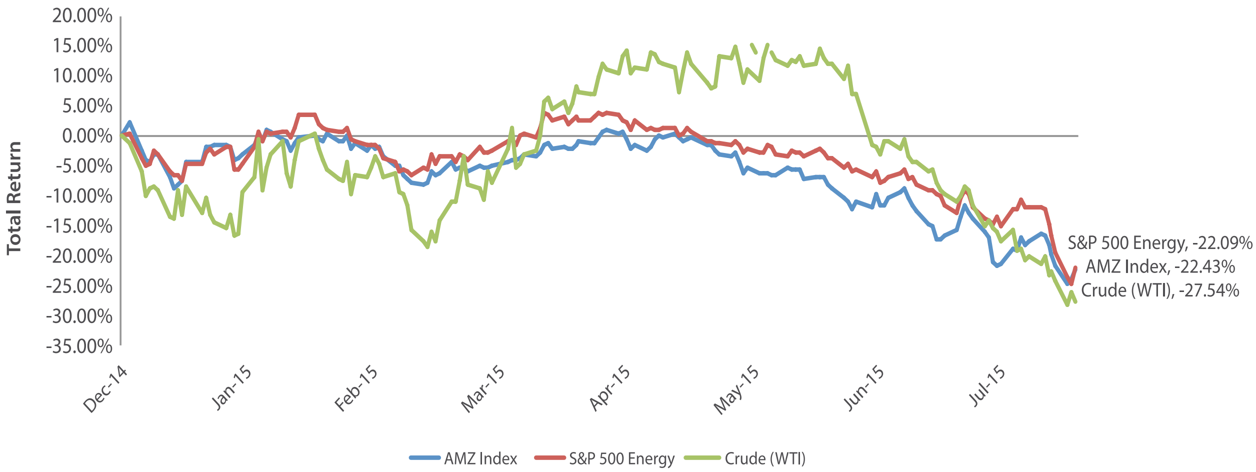
HIGHLAND CAPITAL MANAGEMENT

The Sky is Falling . . .

September 2015
James Dondero

Chicken Little is a large MLP investor. In the recent period of declining crude prices, virtually all energy-related assets have been impacted, including MLPs – despite their largely fee-based business models. Since the beginning of the year, MLPs (as measured by the Alerian MLP Index, AMZ) have lost -22.4%, underperforming the S&P 500 Energy Index and only somewhat bettering crude itself (Figure 1). What makes MLP underperformance unexpected is the substantially lower direct commodity exposure. Most MLP revenues are derived from fixed fee contracts, many with sizable minimum volume commitments.

