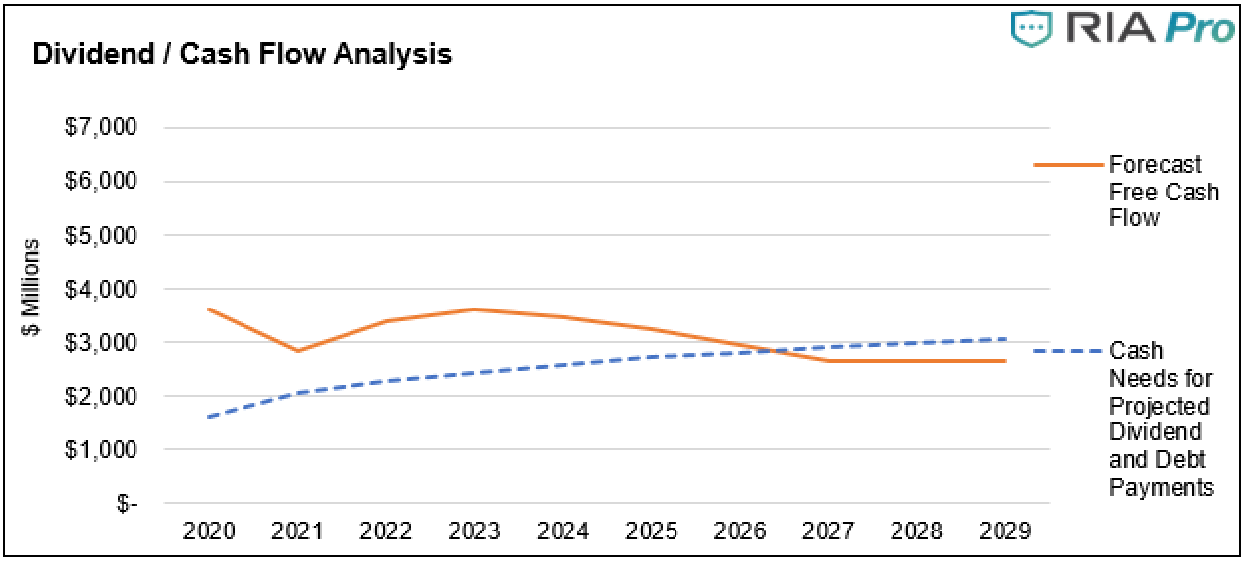
In this edition of the Value Seeker Report, we analyze an investment opportunity in Kinder Morgan (NYSE: KMI) using fundamental and technical analysis.

Overview

- Last week we posted our initial report highlighting the woes of the energy sector. While the sector is certainly ailing we believe prices have more than reflected the sector's problems and are presenting some great opportunities. This week we explore one such company that we believe is being undervalued by the market.
- Kinder Morgan (KMI) owns and operates the largest network of natural gas and petroleum product pipelines in North America. Besides the transportation of these products, KMI also operates storage terminals for refined products, chemicals, and crude oil.
- Using our forecasts, we arrive at an intrinsic value of **$13.98** for KMI?s stock. The stock is currently trading at $12.02 per share, which implies an upside of 16.3%. Further, the stock pays a current dividend yield of 8.5%.

Pros

- KMI owns a network of pipelines feeding from several North American shale plays that are rich in natural gas and operates them under a fee-based system. By sourcing revenue primarily from fee-based services, KMI can maintain relatively steady cash flow even in a cyclical market.
- The Permian Highway Pipeline (PHP) project, described below, is expected to be incredibly beneficial for KMI.
- KMI pays a quarterly dividend and has raised the amount each year since 2017. The last dividend declared was for $0.2625 per share, resulting in $1.03 total for 2020. The dividend yield is currently 8.5%.
- Prior to the pandemic, management had a plan to raise the dividend to $1.45 per share over a specified timeframe. However, the pandemic prompted a re-evaluation of this strategy, and management is now focused on maintaining financial flexibility**.** Accordingly, the rate of dividend increases is expected to slow, and management guided that it would use opportunistic share repurchases to return capital to shareholders.
- As shown below, our forecasts indicate that KMI will earn free cash flow above the amount necessary to raise its dividend by $0.04 per share annually over the forecast period.



