**From:** Maryann Harper [mailto:mbharper17@gmail.com]
**Sent:** Wednesday, December 23, 2015 1:15 PM
**To:** Monroe, Pamela
**Subject:** 28 Months Later: A Review Of The Infamous Hedgeye Kinder Morgan Report

**Dear Ms. Monroe:**

**Please include these comments under Docket NH SEC 2015-08 for Tennessee Gas Pipeline Co., LLC (a subsidiary of Kinder Morgan)**

**SEC Findings Re: Proposed Site and Facility RSA 162-H:16, IV (a)-(c)**
• Applicant has adequate financial, technical, and managerial capability to assure construction and operation of the facility in continuing compliance with the terms and conditions of the certificate.

**I am requesting that the NH SEC investigate the financial and managerial capability of Kinder Morgan's Tennessee Gas Pipeline Company to construct and operate a Safe Facility taking into consideration the following information. In February of 2014 Barron's noted that the Hedgeye report by Kevin Kaiser was causing concern about the company. Attached below is Mr. Kaiser's summary of his report found here: http://www.streetinsider.com/Analyst+Comments/Hedgeyes+Kevin+Kaiser+Discusses+Kinder+Morgan+%28KMI%29+%28KMR%29+%28KMP%29+on+FBN/8680177.html**

# Hedgeye's Kevin Kaiser Discusses Kinder Morgan (KMI) (KMR) (KMP) on FBN

September 11, 2013 4:08 PM EDT

Controversial Hedgeye analyst Kevin Kaiser spoke with FOX Business Network's (FBN) Charlie Gasparino about his recent statement about Kinder Morgan (NYSE: KMI)

(NYSE: KMR) (NYSE: KMP), which he called "a house of cards."

Kaiser said, "Kinder Morgan's issues are very concerning" and that the "entire MLP sector is sort of a regulatory nightmare." When asked whether Kaiser thinks Kinder Morgan is doing anything illegal Kaiser said, "I am not saying that anything is illegal here. I think there are some very misleading statements with some of the non-GAAP financials." Kaiser discussed further that he doesn't think Kinder Morgan's stock is safe for investors.

**On whether Kinder Morgan should be investigated:**
"I would say that Kinder Morgan's issues are very concerning, that there issues are broad across the MLP [Master Limited Partnerships] sector, but theirs are more egregious than some of the others. I think that the entire MLP sector is sort of a regulatory nightmare to be honest with you."

**On whether Kinder Morgan is transparent:**
"I don't think they're transparent at all. A great example of this is in their E&P business they have $450 million dollars - $400 million dollars of capital expenditures that they are calling expansion capex and it should be maintenance."

**On whether Kinder Morgan's stock is not safe for investors:**
"Yes"

**On whether Kinder Morgan is improperly accounting for things:**
"I am not saying that anything is illegal here. I think there are some very misleading statements with some of the non-GAAP financials and when I say house of cards, to me house of cards means something that has an unstable foundation and when you need to raise more and more capital to continue to pay out higher and higher distributions. In my view that's a very unstable foundation."

**Kinder Morgan was highly critical of the Hedgeye report and facilitated a conference call in an attempt to dispute it. Kaiser admitted to one error in the original report but stood by his findings. In February of 2014 Barrons issued the following:**

*From Barrons Online, February 22, 2014*:

> '…**KINDER MORGAN'S** CAPITAL EXPENDITURES in its vast pipeline business is another area of debate. **Hedgeye's Kaiser** criticized the company in September for sharply cutting sustaining capex on newly purchased pipelines.
> Jefferies analyst Sighinolfi has different concerns. **"Every company defines maintenance capex differently, but we struggle to understand how KMP can safely operate the largest portfolio of transmission and storage assets in the industry for just a fraction of its peers' expenditures,"** he wrote last year. Comparing Kinder Morgan with Spectra Energy Partners (SEP), another big pipeline operator, he found that **Kinder Morgan was spending about half the maintenance capital of Spectra per mile of pipeline**. He has a Hold rating on the Kinder Morgan MLP…'

**Now 28 months later - the Hedgeye report is reviewed and shows concerns about Kinder Morgan's financial status were not unfounded. Please note that as of today's date 12/23/2015, FERC has issued an additional request for accounting data on the Company. I am including the review of the Hedgeye report in its entirety below as well as the link for reference:**
http://seekingalpha.com/article/3766656-28-months-later-a-review-of-the-infamous-hedgeye-kinder-morgan-report?auth_param=9s1id:1b7cs87:1478df096a926a1aebb112d0e49f6ed1&uprof=45

Respectfully submitted,

Maryann B. Harper

Rindge, NH

# 28 Months Later: A Review Of The Infamous Hedgeye Kinder Morgan Report

## Summary

In September 2013, Hedgeye issued a short recommendation for Kinder Morgan.