Figure 1 - Relative Performance: YTD Total Return

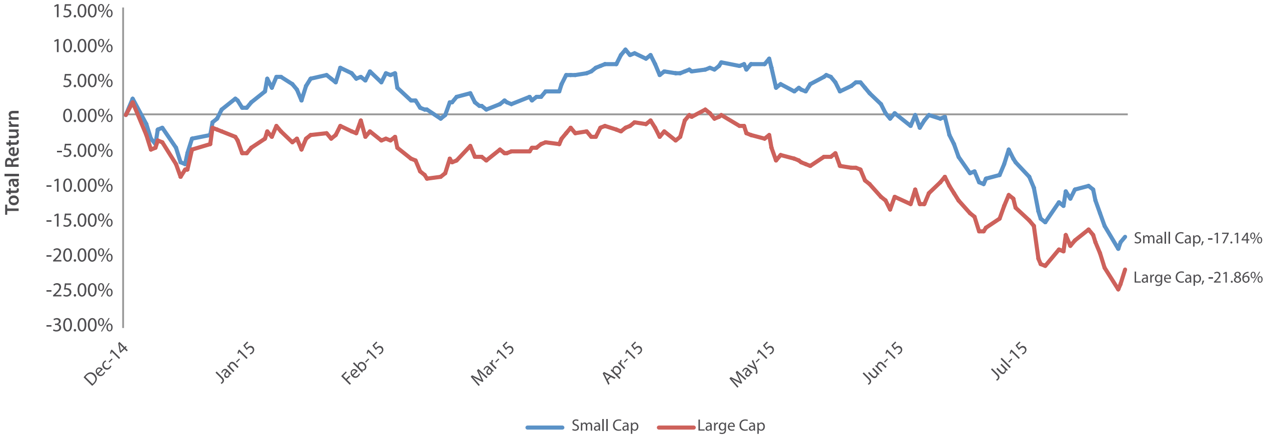


Source: Bloomberg; 12/31/14-8/26/2015

What Could Be Driving this Selloff?

We believe that recent performance is being driven by both commodity price fears and increased news coverage of the forced liquidation of investment funds with high energy exposure. For example, Mount Kellett Capital was recently forced into the arms of Fortress *(Source: Wall Street Journal, May 22, 2015)*, and investors in Carlyle's Claren Road funds have requested redemptions totaling about half of the current $4.1 billion assets under management, following earlier redemptions of approximately $2.3 billion *(Source: Bloomberg, August 17, 2015)*. In addition, there has been chatter about other energy-focused hedge funds liquidating and levered MLP funds facing large redemptions. Although some funds may not be directly

Figure 2 - MLP Relative Size Performance: YTD Total Return



Small Cap Names: GEL, NS, DPM, TLLP, ENLK, TCP, NGL, CMLP, TEP, PSXP, MPLX, AM, HEP, SMLP, MMLP, SUN, VLP, GLP, DM, RRMS
Large Cap Names: EPD, ETP, MMP, PAA, MWE, WPZ, EEP, SEP, KMP/KMI
Source: Bloomberg; 12/31/14-8/26/15

invested in MLPs, large amounts of selling in the energy sector may have impacted MLP prices as well.

We also believe that recent market performance has been driven by investors seeking liquidity in the larger cap names (Figure 2). Ironically, these are the companies that may be best-suited to survive the commodity market turbulence via their large, diversified business models, extensive asset footprints and balance sheet capacity to absorb weaker competitors. For example, Enterprise Products Partners (EPD, the largest MLP by market capitalization) has raised its distribution each consecutive quarter since the beginning of 2000. In the context of what has happened over the last 15 years (e.g., the dot-com boom/bust; WTI crude prices ranging from $18 to $145 per barrel; Henry Hub natural gas prices ranging from $1.69 to $18.48 per mmBtu; the Great Recession; and the lack of crude supply growth outside of the U.S. and OPEC) exemplifies what makes the MLP asset class so exceptional. We believe MLPs have one of the highest quality risk-adjusted business models in the energy space and may likely be among the first to rebound when the sector recovers.

. . . Meanwhile Industry Insiders Are Buying

Despite the turbulent energy commodity backdrop, MLP management teams exhibit confidence in their abilities to weather the storm and to continue increasing their distribution levels. Here is a sampling of such commentary from the first and second quarter earnings calls.

"And to me, that's what makes this a great story. When you're out there saying we're paying a 5% dividend and we're giving you 10% growth for the next six years, that to me is just a wonderful story, based on $130 billion of enterprise value. So we're very disappointed in the price, so thank you for giving me the opportunity to comment on it." *(Source: Richard Kinder, Executive Chairman, Kinder Morgan Inc., Bloomberg earnings transcript, July 15, 2015)*

"In terms of distribution growth, we continue to target 20% annual distribution growth through 2017 at EQM." *(Source: Randall Crawford, Executive VP/COO, EQT Midstream Partners, Bloomberg earnings transcript, July 23, 2015)*

"We continue to believe that our diversified fee-based integrated system of assets positions us to succeed in a challenging commodity price environment. Our financial flexibility and healthy distribution coverage continues to provide a margin of safety for our investors with an average distribution coverage greater than 1.4 times and approximately $7 billion of retained cash flow over the last five years. We have clear visibility to grow with over

$6 billion of announced projects under construction that are targeted for completion between now and the end of 2017. These fee-based projects are supported by long-term customer commitments."

