The Priority Senior Secured Income Fund

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The Priority Senior Secured Income Fund (PSSI) is the first registered investment company that invests primarily in leveraged loans and CLOs. Unlike the mutual funds with which most retail investors are familiar, PSSI investors are not able to redeem shares daily at PSSI's net asset value. PSSI is not listed on an exchange and traded like a closed-end fund and so investors will have neither an observable market price nor any opportunity to sell shares in the secondary market.

PSSI, like other non-traded investments, is an extremely high cost offering. Its upfront fees of at least 9% and annual fees of over 8%, in addition to the high cost of its underlying structured finance investments, require persistently high returns on its portfolio to generate a positive internal rate of return for fund investors. The increased risks borne by investors to generate that return are complex and are not likely to be appreciated by brokers or retail investors.

I. Introduction

Over the last decade there has been a growing number of "non-traded" investments, including non-traded real estate investment trusts (REITs) and business development companies (BDCs). Non-traded investments straddle the line between exchange-traded REITs and BDCs and private placement securities, such as hedge funds and limited partnerships. Non-traded investments are registered as investment companies with the SEC, and their shares can therefore be sold to retail investors, but are not listed on any public exchange. Non-traded REITs and BDCs are controversial: they haven't provided accurate mark-to-market values, are highly illiquid, charge high upfront fees and contain numerous conflicts of interest.

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On May 9, 2013, one of the largest sponsors of non-traded REITs (Behringer Harvard) and the manager of one of the largest publicly traded BDCs (Prospect Capital Management) announced the initial public offering for their new joint-effort Priority Senior Secured Income Fund (PSSI).[2] PSSI has many of the controversial features of non-traded REITs and BDCs, including high upfront fees, lack of price transparency, lack of liquidity and a remarkable 2/20 ongoing management fee, which is common in hedge funds but not in retail investments.

PSSI is a non-traded closed-end fund that will invest approximately 80% of its assets in senior secured loans, either directly or through junior and equity tranches of collateralized loan obligations (CLOs). Senior secured loans, also known as 'leveraged loans,' are private loans made to medium to large below investment grade companies. CLOs are complex asset-backed securities built upon portfolios of such loans, and the equity and junior tranches are typically the most risky class of CLO investments. While such a strategy would not be suitable for anyone without significant investment expertise, shares of PSSI are currently being sold through brokers to retail investors.

In this paper, we describe the structure and objectives of PSSI and illustrate its excessive costs and uncompensated risks. We develop an analysis that suggests PSSI will have to achieve 8.4% returns on its underlying investments each year to overcome the draconian annual fees, and that such returns are not characteristic of the senior secured loan market over long periods of time. Therefore, in order for PSSI to generate positive returns to investors, it must use leverage or other risky strategies (through the use of high-risk tranches of CLOs) which may not be understood by brokers or suitable for retail investors.

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[2] The initial offering document dated May 9, 2013 (accessed May 23, 2013) can be found at: http://www.sec.gov/Archives/edgar/data/1554625/000104746913005806/a2214895z497.htm; references to this document will follow the abbreviation "PSSI PPM pg. ###" where ### is the page number.

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II. The Issuers

Behringer Harvard is a Dallas-based issuer, manager, and distributer of more than $6 billion in equity real estate limited partnerships and non-traded REITs.[3] Its non-traded REITs include Behringer Harvard REIT I, which is the subject of a class action suit alleging that the REIT misrepresented its share value to investors.[4] As we have discussed in a white paper on non-traded REITs, these investments were not required to inform investors of changes in the values of their underlying assets (and thus the value of the investors' shares) for many years. Instead, the value of non-traded REIT shares was reported at historical cost, even during the precipitous decline in real estate values in 2008.[5] In fact, this lack of price transparency was highlighted in marketing materials as an advantage of non-traded investments (a 'lack of volatility'), until such claims were specifically prohibited by the SEC.[6]

The SEC has since required non-traded REITs' management to report estimated per share net asset values. While these values are still not market prices and allow significant discretion, the per share estimates for some Behringer Harvard non-traded REITs show significant declines in value from their offering prices. For example, Behringer Harvard REIT I has most recently reported a per share value of $4.64, having been sold at $10 as recently as 2009.[7] Likewise, Behringer Harvard Opportunity REIT I, which was also sold at $10 per share, has a current estimated value of $3.58.[8] Many of the issues and criticisms that have arisen in regards to non-traded REITs also apply to PSSI, which also will not have an observable market price.

