Highland Income Fund (NYSE:HFRO)

2021
YEAR IN REVIEW

INTRODUCTION

The following provides an update for shareholders of the Highland Income Fund (NSYE:HFRO) ("HFRO" or the "Fund") covering the Fund's 2021 year in review. The outlook and commentary included herein captures the perspectives of the Fund's portfolio managers as well as other members of the team working across the integrated investment platform to support HFRO's investment and portfolio management activities (together "we").

In this update we reflect on key events and developments related to the Fund and its portfolio over the past year—from major deals announced throughout the year involving some of HFRO's top holdings, to the conversion proposal that was made to shareholders in Q2 and the communications and activities surrounding it.

As we begin 2022, we are contemplating the many scenarios we may encounter in the months ahead and ensuring the Fund is aptly prepared to handle them. We expect to see the uncertainty and unpredictability of the market, economy, and geopolitical environment continue, and therefore consider resiliency to be an important investment feature (and one that is already well represented across the portfolio).

In our view, the most compelling opportunities are in areas that either call for a more active approach to investment management or require specialized expertise to unlock value. In many cases, these investments not only have strong growth potential but can also weather periods of market volatility, as they tend to be less driven by market forces. We continue to focus on these opportunities, as they provide a compelling way to prepare for the various scenarios in 2022.

In the meantime, we thank you for your investment in the Fund. We appreciate your continued support and look forward to the year ahead.

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HIGHLAND INCOME FUND (HFRO) YEAR IN REVIEW

Disclosures

This document contains forward-looking statements. These statements reflect the current views of management with respect to future events and financial performance. Forward-looking statements can be identified by words such as "anticipate", "expect", "could," "may", "potential", "will", "ability," "targets," "believe," "likely," "assumes," "ensuring," "available," "optionality," "viability," "maintain," "consistent," "pace," "should," "emerging," "driving," "looking to," and similar statements of a future or forward-looking nature. Forward-looking statements address matters that involve risks and uncertainties. Past performance does not guarantee future results. Performance during time periods shown is limited and may not reflect the performance in difference economic and market cycles. There can be no assurance that similar performance will be experienced.

Additional risks and disclosures can be found on pages 24-26.

2021 FUND REVIEW

CONVERSION PROPOSAL

Proposal Background

On June 14, 2021, Highland Capital Management Fund Advisors, L.P. (the "Adviser") announced the filing of a preliminary proxy statement with the Securities and Exchange Commission (the "SEC") for a special meeting of shareholders ("Special Meeting") in connection with its proposal to convert the Fund from a registered investment company to a diversified holding company (the "Holding Company").

The following provides a review of the conversion proposal process and the plan for the Fund going forward, following the decision to withdraw the proposal. The proposed conversion was meant to offer a potential solution to bring HFRO's share price in line with the net asset value ("NAV") and to position the Fund to capture long-term growth opportunities. Those remain key objectives, which we will continue to pursue in the coming year through various means available within the existing structure.

Intended Benefits

Our goal in developing the proposal and pursing the conversion to the Holding Company structure was to increase shareholder value and better position HFRO in the current and future market environment. The conversion had the potential to benefit shareholders in a number of ways. Among the most compelling was the potential to narrow the discount (the amount that HFRO shares trade below the NAV). Historical performance data showed more favorable trading among comparable holding companies compared to the equivalent closed-end fund group.

We also believed the holding company structure would be more supportive of certain investments in HFRO's portfolio that were not understood in the context of a closed-end fund, but where we saw outsized potential. Many such investments are typical for a holding company and better understood in that structure, making it easier for the market to recognize their value and for the Holding Company's share price to reflect the NAV.

Our goal in pursing the conversion was to increase shareholder value and better position the Fund in the current and future market environment.

Another potential benefit of the conversion was that it supported HFRO's ongoing transition away from less favorable asset classes like credit, where high yield spreads are at all-time lows, into those with better growth potential and thus better potential for shareholder value. We believed—and continue to believe—that the most compelling opportunities will be found outside of traditional credit and equity markets, where today the ability to deliver excess value is limited. Enormous scale has become the primary advantage for managers operating in mainstream credit and equity markets, and ongoing consolidation across the asset management industry will only solidify that advantage, making it challenging to generate alpha and meet return expectations without taking on undue risk.

We see much stronger potential in private markets and areas where we can draw on our networks and relationships, research and due diligence capabilities, and structuring, execution, and operational expertise to capitalize on inefficiencies and unlock value. The opportunities in those areas are well suited for a platform of our size and expertise and are better aligned with our investment approach, which typically includes longer-term horizons for our investments. We see those opportunities in a number of different areas today and expect that prevalence to continue over the long term, driven by several potential catalysts (including finance and investment industry trends, the overall business climate, and the follow-on effects of the global pandemic across countless areas).

Decision to Withdraw Proposal

There was significant thought, discussion, and research that went into the decision to pursue the conversion last year. Ultimately, after evaluating the intended benefits, including those mentioned earlier as well as others, and weighing them against the various risks that we highlighted in the proxy statement, we determined that the transition to a Holding Company represented the best path to increase shareholder value for all HFRO shareholders.