"Our recent acquisitions and announced organic projects provide clear visibility to increase cash flows to support future distribution growth. Since the beginning of the year, we believe for technical reasons, the market has not rewarded us for our efforts. We will continue to execute our strategies and strive to deliver solid financial results. We're confident that the dedicated team at Enterprise will continue to find and execute new opportunities to grow our partnership and add value for our investors as we extend our strong track record of increasing the quarterly distribution paid to investors."
(Source: Michael Creel, CEO, Enterprise Product Partners, Bloomberg earnings transcripts, April 30, 2015 and July 30, 2015, respectively)

"We continue to be very proud of our overall financial performance. We've continued our distribution increases. And we expect to be able to maintain these level of increases through this challenging cycle."
(Source: Jamie Welch, CFO, Energy Transfer Equity, Bloomberg earnings transcript, August 6, 2015)

"Our distribution forecast remains unchanged, and we expect distributions of approximately $3.70 for 2015, $3.97 for 2016 and an annual growth rate of 10% for 2017 to 2020. We anticipate the annualized distribution coverage ratio during the entire period will be between 1 times and 1.2 times."

"As far as the longer-term distribution growth guidance, the 5%, 7% and 10%, yes, as we previously stated, that is our plan; that is the expectation in terms of distribution growth guidance for 2015, 2016, and 2017, and we are comfortable with that guidance."
(Source: Frank Semple, CEO, MarkWest Energy, Bloomberg earnings transcripts, May 6, 2015 and August 5, 2015, respectively)

"We continue to project 5% to 7% organic growth in our distributable cash flow through the end of 2017, from previously announced growth projects."
(Source: Margaret Montana, then-current President/CEO, Shell Midstream Partners, Bloomberg earnings transcript, May 13, 2015)

"And this quarter's results also show the very strong underpinning of growth in our fee-based revenues that will drive our growth for many years to come, and in fact all five of WPZ's operating areas had fee-based revenue growth and four of the five enjoyed double-digit growth compared to the first quarter of 2014."

"And so, let's move on to guidance. First of all, we are reaffirming our Williams dividend guidance for 2015 through 2020."
(Source: Alan Armstrong, CEO, Williams, Bloomberg earnings transcripts, April 30, 2015 and July 30, 2015, respectively)

Management teams are discussing the resilience of their operating models and demonstrating their willingness to make sizeable purchases at these levels (Figure 3).

Figure 3

Company	Date	Person	Open Mkt Purchase	Average Price
Energy Transfer	July 2015	Kelcy Warren, Chairman/CEO	$39.4mm	$63.10
Kinder Morgan	March-July 2015	Richard Kinder, Exec. Chairman	$15.4mm	$38.52
Enterprise Products Partners	July 2015	Various Officers and Directors	$3.9mm	$27.48
Plains All American	August 2015	Greg Armstrong, Chairman/CEO	$2.5mm	$18.27, $36.46

Source: Bloomberg (Plains All American purchases represent both those in Plains All American Pipeline, LP (PAA) and Plains GP Holdings LP (PAGP))

. . . and Pursuing M&A

We have recently seen a pickup in M&A activity, which we think is a positive sign for both acquirers and targets. Over the past several months we have seen potential deals announced for WMB and MWE, for example. We think there are several other MLPs which could make attractive acquisition candidates, including SEMG and TRGP, and others that are likely to benefit from making acquisitions, including KMI and PAGP (Figure 4). All four of these companies have been the target of recent takeover attempts, have experienced activist investor involvement, or have publicly disclosed the attractiveness of sector consolidation.

