

A Midstream Megadeal, Implications, and Fallout for Investors

On May 15th, ONEOK (OKE) and Magellan Midstream Partners (MMP) agreed to a deal merging the Tulsa-based firms. A shareholder vote is expected in the back half of 2023 and would create one of the largest pro-forma energy infrastructure entities. We believe the current deal spread based on ONEOK and Magellan Midstream Partners stock prices implies that the deal is more likely than not to be approved and close in 2023.

On August 16th, Energy Transfer LP (ET) announced it entered an agreement to acquire Crestwood Equity Partners (CEQP). The all equity transaction is tax-efficient for CEQP unitholders. This agreement is subject to a vote of CEQP unitholders expected in the fourth quarter of 2023.

The ramifications of these potential transactions are wide-ranging. We first wrote about midstream M&A implications in June 2023. In an update to our first writeup, we cover macro takeaways, specifically the continued move away from MLPs towards C-Corps.

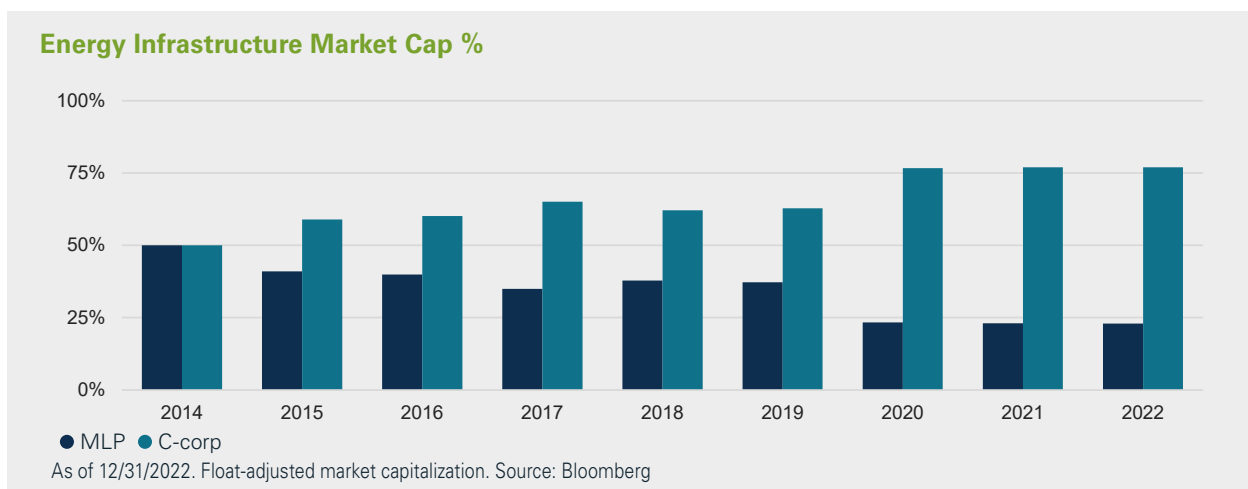
Macro Takeaways:

The MLP consolidation trend has increased in 2023, and it is now becoming increasingly difficult to achieve a diversified MLP only portfolio.

List of Closed/Pending MLP Acquisitions	Acquirer	Date of Announcement	Closing Date*
DCP Midstream	Phillips 66	Jan 2023	June 15, 2023
Magellan Midstream Partners	ONEOK	May 2023	Second half 2023
Holly Energy Partners	HF Sinclair Corp	May 2023	Second Half 2023
Green Plains Inc.	Green Plains LLC	May 2023	Second half 2023
Crestwood Equity Partners	Energy Transfer LP	August 2023	Fourth quarter 2023

*Subject to change.

The diversion of market cap between MLPs and C-Corps continues to widen through simplifications and consolidations of MLPs. The chart below shows how on a percentage basis the float-adjusted market cap between C-Corps and MLPs shifted from 50/50 in 2014 to 77/23 at the end of 2022.



At the end of 2022, Alerian MLP Infrastructure Index (AMZI) constituents, which consist of midstream MLPs, had a market cap of \$210 billion and a float adjusted market cap of only \$112 billion. The Tortoise North American Pipeline IndexSM (TNAP), which consists of MLPs and C-Corps had a market cap of \$624 billion and a float adjusted market cap of \$501 billion. The \$501 billion is almost 5x the market cap of MLPs! This ratio will only be further exacerbated by the pending MLP acquisitions.

Index	TNAPT	AMZI
Market Cap	\$624 billion	\$210 billion
Float Adjusted Market Cap	\$501 billion	\$112 billion
Constituents	48	15
Top 10 Constituents	59%	88%

In fact, should the four pending transactions close, the number of constituents in the AMZI would fall to just 11. Given the trend of MLPs being acquired over the past decade, have energy infrastructure investment products realigned their investment strategies to reflect a narrower opportunity for MLPs?

We believe a mismatch remains. Of the \$32.4 billion in structured products, just \$11.5 billion (34%) of the energy infrastructure investment product is in regulated investment company (RIC) structured funds. The remaining 66% of energy infrastructure product is in C-Corp structured funds or exchange-traded notes (ETNs) which track MLP-focused indices. Again, that is opposite of the market cap of companies in the universe! While some C-Corp funds may own non-MLP holdings, C-Corp funds are predominantly invested in the narrow subset of MLPs remaining today.

Product Structure	AUM (\$bn)	Percent %
RIC Open-End Funds	\$6,184	20%
RIC ETFs (max 25% in MLPs)	\$4,479	14%
C-Corp Open-End Funds	\$9,383	30%
C-Corp ETFs / ETNs	\$11,296	36%
Total	\$31,342	100%

As of 4/30/2023. Source: TCA, U.S. Capital

With a narrower universe comes the possibility for tax consequences, additional volatility, less liquidity and potential tracking error for C-Corp Funds.