While we are disappointed to withdraw the proposal, we remain committed to optimizing HFRO going forward in its current structure and operating in the best interest of the Fund and its shareholders.

Despite that assessment—and after having numerous conversations with investors and making material changes to the proposal that incorporated investor feedback and recommendations—as we entered the fourth quarter of 2021, we decided to withdraw the proposal. That decision was in part driven by the fact that we can still pursue some of the opportunities described above within the current closed-end structure. In fact, many positions that outperformed and generated strong returns for shareholders in the Fund in recent years have been the kinds of opportunities mentioned earlier.

INITIATIVES FOR THE CURRENT STRUCTURE

Plans for HFRO Going Forward

For many of the Fund's top holdings today (discussed in more detail in subsequent sections), our specialized expertise and resources enabled us to source, structure, and manage the investment in a way that strengthens our conviction in its growth potential. While we would be able to pursue a larger universe of those opportunities and draw on a wider range of resources to manage them as a Holding Company, we have shown that those investments can still be represented in a closed-end fund portfolio and effectively managed in a registered fund format.

We were always prepared to continue to manage HFRO as a closed-end fund. Given our ability to pursue the Fund's investment strategy and capture compelling opportunities within the prevailing structure, we opted to withdraw the proposal and continue our existing approach as we seek to deliver total returns and create value for shareholders. We remain committed to optimizing HFRO going forward in its current structure and operating in the best interest of the Fund and its shareholders.

Buyback Program

The conversion proposal included several features designed to address the Fund's discount to NAV, so in conjunction with our decision to withdraw the proposal, we put plans in place to establish a share buyback program to address the discount in the existing structure. In October, we commenced a $40 million common share buyback that would take place over six months, and committed to purchase up to $7 million in shares per month, bolstering efforts to reduce the discount between the Fund's market price and NAV.

To further support those efforts, we also committed to providing updates on purchases throughout the buyback period. We have been providing those updates in the form of monthly reports that are posted to the Fund website, which show each month's purchases and the overall progress to date. We commenced the repurchases in October and have posted three reports thus far.[1]

In the first three months of the buyback program, 1,863,881 shares were repurchased for $20,995,570, reflecting an average price of $11.26/share.[1]

The latest buyback summary can be found on the Fund's website (highlandfunds.com/income-fund) under the "Monthly Repurchases" section.

Other Initiatives

We have other changes planned that reflect insight we gained throughout 2021 from investor feedback and other sources. These changes are focused on increasing shareholder communications to improve the understanding of the Fund's strategy and current portfolio. Specific initiatives include providing shareholder materials/communications in several different formats beyond the typical filings and making communications easily accessible through an improved website experience.

We appreciate the engagement and support from shareholders throughout 2021 and look forward to continuing to implement these initiatives in the year ahead.

[1] *As of 12/31/2021.*

2021 PORTFOLIO REVIEW

In 2021, the Highland Income Fund experienced a total market price return of 15.48% and a total NAV return of 9.55%. The Fund's benchmark, the Credit Suisse Leveraged Loan Index, returned 5.40% in that time.

TOP 10 EXPOSURES[2] (% OF PORTFOLIO)

As of 9/30/2021

INVESTMENT	EQUITY	DEBT	PREFERRED	TOTAL[3]
Creek Pine Holdings, LLC[4]	25.3%			25.3%
SAFStor[5]	10.1%			10.1%
NexPoint Real Estate Finance (NREF)	7.1%			7.1%
Metro Goldwyn Mayer, Inc. (MGM)	6.4%			6.4%
EDS Legacy Partners	0.1%		4.8%	4.9%
IQHQ	3.7%			3.7%
CCS Medical		3.4%		3.4%
Grayson CLO	2.7%			2.7%
SFR WLIF III, LLC[4]	2.3%			2.3%
NEXLS LLC	2.3%			2.3%

2021 Top Investment = Investment appearing in top 10 exposures in all HFRO 2021 quarterly holdings (to date) *

* *Includes HFRO quarterly holdings from Q1-Q3 (as of 3/31/21, 6/30/21, and 9/30/21)*

The following provides a review of the eight investments designated above as a "2021 Top Investment." These represent the investments that appeared among the Fund's Top 10 Exposures in all quarterly holdings of 2021 reported to date. This includes HFRO quarterly holdings for the first three quarters (as of 3/31/21, 6/30/21, and 9/30/21).

All investment highlights and data on top holdings as percentages of the HFRO portfolio referenced in the content below is as of 9/30/21 unless stated otherwise.