Cons

- On top of other potential headwinds, demand weakened by COVID still plays a large role in determining the intrinsic value of KMI. The fourth quarter of 2020 is very important for the performance of KMI for the year. Seasonal demand for natural gas tends to be highest in the winter months, and without timely stimulus, demand could suffer more than already expected.
- The United States? transition to green energy could lead to excess capacity in midstream infrastructure, and result in lower shipping rates for midstream operators.
- KMI currently has a high leverage ratio compared to some of its competitors. However, the firm has a Times Interest Earned (TIE) ratio above one, and thanks to the Fed, should be able to roll over its short-term debt despite the current environment. As a testimony to the last statement, their 3-year bonds yield 0.75%.

Permian Highway Pipeline (PHP) Project

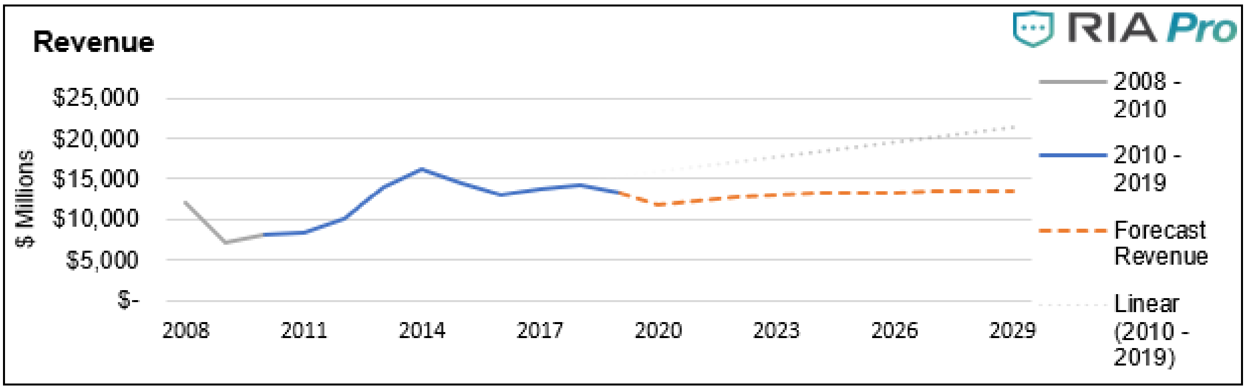
- Natural gas prices tend to be significantly lower in the Permian Basin than end-markets. There generally exists a differential, but it is especially wide in the Permian due to a lack of midstream infrastructure to transport natural gas away from the basin. This bottleneck creates excess supply, which lowers prices in the Permian. One method used by shale drillers to combat this effect is to burn off associated gas at the wellhead. Needless to say, this helps producers of oil & gas but not the environment. The PHP is a 430-mile, 42-inch natural gas pipeline capable of transporting up to two billion cubic feet of gas per day. It will transport natural gas from West Texas to the gulf coast area and is expected to be fully operational by early 2021. The pipeline is poised to help alleviate the flaring problem facing the Permian Basin, and will allow KMI and its partners to benefit while doing something good for the environment. KMI owns roughly a 27% stake in the project.

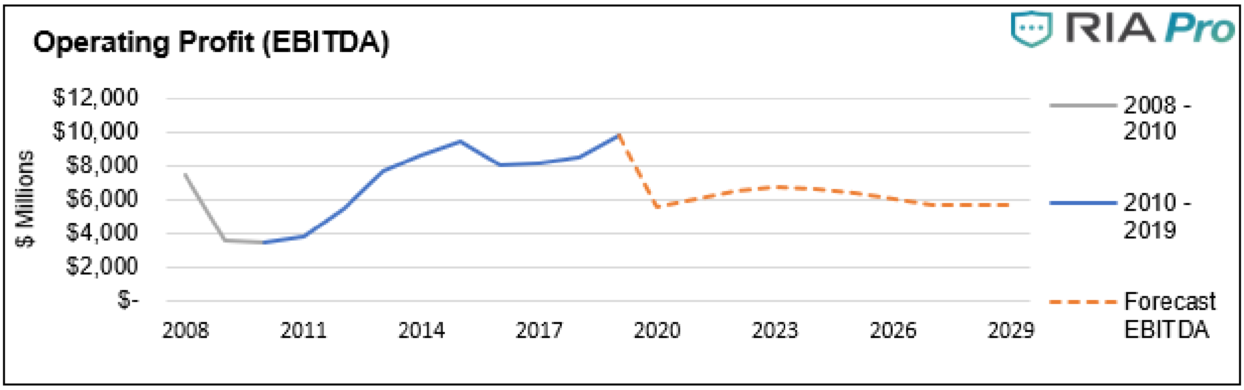
Key Assumptions

- For our base case, to remain consistent with our last report, we assume a Biden victory in the White House with a Republican majority senate.
- Revenue growth for 2020 is based on three quarters of results and management?s comments in the KMI 3rd quarter earnings call. We assume a slow recovery in demand spanning into 2023, with revenue growth slowing thereafter as society scales up the use of renewable energy sources. The chart below illustrates our forecasts in relation to historical

revenue.