The report was widely criticized and ignored. Kinder Morgan stock would later reach its all-time high in early 2015.

With the recent Moody's outlook change and the drop in energy prices, Kinder Morgan’s share price has collapsed and people who shorted in September in 2013 made money.

Based on the decline of Kinder Morgan's stock price, and the causes of that decline, it appears Hedgeye should receive credit for making a good call two years ago.

Back in September 2013, Hedgeye published a report recommending to short Kinder Morgan. At the time Kinder Morgan had a very complex structure with three subsidiary MLPs (KMP, KMR, and ELP) and a corporate piece (NYSE:KMI). Later, in 2014, the company consolidated, with KMI becoming the only surviving entity.

The big issue in the analysis was the theory that Kinder Morgan was holding down maintenance CAPEX and doing other things so that they could report a higher distributable cash flow (DCF). Then when the asset needed to be replaced the capacity of the line would be increased so that the spending would be considered "growth CAPEX" and not go against the calculation of DCF. This accounting policy would also increase the incentive distribution rights (IDR) that the various subsidiaries would pay to general partner KMI, unfairly transferring value from one set of stakeholders to another.

Not only was the maintenance CAPEX policy leading to overstated DCF, but Hedgeye felt there would be an increased risk of reliability and safety problems in the future as maintenance was delayed. The complexity of the corporate structure was also felt to be distorting the underlying economics of the business.

Kinder Morgan held a special investor conference call to discuss the report soon after it came out. During the call they laid out their CAPEX spending and how they took care of their pipelines to make sure that they were safe. This was important, and on this point it appears that Hedgeye was wrong. (At least as of now.) There has not been an increase in reliability problems or a major disaster on their system. Kinder Morgan provides substantial information on environmental and safety performance on their website here. In general KMI's performance on these measures has remained steady since the Hedgeye report. Maybe some big failure is on the brink of occurring, but we haven't seen it yet, so it seems like Kinder Morgan should get the benefit of the doubt on this issue.

However, the remaining Hedgeye issues were essentially accounting and disclosure issues, and Kinder Morgan did nothing to address them in the call. Only one analyst (Mark Reichman, from Simmons) really asked about the topic in his question during the call (my emphasis):

"...It seems to me that the recent criticism has really been directed at the integrity of the partnership's financial reporting. So, I wanted to ask about management's philosophy regarding non-GAAP financial disclosures... I was wondering if you could address how you think about what you include and/or exclude and to what degree your public accounting firm and legal counsel opines on the financial reporting including the non-GAAP disclosures? ...to what degree do you think that the distributable cash flow measure shown in the earnings release should reflect the economic reality or actual cash flow available for distribution to unit holders?"

Kinder Morgan said that DCF is fully reconciled to the GAAP numbers, but they didn't really discuss the philosophy of how they decide what items should be included in the DCF adjustments. They basically said that their DCF number is what they believe to be "...our business' ongoing ability to generate cash." They gave examples about when items increased or decreased the DCF, but no big picture discussion about making these adjustments and why their adjustments were the best way to look at the company.

After Kinder Morgan's call, the majority of Wall Street seemed to ignore Hedgeye's analysis. Many articles came out criticizing the report, and often the fact the Hedegeye's analyst was 26 years old was a part of the criticism.

A year later Kinder Morgan announced a restructuring of the company that would consolidate all of the different entities under the KMI ticker. The justification for this was that it would simplify the corporate structure and that it would lower the company's cost of capital. The lower cost of capital was a bit of a surprise, since the whole point of MLPs is to be an entity with lower capital costs. A significant portion of the conference call was discussion about why the change would lower the cost of capital. In some ways, this whole restructuring was admitting that Hedgeye's analysis about Kinder Morgan's complex capital structure distorting the economic performance of the company was right.