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[2] *Top Exposures include non-income producing, illiquid investments that may be deemed an affiliate of the Adviser. Current and future portfolio holdings are subject to change and risk. As of 9/30/2021, the Fund had a short exposure of -18.57% and -4.76% in the S&P 500 E-mini and E-mini Russell 2000, respectively.*

[3] *Top Exposures as a percentage of long-only market value.*

[4] *Creek Pine Holdings, LLC is structured as a 10.25% preferred security (paid-in-kind). Pay-in-kind securities are financial instruments that pay investors in the form of additional securities rather than cash coupons. The securities used to pay the interest or dividends are usually identical to the underlying securities. Pay-in-kind securities tend to pay a higher rate of interest but are considered higher risk.*

[5] *Held in NFRO REIT SUB, LLC.*

CREEK PINE

INVESTMENT HIGHLIGHTS

INVESTMENT TYPE
EQUITY

INITIAL INVESTMENT
2018

$ INVESTED ACROSS PLATFORM
$200M

FUND'S ORIGINAL INVESTMENT ($)
$180M

9/30 VALUE OF FUND INVESTMENT
$264M

AS OF 9/30/21

CREEK PINE HOLDINGS LLC

Investment Background

The Fund invested in Creek Pine Holdings, LLC ("Creek Pine") in 2018 through TexMark Timber Treasury, L.P. ("Triple T"), a joint venture with CatchMark Timber Trust (NYSE:CTT) ("CatchMark" or "CTT") and a group of institutional investors.

Affiliated funds managed by NexPoint Advisors, L.P. (the "NexPoint Funds") were also included in the investment. HFRO initially invested $180 million, representing the majority of the $200 million invested across the platform.

The Creek Pine investment comprised 1.1 million acres of prime East Texas timberlands located near top quartile mills and within approximately 100 miles of three of the top five U.S. homebuilding markets: Austin, Dallas, and Houston.

When Triple T acquired the asset in 2018, the group planned to renegotiate a long-term wood supply agreement, bringing it to current market terms for both pricing and volume. The agreement was successfully amended in 2020.

TIMELINE OF MAJOR EVENTS

JUL 2018	In July 2018, the Fund established its initial position in Creek Pine, investing $180 million through the Triple T, which included CatchMark and a group of institutional investors. HFRO's initial investment was a portion of the $200 million invested across the platform, with the additional amount committed by affiliated funds managed by NexPoint Advisors, L.P.
JUN 2020	On June 24, 2020, CatchMark announced that the joint venture amended its wood supply agreement. The agreement also included an increase in the 10.25% cumulative return on the preferred investors' interests in triple net lease subsidiary real estate investment trust of 0.5% per quarter, subject to a maximum increase of 2.0% and subject to decrease in other circumstances.
JUL 2021	On July 30, 2021, CatchMark announced a definitive agreement to sell 301,000 acres of timberlands for approximately $498 million in cash (~$1,656/acre). The property represents a portion of the 1.1 million acres in East Texas, which was purchased for $1,264/acre. When the agreement was announced, CTT noted that the proceeds of the sale would be used to reduce leverage and pay down a portion of the preferred partnership interests in the joint venture.
SEPT 2021	On September 30, 2021, HFRO's Creek Pine position was valued at $264 million (based on original $180 million investment).
OCT 2021	On October 15, 2021, CTT announced that it had reached an agreement with its joint venture partners, including HFRO, for CTT to redeem its common equity interest. This follows the previously announced sale of 301,000 acres of timberlands for $498 million in cash. As part of these transactions, HFRO and the NexPoint Funds redeemed $180 million, plus an early call premium. HFRO received its pro-rata share in the amount of $167 million.

Investment Update

The balance of HFRO's original investment after the October 2021 redemption was converted into common equity in a new venture formed with a small group of institutional investors. The new entity now owns the remaining portion of the assets following the sale of 301,000 acres announced in September.

The parties involved in the new venture alongside the Fund are sophisticated institutional investors that manage private investment vehicles. Together they have significant experience owning and managing timber assets. With this expertise, the new venture intends to increase efficiencies and drive revenue for the property under a more favorable capital structure. A formal announcement introducing the new venture is expected at some point in 2022.

A summary of this update can be found on the HFRO webpage (highlandfunds.com/income-fund) under the Portfolio Updates section.

% HFRO PORTFOLIO

10.1%

SAFSTOR

SAFSTOR

Investment Background

SAFStor owns, develops, and redevelops high-quality single- and multi-story self-storage properties in undersupplied markets with high barriers to entry.

SAFStor's principals have in-depth real estate experience, having developed over $3.5 billion of mixed-use real estate since 2012, and over $400 million of self-storage since 2017. Prior partners include sovereign wealth funds, top-tier private equity firms, and pension funds.

Target markets include those that offer low delinquency, high traffic count, high population growth, and above-average household income. SAFStor's current footprint includes markets in the Southeast and mid-Atlantic regions, as well as in Texas.

Property management is performed by reputable operators such as Extra Space Storage and CubeSmart.

Investment Update

As of September 30, 2021, HFRO has invested in 19 individual storage facilities that are at various stages of lease up and development.

INVESTMENT HIGHLIGHTS

INVESTMENT TYPE

EQUITY

INITIAL INVESTMENT

2019

$ INVESTED ACROSS PLATFORM

$163M

WEIGHTED AVG. YIELD ON COST

8.6%

(All SAFStor properties)

AS OF 9/30/21

An additional seven projects are in the construction and planning phases, with completions expected through the next 12 months. Stabilized cap rates for similar properties average approximately 5.5%, reflecting the potential for SAFStor properties to see significant increases in value once stabilized.

There is also potential for appreciation of the storage portfolio once development is complete. The weighted average yield on cost is 8.6% for all SAFStor properties.