We Think Valuations Are Attractive

Prior to the Great Recession, crude has not traded at current levels since May 2005. Average LTM EBITDA multiples are noticeably lower, and current forward

Figure 4

Date	6/21/15	7/13/15	?	?	?	?
Target	WMB	MWE	SEMG	TRGP	?	?
Acquirer	ETE	MPLX	?	?	KMI	PAGP
Announced Premium	32.4%	31.6%	?	?	?	?

Source: Bloomberg, HCM Estimates

Figure 5

Ticker	Company	EV / LTM EMITDA		EV / FWD EMITDA		Yield		10-yr UST Spread	
		Current	May-05	Current	May-05	Current	May-05	Current	May-05
EPD	Enterprise Products Partners	16.2x	18.5x	14.9x	12.7x	5.35%	6.31%	318bps	220bps
PAA	Plains All American Pipeline	12.4x	17.1x	10.5x	15.0x	8.02%	6.14%	585bps	203bps
ETP	Energy Transfer Partners	14.3x	15.7x	10.4x	11.1x	8.53%	6.03%	637bps	192bps
EEP	Enbridge Energy Partners	14.8x	13.4x	12.3x	12.2x	8.44%	7.34%	627bps	323bps
	Average	14.4x	16.2x	12.0x	12.7x			542bps	234bps

Source: Bloomberg and Capital IQ, as of 8/27/15

Figure 6 - MLPs (AMZ) Spread to 10-yr Treasuries

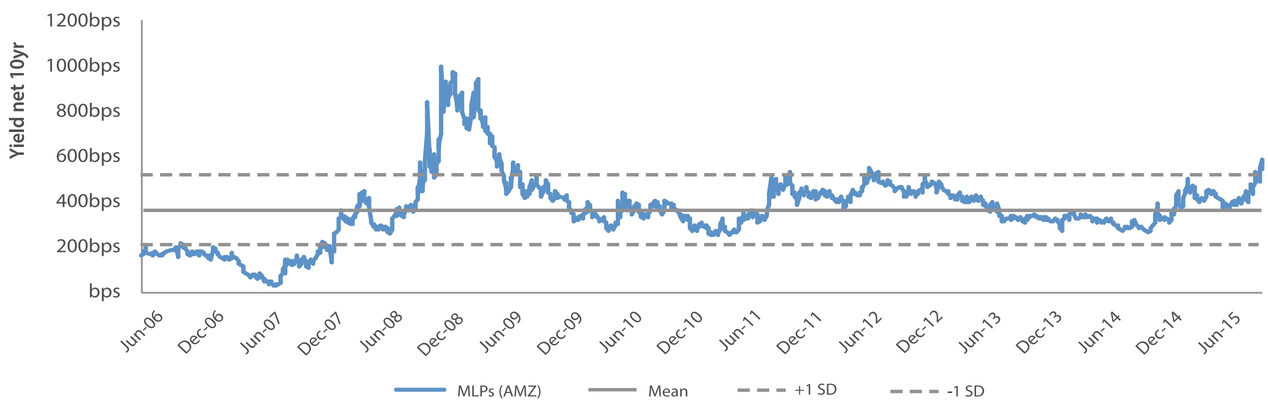
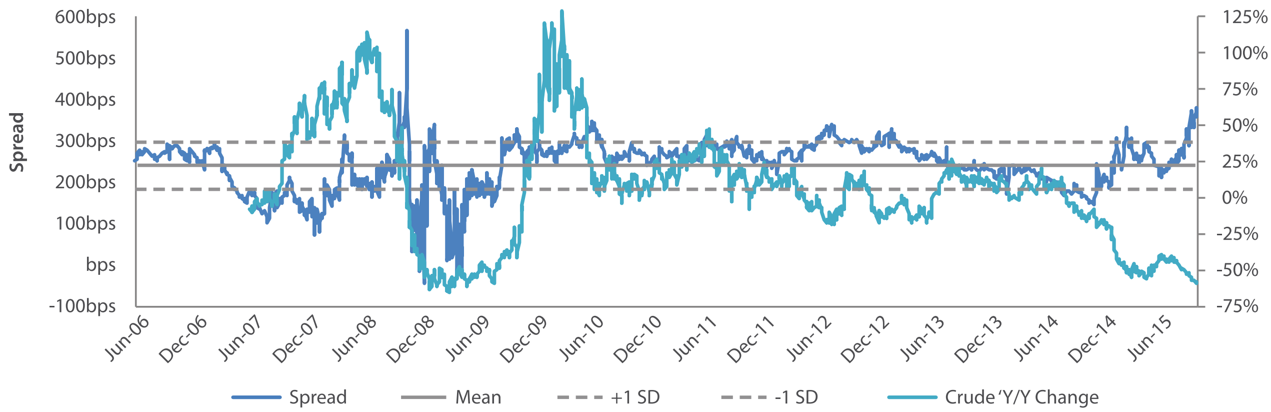


