Part 2: A Tale of Two Cities is Coming to the MLP Space . . .

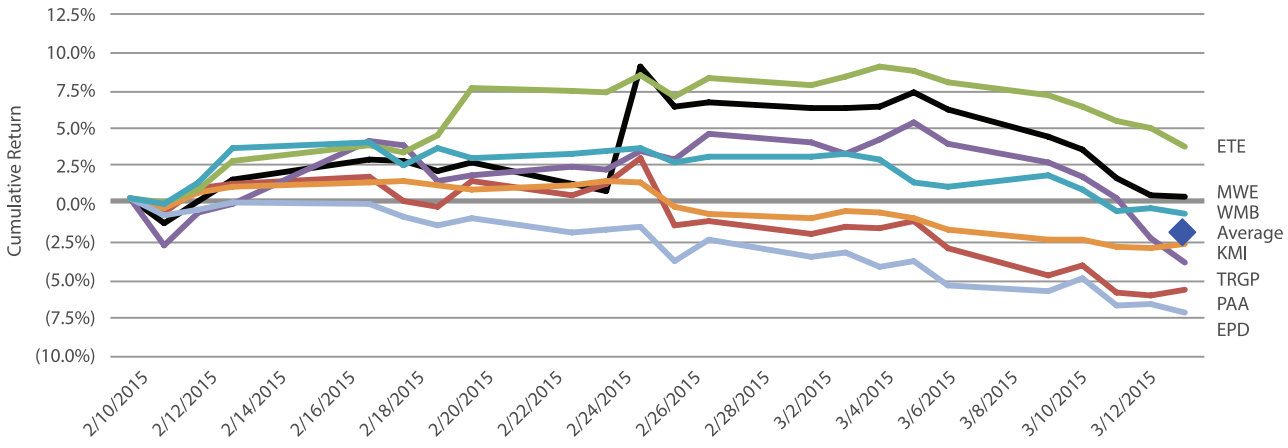
March 2015
James Dondero, President & Co-Founder, Highland Capital Management

The yield differentials between high quality midstream MLPs and high quality REITs are the widest in two years, and we believe that current midstream MLP distributions are sustainable even if crude and natural gas prices fall to draconian levels of $30/bbl and $2/mcf and persist there for 3 years. On average, an over 30% gain can be achieved if MLP yields converge to historical spread levels.

Despite little change in crude and natural gas prices since our initial report at the beginning of February, investor interest in the MLP space as an alternative source of yield has increased. However, **we believe this story is just beginning.** There are several companies that we continue to like for the reasons mentioned previously, and the graph below highlights the performance of our favorites since our report was released on 2/10/15 [see Figure 1 below].

We believe these companies still have the potential to experience substantial price appreciation as the yield convergence theme plays out. Kinder Morgan (KMI) and Enterprise Products Partners (EPD) are two of the largest and most diversified companies in the space, and Plains All American Pipeline (PAA) is one of the largest crude midstream-focused providers in North America. Given their large, established asset footprints and relative yield spreads, we believe that all three are particularly compelling at current price levels. In addition, Energy Transfer Equity (ETE), MarkWest Energy Partners (MWE), Targa Resources (TRGP), and Williams Companies (WMB) all recently provided good earnings reports and/or affirmed guidance in February, quelling investor concerns about the commodity price backdrop.