SAFSTOR MARKETS

(Operating, Construction, and Development Projects)

Sector Outlook

The last two years have reinforced the self-storage sector's reputation for resiliency and stability. Self-storage has been among the top performing real estate asset classes since the COVID-19 pandemic began in Q1 2020. We believe self-storage will maintain this status due to strong relative performance in previous periods of economic weakness and volatility.

NREF
NEXPOINT REAL ESTATE FINANCE

NEXPOINT REAL ESTATE FINANCE (NREF)

Investment Background

NexPoint Real Estate Finance (“NREF”) is a publicly traded mortgage REIT listed on the New York Stock Exchange under the symbol: NREF.

NREF pursues investments in real estate sectors where its senior management team has operating expertise.

Target sectors include:

- multifamily
- single-family rental (”SFR”); and
- self-storage

Investments are predominantly located in the top 50 metropolitan statistical areas (“MSAs”). The company focuses on lending or investing in properties that are stabilized or have a “light-transitional” business plan.

In February 2020, as part of the NREF formation transaction, certain HFRO assets valued at $46 million were exchanged for NREF operating partnership units (convertible one-to-one for NREF common shares).

INVESTMENT HIGHLIGHTS

INVESTMENT TYPE
EQUITY

INITIAL INVESTMENT
2020

$ INVESTED ACROSS PLATFORM
$243M

DIVIDEND YIELD
9.2%

% PORTFOLIO STABILIZED
92.5%

AS OF 9/30/21

Investment Update

NREF reported its third quarter earnings in November 2021.[6]

Highlights from the earnings reported in the latest quarter include:

- Outstanding total portfolio of $1.6 billion grew to 68 investments.
- Generated net income of $25.2 million for the quarter, compared to $11.5 million for the third quarter of 2020, representing an increase of 118.3%.
- Produced year-over-year increases of earnings available for distribution per common share, cash available for distribution per common share, and book value per combined share (common shares and noncontrolling interests) of 69.0%, 55.6%, and 13.9%, respectively.

NREF's portfolio consists of senior loans, mezzanine debt, preferred equity, and common stock investments in short-duration lease-term assets across the U.S. Assets are primarily in single-family rental, multifamily, and self-storage. These defensive characteristics add to the resiliency of the NREF portfolio.

Investment Outlook

Single-family rentals represent a relatively new asset class that was institutionalized in the wake of the global financial crisis. Only a small percentage of homes are owned by institutional investors, allowing for consolidation opportunities. In addition to the long-term growth potential for the asset class, we believe SFR offers resiliency in the short term, evidenced in its ability to not only weather the pandemic-related volatility, but ultimately continue its growth, which has accelerated in the last year.

In multifamily, while certain areas faced challenges related to the pandemic, the challenges were not universal. Where challenges emerged, they largely proved transient, as occupancy and rents have returned to pre-pandemic levels and growth is expected across the sector in 2022. If actual growth falls short of forecasts, defensive features of NREF's multifamily portfolio—the geographical diversity, which covers the top 50 MSAs, the focus on stabilized properties, and the quality of the underlying assets in securitized investments, among others—can provide stability. The historically low losses in Freddie Mac debt issuances secured by multifamily assets, including during periods of market stress, reinforce this point.

Self-storage, as mentioned earlier, has been known as a resilient asset. We believe this will continue, making it a defensive component of the portfolio that can help mitigate downside risk in a weak market environment. At the same time, the last year was one of major growth for self-storage, fueled by several recent trends (demographics, employment, etc.). This growth appears likely to continue, as there has been no significant change in customer behavior to indicate that a slowdown is imminent.

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[6] *See the NREF earnings press release and supplemental information for a more complete update. This information can be found at www.nref.nexpoint.com.*

INVESTMENT HIGHLIGHTS

INVESTMENT TYPE
EQUITY

INITIAL INVESTMENT
2010

INITIAL INVESTMENT VALUE ($/SHARE)
$23.75

9/30 INVESTMENT VALUE ($/SHARE)
$131.00

AS OF 9/30/21

METRO GOLDWYN MAYER (MGM)

Investment Background

Metro Goldwyn Mayer (“MGM”) is a leading entertainment company focused on the production and global distribution of film and television content across all platforms.

MGM owns one of the world’s deepest libraries of premium film and television content, with more than 4,000 titles in the company’s film content library including iconic film franchises like *James Bond, Rocky, Creed, The Magnificent Seven, Thelma & Louise*, and many others. MGM also has over 17,000 episodes of programming in the company’s television content library, including hit shows like *The Handmaid’s Tale, Fargo,* and *Vikings*. The company has collectively won more than 180 Academy Awards and 100 Emmys.

MGM also has investments in several other television channels, digital platforms, and interactive ventures.

The Fund’s initial investment was in the company’s debt, which converted to equity when MGM emerged from bankruptcy in 2010. In addition to the reorg equity, HFRO and its affiliates secured representation on the MGM board of directors as part of the reorganization.

Investment Update

On May 26, 2021, MGM and Amazon issued a press release announcing that the companies had entered into a definitive merger agreement under which Amazon will acquire MGM for a purchase price of $8.45 billion.[7]

Amazon cited MGM's extensive content library among the key reasons it pursued the acquisition.

