NHF – Force Feeding its Shareholders

Recently, the NexPoint Credit Strategies Fund (NHF), a closed-end mutual fund managed by NexPoint Advisors, an affiliate of Highland Capital Management, announced a rights-offering that would enable shareholders to purchase more shares at a discount to NAV. Rights-offerings are a common way for closed-end funds to issue more shares thereby increasing assets under management. Hence, they are clearly a benefit to the management company, and in cases where the funds are trading at a premium to their NAV, they may be a welcome benefit to shareholders. But, when shares are trading consistently below NAV, the benefits to shareholders are questionable, and there are clear drawbacks.

It is important to note that we admire the talents of lead portfolio manager James Dondero and the team at NexPoint Advisors. That is why we have our clients' assets invested in NHF and our own assets along with them.

When a closed-end fund trades at a premium to NAV, it is evidence that demand for shares exceeds supply at a price equal to NAV. Shares trading at a discount to NAV implies the reverse. The April 19th press release that announced the rights offering also noted that the Fund would be extending its share repurchase program. A share repurchase program is the logical, shareholder friendly, method of managing the discount in that it reduces the supply of shares outstanding and creates value for current shareholders by purchasing shares below NAV (reverse dilution). The drawback is to the Fund's advisor which sees its AUM reduced. In this case, even though the share repurchase program has been available for some time, no shares have been repurchased.

When the rights-offering was announced, on April 19th, the Fund was trading at a discount of 9.5%. Specifically, the rights will enable shareholders to purchase one additional share of NHF for every three held as of record date May 5, 2017 at the lesser of 95% of the NAV at the expiration (May 24, 2017) or 95% of the average closing price for the last five days up to expiration. Since the Fund has never traded at a premium, it is likely that the new issuance will be at a price less than NAV. Hence, any shareholders who do not subscribe to the rights-offering will be diluted. If, for example, the rights were to be executed on the April 19th announcement day when shares had closed at an average of 9.2% discount to NAV, shares would be issued at a 14.2% discount so that all current outstanding shares would be diluted by 4.7% (14.2% ÷ 3). In addition, there are administrative costs of the rights-offering which will be borne by the Fund (shareholders). NexPoint estimates that the expenses will be $400,000 which equates to about 10 basis points (0.10%). Shareholders who fully exercise their rights and purchase more shares will not be diluted because the benefit they receive by purchasing new shares below NAV will equal the dilution of their current shares. Shareholders that sign up to oversubscribe will benefit from others' dilution. That is a potential free bonus. Oversubscription rights will be distributed to over-subscribers pro-rata to their holdings at the record date. So, it is not surprising to see that the fund's price/NAV discount contracted by a few percentage points since the announcement, as investors and traders add to holdings to potentially earn more bonus. It was also not surprising to see the price drop back down immediately after the ex-date because any shares purchased after the record-date but before the expiration date will very likely be diluted.

According to the prospectus, "The Board of Trustees of the Trust, after considering a number of factors, including potential benefits and costs of the rights-offering and based on the recommendation of NexPoint Advisors, L.P., the Trust's investment advisor, has determined that the rights-offering would be in the best interest of the Trust and its existing shareholders." According to NexPoint Advisors[1], the "potential benefits" of the rights-offering are "potential reduction in expenses. . .[and] potential for better liquidity," the idea that a larger fund is more efficient so the expense ratio may drop and more liquid because of its bigger base. The slight reduction in expense ratio will likely take a few years to make up for the 10 basis point expense of running the rights-offering and pales in comparison to the dilution for non-subscribers. In addition, the bigger is better idea calls into question the benefits of the 2015 spin-out of NXRT, a REIT that NexPoint had built within the portfolio over the previous several years. Management claims that the spin-off created significant value for shareholders. We believe that management created the value by making the very profitable investments that went into NXRT, but it is unclear whether there was any shareholder benefit to have spun it out. What is clear is that NHF became significantly smaller and lost some of its yield.

The strategic uses of the additional $120 million to be raised in the offering will be "opportunistic investments identified by Jim Dondero and the NHF team," including and investment in "Jernigan Capital or other similar deals." Given his track record there is reason to believe that Dondero will make good investments, but these could also be funded by selling other portfolio holdings, a basic portfolio management activity.

According to NexPoint Advisors, another potential strategic use of the additional funds is a "potential spin-off of a REIT sub." Indeed, as soon as NXRT was spun out in 2015, the portfolio managers began purchasing additional real estate positions which, for good business reasons were rolled up into REIT structures within the portfolio. These REITs could be spun-out like NXRT, which, by the way, would negate the bigger-is-better thesis of the rights-offering.

What is happening here is that Highland Capital has found an elegant way of creating and selling new securities with minimal risk and costs to themselves. The shares are force-fed to current shareholders of NHF who also bear the cost of underwriting.

From a shareholder's portfolio management point of view, the rights-offering creates issues. Our client portfolios currently have exactly as much NHF as they need. If we wanted more we would simply add to it. The Fund is selling at a discount to NAV and offers a very attractive yield. To protect from dilution, however, we must subscribe to the rights or liquidate completely. Both have tax considerations and costs. To subscribe to the rights-offering we need to sell other investments or sell shares of NHF. The game theory surrounding various parties' subscription, oversubscription and the pricing around the record date along with the price and market risk during the weeks between record and execution increases the price volatility and forces short-horizon decisions. These drawbacks may not be obvious or easily quantified at the Trust level, but they are real and they exist for all shareholders. It has come to our attention that some brokerages are charging a fee to small accounts for subscribing to the rights which makes it uneconomic for those shareholders to subscribe.

Who benefits? It is clear that NexPoint Capital benefits from raising AUM by about $120 million with little cost. Over-subscribers may benefit from others' dilution but with some market risk. That's about it. All other shareholders are at best unaffected, but more likely forced into some unexpected trades with tax consequences or, at worst, diluted. The ship has already sailed on this rights-offering, but we hope that next time, the independent Trustees will evaluate all the

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[1] All of the following quotes are from a written presentation that NexPoint provided to financial advisors to explain the offering. These ideas are restated more formally within the offering prospectus.

ramifications, not just the obvious ones before approving an action like this. Shareholders and Trustees of closed-end funds should always be skeptical of a rights-offering when shares are selling at a consistent, significant discount to NAV.

We have always considered NHF to be a hedge fund in a mutual fund box and we believe the closed-end fund structure offers many advantages and a few disadvantages. For any hedge fund investment, we need to consider the value a manager can add along with the costs, risks and drawbacks that often exist from a structure designed in favor of the manager. We take some comfort in the fact that Jim Dondero has a large personal investment in the Fund, but that does not eliminate conflicts of interest. We, along with our clients, are still shareholders and will subscribe to the rights-offering but are fully aware and not pleased that we are being used and force-fed new capital in this fund.

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