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[3] Press Release dated July 31, 2012. http://pressroom.behringerharvard.com/2012-07-31-Behringer-Harvard-and-Prospect-Capital-Management-Announce-Joint-Venture-to-Launch-Alternative-Investment-Programs

[4] Hohenstein v. Behringer Harvard REIT I, Texas Northern district court, filed Septermber 17, 2012.

[5] Husson, McCann, and Taveras (2012). "A Non-Traded REITs Primer." Available at www.slcg.com/research.php

[6] SEC Corporate Finance Disclosure Guidance: Topic No. 3 dated December 19, 2011. Available at http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic3.htm

[7] Behringer Harvard REIT I 10-K for year ended December 31, 2012. http://www.sec.gov/Archives/edgar/data/1176373/000117637313000003/behringerharvardreitiinc10.htm

[8] Behringer Harvard Opportunity REIT I 10-K for year ended December 31, 2012. http://www.sec.gov/Archives/edgar/data/1308711/000104746913003591/a2213978z10-k.htm

Prospect Capital Management is the investment advisor for Prospect Capital Corporation (ticker: PSEC), one of the largest traded BDCs. Prospect Capital Corporation is notable for its relatively large portfolio of $214.6 million in equity and $27.3 million in junior debt tranches of CLOs as of June 30, 2012.[9] Prospect Capital Management's role in PSSI will be to "lead the investment strategy for each investment program that the partners co-advise." Behringer Harvard "will lead capital-raising for such alternative investment programs through its relationships with a wide network of independent financial advisors."

III. Leveraged Loans

Leveraged loans are loans issued to below investment grade corporations.[10] The loans are frequently large and extended by a syndicate of lenders intending to re-sell participations in the loans to other banks and institutional investors including hedge funds, mutual funds and CLO trusts.

Standard and Poor's (S&P) and the Loan Syndications and Trading Association (LSTA) produce benchmark indices of the market value of leveraged loans. Figure 1 plots the price and total return indexes from 2008 to 2013 for the largest loans of the type securitized into CLOs.[11] The index level declined substantially in late 2008 and has rebounded since. This leveraged loan market pattern coincides with the high yield bond market decline and rebound.[12] Notably, the average annual return of the total return index is only 6% from 2002-2012, suggesting that PSSI may not be able to clear its 8.4% break-even rate of return in most years investing solely in leveraged loans. Those returns are presented in Figure 1.

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[9] Prospect Capital Corporation 10-K for fiscal year ended June 30, 2012. http://www.sec.gov/Archives/edgar/data/1287032/000104746912008467/a2210797z10-k.htm. According to this 10-K, the maximum portfolio allocation to Senior Secured Loans and CLO assets is limited to 30%.

[10] The qualifier "leveraged" might just as well be replaced with "high-yield" but we follow industry convention and refer to them as leveraged loans. For an extended discussion of this market please see Antczak, Lucas and Fabozzi [2009], Tavakoli [2008] and Standard and Poor's [2011].

[11] www.standardandpoors.com/indices/sp-lsta-leverage-loan-100-index/en/us/?indexId=SPFI--LL--USD----T-------

[12] The decline in the market value of leveraged loans in July 2007 was as a result of credit risk not liquidity risk as credit spreads on these loans increased dramatically in July 2007. See slide 23 of www.lsta.org/assets/0/190/9DA26E16-92D9-4420-B866-08D22D896ACB.pdf.

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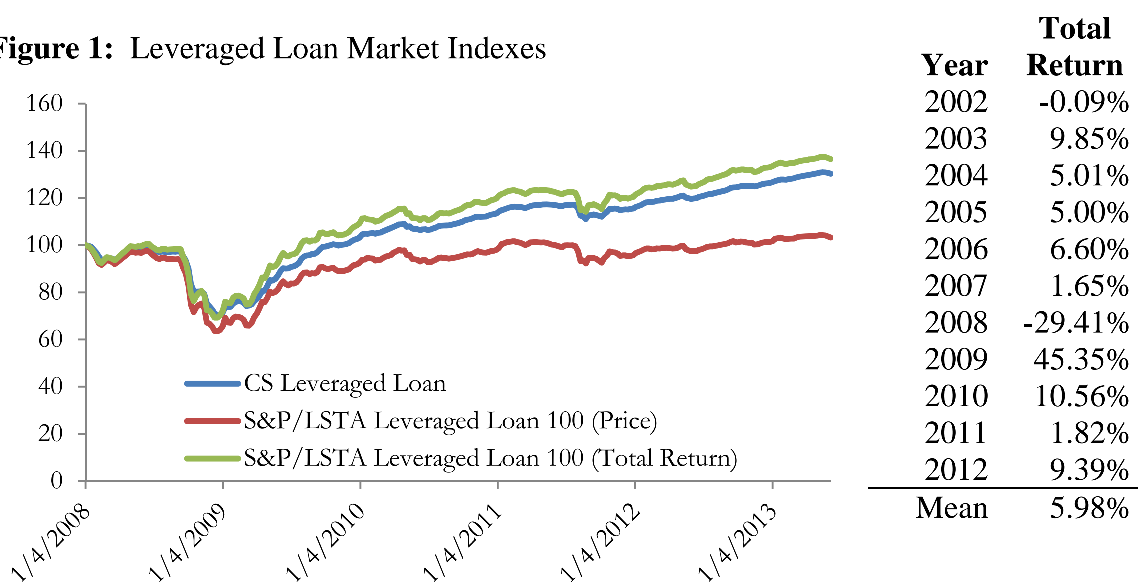