> **"MGM has nearly a century of filmmaking history and complements the work of Amazon Studios, which has primarily focused on producing TV show programming. Amazon will help preserve MGM's heritage and catalog of films, and provide customers with greater access to these existing works. Through this acquisition, Amazon would empower MGM to continue to do what they do best: great storytelling."**
>
> - *Amazon acquisition announcement*

> **"The real financial value behind this deal is the treasure trove of IP in the deep catalog that we plan to reimagine and develop together with MGM's talented team. It's very exciting and provides so many opportunities for high-quality storytelling."**
>
> - *SVP of Prime Video and Amazon Studios*

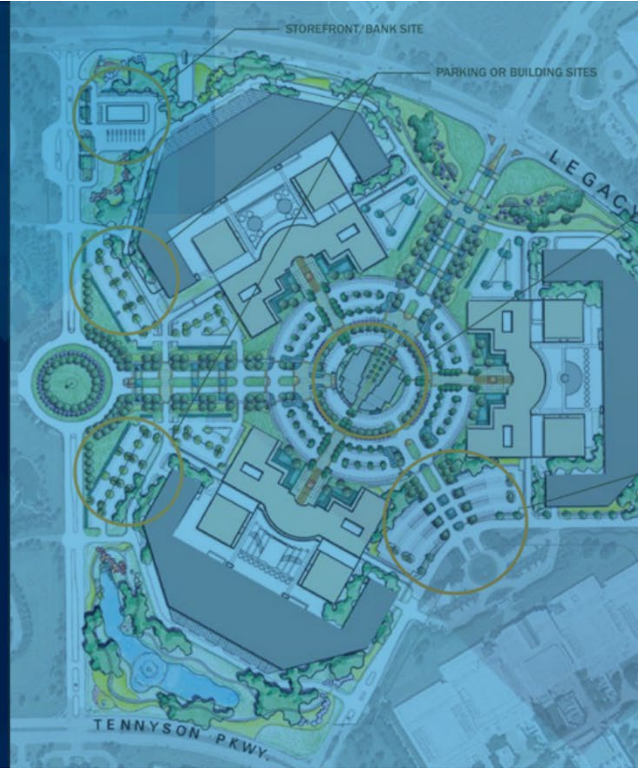
Completion of this transaction is subject to regulatory approvals and other customary closing conditions. The transaction has not yet closed.

[7] *Completion of this transaction is subject to regulatory approvals and other customary closing conditions. Accordingly, there can be no assurance that the transaction will be consummated on the proposed terms or at all.*

% OF HFRO PORTFOLIO

6.4%

EDS LEGACY PARTNERS



INVESTMENT HIGHLIGHTS

INVESTMENT TYPE(S)

PREFERRED EQUITY

INITIAL INVESTMENT

2018

NET RENTABLE SQUARE FEET

1.5M+

TOTAL SITE ACREAGE

91

AS OF 9/30/21

EDS LEGACY PARTNERS

Investment Background

EDS Legacy Partners is an ideal corporate headquarters location in Plano, Texas. The campus was built in 1992 and previously served as the headquarters of global technology services company Electronic Data Systems (EDS).

There are a range of possibilities for the property, with potential for renovation, expansion, and/or redevelopment.

An additional HFRO holding includes adjacent land that can be developed as part of investment strategy.

Investment Update

We are currently evaluating a range of options for the property. The property's permitted uses include office, retail, and multifamily.

Corporate relocations are a key focus area given the size of the campus and the wide range of possibilities for the site. North Texas has seen significant relocation activity over the last decade, and the property is in an area where growth has been accelerating.

Investment Outlook

The Dallas Regional Chamber is currently tracking 111 projects that it deems to be seriously considering a relocation to DFW. That number has increased significantly throughout the pandemic.

> **“Dallas–Fort Worth is one of the top regions in the nation for business, thanks to low cost of living, a business-friendly environment, a strong base of well-educated and skilled employees, and robust access to both U.S. and international markets through its transportation network.**
>
> **[It] is consistently ranked among the top places to work, the best places to live, and the best places for investment.”**

- *Dallas Regional Chamber*

There were 21 companies that relocated headquarters to Dallas-Fort Worth in 2021, including two Fortune 500 companies. Six Fortune 500 companies relocated their headquarters to DFW in the past six years.

IQHQ

Investment Background

IQHQ is a private REIT that focuses on acquiring, developing, redeveloping, and managing life-sciences real estate across several core-markets. The company was founded by Alan Gold, founder of several successful life-sciences and healthcare REITs.

IQHQ targets top life science clusters for its projects. Core markets include Boston, San Francisco, and San Diego in the U.S., as well as Cambridge/London in the U.K.

HFRO first invested in 2019. The investment includes representation on the board of directors.

Even before COVID, sector demand for high quality life science real estate was consistently strong without commensurate levels of supply. The effects of this can be seen in the historical performance of the life-sciences sector compared to the broader REIT market. Life sciences real estate has been constrained in core markets with high occupancy and increasing tenant demand. This "mission critical" real estate usually lacks price sensitivity resulting from healthy tenant budgets of which rent typically comprises a very small portion.

