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Closed End Funds

Highland Income Fund: High Discount, High Yield, Questionable Corporate Governance And Lots Of Drama

Sep. 15, 2021 5:20 AM ET | **Highland Income Fund (HFRO)** | HFRO.PA, HGLB, NHF | 18 Comments | 7 Likes

Summary

- HFRO pays an 8.5% distribution yield and trades at a 22% discount to NAV.
- HFRO management is recommending a conversion from an income-based closed-end fund to a diversified holdings company.
- Phil Goldstein, Mike Taggart, Tom Herzfeld and ISS (corporate governance advisor) have all come out opposing the HFRO conversion plan.
- HFRO and sister fund NHF have a long running lawsuit with

Credit Suisse originally filed in 2013. The two funds were awarded $121 million before litigation expenses, but Credit Suisse has appealed the case.

- HFRO has offered several shareholder-friendly "inducements", but these will only occur if shareholders vote to approve the HFRO conversion plan.
- This idea was discussed in more depth with members of my private investing community, Yield Hunting: Alt Inc Opps. Learn More »

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HIGHLAND CAPITAL
MANAGEMENT

(Data below is sourced from the Highland Income Fund website unless otherwise stated.)

Fund History

Highland Income Fund (NYSE:HFRO) is an eclectic closed end fund that invests in a diverse set of asset classes: real estate, timber, CLOs, fixed and floating rate loans and public and private equity.

The fund is quite controversial. It was originally an open-end mutual fund (HFROX) that invested in floating rate loans. In 2017, when it appeared that the fund could win a large award from the Credit Suisse (NYSE:CS) lawsuit, the fund started to attract a lot of inflows and management asked shareholders to convert the open-end mutual fund into a closed-end fund.

The management claimed they would be protecting the potential lawsuit proceeds for the original fund investors by converting to the closed-end fund format. But unfortunately, the fund now trades at a sizable discount, and the lawsuit proceeds have still not been awarded. Credit Suisse appealed the case, and it is now being reviewed by the Dallas Court of Appeals.

The end result is that shareholders were hurt by the discount, but management benefited by capturing additional assets under management by converting to the closed-end fund format.

The fund later changed its objectives and now owns a more eclectic set of assets, not just floating rate loans.

Investment Approach

- The primary objective is to provide a high level of current income, consistent with preservation of capital.

- Uses effective leverage of about 30%, but that may increase if the fund converts to a holding company structure.

- Invests at least 25% in assets directly or indirectly secured by real estate.

- Focuses on floating rate securities, real estate securities, secured and unsecured fixed-rate loans and corporate bonds, mezzanine securities, structured products, convertible and preferred securities and equities (public and private)

Corporate Governance Has Been Highly Questionable

1) The fund management runs three closed-end funds that all trade at sizable discounts to NAV - HFRO, HGLB and NHF.

2) Highland Global Allocation Fund (HGLB) is another fund run by Highland. In 2018, the fund managers offered a 3% "consent" fee as an inducement to get shareholders to vote for the conversion from an open-end fund to a closed-end fund. They are similarly offering conditional benefits to get the HFRO shareholders to approve the conversion to a holding company.

3) James Dondero is the leader of Highland Capital Management . In addition to his duties at the firm, he is involved in several legal matters too lengthy to discuss here. One is his divorce battle with Becky Dondero. Another legal battle has been with Patrick Dougherty, who was once a senior partner at Highland Capital. This article from the Institutional Investor describes several lawsuits in more detail:

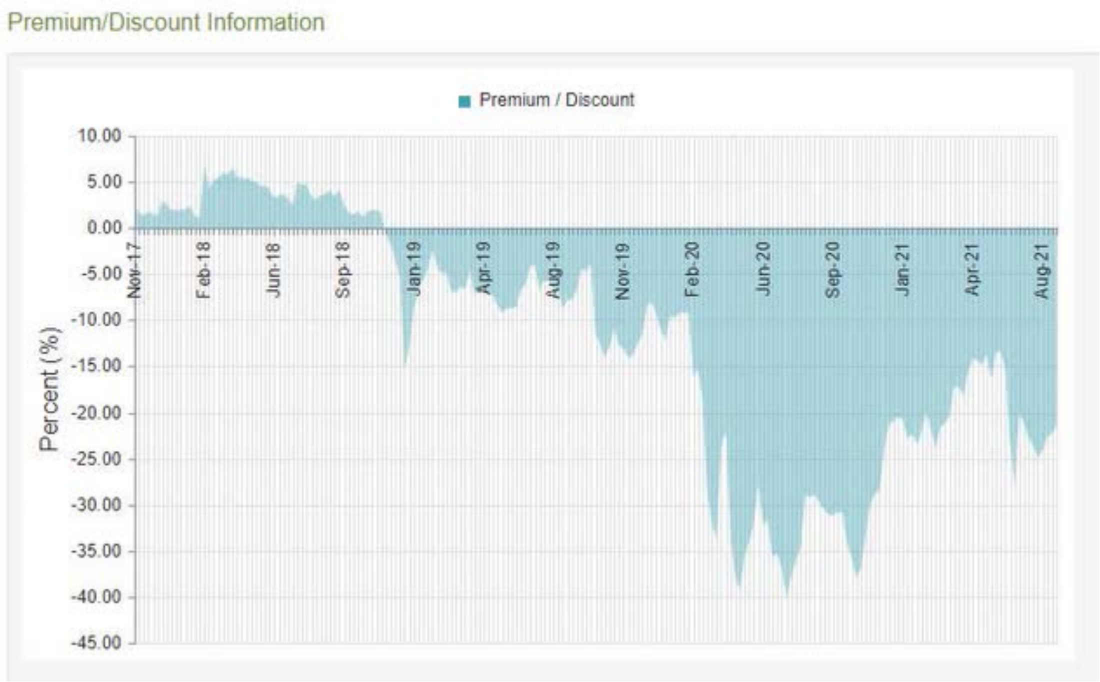
Nothing Can Stop This Hedge Fund Soap Opera.

4) Phil Goldstein discussed the recent Chapter 11 bankruptcy of Highland Capital Management in a letter to HFRO shareholders:

- *Mr. Dondero, the proposed President and CEO of HFRO post-*

conversion, has a long history of contentious litigation. On October 16, 2019, Highland Capital Management, L.P. ("HCMLP"), an investment advisor controlled by Mr. Dondero, filed for Chapter 11 bankruptcy protection. The judge in that case ordered him to stay away from HCMLP's business during the bankruptcy. On June 7, 2021, the judge found Mr. Dondero in contempt for knowingly violating that court order. The judge also found that he improperly disposed of a company-issued cell phone that may have contained evidence. And just a few days ago, the judge again found Mr. Dondero in contempt of court, this time for violating an order barring him from suing HCLMP's replacement CEO without the court's permission.

Historical Premium/Discount for HFRO



Source: CEFConnect

This was the asset allocation breakdown as of June 30, 2021:

Portfolio Allocation Breakdown

Equity	8.6%
Real Estate	36.1%
CLOs	18.1%
Timber	23.7%
Loans	11.2%
Other	2.3%

Source: HFRO Fund Fact Sheet Q2 2021

Portfolio- Top 10 Holdings (as of June 30, 2021)

TOP 10 EXPOSURES[2*]

Investment	Equity	Debt	Preferred	Total
Creek Pine Holdings, LLC	23.7%	-	-	23.7%
SAFStor[3]	11.2%	-	-	11.2%
NexPoint Real Estate Finance[4]	8.2%	-	-	8.2%
Metro Goldwyn Mayer, Inc.	6.2%	-	-	6.2%
EDS Legacy Partners	0.2%	-	4.5%	4.7%
IQHQ	3.6%	-	-	3.6%
CCS Medical	0.1%	2.8%	-	2.9%
Grayson CLO	2.7%	-	-	2.7%
NEXLS LLC	2.1%	-	-	2.1%
SFR WLIF III, LC[3]	2.1%	-	-	2.1%

*As of 6/30 the Fund had a short exposure of -18.55% and -3.37% in the S&P 500 E-mini and E-mini Russell 2000, respectively.

