GRANT'S
INTEREST RATE OBSERVER®

Vol. 30, No. 12b Two Wall Street, New York, New York 10005 • www.grantspub.com JUNE 29, 2012

Standing with Mr. Kinder

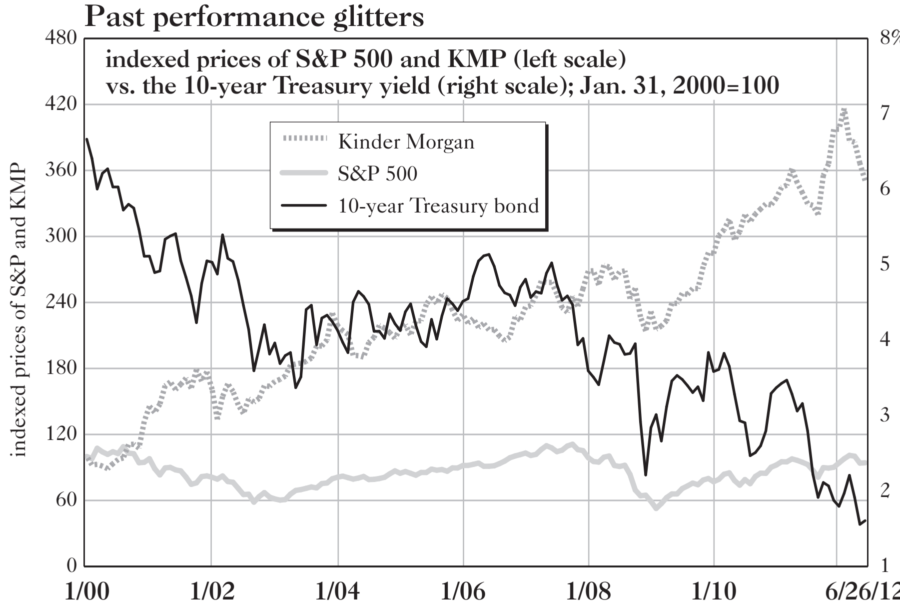
Income is the scarce thing—that and actionable ideas on how to procure it. On the topical point of income, a pair of longtime readers, Brett Haire and Dave Bunting, principals of Brave Asset Management, Summit, N.J., pose a question: Has *Grant's* considered the new, underperforming, quasi-orphaned, five-year Kinder Morgan warrants? We hereby make a start.

Houston-based Kinder Morgan (KMI on the New York Stock Exchange) is North America's largest midstream energy company, as measured by enterprise value. Among the corporate jewels are 62,000 miles of natural gas pipeline and 180 terminals. In the terminal department, Kinder Morgan is, in fact, the nonpareil. You can find its storage or transportation sites—holding or moving oil or gas or petrochemicals, coal or steel or petroleum coke—along the Houston Ship Channel, around New York Harbor and hard by New Orleans, among other places. The assets produce the kind of cash flow that, in its stability, bears not the least resemblance to the oscillations of the commodities that stock the Kinder Morgan terminals or flow through the Kinder Morgan pipelines. The shares yield 4.16%.

Four percent isn't the subject before the house. Front and center, rather, is that yield at one remove. It is that yield reflected in the warrants that derive their value from the KMI dividend. The blessed event that delivered no fewer than 505 million KMI warrants into the world was Kinder Morgan's $38 billion acquisition of El Paso Corp. last month. It was an immense transaction. "Acquired EP assets," recounts Morgan Stanley, a banker in the deal, "consist of 10 interstate gas pipelines (and LNG import terminal) comprising 19% of total U.S. interstate pipeline mileage, 13% of capacity (28 billion cubic feet a day) and 26% of gas delivered to consumers (17 billion cubic feet a day of throughput). . . . The merger transitions KMI's total EBITDA attributable to natural gas pipelines from about one-third to about two-thirds. . . . The transaction repositions KMI with a high degree of FERC-regulated, fee-based cash flow through an expansive nationwide natural gas infrastructure system that further reinforces the overall stability of KMI's dividends." You may recall (*Grant's*, May 4) that among the more fetching attributes of Boardwalk Pipeline Partners (BWP on the Big Board) is the persistence of its cash flow.

The phrase "Kinder Morgan" covers a multitude of businesses, of which the most important are Kinder Morgan Energy Partners (NYSE: KMP), one of the biggest, publicly traded pipeline limited partnerships in America, and El Paso Pipeline Partners (NYSE: EPB), an owner of natural gas pipelines and LNG terminals that the El Paso acquisition brought under the Kinder Morgan

