The Tax Story Behind Kinder Morgan's Big Transaction

On Sunday evening Rich Kinder, CEO of Kinder Morgan Inc (KMI) announced the transaction that many had been expecting as a response to the persistently low price of Kinder Morgan Partners (KMP) and El Paso (EPB), two MLPs in which KMI owns the General Partner (GP). The problem was that Kinder expects an increasing amount of M&A activity in the energy infrastructure space they inhabit, and his ability to participate has been greatly hampered by the high distribution yields on KMP and EPB. Their high yields (i.e. low prices) make them an expensive source of capital should he wish to acquire any assets by issuing new securities to the seller. He’s long complained that the market didn’t fully recognize the value in the Kinder Morgan complex.

The deal greatly simplifies Kinder’s structure in that four existing public equity securities will be collapsed into one. The drag of Incentive Distribution Rights (IDRs), which direct half of the distributable cashflows to the GP, will be gone and the new KMI will offer a higher dividend and faster growth than the old one. Much has already been written about the transaction. What hasn’t received much attention is the tax issue.

Because KMI is acquiring assets at above their carrying value, they’ll be able to use the new, higher purchase price as their cost basis for taxes. This is quite different than when one corporation buys another. If A buys B for $100 and B’s equity value is $70, A holds $70 of assets and $30 of goodwill. You can’t do much with goodwill. You can’t depreciate it; you can’t write it off against taxes and from time to time you have to test it for impairment. You certainly can’t borrow against it. Many businesses are worth more than their book value equity, which is why goodwill as a concept exists in the course of an acquisition. But the accounting definition of goodwill plays no role in this transaction.

Because Master Limited Partnerships (MLPs) are pass-through vehicles, the LP unitholders own a direct, proportionate share of the underlying assets (rather than shares in a corporation which in turn own the assets). If KMI was acquiring another corporation, they'd wind up with an asset of goodwill equal to the difference between the purchase price and the book value of the acquired company.

Because KMI is buying the underlying energy infrastructure assets directly (since MLPs are pass-through vehicles) the newly acquired assets go on KMI's balance sheet at the new purchase price. It means they can be depreciated from this new higher value, and depreciation is tax-deductible. KMI used to benefit from depreciation of these assets before the transaction, but only from their lower, original purchase price. And over time the difference between depreciated value and actual value grows, since many pipelines increase in value. For example, Williams Companies (WMB) owns a pipeline network that runs down the east coast from NY to Texas called Transco. On an investor call recently a WMB executive commented that they had once tried to estimate what it would cost to build Transco today if it didn't already exist, and had come up with a number of $100 billion. To put this in perspective, WMB's entire enterprise value is $58 billion. It doesn't mean Transco is worth $100 billion, but it illustrates that easements with perpetual ownership are much harder to replicate in today's America of 310 million people than they were 30 or 50 years ago.

KMI's tax savings through the higher depreciation afforded through a higher asset value is worth, they estimate, $20 billion. This is an important source of the higher dividend and the faster, 10% annual dividend growth they now forecast.

Meanwhile, taxes work in a different way for KMP and EPB unitholders. MLP investors pay less tax today on distributions than if the same cash was a dividend, but owe the tax not paid when they eventually sell the MLP. Some investors hold their MLPs for a long time, and maybe even until death (when their heirs are not liable for the taxes). As an MLP investor you're trying to put off paying taxes as long as possible. The Kinder Morgan transaction is a taxable event for the KMP and EPB unitholders. KMI estimates that the typical KMP unitholder will owe from $13.81 to $18.16 per KMP unit owned, depending on the closing price of the transaction later this year. That's more than the cash component of the deal and makes it substantially less attractive for some unitholders (the longer you've been an investor the worse off you are). Even if you assume that the taxes would have been paid in 10 years (and assume a 10% return on the money* that would have been invested in KMP but now has to go to the IRS) it still eats up $8.49 to $11.16 of value.

So although the deal was priced at a 12% premium to Friday's close (in the case of KMP) or a 15.4% premium (in the case of EPB), the impact of having to pay taxes now rather than later gets the typical KMP investor roughly back to where they were with no transaction. KMI though has better prospects, in part due to the tax savings from higher depreciation.

It's not always appreciated how much control GPs have over their MLPs. Although KMP's high dividend yield represented a high cost of equity, this never actually precluded them making new acquisitions. The GP, KMI, could have directed KMP to raise capital at a cost above the return on the assets acquired which, while it would have diluted the LP's returns would still have been good for KMI which would have shared in 50% of the increased DCF without having to put up any extra capital. A GP who so wished could exploit the LPs in his MLP by issuing equity to make acquisitions no matter how bad it was for the LP unitholders because the GP would still get its IDR-based share of the additional cashflows.

So while the transaction may look slightly less attractive to LP unitholders once taxes are considered, they could have received far worse treatment from an unscrupulous GP. Rich Kinder is not like that.

So the lesson here is, to invest alongside the people who run the businesses, which is in the GP. Rich Kinder’s a taxpayer and you can be sure that he gave careful consideration to what his own tax outcome would be. This is why we’ve long been owners of KMI, but had avoided KMP, EPB and indeed most other MLPs where a GP has a claim on the cashflows. If you invest in the GP at least your tax situation will receive more careful consideration from the billionaire alongside whom you’re investing.

*There is a theoretical case for using the investor’s borrowing cost to discount the tax liability. This results in a lower set of numbers and makes the tax analysis less adverse for the KMP unitholder.