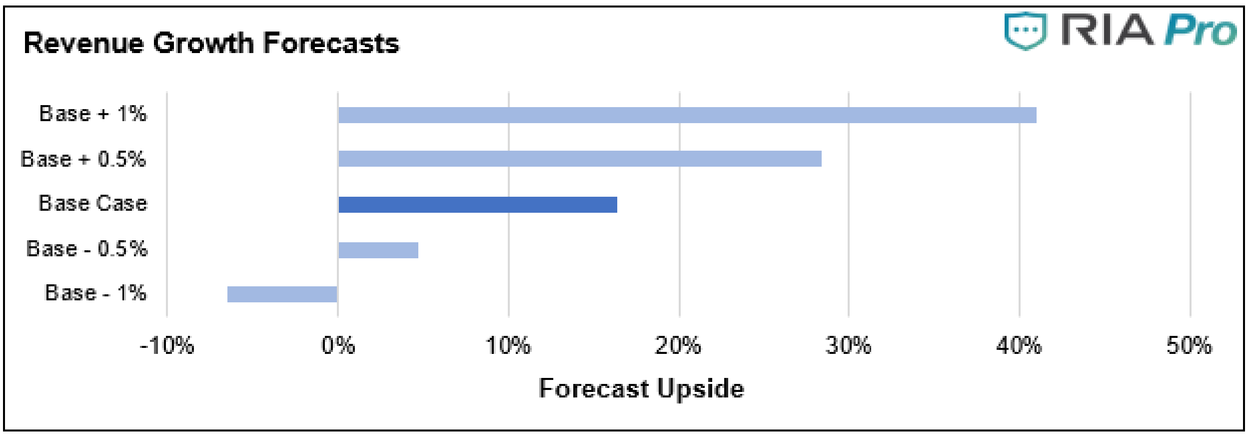
- We forecast KMI operating margins to shrink significantly in 2020 as crude and natural gas production volumes have plummeted in the wake of COVID. Margins will then recover through 2024, and finally move lower through 2027 as the US begins its transition toward green energy. The chart below shows our forecasts of operating profit compared to historical figures.