INVESTMENT HIGHLIGHTS

INVESTMENT TYPE
EQUITY

INITIAL INVESTMENT
2019

$ INVESTED ACROSS PLATFORM
$75M

TOTAL CAPITAL RAISED ($)
$2.4B

MARKETS
3

AS OF 9/30/21

Investment Update

The effects of COVID have only exacerbated the supply-demand imbalance of the life science sector, making companies like IQHQ—which has several major development projects underway and a strong acquisition pipeline, not to mention extensive experience in the sector—well positioned.

In November 2020, IQHQ completed a second equity raise of $1.7 billion from new and existing investors. To date, IQHQ has raised more than $2.4 billion. Its portfolio totals over 5.8 million square feet.

In April 2021, IQHQ began construction on its $1 billion Fenway Center Life Sciences Campus in Boston, Massachusetts. The project features more than 960,000 square feet of state-of-the-art life-science buildings with approximately 10,000 square feet of ground floor retail. The project will be situated on an air rights deck over the Massachusetts Turnpike, creating key connections across neighborhoods.

In November 2021, the company announced the acquisition of a property directly adjacent to the Fenway Center development, which provides an opportunity to further scale the Fenway Center campus.

Earlier that same month, IQHQ also announced an acquisition on the West Coast. The company acquired Elco Yards in Redwood City, California, which is home to several life sciences companies. The project will be the city's first life science development site and will further expand IQHQ's portfolio in the Bay Area.

% HFRO PORTFOLIO

3.4%

CCS MEDICAL

INVESTMENT HIGHLIGHTS

INVESTMENT TYPE
DEBT

INITIAL INVESTMENT
2010

INSTALLED CUSTOMER BASE (# PATIENTS)
70,000+

% POPULATION COVERED BY PAYOR NETWORK
60%

AS OF 9/30/21

CCS MEDICAL

Investment Background

CCS Medical is a leading national distributor of home medical equipment and supplies for patients with chronic conditions, with a focus on diabetes management. The company has an expansive, diversified payor network covering the majority of the U.S. population.

The company is headquartered in North Texas and has sales associates and distribution centers nationwide. CCS holds pharmacy licenses or permits in all states and is a Medicare Competitive Bid company.

HFRO’s investment includes representation on the board.

Investment Update

CCS is well positioned to compete in the rapidly growing distribution market for continuous glucose monitoring (CGM) diabetes supplies and to capture growth stemming from the secular trend of healthcare moving to the home.

Health care moving to the home has been a trend we have seen growing over the last five years. Now, with the impact of the pandemic, that trend has accelerated even further.

CCS is actively leveraging innovative technological service offerings to take advantage of this growth and promote patient engagement and clinical adherence, while keeping patients safe at home."

- *Tony Vahedian*
CEO of CCS Medical

The company has made several key C-suite level hires in recent years to capitalize on its favorable position in the diabetes supplies space and on the trends in home health.

These hires began with the appointment of a new Chief Executive Officer to lead these efforts. CCS named Tony Vahedian as the company's CEO in October 2020. He joined the company from a Fortune 20 global healthcare product and services company and has experience working across a broad range of healthcare business models.

Vahedian's plan for growth includes leveraging digital engagement platforms and clinical education opportunities to optimize offerings. This includes combining the medical supplies business with telehealth and remote patient monitoring offerings in order to provide patients with critical care in the safest *and* most convenient way possible.

CCS also added a new C-suite position in 2021 with the appointment of Barbara Hess as Chief Human Resources Officer. She has a strong track record of building human capital capabilities and aligning systems to drive results. Hess started in the new CHRO role in March 2021.

There have also been notable senior hires across several key business units this year.

SFR WLIF III

SFR WLIF III

Investment Background

SFR WLIF III is a whole loan originated by Freddie Mac that was purchased by HFRO and affiliates. The borrower is an experienced owner/operator of single-family rental (SFR) homes.

Seller financing on the investment is equal to approximately 85% of the loan's unpaid principal balance. The financing was provided by Freddie Mac at favorable rates.

Investment Update

We believe there is a long-term opportunity to create value in the SFR space as it grows as an asset class, and this loan is well positioned amid that growth. Additionally, the borrower has a long-term track record owning and operating single-family rental homes at scale. As the asset class becomes more mainstream, there may be newer entrants to the market who, despite being adept in other areas of the real estate sector, struggle to adjust to the nuances of the SFR space. SFR experience is relatively limited across the industry, given the infancy of the asset class, so the borrower's expertise is an especially compelling feature of this holding.

INVESTMENT HIGHLIGHTS

INVESTMENT TYPE
EQUITY

INITIAL INVESTMENT
2019

CASH-FLOWING, STABILIZED SFR HOMES BACKING LOAN
4,111

SELLER FINANCING (% OF LOAN'S UNPAID PRINCIPAL BALANCE)
85%

AS OF 9/30/21

Additionally, the loan is backed by a strong subset of homes within the borrower's SFR portfolio. The specific loan is backed by 4,111 cash flowing, stabilized homes across a core group of MSAs in the Midwest. These assets have robust credit metrics, and the majority are located in the borrower's most established markets where it has achieved scale and has a proven track record of successful operations.