Portfolio Review - Recent Developments

1) Creek Pine Holdings, LLC: A 23.7% holding. The fund initially purchased Creek Pine Holdings participating preferred back in 2018 as part of a joint venture with a group of institutional investors led by CatchMark Timber Trust. The group owns 1.1 million acres of prime East Texas timberlands.

At the end of July, CatchMark announced a definitive agreement to sell 301,000 acres of timberlands (about 27%) for approximately $498 million in cash, or approximately $1,656 per acre. The property was purchased for $1,264 per acre. The proceeds of the sale will be used to reduce leverage and pay down a portion of the preferred partnership interests in the joint venture.

2) Metro Goldwyn Mayer, Inc. "MGM": A 6.2% holding. MGM shares trade on the LoanX, which is a global electronic trading platform for syndicated loans that was acquired by IHS Markit. Amazon recently announced plans to acquire MGM for $8.45 Billion which caused a nice boost in the NAV.

3) CLO Equity: The Highland Income Fund holds various CLO equity positions in its portfolio. There was a recent monetization event in underlying securities of certain CLO equity holdings that contributed to performance. This resulted in a NAV increase of approximately $23.9 million, which was reflected on August 19, 2021.

Fund Performance

The NAV performance of HFRO has been reasonable when compared to its bank loan fund peers. But its market performance has lagged considerably largely because of the widening of its discount. More recently, the fund has changed its asset mix to include real estate, CLOs and timber investments, so Morningstar will likely change its benchmark category soon.

Here is the year-by-year total return performance record since 2018 when the fund converted to closed-end fund format:

	HFRO NAV Performance	HFRO Market Performance	Bank Loan NAV Performance	Rank in Category (NAV)
2018	+1.53%	-12.15%	- 0.47%	7
2019	+1.48%	+4.20%	+8.82%	94
2020	+4.36%	-8.38%	- 1.26%	1
YTD	+9.33%	+13.08%	+9.38%	23

Three Year Annualized Fund Performance

HFRO Price	-3.78%
HFRO NAV	+4.11%
Bank Loan NAV	+4.49%

"Inducements" Being Offered to Shareholders

To Vote Yes on the Conversion to a Holding Company?

1) Proposed Tender Offer up to $50 million at 95% of NAV.

This is roughly a 5% tender that would be accretive to NAV, even for shareholders that do not tender. Of course, those that do tender can capture most of the discount on at least a small portion of their holdings. Keep in mind that this tender offer is contingent upon the Fund obtaining shareholder approval of the business proposals.

2) Fund Monthly Buyback Program

Each month, HFRO will buy back shares if the following conditions are met:

- If more than 250,000 shares trade below $12.00 on any trading day of the month, HFRO will repurchase $5 million of its shares through the last trading day of the month. This is called the "Initial Buyback Trigger".

- If more than 250,000 shares trade below $11.00 on any trading day of the month, HFRO will repurchase $10 million of its shares through the last trading day of the month. This is called the "Initial Buyback Trigger". This is called the "Secondary Buyback Trigger".

HFRO is currently trading at $10.90 which is only slightly below the $11.00 level for the secondary buyback trigger. The buyback program is only effective from the date of shareholder approval through Jan. 31, 2022.

3) Management Share Purchases

Management will buy between $10 million and $20 million of HFRO common shares after shareholder approval of the conversion.

4) Plan to Maintain Dividend

Management intends to maintain the HFRO dividend through Jan. 31, 2022.