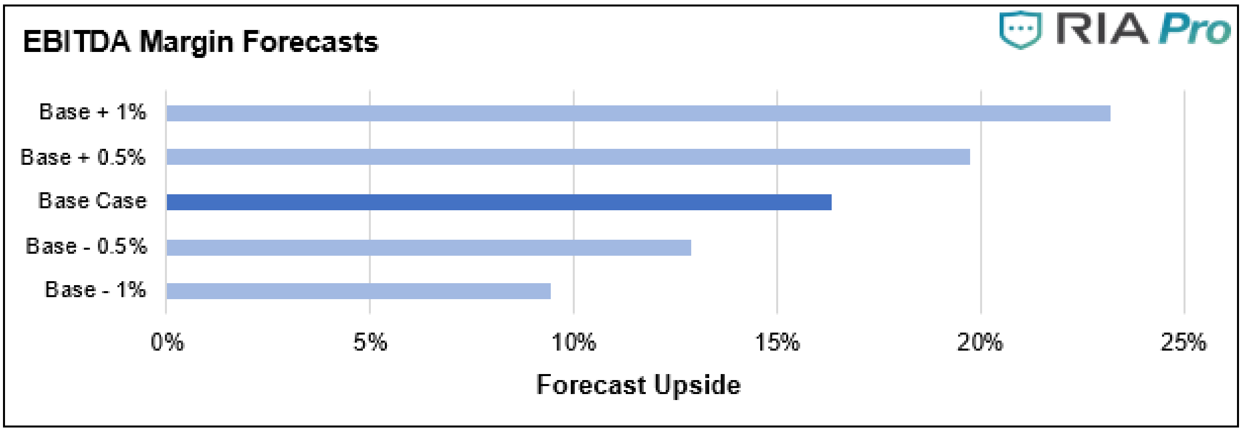


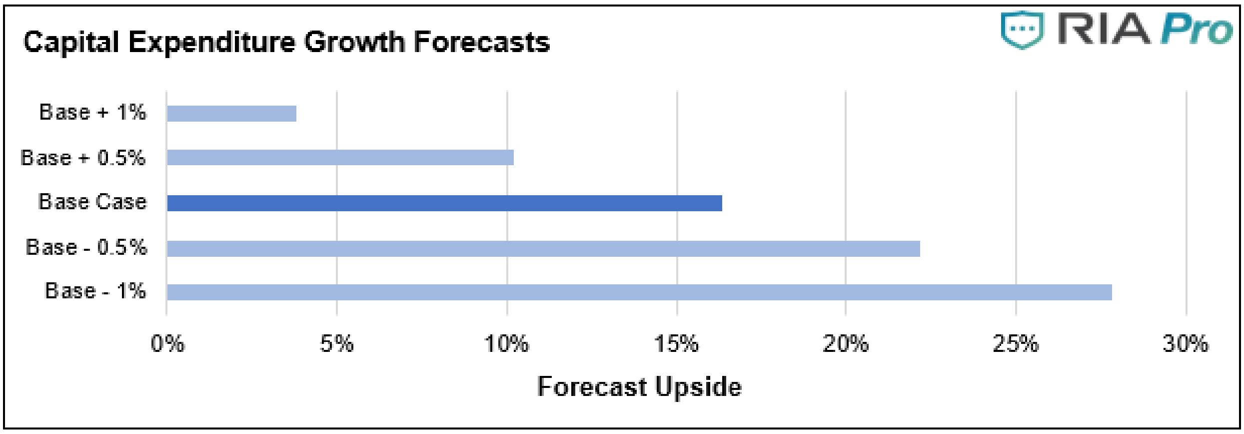


Sensitivity Analysis

- A brief note on why we present sensitivity analysis can be found here.
- Aside from COVID, the major concern for the market appears to be the looming transition towards green energy by the U.S. However, we see slight upside even when dropping our long-term FCF growth rate assumption to 0% (Nominal).




EBITDA Margin Forecasts
RIA Pro
Base + 1%
Base + 0.5%
Base Case
Base - 0.5%
Base - 1%
0%
5%
10%
15%
20%
25%
Forecast Upside


Capital Expenditure Growth Forecasts
RIA Pro
Base + 1%
Base + 0.5%
Base Case
Base - 0.5%
Base - 1%
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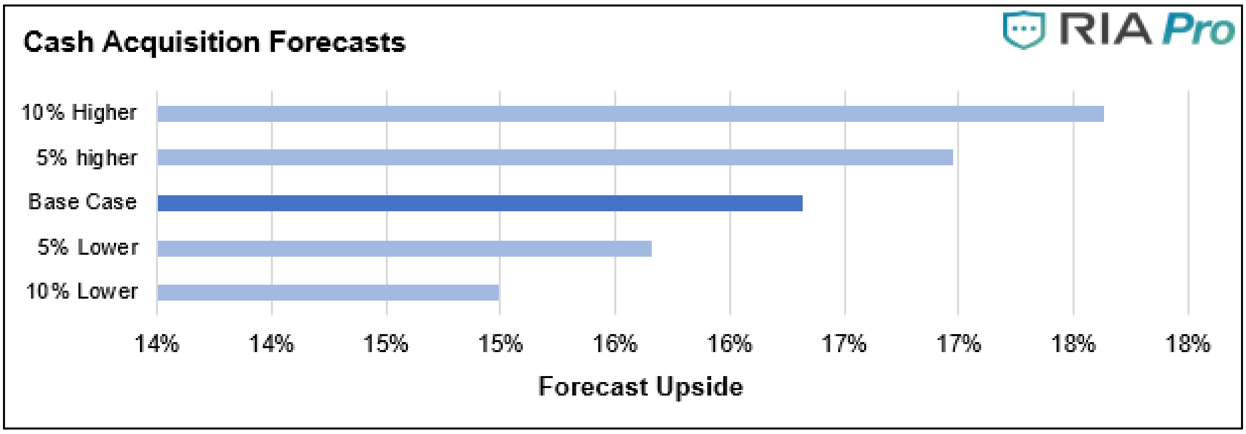
30%
Forecast Upside