Figure 7 - MLPs (AMZ) Spread to REITs (FNER) vs. Change in Crude Price



Sources for Figures 6 and 7: Bloomberg, Alerian

valuations do not appear stretched, especially in comparison to LTM multiples (Figure 5). However, spreads to Treasuries are now 308bps wider.

Due to extremely negative energy market sentiment, the spread between MLPs and REITs is at the highest level in the past 15 years, and once again MLP spreads to Treasuries are over one standard deviation higher (Figures 6 and 7). As a reminder, REITs are not without risk themselves (e.g., re-leasing, capital underinvestment, and geographic / asset concentration, to name a few). In a world starved for yield, we continue to believe that MLPs can provide an attractive source of current income and an even more compelling total return opportunity given the extreme price dislocation that we currently see in market values.

Crude Price Risks are Exaggerated

MLP spreads have widened recently as crude prices have fallen (Figure 8). In addition, MLP monthly spread widening/tightening has become more highly correlated with monthly movements in crude prices since the shale-related growth experienced after the Great Recession (Figure 9). We think the market is throwing the proverbial baby out with the bathwater for two main reasons. If you

Figure 8 - MLPs (AMZ) Spread to 10 year Treasuries vs. Change in Crude Price

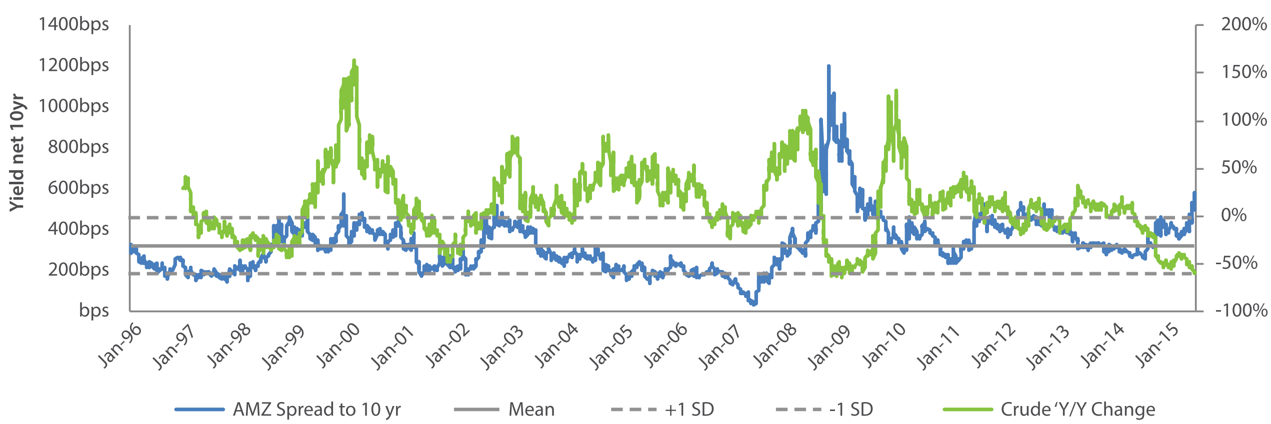
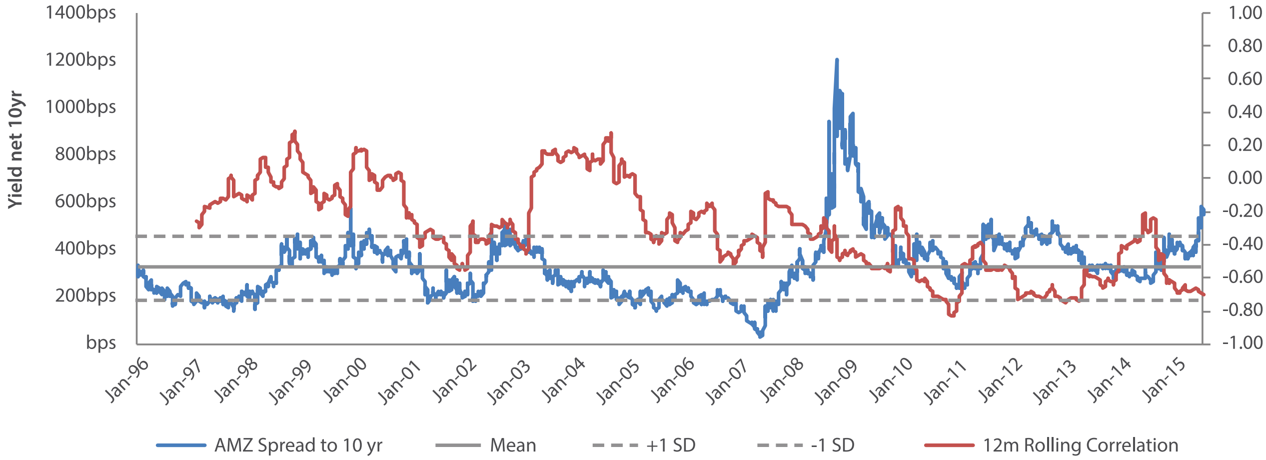
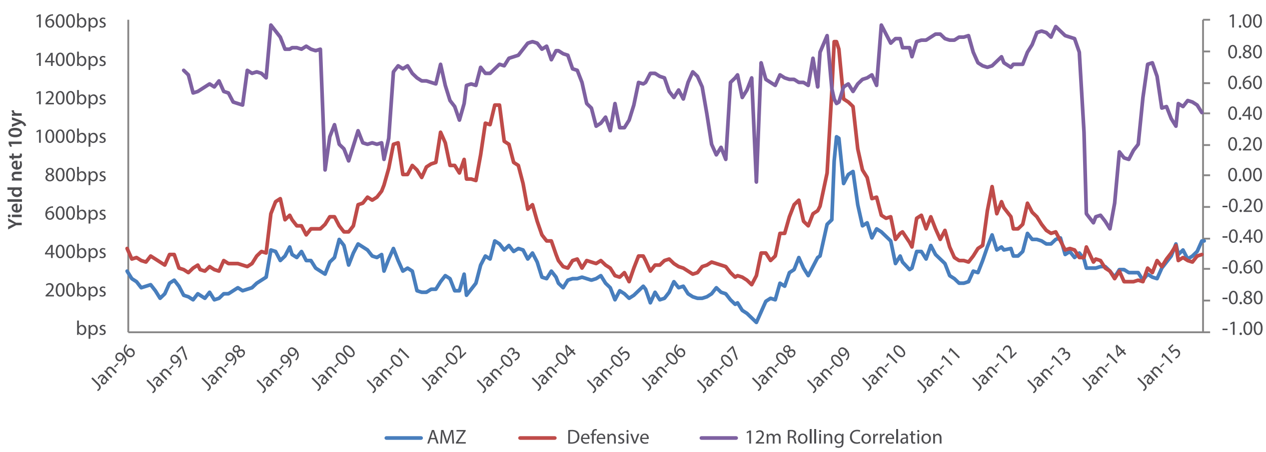