Year	Total Return
2002	-0.09%
2003	9.85%
2004	5.01%
2005	5.00%
2006	6.60%
2007	1.65%
2008	-29.41%
2009	45.35%
2010	10.56%
2011	1.82%
2012	9.39%
Mean	5.98%

IV. Collateralized Loan Obligations

Collateralized Loan Obligations (CLOs) are securities issued by a trust which invests in leveraged loans. CLO trusts package exposure to the underlying leveraged loans into slices (called 'tranches') that represent varying degrees of risk. The leveraged loans serving as collateral for the CLO produce cash flows that used to pay the CLO investors. To illustrate the properties of CLO's, we will use the *Madison Park Funding IX, Ltd. CLO* ("Madison Park") and the *Halcyon Loan Advisors Funding 2012-1 Ltd. CLO* ("Halcyon"). We choose these as our examples because Prospect Capital Corporation invested in these two CLOs and PSSI will likely make similar investments.[13]

The Madison Park CLO was a $523 million deal at issuance with several tranches paying fixed interest, floating interest based on LIBOR or residual interest (in the case of the subordinated notes). Figure 2 shows the capital structure of the Madison Park CLO.

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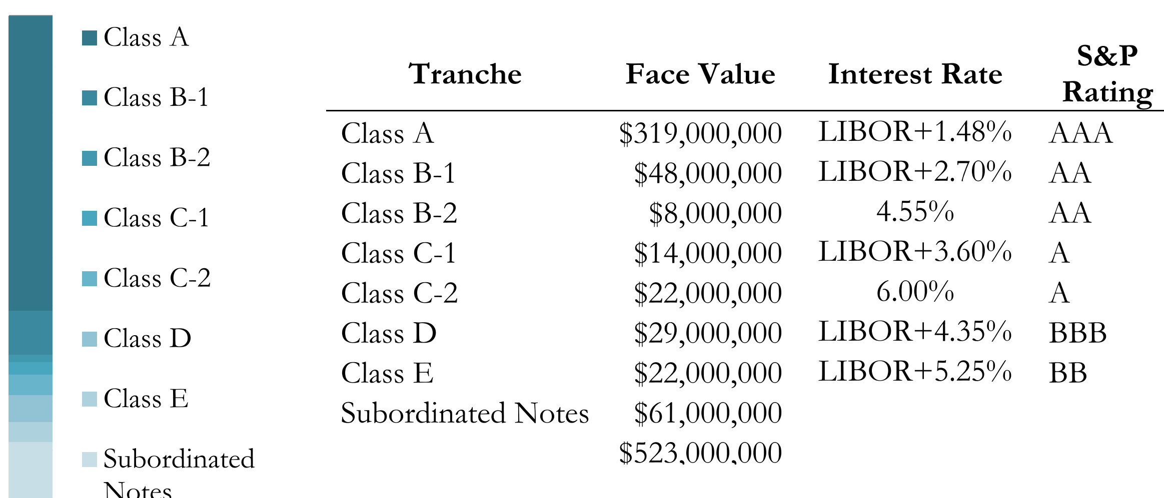
[13] Prospect Capital Corporation 10-K for fiscal year ended June 30, 2012. http://www.sec.gov/Archives/edgar/data/1287032/000104746912008467/a2210797z10-k.htm. Prospect Capital Corporation purchased 51% of the subordinated notes in Madison Park on June 22, 2012 and purchased 62.9% of the subordinated notes in Halcyon on August 6, 2012.