Cash Acquisition Forecasts
RIA Pro
10% Higher
5% higher
Base Case
5% Lower
10% Lower
14%
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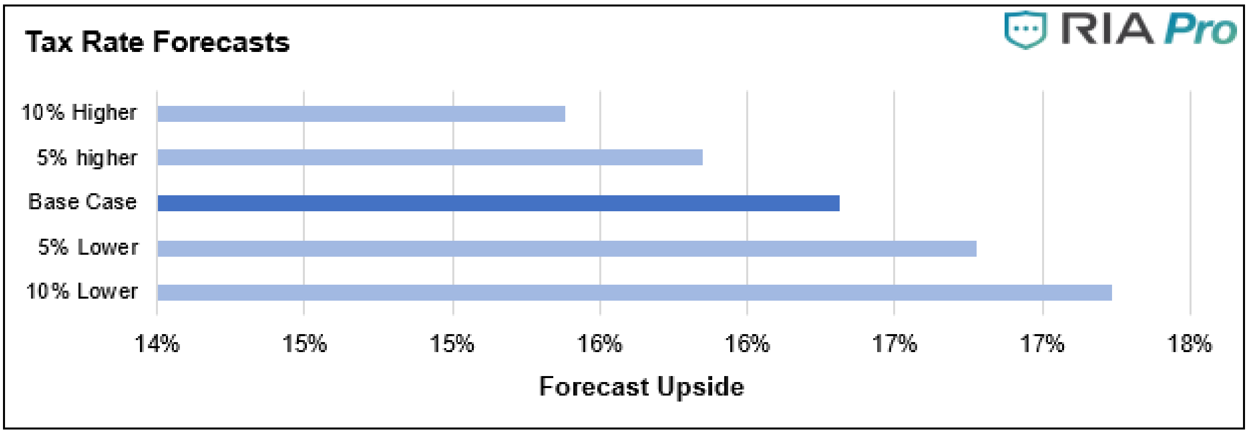
Forecast Upside


Tax Rate Forecasts
RIA Pro
10% Higher
5% higher
Base Case
5% Lower
10% Lower
14%
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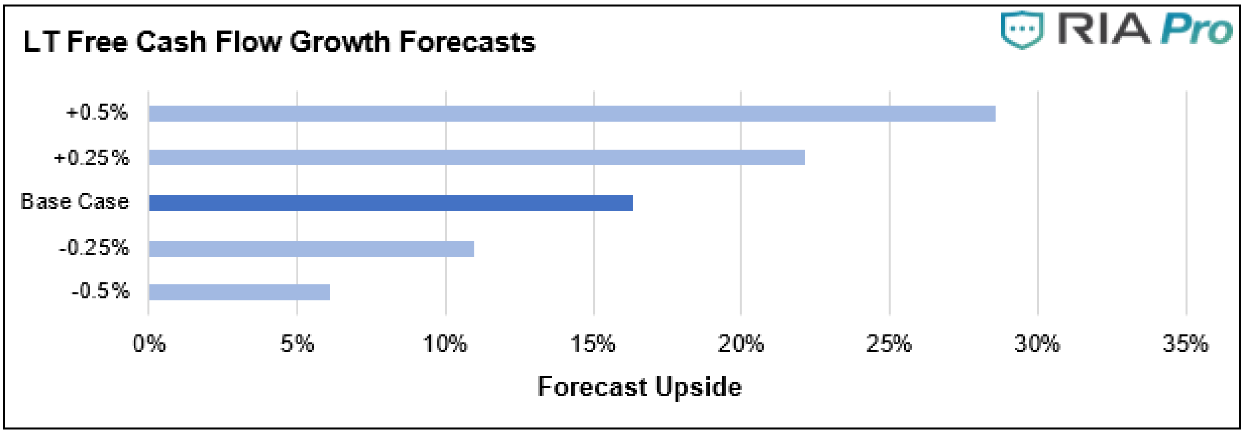
Forecast Upside