5) Management Fee Expense Cap

Management has agreed to a total expense cap of 1.15% of total assets during the first year of operations of the holding company, if the conversion proposal passes.

Alpha is Generated by High Discount + High Distributions

HFRO has an interesting portfolio, but the main reasons to invest in HFRO now are the potential to capture "alpha" from the high discount and the possibility of future shareholder activism.

The distribution rate of 8.48% along with the 22% discount allows investors to capture some alpha by recovering a portion of the discount whenever a distribution is paid out.

When you recover NAV from a fund selling at a 22% discount, the percentage return is 1.00/ 0.78 or about 28.2%. So the alpha generated by the 8.48% distribution is computed as:

(0.0848)*(0.282)=0.0239 or about 2.4% a year.

Note that this is more than the 1.83% baseline expense ratio, so you are effectively getting the fund managed for free.

Institutions hold about 35% of the shares.

Here are some activist investors (or institutional investors that would likely support them) that own shares in HFRO:

Activist #shares

Thomas J. Herzfeld 2,502,355

Matisse Capital 1,377,000

Penserra Capital Management 1,666,592

Advisor Group Holdings 632,312

Philip Goldstein 100,000

There are currently about 6,000 active investors who subscribe to various Seeking Alpha Marketplace offerings related to income investing and closed-end funds. Many of these investors who own HFRO will likely vote with the activist investors and vote against the HFRO proposal.

What is the latest update on the Credit Suisse lawsuit?

On June 28, 2021, a judgment of $121 million was awarded against Credit Suisse to Claymore Holdings LLC. This is an entity formed to pursue the collective claims on behalf of HFRO and NexPoint Strategic Opportunities Fund (NHF).

On July 23, 2021, Credit Suisse filed a notice of appeal of the judgment. The matter will now be reviewed by the Dallas Court of Appeals, which previously ruled unanimously in favor of Claymore during the last round of appeals.

The total aggregate award stood at $121 million on June 28 and consists of damages and prejudgment interest. The award will continue to accrue interest until the appeals process is exhausted. Any final judgment amount would be reduced by attorney fees and other litigation-related expenses. This will most likely be around 30% of the total.

The net proceeds would then be allocated to the Funds based on respective damages (approximately 82% to HFRO and 18% to NHF). Since all recoveries remain contingent, no award amount has yet been recorded in the Fund's NAV.

Will Shareholders Vote in Favor of the HFRO Conversion?

Because of the strong opposition to the conversion plan, I believe HFRO is having a hard time getting enough shareholder support to approve the plan. On August 20, 2021, they apparently did not have enough votes, and they decided to adjourn the Special Meeting of Shareholders until September 24, 2021.

One important point is that two separate votes are needed to approve the Business Change Proposal. One vote includes all shareholders together (equity plus preferred). But they also need a majority of just the preferred shareholders. This is the relevant section in the proxy statement:

Business Change Proposal. Under the 1940 Act, changing the Company's business from an investment company to a diversified holding company and changing the Company's fundamental investment restrictions requires the affirmative vote of the lesser of (A) 67% of our outstanding voting securities present at the Special Meeting, if the holders of more than 50% of our outstanding voting securities are present in person or represented by proxy, or (B) more than 50% of our outstanding voting securities. For purposes of the foregoing, holders of the common shares and holders of the preferred shares will vote together as a single class.

In addition, the Business Change proposal requires the affirmative vote of the lesser of (A) 67% of our outstanding preferred shares present at the Special Meeting, if the holders of more than 50% of our outstanding preferred shares are present in person or represented by proxy, or (B) more than 50% of our outstanding preferred shares. For purposes of the foregoing, holders of the preferred shares will vote separately as a class.

The conditional tender offers and share buybacks do nothing to help the preferred shareholders. HFRO preferred shareholders have considerable downside if the plan is approved. They could easily see the credit rating downgraded from investment grade to junk status.