Figure 1: Total Returns Since 2/10/15

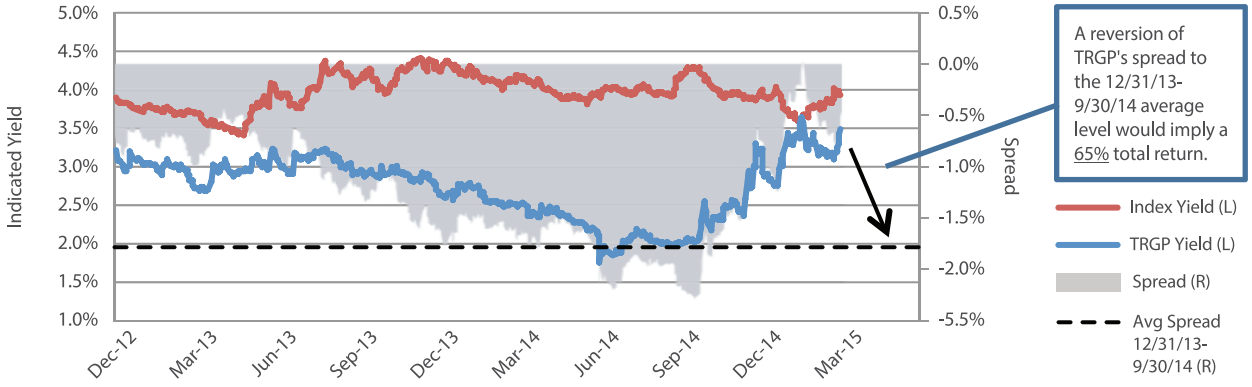


Source: Bloomberg 2/10/15-3/13/15

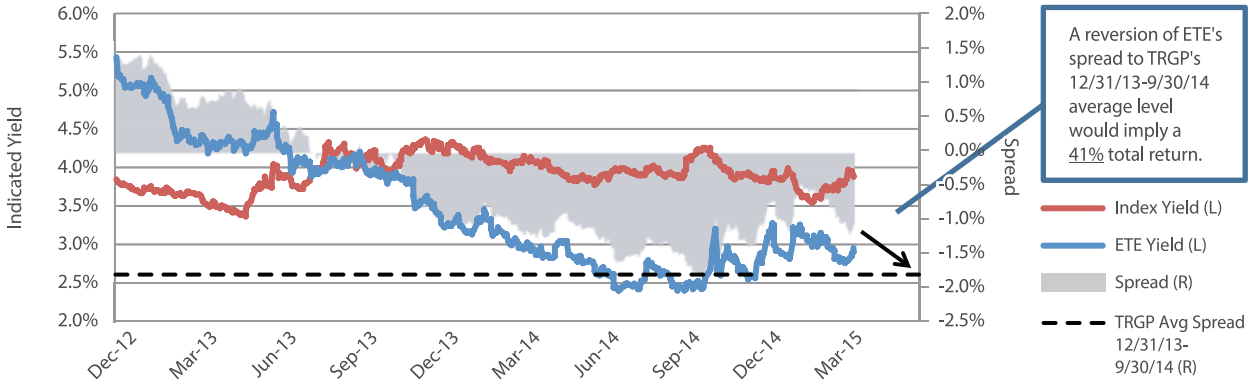
The return potentials are illustrated in the following graphs, where the current yield spreads of the individual names are compared against their historical average (each versus the high quality REIT index described in our prior report).[1] The graphs reflect potential return from spread compression only; company-specific growth or other idiosyncratic factors could provide additional upside.