Sector Outlook

As homeownership has become less attainable for low- to middle-income wage earners, rental homes have become more desirable—especially for families who prefer the amenities of a single-family home to those of a multifamily property.

The SFR space is a relatively new asset class, which only began to get institutional interest in the wake of the global financial crisis. SFR investors have traditionally been "mom and pop" landlords; out of the 16 million SFR households, only 2% of homes are owned by institutional investors, creating consolidation opportunities for experienced operators who can achieve scale.[8]

We believe SFR not only has significant growth potential, but we also view it as a sector that can exhibit resiliency, evidenced by its performance during the volatility in markets during 2020.

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[8] *Green Street Advisors & Consulting Group, February 2021*

ADDITIONAL PORTFOLIO UPDATES

CREDIT SUISSE LITIGATION

The following provides an update on the case against Credit Suisse, AG, Cayman Islands Branch, and Credit Suisse Securities (USA), LLC (together "Credit Suisse").

Background on the Case

The case was originally filed in 2013 by Claymore Holdings LLC ("Claymore"), the entity formed to pursue the collective claims on behalf of HFRO and an affiliated fund managed by NexPoint Advisors, L.P. (together the "Funds").

In 2015, following a bench trial and jury trial, the 134th Judicial District Court (the "Trial Court") issued its original judgment in favor of Claymore. The judgment was confirmed by an appellate court in 2018. Credit Suisse's appeal of that ruling sent the matter to the Texas Supreme Court, which heard the case on January 8, 2020.

On April 24, 2020, the Texas Supreme Court issued an order that affirmed in part and reversed in part the 2018 ruling from the court of appeals. In the April 2020 order, the Texas Supreme Court upheld the $40 million fraud verdict that resulted from the jury trial; however, it did not uphold the contract damages and equitable relief awarded to Claymore by the Trial Court following the bench trial.

In its opinion, the Texas Supreme Court noted procedural issues related to the calculation of damages among the reasons for reversing part of the appellate court ruling. So while it upheld the prior findings that Credit Suisse committed fraud, it remanded the case to the Trial Court to determine the appropriate damages calculations and enter a new damages award.

Case Update

On June 28, 2021, the Trial Court issued a judgment against Credit Suisse, awarding $121 million to Claymore. This award stemmed from the Texas Supreme Court's April 2020 order, which remanded the case to the Trial Court to calculate new damages.

On July 23, 2021, Credit Suisse filed a notice of appeal of the June 28 judgment. The matter will be reviewed by the Dallas Court of Appeals, which ruled unanimously in favor of Claymore in the last round of appeals.

The total aggregate award, which, as of June 28, stood at $121 million, 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. The net proceeds would then be allocated to the Funds based on respective damages (approximately 82% to HFRO). As legal proceedings are ongoing and all recoveries remain contingent, no award amount has been recorded in the Funds' net asset values at this time.

The case is Claymore Holdings LLC v. Credit Suisse AG, Cayman Islands Branch et al., case number DC-13-07858, in the 134th District Court in Dallas County, Texas.

RISKS & DISCLOSURES

Past performance is no guarantee of future results. The rate of return will vary, and the principal value of an investment will fluctuate and shares, if sold, may be worth more or less than their original cost. current performance may be lower or higher than the performance data quoted. Returns are historical and include change in share price and reinvestment of all distributions. Total investment return does not reflect broker sales charges or commissions. All performance information is for common shares of the Trust. You should carefully consider HFRO's business strategy, risks, fees, and expenses before investing.

This document contains forward-looking statements. These statements reflect the current views of management with respect to future events and financial performance. Forward-looking statements can be identified by words such as "anticipate", "expect", "could," "may", "potential", "will", "ability," "targets," "believe," "likely," "assumes," "ensuring," "available," "optionality," "viability," "maintain," "consistent," "pace," "should," "emerging," "driving," "looking to," and similar statements of a future or forward-looking nature. Forward-looking statements address matters that involve risks and uncertainties. Past performance does not guarantee future results. Performance during time periods shown is limited and may not reflect the performance in difference economic and market cycles. There can be no assurance that similar performance will be experienced.

This document contains information about prior investments made by the Adviser of HFRO. This information was prepared by the Adviser based on its experience in the industry and on assumptions of fact and opinion as to future events which the Adviser believed to be reasonable when made. There can be no assurance that the Adviser and/or HFRO will be as successful as these earlier investments. Prior investment returns are not indicative of future results. It should not be assumed that investment recommendations made in the future will be profitable or will equal the performance of the securities included herein.

Closed-end funds, unlike open-end funds, are not continuously offered. There is a one-time public offering and once issued, shares of closed-end funds are sold in the open market through a stock exchange and frequently trade at prices lower than their net asset value. Net Asset Value ("NAV") is total assets less total liabilities, which includes preferred shares, divided by the number of common shares outstanding. When NAV is lower than market price, dividends are assumed to be reinvested at the greater of NAV or 95% of the market price. When NAV is higher, dividends are assumed to be reinvested at market price. For additional information, please contact your investment adviser or visit our website https://www.highlandfunds.com/income-fund.