Tax Details

For Magellan shareholders, the proposed merger is a taxable event. In slides released by the company, Magellan disclosed that 35% of shareholders have held the stock for 5 years or longer. MLP deals can involve tax consequences, specifically around recapture. MLP investments have two components that impact unitholders – first, instead of distributions being subject to tax when they are paid, the investor defers the taxes until the units are sold. Second, each year unitholders receive their share of the MLP's income or loss (which includes depreciation deductions) that gets included in the investors overall taxable income calculation. Therefore, upon sale, the government "recaptures" or "recharacterizes" capital gain to ordinary gain and the shareholder pays the previously deferred taxes. This highlights a potential risk for MLP unitholders and C-Corp investment products which invest predominantly MLPs.

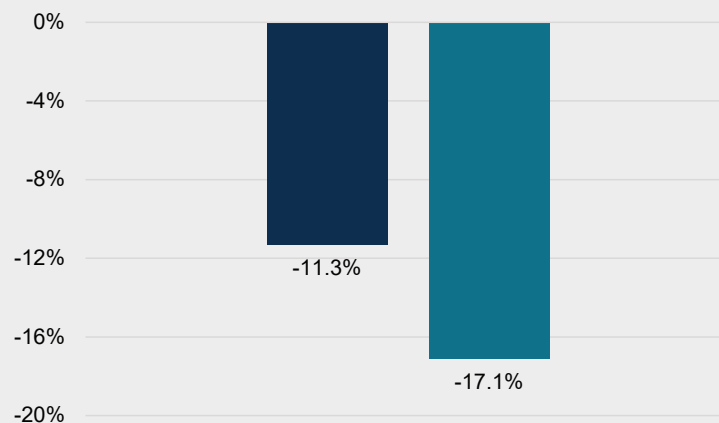
One final wrinkle is taxation at the fund level. Despite a scenario where recapture occurs, C-Corp funds are subject to tax at the fund level if there is taxable income, which includes income or loss passed-through from MLP's RIC structured funds are by definition pass-through structures, own less than 25% in MLPs, and therefore are not subject to a tax at the fund level.

Volatility

The concentration risk of an MLP only portfolio is particularly evident during down months, as shown below. The Tortoise North American Pipeline Index which represents the broad pipeline space, has 0.66 of the downside capture of the MLP only Alerian MLP Infrastructure Index.

In addition to the benefits provided by a larger and more diversified universe, midstream indices with a broader strategy have historically provided better returns, lower volatility and thus better risk-adjusted returns.

Average Monthly Performance in 10 Worst Markets



● Tortoise North American Pipeline Total Return Index ● Alerian MLP Infrastructure Total Return Index

Source: Morningstar; Date: Jan. 2000 - April 2023. The 10 worst markets were: September 2008, November 2008, June 2015, September 2015, January 2016, February 2018, February 2020, March 2020, September 2020, June 2022. The Tortoise North American Pipeline Index inception date is December 27, 1999. The Alerian MLP Infrastructure Index inception date is December 29, 1995.

Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect the deduction of any fees or expenses.

Liquidity

A quick assessment of asset class liquidity emphasizes the narrow size of MLPs within the broader midstream sector. The 2022 average daily trading \$ volume for AMZI Index constituents was \$705 million or less than 1% of the float adjust market cap. However, that liquidity is severely skewed towards the larger, more liquid MLPs. The six largest AMZI Index constituents represented \$584 million (82%) of the \$705 million in 2022 average daily trading \$ volume. As larger constituents leave, smaller MLPs may become a larger allocation in MLP focused investment products. Less liquidity can be more difficult to trade and create excess volatility for investors. With nearly \$10 billion concentrated in passively managed MLP products alone, money coming out could easily create a liquidity event.

Tracking Error & Risk-Adjusted Returns

Despite underperformance in the short term, we believe the movement away from MLPs presents investors an opportunity to align their portfolios with the broader opportunity set for the sector. In addition to the benefits provided by a larger and more diversified universe, midstream portfolios with a broader strategy historically provided better returns, lower volatility, and thus better risk-adjusted returns.

TNAPT vs. AMZIX - Performance Metrics

	TNAPT	AMZIX
Returns		
10-Year	5.9%	1.4%
5-Year	7.0%	5.8%
3-Year	22.5%	35.5%
1-Year	2.4%	23.9%
Std. Deviation		
10-Year	21.3%	30.6%
5-Year	26.3%	39.0%
3-Year	20.3%	25.3%
1-Year	18.9%	18.9%
Sharpe Ratio		
10-Year	0.33	0.18
5-Year	0.34	0.31
3-Year	1.04	1.29
1-year	0.01	1.03

As of 7/31/2023. Source: S&P Index, Bloomberg

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Disclosures

The characteristics provided for the index are illustrative of the characteristics of an asset class and are not indicative of the performance of any investment product. The historical data of the index prior to its inception date was calculated on the same basis on which the index is currently calculated. Past characteristics are no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect the deduction of any fees or expenses.

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The Alerian MLP Infrastructure Index is a composite of energy infrastructure Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMZI) and on a total-return basis (AMZIX). AMZIX Index rules are available on vettafi.com. TNAPT Index rules are available on tortoiseecofin.com.

Standard deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation. Standard deviation is calculated as the square root of variance and is used by investors as a gauge for the amount of expected volatility. Sharpe ratio measures risk-adjusted performance. It is calculated by subtracting the risk-free rate from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns. The greater a portfolio's Sharpe ratio, the better its risk-adjusted performance has been.

For additional information on TNAPT, please call 844-TR-INDEX (844-874-6339) or visit www.TortoiseEcofin.com.

For more information on AMZ or AMZI, visit www.alerian.com.

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