Figure 2

REIT Index vs TRGP



REIT Index vs ETE



REIT Index vs WMB

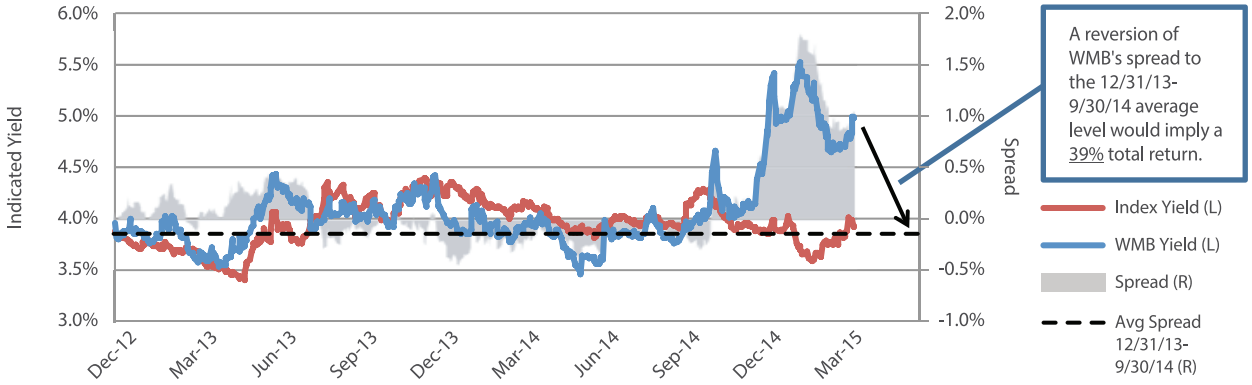
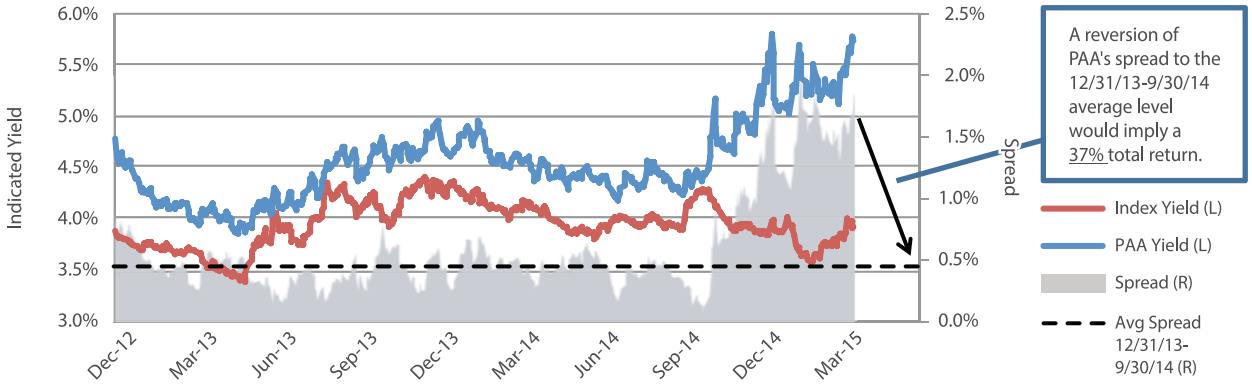
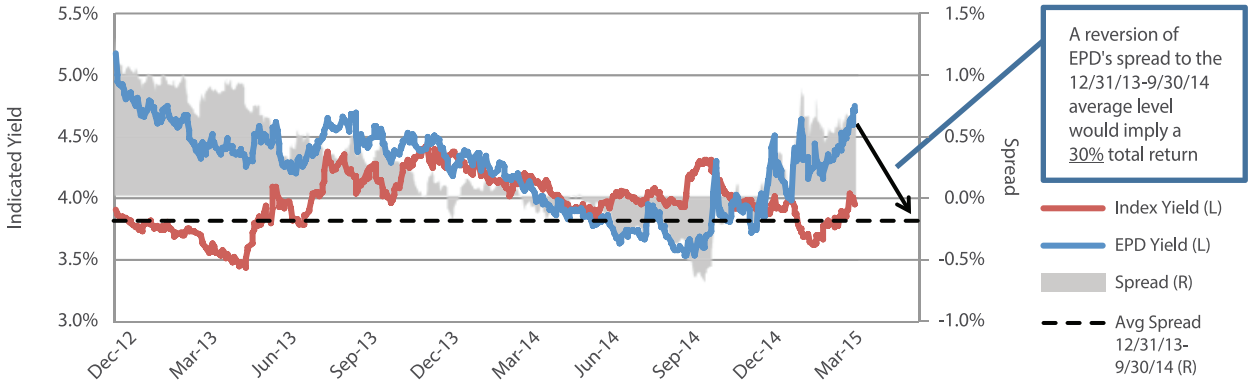


Figure 2 (Continued)

