.05	2.36	2.58	2.71	Dividends $
23	25	26	26	80	97	128	154	172	185	189	Shares Mil
4.85	4.04	3.88	5.20	13.81	18.15	15.09	11.43	10.20	10.29	25.79	Book Value Per Share $
19	23	23	32	134	183	302	581	870	769	895	Oper Cash Flow $Mil
-5	-8	-9	-7	-38	-83	-126	-295	-542	-577	-643	Cap Spending $Mil
14	15	14	25	96	100	176	286	327	192	252	Free Cash Flow $Mil

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	TTM	Profitability
3.8	3.8	3.9	5.8	8.4	6.8	7.1	7.8	8.1	8.0	8.1	Return on Assets %
8.6	9.1	10.0	13.5	15.6	11.6	14.3	16.9	18.6	20.3	21.2	Return on Equity %
20.2	17.6	16.7	24.0	32.1	42.5	34.1	15.0	14.4	10.5	10.7	Net Margin %
0.19	0.21	0.23	0.24	0.26	0.16	0.21	0.52	0.56	0.76	0.76	Asset Turnover
2.3	2.4	2.5	2.4	1.9	1.7	2.0	2.2	2.3	2.6	2.6	Financial Leverage

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	06-04	Financial Health
5	8	10	10	24	-187	-588	-395	-144	-99	-553	Working Capital $Mil
150	157	160	147	612	989	1255	2232	3826	4438	3933	Long-Term Debt $Mil
128	123	118	150	1361	1775	2117	3159	3416	3511	3612	Total Equity $Mil
1.41	1.53	1.65	1.00	0.46	0.68	0.98	1.48	2.10	2.28	1.19	Debt/Equity

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	TTM	Valuation
13.2	14.3	15.4	33.2	17.3	15.8	21.1	24.2	17.9	24.9	22.0	Price/Earnings
0.7	0.7	0.6	1.2	0.5	0.4	0.7	0.8	0.7	0.9	0.8	P/E vs. Market
2.6	2.5	2.5	6.1	4.5	4.7	4.3	2.0	1.4	1.4	1.2	Price/Sales
1.3	1.5	1.8	3.3	1.3	1.1	1.9	3.3	3.4	4.8	1.7	Price/Book
7.6	7.0	7.9	14.2	10.9	11.1	11.8	10.0	6.9	11.9	9.5	Price/Cash Flow

Growth Rates Compound Annual

Grade: A	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	56.3	100.9	83.0	62.9
Operating Income %	11.4	36.7	42.0	47.6
Earnings/Share %	1.0	14.0	13.6	18.1
Dividends %	9.3	13.7	15.5	16.3
Book Value/Share %	1.0	-12.0	-5.7	—
Stock Total Return %	7.4	14.2	23.2	30.8
+/- Industry	-18.0	16.2	19.9	20.8
+/- Market	-6.7	11.1	25.2	18.9

Profitability Analysis

Grade: B-	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	21.2	16.3	4.5	18.6
Return on Assets %	8.1	7.5	2.6	6.8
Fixed Asset Turns	1.0	0.6	1.3	6.4
Inventory Turns	86.0	84.6	28.6	12.2
Revenue/Employee $K	1289.5	—	1992.6	572.7
Gross Margin %	19.6	39.8	51.6	42.7
Operating Margin %	12.5	26.1	11.5	14.6
Net Margin %	10.7	23.3	1.5	10.2
Free Cash Flow/Rev %	3.6	13.1	14.9	12.3
R&D/Rev %	—	—	—	5.4

Financial Position

Grade: C	12-03 $Mil	08-04 $Mil
Cash	23	34
Inventories	26	48
Receivables	591	709
Current Assets	706	831
Fixed Assets	7092	7350
Intangibles	743	741
Total Assets	9139	9492
Payables	478	632
Short-Term Debt	2	367
Current Liabilities	804	1384
Long-Term Debt	4438	3933
Total Liabilities	5628	5880
Total Equity	3511	3612

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	22.0	20.8	22.7	26.1
Forward P/E	20.6	—	22.8	21.3
Price/Cash Flow	9.5	10.4	9.6	15.6
Price/Free Cash Flow	33.7	25.4	22.5	24.4
Dividend Yield %	6.3	—	3.6	1.6
Price/Book	1.7	2.9	2.3	4.4
Price/Sales	1.2	2.8	3.3	3.1
PEG Ratio	2.4	—	3.1	2.1

*3Yr Avg data is displayed in place of 5Yr Avg

Quarterly Results

Revenue $Mil	Sep 03	Dec 03	Mar 04	Jun 04
Most Recent Period	1650.8	1520.2	1822.3	1957.2
Prior Year Period	1121.3	1221.7	1788.8	1664.5
Rev Growth %	**Sep 03**	**Dec 03**	**Mar 04**	**Jun 04**
Most Recent Period	47.2	24.4	1.9	17.6
Prior Year Period	75.6	124.7	122.8	52.6
Earnings Per Share $	**Sep 03**	**Dec 03**	**Mar 04**	**Jun 04**
Most Recent Period	0.49	0.51	0.52	0.51
Prior Year Period	0.50	0.50	0.50	0.48