Registered investment companies like HFRO are subject to certain risks.

Senior Loans Risk. The risk that the issuer of a senior may fail to pay interest or principal when due, and changes in market interest rates may reduce the value of the senior loan or reduce HFRO's returns. The risks associated with senior loans are similar to the risks of high yield debt securities. Senior loans and other debt securities are also subject to the risk of price declines and to increases in interest rates, particularly long-term rates. Senior loans are also subject to the risk that, as interest rates rise, the cost of borrowing increases, which may increase the risk of default. In addition, the interest rates of floating rate loans typically only adjust to changes in short-term interest rates; long-term interest rates can vary dramatically from short-term interest rates. Therefore, senior loans may not mitigate price declines in a long-term interest rate environment. HFRO's investments in senior loans are typically below investment grade and are considered speculative because of the credit risk of their issuers. Please refer to “Interest Rate Risk” for more information.

Industry Concentration Risk. HFRO must invest at least 25% of the value of its total assets at the time of purchase in securities of issuers conducting their principal business activities in the real estate industry. HFRO may be subject to greater market fluctuations than a fund that does not concentrate its investments in a particular industry. Financial, economic, business, and other developments affecting issuers in the real estate industry will have a greater effect on HFRO, and if securities of the real estate industry fall out of favor, HFRO could underperform, or its NAV may be more volatile than, funds that have greater industry diversification.

Interest Rate Risk. The risk that debt securities, and HFRO’s net assets, may decline in value because of changes in interest rates. Generally, debt securities will decrease in value when interest rates rise and increase in value when interest rates decline. On July 27, 2017, the head of the United Kingdom’s Financial Conduct Authority announced a desire to phase out the use of the London Interbank Offered Rate (“LIBOR”) by the end of 2021. Please refer to “LIBOR Transition and Associated Risk” for more information.

Credit Risk. The risk that HFRO could lose money if the issuer or guarantor of a fixed income security, or the counterparty of a derivatives contract or repurchase agreement, is unable or unwilling (or is perceived to be unable or unwilling) to make a timely payment of principal and/or interest, or to otherwise honor its obligations.

Leverage Risk. Leverage may increase the risk of loss, cause fluctuations in the market value of HFRO’s portfolio to have disproportionately large effects or cause our NAV to decline faster than it would otherwise.

LIBOR Transition and Associated Risk. Certain instruments held by the Fund pay an interest rate based on the LIBOR, which is the average offered rate for various maturities of short-term loans between certain major international banks. LIBOR is expected to be phased out by the end of 2021. While the effect of the phase out cannot yet be determined, it may result in, among other things, increased volatility, or illiquidity in markets for instruments based on LIBOR and changes in the value of such instruments.

Real Estate Market Risk. HFRO is exposed to economic, market and regulatory changes that impact the real estate market generally and through its investment in NFRO REIT Sub, LLC (the “REIT Subsidiary”), which may cause HFRO’s operating results to suffer. A number of factors may prevent the REIT Subsidiary’s properties and other real estate-related investments from generating sufficient net cash flow or may adversely affect their value, or both, resulting in less cash available for distribution, or a loss, to us. These factors include: national, regional and local economic conditions; changing demographics; the ability of property managers to provide capable management and adequate maintenance; the quality of a property’s construction and design; increases in costs of maintenance, insurance, and operations (including energy costs and real estate taxes); potential environmental and other legal liabilities; the level of financing used by the REIT Subsidiary and the availability and cost of refinancing; potential instability, default or bankruptcy of tenants in the properties owned by the REIT Subsidiary; the relative illiquidity of real estate investments in general, which may make it difficult to sell a property at an attractive price or within a reasonable time frame. The full extent of the impact and effects of the recent outbreak of COVID-19 on the future financial performance of HFRO, and specifically, on its investments and tenants to properties held by its REIT

Subsidiary, are uncertain at this time. The outbreak could have a continued adverse impact on economic and market conditions and trigger a period of global economic slowdown.

Pandemics and Associated Economic Disruption. An outbreak of respiratory disease caused by a novel coronavirus was first detected in China in December 2019 and subsequently spread internationally. This coronavirus has resulted in the closing of borders, enhanced health screenings, healthcare service preparation and delivery, quarantines, cancellations, disruptions to supply chains and customer activity, as well as general anxiety and economic uncertainty. It is not known how long any negative impacts, or any future impacts of other significant events such as a substantial economic downturn, will last. Health crises caused by outbreaks of disease, such as the coronavirus, may exacerbate other preexisting political, social, and economic risks. This outbreak, and other epidemics and pandemics that may arise in the future, could negatively affect the global economy, as well as the economies of individual countries, individual companies, and the market in general in significant and unforeseen ways. For example, a widespread health crisis such as a global pandemic could cause substantial market volatility, exchange trading suspensions and closures, which could adversely affect HFRO's performance, the performance of the securities in which HFRO invests, lines of credit available to HFRO and may lead to losses on your investment in HFRO. In addition, the increasing interconnectedness of markets around the world may result in many markets being affected by events or conditions in a single country or region or events affecting a single or small number of issuers.