REIT Index vs PAA



REIT Index vs EPD



REIT Index vs MWE

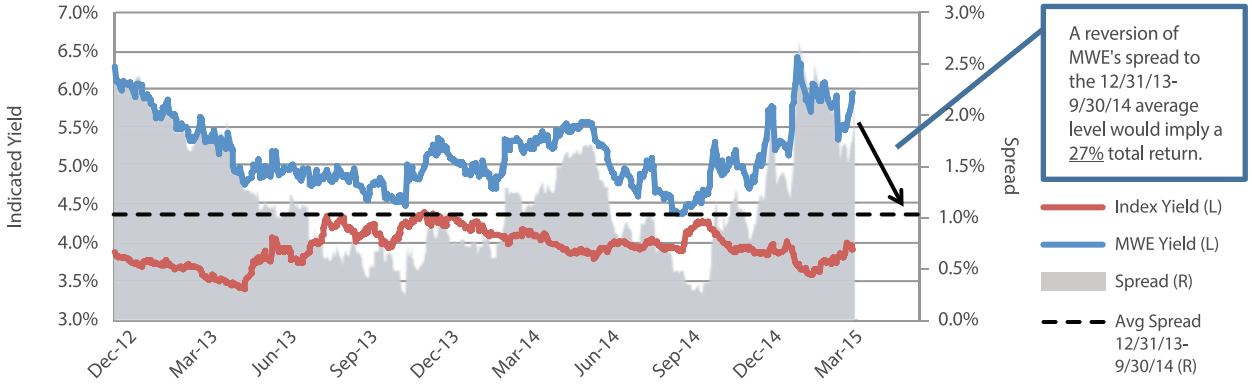


Figure 2 (Continued)

REIT Index vs KMI

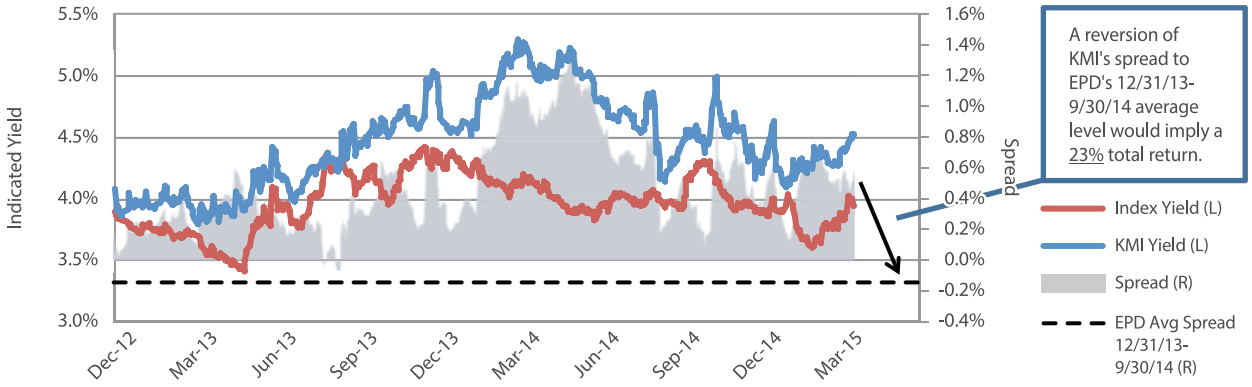


Figure 3

12 Month Return Potential	
TRGP	65%
ETE[1]	41%
WMB	39%
PAA	37%
EPD	30%
MWE	27%
KMI[2]	23%

Notes: (1) Given ETE's strong growth potential, its return is based on a compression to the spread of a fellow GP, TRGP; (2) Given KMI's recent corporate transformation, its return is based on a compression to the spread of EPD, a similar company in terms of size and diversification

Investor concern regarding the MLP space centers on the impact of commodity prices on distribution coverage and growth. The majority of midstream MLP earnings are driven by fixed-fee type revenue arrangements, and there is only modest commodity price exposure (arising from natural gas liquid (NGL) processing contracts, basin price differentials, etc.) which varies by company. However, for the purpose of this comparison, it is important to note that REITs are exposed to risks related to re-leasing, capital underinvestment, and geographic / asset concentration, to name a few.