The restructuring was completed at the end of 2014. In the first nine months of 2015 KMI paid out $3,084M in dividends while they issued $3,833M in stock. CAPEX was about $3B, and they spent $1.9B on acquisitions. Cash flow from operations was $3,507M. At the end of October KMI essentially sold more equity with the issuance of $1,541M of mandatory convertible preferred stock. Eventually Moody's said "enough is enough". They felt that Kinder Morgan had too much leverage and Moody's moved their outlook on KMI to negative from stable. KMI decided to dramatically reduce the dividend to maintain their credit rating and not overly dilute their stock with a new equity issuance.

Kinder Morgan held a conference call after the dividend cut, and when you look at Chairman Richard Kinder's comments you can see that a large drop in the stock price had to happen eventually. On the call Kinder said (my emphasis):

"Now, for over 18 years, <u>our policy has been to fund our growth projects with externally raised debt and equity, and distribute virtually all of our available cash flow</u>. So, what's changed? While there have been enormous headwinds in our industry, <u>primarily what has changed in recent months is the price of our common stock</u>, a downturn that has negatively impacted the whole midstream energy field."

**When you think about it, a company can only keep up this strategy for so long. By keeping a high payout they kept their dividend high, and the high dividend helped keep their stock price high, and a high stock price gave them a lower cost of equity. The low equity cost allowed them to cheaply issue more stock so they could keep growing the dividend and keep the stock price up. But the growth rate eventually had to slow down because they were having to maintain the growth rate off of a bigger base. The reduced growth rate lowers the**

**multiple people are willing to pay for the name, which lowers the stock price. The decline in stock price increases the cost of equity, and then the whole virtuous cycle collapses in on itself, and that is what has happened these past few months.**

My one criticism of the Hedgeye report is that they didn't clearly lay out the perpetual financing logic as well as they could have. The closest example in the report is when they said (emphasis mine):

"In our view, <u>KMP needs to constantly issue new equity to continue to finance its distributions, IDR fees to KMI, and maintenance spending</u>; thus, it is difficult for us to see how KMP's cost of equity (price) does not have a major impact on KMI, in the same direction. ...given that the IDR payment represents a wealth transfer from KMP to KMI, the expectation of a reduction in future LP distributions [<u>i.e. dividends</u>] is not good for any Kinder Morgan security, but it is particularly bad for KMI."

**However, in interviews, Hedgeye analyst Kevin Kaiser does a much better job in explaining how Kinder Morgan is depending on continual financing to keep the enterprise going.** (See example here.) The interviews and report also admitted that the lack of a catalyst made it unclear when the stock would fall. The big drop in oil prices and decline in the energy space is probably what started KMI's drop, and if that hadn't happened it might have been a few more years before we got the correction in the stock price. As you can see from the table below, anyone who followed their recommendation did well.

**Kinder Morgan return since Hedgeye report**

| Share Class | KMP | KMR | EPB | KMI |
|---|---|---|---|---|
| 9/9/13 Closing Stock Price | 80.33 | 69.66 | 41.43 | 36.33 |
| Shares in 2014 buyout | 2.1931 | 2.4849 | 0.9451 | 1.00 |
| Additional cash | 10.77 | - | 4.65 | - |
| Value of shares on 12/15/15 | 34.74 | 39.36 | 14.97 | 15.84 |
| Value of shares + cash | 45.51 | 39.36 | 19.62 | 15.84 |
| % change in value | -43.3% | -43.5% | -52.6% | -56.4% |

*(click to enlarge)* Source: FactSet and Garnet Research, LLC

Obviously Kinder Morgan's large dividend cushioned the drop slightly for the shareholders who stuck with the name, but these people still took a really big hit.

You have to give credit to Hedgeye for sticking with their call when everyone was against them and they weren't sure when the catalyst would arrive to prove them right. While it appears that they got the maintenance CAPEX part of their thesis wrong, **they were right in recognizing that KMI had an unsustainable structure that would lead to a stock decline**. It took a while, but their short recommendation appears justified today.