Figure 9 - MLPs (AMZ) Spread to 10-yr Treasuries vs. Crude Correlation



Sources for Figures 8 and 9: Bloomberg, Alerian

Figure 10 - MLPs (AMZ) vs. HY Spreads (Defensive Subsector) to 10 year Treasuries



Source: Bloomberg, Credit Suisse

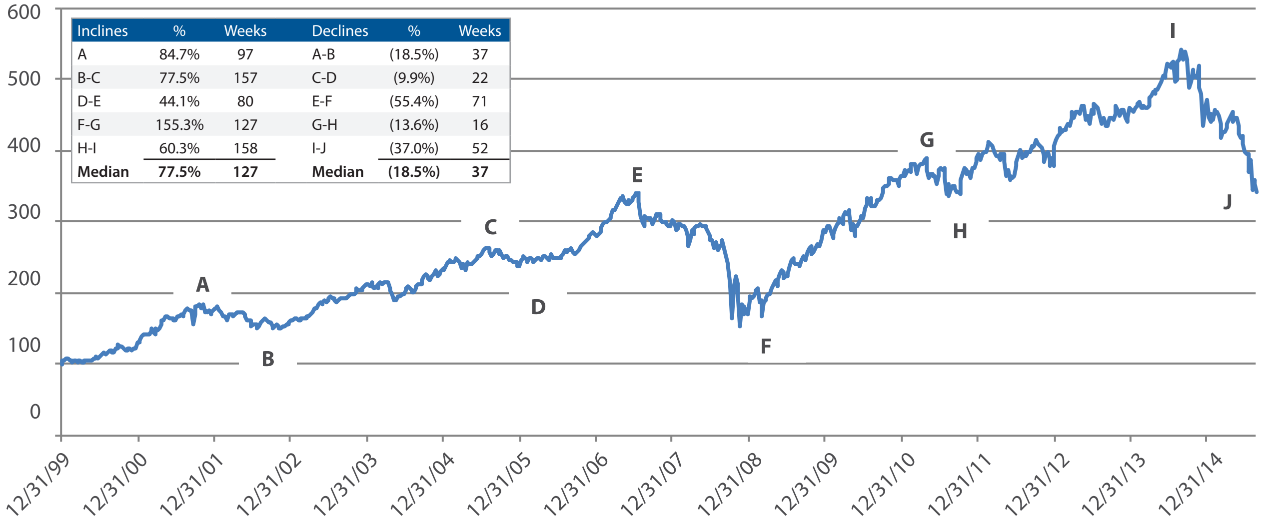
are a crude bear and believe commodity prices will remain lower for longer, the future should resemble the pre-recession / pre-shale era when the North American midstream sector had a less-robust organic growth. MLPs were less correlated to crude during this period. Simple mean reversion would argue for an MLP price correction as spreads revert to their mean or undershoot like they did in 2004-2007. If you are a crude bull, you believe crude prices will rally significantly after the current correction (Figure 8). If the current correlation to crude is sustained (Figure 9), there is significant price appreciation potential for MLPs if crude prices reverse.

Either way, we think the market is simply exaggerating the impact commodity prices will have on midstream MLPs. Over the course of several business and commodity cycles, we see a more consistently strong correlation between MLP spreads and High Yield spreads (Figure 10). Notice that the High Yield market has historically traded wide of MLPs, but MLPs now trade on top of or slightly wide of High Yield – we think this is another indication that MLPs represent attractive value.

Is Now the Time to Act?