I have a friend who holds a fairly large position in the HFRO preferred who has voted "abstain" on the HFRO conversion plan. The abstention makes it harder for management to obtain a majority of the vote. The proxy solicitor firm has already called him several times trying (unsuccessfully) to get him to change his vote.

How Should I Vote?

I have voted against the HFRO conversion plan. I might have reconsidered if management had offered a 15% tender offer, but 5% was just not enough of an incentive to move the needle for me.

Here are some summary statistics on HFRO:

- Total Assets: $1,433 Million
- Total Common assets: $993 Million
- Annual Distribution (Market) Rate= 8.60%
- Last Regular Quarterly Distribution= $0.077 (Annual= $0.924)
- Fund Baseline Expense ratio: 1.83%
- Discount to NAV= -22.77%
- Portfolio Turnover rate: 122%
- Effective Leverage: 31%
- Average 3 Month Daily Volume (shares)= 462,976 (Source: Yahoo Finance)
- Average Dollar Volume = $5,000,000

HFRO is a fairly liquid stock and usually trades with a bid-asked spread of about three cents. There is often limited size available on both the bid and asked, so some care must be taken when trading HFRO. If you use a market order, you will usually get some price improvement and receive a price somewhere between the bid and the asked price.

I believe that HFRO is a decent purchase now for opportunistic investors when the discount to NAV is 20% or higher. HFRO can be a good holding for a shorter-term swing trader (hoping for the discount to narrow).

A lot will depend on whether or not the conversion proposal is approved.

If the conversion plan is approved, many income-oriented investors will almost certainly look to sell the fund before February of next year. But opportunistic investors who focus on total return might look to purchase shares of the fund at that point if the discount widens out a lot.

If the conversion plan is not approved, I would expect there will be some narrowing of the discount. If HFRO management loses the vote decisively, the Board may even decide to offer shareholders a tender offer or share buybacks in order to keep activist investors from making a run at the fund.

Before closing this article, I would like to quote an excerpt from "The Intelligent Investor" by Benjamin Graham that was published over seventy years ago. Graham comments on the large discounts on closed-end funds at that time. It is amazing how little has changed since then!

Excerpt from "The Intelligent Investor" by Benjamin Graham 1949

> The price discount on the shares of these companies may be viewed as an expensive monument erected to the inertia and stupidity of shareholders. It has cost the owners of these businesses countless millions of dollars, yet it has been totally unnecessary. It could have been terminated at any time by the mere passing of a resolution at a stockholders meeting. Yet the matter never seems even to have been brought up for discussion.
>
> We have here a clear-cut illustration of management's domination of stockholder thinking. The resolution to abolish the discount would merely instruct the management to repurchase shares when tendered or available at a price equal to their net asset value- in other words, to place the closed-end company on an open-end basis. If such a resolution were presented by a management it would be passed with enthusiasm. But managements are opposed to such a policy, because it would mean using up part of the corporation's resources, contracting its size, and impairing their own position.
>
> Since managements do not recommend any such action, the stockholders do not vote it or even discuss it. It never occurs to the owners of these funds that an open-end, no discount arrangement might be good for them, even though the management did not like it. In fact, the very idea of taking any independent action in their own interest is so alien to stockholders' thinking that if someone proposed such a resolution it would no doubt be voted down automatically at the request of management."

Marketplace Service For Those Hunting For Yield

George Spritzer's top investment ideas are being featured on Alpha Gen Capital's "Yield Hunting" marketplace service.

This service is dedicated to yield/income investors who wish to avoid market froth. We encourage investors to benefit from yield opportunities within closed-end funds, business development companies, and other niche areas. For safe and reliable income streams, check out Yield Hunting.

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Safe 8+% Income Stream using CEFs, ETFs, Munis, Preferreds, and REITs.

Disclosure: I/we have a beneficial long position in the shares of HFRO either through stock ownership, options, or other derivatives. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.