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We said, he said

A new Hedgeye report on Kinder Morgan Inc. says "sell." A June 29, 2012, *Grant's* article on the Kinder warrants (KMI on the Big Board) said "buy." What did the bears just say? And what do we say now?

By way of preface, Kinder Morgan is the nation's biggest midstream energy company. Through a majority stake in El Paso Pipeline Partners LP (EPB) and through control of Kinder Morgan Energy Partners LP (KMP), KMI holds interests in 80,000 miles of pipeline and 180 terminals.

The bearish Hedgeye report, unveiled last week, urges short sales of KMI and KMP—KMI being the general partner of the KMP master limited partnership. "Kinder Morgan's high-level business strategy is to starve its pipelines and related infrastructure of routine maintenance spending," explodes the first Hedgeye bullet point.

This is a serious yet—on its face—puzzling allegation. The eponymous Kinder CEO, Richard D. Kinder, bought 500,000 shares of KMI as recently as June 24 at a cost of $17.9 million. The purchase raised his stake to 241.4 million shares with a current market value of $8.4 billion (nor does this include his holdings in related Kinder entities). He draws a salary of $1 a year. What incentive would he, of all people, have to degrade his own earning assets, not to mention imperiling the life and limb of any who live along the right-of-way of his pipelines?

His motivation springs from the KMI business model, the bearish indictment alleges. Distributable cash flow—DCF—is the Kinder bottom line. To derive it, the company subtracts maintenance capital spending from earnings before noncash depreciation, depletion and amortization. The lower the maintenance cap-ex, the greater the share of incremental earnings accruing to the general partner, i.e., KMI.

You would imagine that this supposed policy of calculated neglect would exact its cost, and so it would. But, the Hedgeye analysis contends, Kinder makes it coming and going. By replacing a broken pipe of a certain gauge with a new pipe of a slightly larger gauge, management can classify the outlay as "expansion" cap-ex, which does not count against DCF, as opposed to maintenance cap-ex, which does. And because, as master limited partnerships, KMP and EPB may not retain earnings, equity issuance funds expansion cap-ex. Which corporate entity just happens to collect $4.5 million for every new one million shares of KMP to hit the market? Why, KMI does.

Kinder Morgan replied to the Hedgeye blast at the Barclays CEO Energy Conference last Thursday. In a breakout session after the main event, according to an attendee, a still slightly defensive Steven J. Kean, KMI's COO, replied to a question about cap-ex on El Paso's pipelines. Prior to its acquisition by Kinder, said Kean, El Paso had four corporate jets, the upkeep for which added millions to El Paso's annual cap-ex line. Frugal KMI has no corporate jets. When a pipeline springs a leak, Kean continued, Kinder goes first to patch it. El Paso would replace it. And when Kinder does replace pipe, it does so in 60-foot segments, whereas El Paso worked in 100-foot lengths.

Evan Lorenz of this staff read the Hedgeye report and talked to KMI. He talked with a long-term holder of KMI (who noted, among other things, that allegations similar to Hedgeye's first surfaced a decade ago). Weighing up the evidence, *Grant's* throws in its lot with Hedgeye—that is, specifically, the passage of the Hedgeye report that admiringly says, "KMI's economics are incredible—it puts up no capital for 50% of all incremental cash flows, and its fee grows larger with every new unit that the LPs issue. That means KMI can grow its dividend per share even if KMP's distribution per unit does not grow or declines."

Since we wrote less than a year-and-a-half ago, the KMI warrants have appreciated by 123%, to $4.64. We remain bullish on them and on the Kinder enterprise.

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