The seven companies previously mentioned all have fixed-fee contracts covering at least 75% of their earnings, and they expect to be capable of covering their distribution at current commodity price levels [see Figure 4 below]. Although WMB falls slightly short of full coverage for 2015, we believe any shortfall will be relatively small and the company will sustain the current distribution given projects expected to come online shortly.

Figure 4

	% Fee-Based	Coverage Ratios at Current Strip Pricing		
		2015E	2016E	2017E
TRGP	75% - 80%	1.24x	1.50x	1.71x
ETE	85%	1.15x	1.50x	2.19x
WMB	80% - 85%	0.97x	1.15x	1.31x
PAA	75% - 80%	1.11x	1.21x	1.26x
EPD	85%	1.30x	1.38x	1.49x
MWE	90%	1.05x	1.23x	1.31x
KMI	85%	1.28x	1.34x	1.42x

Note: Values are based on company disclosures and HCM estimates as of 3/13/15

Energy bears would argue that crude and natural gas prices have more downside, which may persist longer than expected. While we do not ascribe to this latter view, we agree that it represents the largest risk to the asset class. In order to handicap this risk, we recalculated company models with draconian price assumptions (flat $30 per barrel crude and $2 per mcf natural gas), and the results are rather interesting. Only two companies, PAA and WMB, fall below 1x coverage, and the adjusted return potential for both is still significant at 29% and 23%, respectively [see Figure 5 below].

We believe that all of these companies represent compelling opportunities from the perspective of potential yield compression, leverage to any improvement in crude prices, project-based growth, and industry consolidation. **In this environment, it is easy for investors to shun anything energy-related given the uncertainty surrounding the direction of commodity prices. However, if one takes the time to more closely examine midstream MLPs, we believe that you will discover an asset class that has the potential to withstand the current commodity price storm and should provide an attractive total return with a compelling current yield.**

Figure 5

	12 Month Return Potential	Coverage Ratios at $30 Crude / $2 Natural Gas[1]		
		2015E	2016E	2017E
TRGP	65%	1.17x	1.13x	1.30x
ETE	41%	1.12x	1.42x	2.10x
WMB[2]	23%	0.88x	0.95x	1.09x
PAA[2]	29%	0.94x	1.00x	1.03x
EPD	30%	1.21x	1.23x	1.27x
MWE	27%	1.00x	1.18x	1.26x
KMI	23%	1.15x	1.21x	1.28x

Note: (1) Values are based on data from Bloomberg and HCM estimates as of 3/13/15; (2) The returns for PAA and WMB are based on the distribution being reduced to achieve 1.0x coverage in 2015

Highland Capital Management Fund Advisors, L.P.

Shareholder Services:
info@highlandfunds.com
(877) 665-1287

For more market insights and commentary from James Dondero please follow our online resources:

Twitter @JamesDondero: https://twitter.com/JamesDondero

Market Commentary: http://highlandfunds.com/james-dondero-market-commentary/

Yahoo! Finance Contributor: http://jamesdondero.tumblr.com/

[1] Source: Bloomberg, 12/31/12-3/13/15; REIT Index is comprised of an equal weighted index of the following indices: (1) FTSE NAREIT Industrial/Office Property Sector Index, (2) FTSE NAREIT Retail Property Sector Index, (3) FTSE NAREIT Residential Property Sector Index, (4) FTSE NAREIT Diversified Property Sector Index, (5) FTSE NAREIT Health Care Property Sector Index

[2] Includes Highland Capital Management Fund Advisors, L.P. and its affiliated advisers

HIGHLAND CAPITAL
MANAGEMENT

300 Crescent Court
Suite 700
Dallas, TX 75201
Phone: 972-628-4100
Fax: 972-628-4147

DALLAS NEW YORK SINGAPORE SEOUL SÃO PAULO