Technical Snapshot

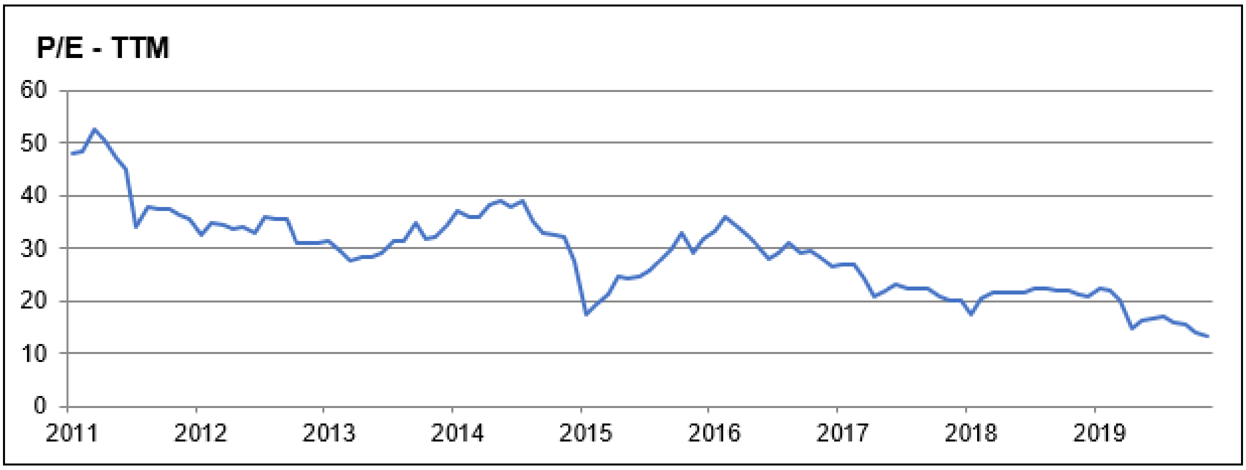
- KMI has been in a constant downtrend since mid-June, along with many other energy stocks.
- The price of KMI has been stuck below its 50-day moving average since late-June. The march lows coincide with lows established in early 2016, and provide a substantial level of support near $9 per share. However, if this support is broken convincingly, investors may want to consider exiting the position.

Value Seeker Report Conclusion On KMI

- The market?s lack of interest in energy stocks has led to some dropping significantly below intrinsic value. With a forecast upside of 16.3% and a dividend yield of 8.5%, we believe KMI is worthy of consideration.
- Unfortunately, due to the market?s narrative for energy and the election, prices may get worse before they improve. As Rich Kinder put it in the KMI Q3 earnings call:

?*So the results and outlook are that positive, why is that not reflected in our stock price? I'm certainly no expert on that subject, but it appears that many investors are not committing any funds to the energy business without any consideration of the unique characteristics of our midstream sector. Now, we are not climate change deniers and we recognize the growing momentum of renewables in America's energy mix. That said, there is a long runway for the products we handle, particularly natural gas.***?**

- While we think there is a lot of value to be found in the energy space, the market may continue to disagree with us. As such, we are fighting an uphill battle and KMI could dip lower before eventually heading for intrinsic value.



Source: Zacks Investment Research

Fundamental Ratios	
Price / Sales TTM	2.29
Price / Earnings TTM	13.7
Current Ratio (Quarterly)	0.61
Quick Ratio	0.41
Times Interest Earned (TIE) Ratio TTM	1.57

Latest Report Date	Ticker	Last Close Price	Intrinsic Value	Forecast Upside Remaining	Original Conviction Rating	Current Conviction Rating	Currently Held in RIA Pro Portfolio?
8/6/2020	T	$ 26.76	$ 38.09	42.3%	3-Star	2-Star	No
8/13/2020	XOM	$ 32.97	$ 55.42	68.1%	3-Star	2-Star	No
8/28/2020	VIAC	$ 28.13	$ 36.70	30.5%	4-Star	2-Star	No
9/3/2020	DOX	$ 55.42	$ 76.76	38.5%	3-Star	3-Star	Yes
9/11/2020	CVS	$ 55.93	$ 85.35	52.6%	3-Star	3-Star	Yes
9/18/2020	PETS	$ 30.62	$ 41.14	34.4%	3-Star	3-Star	No
9/24/2020	SPB	$ 57.51	$ 61.18	6.4%	4-Star	4-Star	No
10/2/2020	DKS	$ 56.18	$ 68.76	22.4%	4-Star	4-Star	No
10/9/2020	WCC	$ 40.78	$ 61.42	50.6%	4-Star	4-Star	No
10/30/2020	KMI	$ 12.06	$ 13.98	15.9%	3-Star	3-Star	No

For the Value Seeker Report, we utilize RIA Advisors? Discounted Cash Flow (DCF) valuation model to evaluate the investment merits of selected stocks. Our model is based on our forecasts of free cash flow over the next ten years.