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In Pursuit of Value

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Kinder Morgan

Hedge fund investors place considerable importance on the quality of the people in the organization. When I first began interviewing hedge fund managers in the early 1990s, there was often so little hard data made available by the manager that the due diligence process largely consisted of a series of interviews covering all facets of the investment process. Monthly returns were the only source of quantitative analysis, and successful hedge fund investors possessed sound people-judgment skills. In recent years transparency has improved, in some cases substantially as institutional investors have demanded a more open relationship following the 2008 financial crisis. But assessing the people at the top remains of vital importance.

It's not only hedge funds where the quality of senior management is a key consideration. Although the evaluation of public equities is supported by vastly more data than is the case for hedge funds, the people at the top still matter. What they say they'll do and whether or not they carry it out, as well as their overall competence, makes a big difference. Charlie Munger has famously defined "the ham sandwich test", as only investing in companies that can be run by a ham sandwich because one day they will. It's good advice, and as noted recently on our blog the alarm company ADT is currently undergoing such a test as its CEO Naren Gursahaney exhibits a degree of ineptitude totally at odds with the opportunities presented to ADT. Hertz (HTZ) recently joined them as CEO Mark Frissora was forced to blame another disappointing quarter on unexpectedly high demand (advance bookings from business travelers left few vehicles for more profitable, shorter notice leisure travelers). We're invested in both companies because we believe valuations are attractive enough to compensate for the two sorry characters mentioned and provide optionality around activist-driven change. Such appears underway at HTZ.

Kinder Morgan (KMI) is in a different category, in that a good business exists alongside competent management. It remains our most widely held security. Although we run five distinct strategies the investment research can overlap. But KMI is unique for us in that we own it in every strategy. It is, unusually, an undervalued yet reliable dividend paying low volatility stock with management incentives strongly aligned with shareholders, hence its fairly broad inclusion. We've often written about the superior position of the General Partner (GP) in an MLP relative to the Limited Partners (LPs). The LPs are like hedge fund investors and the GP is the hedge fund manager. Asset growth may or may not help the former, but invariably helps the latter. At a time when MLP asset growth is large and visible due to the substantial infrastructure investments required to exploit shale energy reserves in such non-traditional regions as the Bakken in North Dakota, MLP GPs remain a good investment.

Rich Kinder is credited with recognizing that the MLP structure could be combined with growth-oriented infrastructure assets, relying on the MLP's lower cost of equity capital to regularly access the capital markets as needed. Kinder Morgan Partners (KMP) went public in 1996, but Kinder has always recognized that the GP offered the most value, and consequently his holdings were concentrated in that entity. As good as the MLP structure has been, Kinder's recent transaction acknowledged the limits that size ultimately imposes. Just as hedge funds can be too big, so can an MLP. The 50% of the Distributable Cash Flow (DCF) to which KMI was entitled represented an increasingly heavy burden on what KMP had left to pay LPs, and consequently its yield had drifted up to 7% where it reflected the market's very modest assessment of its growth prospects.

You could hear the frustration in Rich Kinder's voice on every quarterly earnings call as he asserted that the

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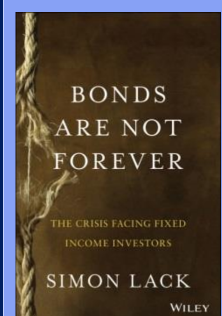

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market was undervaluing the Kinder enterprise. KMP's high yield made it difficult to do secondary offerings of equity to invest in new projects or acquisitions without diluting existing LPs. While a GP could in theory raise capital to invest in projects that didn't cover that capital's cost, that wasn't a sustainable long term strategy. At a time of growing M&A opportunities in energy infrastructure, Kinder needed its securities to be an expensive low-yielding currency to use in deals, not a cheap, high-yielding one. Kinder was aggrieved not only because his $8 billion holding in KMI (worth $9 billion after the announcement) made him the biggest investor, but also because an analyst at Hedgeye, a research boutique in Connecticut, had seemingly picked on Kinder Morgan as exhibit 1 in what he perceived to be wrong with the entire MLP sector.

During the ten months or so following release of Hedgeye's report, written by Kevin Kaiser, all four of the Kinder Morgan stocks stubbornly underperformed a booming MLP sector, perhaps reflecting some sympathy with Kaiser's view. Finally, Rich Kinder did what you'd expect of somebody who'd already demonstrated exquisite investment insight more than once in his career; he recognized the new paradigm and abandoned the MLP structure that once worked but no longer suited his purpose. Additionally surprising was the tax shield unlocked through the consolidating transaction, as KMI established new, current market values for the assets acquired from its MLPs forming the basis for a much bigger tax-deductible depreciation charge. The $20 billion estimated value of the tax shield was behind both a higher KMI dividend and faster growth, creating a substantial savings for shareholders that has curiously drawn far less scrutiny than less significant "tax inversions" (such as the recent Burger King/Tim Horton's deal).

It's too soon to claim victory on the Kinder Morgan story (although Hedgeye has removed its original critical report from its website); there are more developments to come. Kevin Kaiser's bold attacks on Kinder Morgan highlight the importance of researching and understanding your investments. It provides the confidence to hold and/or buy as spooked investors rush to sell. On Kinder Morgan's fourth quarter earnings call, with KMI trading at around $35 and perhaps reflecting his frustration at the negative narrative propagated by Hedgeye's research, Kinder said, "I've purchased over 800,000 shares in December alone. So I guess my message to those who saw the story less positively was you sell, I'll buy, and we see who comes out the best in the long run." It's nice to invest along CEOs with a passion for investor returns. Kaiser was highly critical of what he termed "the "dumb money" invested in MLPs. Presumably the weakness in KMI's stock price following Kaiser's initial barrage at the company was some of this dumb money leaving.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

KMI impacted all our investment strategies in August, but it's still more or less just recouping the last year's underperformance relative to the Alerian MLP index. One major insight from the consolidation of the Kinder Morgan's four publicly traded vehicles into a simpler structure with one public equity security is the desire to lower both the cost of debt and the cost of equity in order to be competitive to make large acquisitions. The strategies are positioned to benefit from a wave of M&A we expect to see in the North American energy infrastructure industry.

Dodging the Potholes on Wall Street

This is the working title of my next book. Each chapter will cover a type of investment frequently sold to uninformed buyers that should carry a substantial warning label. I am fortunate to be collaborating with several other industry professionals who have each agreed to write a chapter. The examples will be drawn from actual situations that we've encountered in our respective businesses, and we hope to enhance investors' understanding about certain products and thereby in some modest way improve the standard of financial advice provided by our industry. The book will be published next year.

We have no shortage of material, but if any reader of this newsletter has an example that they'd like to share with the authors, we'd certainly love to hear from you.