With a 37% price decline lasting 52 weeks, the current correction in MLPs is the longest and most severe

Figure 11 - AMZ Performance: Inclines and Declines



Inclines	%	Weeks	Declines	%	Weeks
A	84.7%	97	A-B	(18.5%)	37
B-C	77.5%	157	C-D	(9.9%)	22
D-E	44.1%	80	E-F	(55.4%)	71
F-G	155.3%	127	G-H	(13.6%)	16
H-I	60.3%	158	I-J	(37.0%)	52
Median	**77.5%**	**127**	**Median**	**(18.5%)**	**37**

Source: Bloomberg, 12/31/99-8/26/15

downturn over the last 15 years, aside from the great recession (Figure 11). We would note that the median price appreciation following a downturn has been 78%.

The energy markets continue to be tumultuous, but MLPs have been unfairly ensnared in the market weakness. In a world of rising energy demand and few non-OPEC sources of supply growth, the U.S. has established itself as not only a world class consumer but as a leading producer as well. Despite the current lower price environment, the country will remain an important supplier in the global energy markets, with MLPs providing the vital infrastructure links to maintain such status. As Warren Buffet once wrote, "be greedy when others are fearful." For value investors, we believe that the current dislocation in MLPs provide an incredibly appealing investment opportunity. Market prices are likely to be volatile in the near-term, but current yields (many in the mid to upper single digits) may provide an ample return as investors await a normalization and recovery in MLP values that we expect to be substantial.

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/market-commentary/

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

This commentary is provided as general information only and is in no way intended as investment advice, investment research, a research report or a recommendation. Any decision to invest or take any other action with respect to the securities discussed in this commentary may involve risks not discussed herein and any such decisions should not be based solely on the information contained in this document. It should not be assumed that any securities discussed in this commentary will increase in value. Highland Capital Management Fund Advisors, L.P. ("Highland") will not accept liability for any loss or damage, including, without limitation, any loss of profit that may arise directly or indirectly from use of or reliance on such information.

Statements in this communication may include forward-looking information and/or may be based on various assumptions. The forward-looking statements and other views or opinions expressed herein are made as of the date of this publication. Actual future results or occurrences may differ significantly from those anticipated and there is no guarantee that any particular outcome will come to pass. The statements made herein are subject to change at any time. Highland disclaims any obligation to update or revise any statements or views expressed herein.

In considering any performance information included in this commentary, it should be noted that past performance is not a guarantee of future results and there can be no assurance that future results will be favorable. Nothing contained herein should be deemed to be a prediction, projection or guarantee of future performance. Any targets contained herein have been prepared and are set out for illustrative purposes only, and no assurances can be made that they will materialize. They have been prepared based on our current view in relation to future events and various estimations and assumptions made by us, including estimations and assumptions about events that have not occurred, any of which may prove to be incorrect. Therefore, the forecasts are subject to uncertainties, changes (including changes in economic, operational, political, sovereign or other circumstances) and other risks, including, but not limited to, broad trends in business and finance, legislation and regulation, monetary and fiscal policies, interest rates, inflation, currency values, market conditions, all of which are beyond our control and any of which may cause the relevant actual, financial and other results to be materially different from the results expressed or implied by such forecasts.

No representation or warranty is made concerning the completeness or accuracy of the information contained herein. Some or all of the information provided herein may be or be based on statements of opinion. In addition, certain information provided herein may be based on third-party sources, which information, although believed to be accurate, has not been independently verified.

Highland and/or certain of its affiliates and/or clients hold and may, in the future, hold a financial interest in securities that are the same as or substantially similar to the securities discussed in this commentary. No claims are made as to the profitability of such financial interests, now, in the past or in the future and Highland and/or its clients may sell such financial interests at any time.

The information provided herein is not intended to be, nor should it be construed as an offer to sell or a solicitation of any offer to buy any securities. This commentary has not been reviewed or approved by any regulatory authority and has been prepared without regard to the individual financial circumstances or objectives of persons who may receive it. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Highland encourages any person considering any action relating to the securities discussed herein to seek the advice of a financial advisor.

[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