Industry Peers by Market Cap

	Mkt Cap $Mil	Rev $Mil	P/E	ROE%
Kinder Morgan Energy	6257	6950	22.0	21.2
Williams Companies	8311	14235	—	1.1
Enterprise Products	6193	6072	54.4	6.6

Major Fund Holders

	% of shares
AXP Dividend Opportunity A	0.13
Gabelli Westwood Balanced AAA	0.03
Flex-funds Total Return Utilities	0.02

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Business Risk
- Margin of Safety
- Consider Buying/Consider Selling

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic values, and allowing those businesses to compound value over long periods of time, is the surest way to create wealth in the stock market.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, we'll often appear to be out of step with the stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. (We rate stocks 1 through 5 stars, with 5 being the best and 1 the worst.) But when the market tumbles, there will likely be many more 5-star stocks. Although you might expect to see more 5-star stocks when the market is rising, we think assets are more attractive when they're cheap than when they're dear. We wait to buy clothes and DVD players when they're on sale, so why not do the same for stocks?

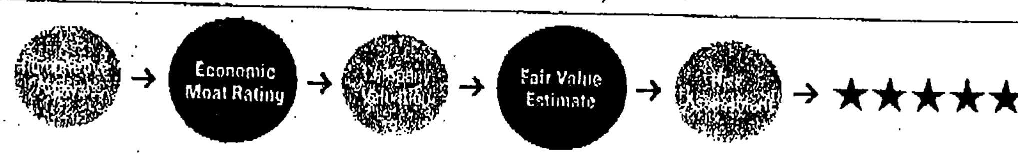
Our star rating is anchored on each analyst's estimate of a company's "fair value," which is what the analyst thinks the business is worth on a per-share basis. Our analysts arrive at this value by forecasting how much excess cash or "free cash flow" the firm will generate in the future, and then adjusting that total for both timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable business is worth more than cash from a cyclical or uncertain business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than we do for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our fair value estimates. The future is inherently uncertain, and that uncertainty is greater for some companies than it is for others. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a poor investment if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

We calculate our star ratings each night after the markets close, which is why the rating date on our reports will always be the previous business day. However, we update the text of the reports as market events warrant -- usually about once or twice per quarter -- which is why you'll see two dates on every Morningstar report. Of course, we monitor all of our stocks every day, so our ratings are always current.

Morningstar Research Methodology for Valuing Companies



Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade shows visits
- Competitor, supplier, distributor, and customer interviews

The depth of the firm's competitive advantage is rated:

- None
- Narrow
- Wide

Analyst considers company financial statements and competitive position to forecast future cash flows.

Assumptions are input into a discounted cash-flow model.

DCF model leads to the firm's fair value estimate, which anchors the rating framework.

A business-risk analysis establishes the margin of safety required for the stock rating.

★
★★
★★★
★★★★
★★★★★

The current stock price relative to fair value, adjusted for risk, determines the rating.

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Morningstar's Approach to Rating Stocks (continued)

Economic Moat

This is our assessment of a firm's ability to earn returns above its cost of capital in the future. Competition tends to drive down excess profits, but companies can earn excess profits for an extended time by creating a competitive advantage (or economic moat) -- and these companies are likely to be superior investments.

We're big fans of companies that are low-cost producers, create high switching costs for their customers, or have strong brands or long-lasting patents, because all of these characteristics allow companies to protect their competitive position. For example, Tiffany is far more profitable than a run-of-the-mill jewelry chain because it has a strong brand that creates a moat around its business, allowing it to charge more than competitors.

Discounted Cash Flow

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate

We use this number to adjust our forecasted cash flows for the risk that those cash flows may not actually come to pass. For a very steady, stable company, we'll use a low discount rate, since we can have a lot of confidence that the firm will generate the amount of cash that we're forecasting. For a firm with a cyclical business and fierce competition, we'll use a much higher discount rate, since there's much uncertainty surrounding the firm's future. The discount rate may also be referred to as the "cost of capital."

Fair Value

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's economic worth. We adjust our fair values for any hidden liabilities or assets that a firm might have - for example, we deduct from a company's fair value if it issues a lot of stock options or has an underfunded pension plan. Our fair value estimate differs from a "target price" in two ways. One, it's an estimate of what the business is worth, whereas a target price is typically an estimate of what other investors will pay for the stock. Two, it's a long-term estimate, whereas target prices generally focus on the next six to 12 months. This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Business Risk

Based on fundamental factors such as cyclicality, leverage, competitive strength, and profitability, we divide our coverage universe into four broad risk categories: Below Average, Average, Above Average, and Speculative. Unlike some risk ratings, ours is not based on the volatility of the firm's shares, but rather the predictability and strength of the underlying business.

Margin of Safety

This is the discount to fair value we would require before recommending a stock. We think it's prudent to always buy stocks for less than they're worth - the margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for riskier stocks, and smaller margins of safety for lower-risk stocks.

Consider Buying/Consider Selling

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

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