Past performance glitters



source: The Bloomberg

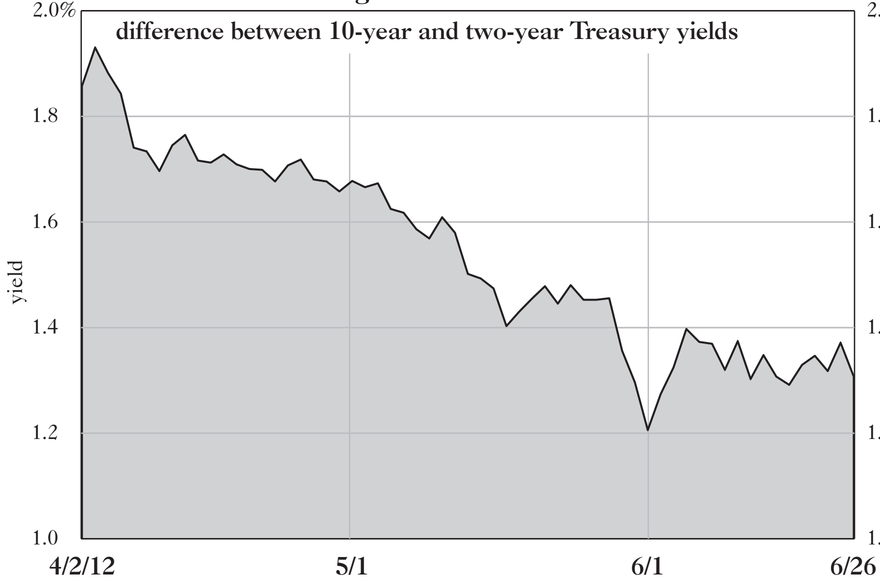
wing. Altogether, the Kinder Morgan family of companies boasts an enterprise value—equity market cap plus debt minus cash—of more than $90 billion.

At the head of the Kinder Morgan family table sits the eponymous Richard D. Kinder, chairman and CEO of Kinder Morgan Inc., owner of 23% of KMI, and by dint of those billions reputedly the richest man in Houston (and, by the lights of *Forbes* magazine, the 41st richest person in America). "If you're buying the KMI 2017 warrants," observes colleague David Peligal, "you're implicitly betting that Rich Kinder will continue to create value. It's not the worst bet to make."

Before delving into the warrants, therefore, a word on the estimable Mr. Kinder. He earns $1 a year and receives no bonuses, stock options or restricted stock. He is 67 years old (the prime of life—ed.). Kinder Morgan Energy Partners, the aforementioned limited pipeline partnership, has delivered an average annual return to its unit holders of 25%. "If you look at KMP's budgeted LP distribution from 2000 to 2011," Peligal observes, "the company achieved its LP distribution target in 11 of 12 years—and in 2006, the year it missed, it missed by only two pennies. Furthermore, it's one of the only companies that publishes its annual budget on its Web site. We're not talking about the typical earnings guidance that your average industrial company puts out. This is literally a line item by line item budget that Mr. Kinder publishes, which he holds himself and his team responsible for meeting. Of course, as for the outsize stock performance, it certainly didn't hurt that he has had the interest-rate wind at his back. As rates have fallen, so have income-starved investors gone piling into Kinder Morgan."

The Kinder Morgan warrants are five-year call options on the KMI share price (not to be confused, though it is easily confusable, with the price of the shares of the big, master limited pipeline partnership, KMP). The new warrants confer on their holders the right to purchase shares of KMI at $40 at any time until May 25, 2017. At this writing, KMI fetches $30.76 a share, while the warrants are quoted at $2.06 apiece.

