Tortoise QuickTake
Special Closed-End Fund Podcast

May 15, 2018

Pam Kearney: Hello, I'm Pam Kearney, Vice President of Investor and Public Relations at Tortoise, I'm joined today by Tortoise Portfolio Manager Matt Sallee and Brad Adams, CEO of the Tortoise closed-end funds for our next QuickTake special podcast. In the past few years, the MLP space has undergone significant change. Today we're going to discuss how these changes might impact our closed-end funds.

First, a quick review of our funds across the energy value chain. Beginning with upstream: Our NDP fund invests in oil and gas producers that, in our view, are located in the best locations in the best oil and gas fields within North America. The fund also utilizes a covered call strategy.

Within the midstream space, TYG, NTG and TTP focus on high quality companies with strategic assets providing visible, growing cash flows and strong balance sheets and distribution coverage.

TPZ is a downstream strategy which invests primarily in power and energy infrastructure fixed income, with the remainder in equities.

Pam Kearney: Let's kick this off with you Matt. Can you recap the structural changes taking place within the MLP sector?

Matt Sallee: As we look at the changing MLP landscape we continue to see companies simplifying their structure and eliminating incentive distribution rights or IDRs. We think this evolution is good for the sector and will result in a more sustainable MLP model as the cost of capital is lowered and corporate governance is improved.

More than half of our companies in our Tortoise MLP Index® no longer have IDRs and by the end of 2019, we expect three/fourths of the companies on a weighted basis in the index will no longer have IDRs. In fact, we expect that the 10 largest MLPs based off of today's trading sizes, will not have IDRs by the end of 2019, maybe even sooner

Pam Kearney: Okay thanks. What's the impact that tax law changes had on MLPs and C-Corporations? Which structure benefitted from the changes?

Matt Sallee: From a tax perspective both the C-Corp and the MLP structures benefitted from tax reform. C-Corps received a corporate tax rate reduction from 35% to 21%, of course. And MLP investors benefitted from a 20% deduction for qualified business income from such investments along with a reduction in the highest marginal individual tax rate by 2.6%.

Despite the negative rhetoric in the market about conversions, we think companies that are assessing their structure is healthy. To be clear, we think this is a company-specific decision and conversions may make sense for a few select MLPs but we don't foresee widespread conversion by any stretch. For some midstream companies, the C-Corp structure may be more attractive, particularly if, as part of the transaction, the company is able to avoid paying taxes for a period of time, or more recently if they were negatively impacted by the loss of the income tax allowance under cost of service contracts. That being said it's hard to argue that there isn't value to having no entity level tax rather than having a tax liability even if it is in the future. I would note though that largely we're structure agnostic, we are interested in the underlying midstream companies so it makes little difference to us whether or not the assets are held by an MLP or a C-corporation.

Pam Kearney: Okay, thanks. Brad, turning specifically to the Tortoise MLP closed-end funds, tickers TYG and NTG, how will the tax law changes impact the closed end funds?

Brad Adams: Well Pam, we think there are three changes to look at: The reduction of the U.S. corporate tax rate, the 100% annual expensing on capital investments and 30% interest expense deduction limitation. The change from a 35% corporate tax rate to 21% on Dec. 22, 2017, was a clear win for MLP funds, since they are structured as C-Corps and have a deferred tax liability. The current tax liability at that time for fiscal year ending 11/30 was calculated using a reduced blended rate and the net asset value for TYG and NTG was increased by $2.76 per share or just over 11% and $1.12 per share or roughly 6.75%, respectively.

The new legislation allows companies to expense 100% of their annual capital investments for the next five years. This could have a meaningful impact on the MLPs in which the funds invest. The tax legislation also includes an interest expense deduction limitation set at 30% of EBITDA for the first four years, but we currently expect the limitation to have little or no impact on our funds.

We'll continue to monitor and evaluate the impact of the new legislation on our funds going forward.

Pam Kearney: Thanks Brad. Matt, as MLPs restructure to C-Corps, does structure change your view on an existing investment?

No, not really. While MLPs we think will remain a principal composition of our closed-end funds, a structure change to a C-Corp would not necessarily trigger us to sell our position. To be clear, we believe MLPs are here to stay. And even though we expect more conversions, we do believe that MLPs will continue to play a critical role in the build-out of pipeline infrastructure to support the energy value chain.

There could be an impact to these funds' deferred tax liability as MLPs convert to C-Corps. That generally results in a taxable gain. Hypothetically this could be pretty meaningful if there were significant conversions, but as I said, we don't expect that to be the case. If you take some of our largest positions, for instance Magellan, Energy Transfer, Enterprise Products, Buckeye and a number of others, just using these companies as an example. These companies have stated publicly that a C-Corp structure does not makes sense for them. And specifically, they would have a pretty negative tax impact if they were to just outright convert.

Pam Kearney: Okay, thanks. Brad, as conversions from MLPs to C-Corps occur, will Tortoise continue to hold those positions in the closed-end fund portfolios? Is there a limit to the % of C-Corps that can be held in the TYG and NTG funds? And if so, what percentage would be allocated to MLPs?

Brad Adams: Alright, let me tackle that. As it relates to TYG's investment policies, under normal circumstances, we invest at least 90% of our total assets in securities of energy infrastructure companies and invest at least 70% of our total assets in equity securities of MLPs. We also may invest in equity and debt securities of energy infrastructure companies that are organized and/or taxed as corporations to the extent consistent with our investment objective.

As it relates to NTG, under normal circumstances, we invest at least 80% of our total assets in equity securities of MLPs in the energy infrastructure sector, with at least 50% of our total assets in equity securities of natural gas infrastructure MLPs. And also, we do consider investments in MLPs to include investments in affiliates of MLPs.

Our funds' Board of Directors can change these non-fundamental investment policies, however we expect to stay within the framework of these investment policies for the foreseeable future.

Pam Kearney: Great, okay thank you. A follow-up question. As MLPs restructure to C-corps, will Tortoise's closed-end funds be able to maintain current distribution levels?

Brad Adams: You know, we get asked if conversions to C-Corps means a distribution cut will take place. And the short answer is no, it really is case-specific. The most recent deal from Tallgrass does not result in a reduced distribution. We also looked at three other transactions that we anticipate. And in each case, we expect little to no impact to the LP distribution.

Broadly, transactions that are taking place from a position of strength are really handled and received much better than transactions that occurred from a position of weakness.

While we're talking distributions, I'll note that we recently declared distributions for our closed-end funds maintaining the distribution levels from Q1. These distributions are payable on May 31st.

Pam Kearney: Thank you. Very good. Matt, do you have any closing thoughts as we wrap-up?

Matt Sallee: Oh boy, here we go again. I'm going to sound like a broken record, but we do continue to have a very high conviction for MLPs and the midstream space overall. We understand that many investors like MLPs for the current income that they provide. We also recognize that the distribution cuts by several MLPs and some MLP products have diminished investor confidence in the space. At Tortoise, our focus is on sustainable income. This is where our high quality, company-focused, actively managed approach has served our closed-end fund investors well during the last few turbulent years, specifically in regards to income. We think owning quality companies with strategic assets and high quality cash flows is the key to growing income streams. For the overall sector, we think going forward, midstream investors should see sustained quarterly growth in income for first time since 2015. This growing distribution stream we think will be a big catalyst for the market, restoring investor confidence.

Pam Kearney: Thank you Matt and Brad. That concludes our discussion. We hope this has been helpful. We look forward to speaking with you again soon.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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