Highland Income Fund (NYSE:HFRO)

HFRO 2022 UPDATE

INTRODUCTION

The following provides an update for shareholders of the Highland Income Fund (NYSE:HFRO) (“HFRO” or the “Fund”). 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.

2022 has been eventful with respect to regulatory, geopolitical, and macroeconomic factors. Markets began 2022 under pressure stemming from concerns around rising inflation, stretched equity valuations, and the prospect of rising interest rates. The pressure continued into February as Russia invaded Ukraine, resulting in a backlash of economic sanctions that drove crude oil prices above $100 a barrel for the first time since 2014. This oil supply shock added to the fears that already existed in the market around rising inflation. To counter against inflation, the Fed increased the Fed Funds Rate 0.25%, 0.75%, 0.75% and 0.75% in March, May, June, and September respectively. Regardless of the regulatory, geopolitical, and macroeconomic environment — the Fund was able to adapt accordingly and outperformed its benchmark by a substantial margin.

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.

In March 2022, we completed the $40 million common share buyback program. Over the six-month period the Fund repurchased $40 million common shares at a weighted average price per share of $11.32. Results of the buy-back are posted to the Fund website. (nexpointassetmgmt.com/income-fund) under the “Monthly Repurchases” section.

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HIGHLAND INCOME FUND (HFRO) MID-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 17-19.

2022 PORTFOLIO REVIEW

TOP 10 EXPOSURES[1] (% OF PORTFOLIO)

As of 9/30/2022

INVESTMENT	EQUITY	DEBT	PREFERRED	TOTAL[2]
SAFStor[3]	14.1%			14.1%
NexPoint Homes	4.7%	6.1%		10.8%
NexPoint Real Estate Finance (NREF)	6.2%		0.3%	6.5%
EDS Legacy Partners	0.6%	5.7%		6.3%
IQHQ	6.2%			6.2%
NHT Convertible Promissory Note		4.6%		4.6%
NexPoint Storage Partners	4.3%			4.3%
CCS Medical	2.5%	1.5%		4.0%
NEXLS LLC	3.8%			3.8%
FREMF 21K-F103 CS FRN	3.8%			3.8%

2022 Top Investment = Investment appearing in top 10 exposures in all HFRO 2022 quarterly holdings (to date) *

** Includes HFRO quarterly holdings from Q1-Q3 (as of 3/31/22, 6/30/22, and 9/30/22)*

The following provides a review of the seven investments designated above as a "2022 Top Investment." These represent the investments that appeared among the Fund's Top 10 Exposures in all quarterly holdings of 2022 reported to date. This includes HFRO quarterly holdings for the first three quarters (as of 3/31/22, 6/30/22, and 9/30/22).

All investment highlights and data on top holdings as percentages of the HFRO portfolio referenced in the content below is as of 9/30/22 unless stated otherwise.

[1] 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.
[2] Top Exposures as a percentage of long-only market value.
[3] Held in NFRO REIT SUB, LLC.

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, 2022, HFRO has invested in 19 individual storage facilities that are at various stages of lease up and development. 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%-5.5%, 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. On December 7th NexPoint Storage Partners acquired 29 new, well-located, and high-quality self-storage properties that were developed by SAFStor.

NEXPOINT HOMES

Investment Background

NexPoint Homes was formed in 2022, in response to the growing need for expanded access to single family rental (“SFR”) housing in the U.S. It focuses on acquiring newer construction homes and partnering with local builders to create build-for-rent communities in secondary and tertiary markets.

Investment Update

We continue to believe in the thesis of providing housing to the workforce housing population and that there is a massive undersupply of housing in all levels of the affordable segment. We believe the higher price point will attract “stickier” residents who are drawn to the new, large, modern homes that are the focus. Our residents are “residents by necessity” at this time in their life but may have the opportunity to buy a house one day. For now, they are able to raise their families in spacious homes, as opposed to an apartment or lower class SFR option. Additionally, we believe a newer build with less required maintenance and rehab, combined with low retention provides for a cost-efficient investment strategy with potential high NOI margins.

NexPoint Real Estate Finance (NREF)

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, and self-storage.

Investments are predominantly located in the top 50 metropolitan statistical areas. 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 were exchanged for NREF operating partnership units (convertible one-to-one for NREF common shares).

Investment Update

NREF reported its third quarter earnings in October 2022. Highlights from the earnings reported in the latest quarter include:

- Outstanding total portfolio of $1.7 billion grew to 83 investments.
- Produced $11.2 million earnings available for distribution
- Continued to effectively deploy capital into over $100 million of accretive investments in our core verticals
- As of October 2022, there are no loans currently in default or forbearance in our plan

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 can add to the resiliency of the NREF portfolio.

EDS Legacy Partners

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 region ranks #1 in job growth among major metros. There were 21 companies that relocated headquarters to Dallas-Fort Worth in 2021, including two Fortune 500 companies. The Dallas region is now home to 2 fortune 500 companies, including two of the Fortune 10. 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

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 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 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.

NexPoint Storage

NEXPOINT STORAGE PARTNERS

Investment Background

In November 2020, NexPoint took Jernigan Capital (formerly NYSE: JCAP) private in a $900 million transaction. The company rebranded as NexPoint Storage Partners, Inc. (“NSP”). JCAP was started as a hybrid mortgage-equity REIT, providing capital to self-storage developers while also owning facilities outright. Today, NSP invests in newly built, multi-story, climate-controlled, Class-A self-storage facilities located in dense and growing markets. All assets are managed by Extra Space Storage, who also invested $300 million in preferred equity during the JCAP buy out.

Investment Update

NexPoint Storage Partners acquired 29 SAFStor (another Storage platform that was largely funded by NexPoint) properties on December 7th. The acquisition brings the total asset value to approximately $.7 billion with 71 wholly owned and operating properties. We believe that combining these platforms will provide us with the scale to attract financing and raise common equity, as we continue to look and grow vertical. Storage fundamentals remain remarkably strong, and with its low capital expenditures and short-term duration leases, we are bullish on the future for this platform.

CCS Medical

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.

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.

Most recently, on September 1, 2022, the company hired Mike Rolla as Chief Growth Officer. Mike will help guide the company's evolution as it scales both its digital health platform and nationwide distribution network.

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

The case was heard for oral argument at the Court of Appeals, Fifth District of Texas at Dallas on October 11, 2022.

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 05-21-00649-CV, in the Court of Appeals for the Fifth District of Texas at Dallas.

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.

HFRO is a closed-end fund managed by NexPoint Asset Management, L.P. The Fund seeks to provide a high level of current income, consistent with the preservation of capital.

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.