The income noose tightens

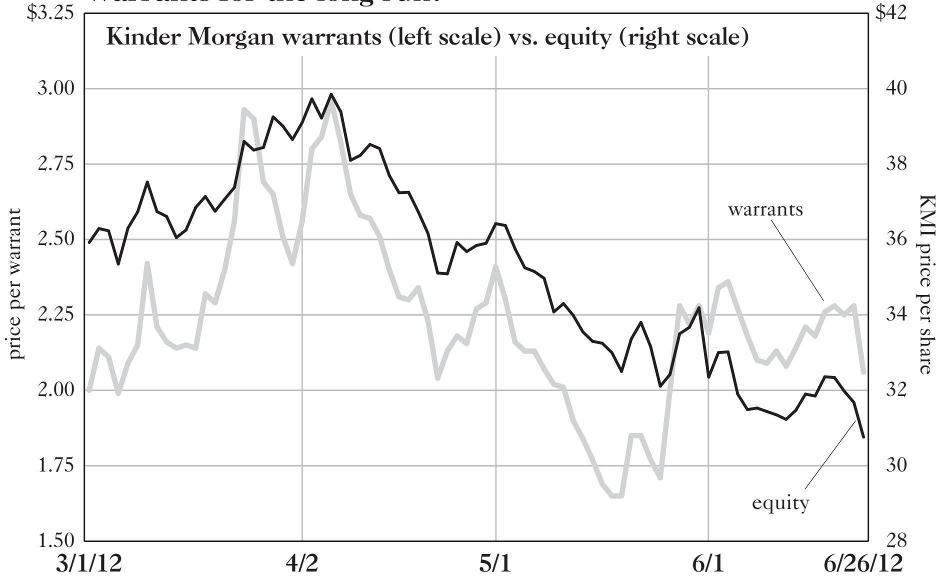


source: The Bloomberg

Before taking an analytical flyer on what the warrants are worth, or could be worth, let us acknowledge that they could turn out to be worthless. It's not so hard to imagine a goose egg, either. Interest rates could go up (well, it's not absolutely impossible). The tax laws that shield MLP income from corporate taxation, i.e., double taxation, could be amended to the disadvantage of the MLPs in which KMI is invested (a long shot but, again, within the realm of possibility). Peligal spoke with a portfolio manager who observes that, in general, the MLPs tend to trade on the basis of an implied total return of 10% to 14%. Our source—he prefers to go unnamed—infers as much because, in 2008-09, the stocks were quoted at yields of 12% or so. Mr. Market seemingly concluded in those dark days that they had no growth in front of them. Indeed, if the financial markets remained closed, the MLPs could not grow because they could not fund growth, the tax laws requiring them to pay out essentially all their cash flow in dividends. Then, too, although Kinder Morgan has 11,000 employees, there is only one Richard Kinder. As Peligal asks, what if he gets hit by a yacht?

The fact is that no income-generating investment is riskless. Take, for instance—now for a short digression—the high-yielding mortgage real estate investment trusts over which we've spilled so much ink, most of it bullish (see, for instance, the April 6 issue of *Grant's*). This is an election year, and many homeowners have been unable to refinance their mortgages even at these beguilingly low interest rates. They are thwarted despite the coming of the second iteration of the Obama administration's Home Affordable Refinance Program (HARP), which loosened eligibility criteria for refinancing federally insured mortgages. To answer the crying election-year need for something like universal happiness, Senators Robert Menendez (D., N.J.) and Barbara Boxer (D., Calif.) have sponsored a bill to accelerate refinancing activity by, among other things, prohibiting Fannie and Freddie from levying higher fees on riskier borrowers. Is it so farfetched to imagine that this bill, or another like it—possibly including a provision to extend such projected federal forbearance to mortgages originated even very recently—might find presidential favor as the autumn elections draw near? If there were legislative action along these lines, mortgages now trading at, say, 102, would be instantly devalued to par, the price at which refi-empowered households may put those obligations back to their lenders. Anyway, whatever bill lands on the president's desk, the mortgage REITs must conduct their basic business of borrowing short and lending long on

Warrants for the long run?



source: The Bloomberg

an ever less hospitable yield curve. In the first week of April, the 10-year Treasury yielded 174 basis points more than the two-year Treasury. At this writing, only 132 basis points of daylight separate the two.

With the understanding that the KMI warrants are a speculation on the future, how might one value them? "The Black-Scholes option-pricing model is a place to begin," Peligal continues. "Depending on one's long-term assumptions about dividends and volatility, a warrant price of as little as $1.75 and as much as $4 is defensible. Ultimately, it's the yield on the so-called underlier, KMI stock, that will drive the value of the derivative, i.e., the warrant. Incorporating the impact of the El Paso transaction, KMI expects to declare dividends of at least $1.40 a share for 2012. KMI has also forecast a 12.5% annual increase in the dividend through 2015, underpinned by 7% growth in annual distributions at KMP and 9% at EPB. Management is saying nothing about 2016 and 2017. But if annual dividend growth of 12.5% is in the cards over the next five years, back-of-the-envelope math gives you a dividend value of about $2.50 in 2017. But, to be on the safe side, let's use $2.25 for 2017. Maybe a truly conservative investor would assume nothing, but we are brainstorming.

"Now, then," Peligal goes on, "another big assumption: Let's say that KMI continues to trade at a price to yield 3.75% or 4%, i.e., if the market interest rates do not shoot higher. In that case, KMI could command a price per share of between $56.25 and $60. If the stock is worth $60 on the high end, the warrants, with an exercise price of $40, would be worth $20. Of course, we have not yet taken into account the dilution that the exercise of these half-billion warrants would entail. Assume that the entire 505 million are exercised at $60 and that 505 million new KMI shares would therefore be materialized. In that case, the implied price per KMI share in 2017 would be not $60 but $52. In other words, we are talking about $10 billion of dilution, or 505 million shares times that $20 difference between the exercise price of $40 and our hypothetical value of $60."

The ink on the brand-new warrants was hardly dry on May 23 when KMI directors approved the purchase of up to $250 million's worth of warrants in the open market. Next day—the last trading day before the closing of the El Paso acquisition—an upsurge in warrant trading suggested that Kinder Morgan had wasted no time getting to work. It would have been a logical step if, indeed, it was the step that KMI took. Kinder would have paid an average price of $1.90 per warrant if it was the unnamed buyer on May 24. There's no mystery as to the identity of the sellers. Merger-arbitrage and event-driven speculators, the final holders of El Paso common and therefore the recipients of many, many KMI warrants, have holding periods rather shorter than those of the typical Benjamin Graham devotee.

"I don't think people understand the instrument," one warrant holder muses to Peligal. "When I talk to guys who own KMI as a straight-out security, they're perfectly happy saying KMI is worth $45 even though it is trading at $31 today. I say, if that's the case, what you really should be doing is buying the warrant because you can buy the warrant for $2 [make that $2.06 as we go to press], and you get $5 back. That's a much better reward than making 50% on KMI."

Noted—along with each and every one of the foregoing risks.

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