Figure 2: Capital Structure of Madison Park Funding IX, Ltd. CLO



Tranche	Face Value	Interest Rate	S&P Rating
Class A	$319,000,000	LIBOR+1.48%	AAA
Class B-1	$48,000,000	LIBOR+2.70%	AA
Class B-2	$8,000,000	4.55%	AA
Class C-1	$14,000,000	LIBOR+3.60%	A
Class C-2	$22,000,000	6.00%	A
Class D	$29,000,000	LIBOR+4.35%	BBB
Class E	$22,000,000	LIBOR+5.25%	BB
Subordinated Notes	$61,000,000		
	$523,000,000		

The Class A notes at the top of the Madison Park capital structure have the first priority in terms of interest payments and principal repayment and so is the least risky tranche. The equity tranche referred to in this deal as the Subordinated Notes is unsecured, subordinated and highly leveraged.

Investors in the Madison Park CLO are paid interest quarterly from the interest proceeds of the collateral, after base management fees, hedging costs and expenses are paid. The remaining proceeds are then used to pay accrued and unpaid interest to the Class A investors, then the Class B investors. At this point, the first "coverage test" is applied. If the test is passed, the remaining proceeds are used to pay Class C investors. Another coverage test is then applied. Remaining proceeds then pay the Class D investors, another coverage test is applied, then the Class E investors and a final coverage test is applied. Table 1 summarizes the criteria for the coverage tests.

Table 1: Summary of Coverage Tests for Madison Park Funding IX, Ltd. CLO

Tranche	Required Overcollateralization Ratio	Required Interest Coverage Ratio
A/B	123.3%	120.0%
C	113.2%	115.0%
D	107.1%	107.5%
E	103.2%	102.5%

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In the first few years of the deal, if the senior notes are not sufficiently collateralized then the remaining interest proceeds will be used to increase the collateralization of the senior notes. The subordinated management fee, administrative expenses and addition hedging costs are deducted from the remaining proceeds. If any proceeds remain, the subordinated notes may now be paid interest. If the annualized internal rate of return of the subordinated notes increases beyond 12%, an incentive management fee is then deducted from the remaining proceeds. Any proceeds remaining are paid to the subordinated notes. Principal repayment follows a similar payment waterfall where, again, the subordinated notes receive the leftovers resulting from the payment of fees, expenses and the senior tranches – if any remain.

The Halcyon CLO was a $359 million deal at issuance with several tranches paying floating interest based on LIBOR or residual interest (in the case of the subordinated notes). Figure 3 shows the capital structure of the Halcyon CLO.

Figure 3: Capital Structure of Halcyon Loan Advisors Funding 2012-1 Ltd. CLO

Tranche	Face Value	Interest Rate	S&P Rating
Class A-1	$230,000,000	LIBOR+1.50%	AAA
Class A-2	$32,000,000	LIBOR+2.50%	AA
Class B	$30,000,000	LIBOR+3.00%	A
Class C	$15,000,000	LIBOR+5.25%	BBB
Class D	$15,000,000	LIBOR+5.50%	BB
Subordinated Notes	$36,875,000		
	$358,875,000		

The payment waterfall for the Halcyon CLO is similar to the Madison Park CLO waterfall with a few exceptions. First, the incentive management fee is applicable when the subordinated notes realize an internal rate of return of 20%. Also, the level of overcollateralization and interest coverage required to pass the coverage tests is different. Table 2 summarizes the criteria for passage of coverage tests in the Halcyon CLO.

Table 2: Summary of Halcyon Loan Advisors Funding 2012-1 Ltd. CLO Coverage Tests

Tranche	Required Overcollateralization Ratio	Required Interest Coverage Ratio
A	123.6%	120.0%
B	111.9%	115.0%
C	108.0%	110.0%
D	104.7%	105.0%

The leveraged exposure to the underlying leveraged loans in each of these CLOs can be approximated by taking the ratio of total invested capital to the liquidation preference of the equity tranche. In the case of the Madison Park CLO, the leverage is approximately 8.6 and, in the case of the Halcyon CLO, the leverage is approximately 9.7. If the underlying collateral is adversely affected by market conditions, the coverage tests may begin to fail and at that point the likelihood of the equity tranche receiving any payments through the deal is greatly diminished.

V. Current CLO Market and Implications

While large amounts of CLO assets were issued in the run-up to the financial crisis of 2008, issuance declined to near zero in subsequent years. Mutual funds and exchange traded funds (ETFs) also invest in leveraged loans are competing with CLOs for the same underlying assets.[14]Although still small compared to the levels seen prior to the financial crisis, the issuance of CLOs has grown in the past 18 months. CLO issuance increased dramatically in the second half of March ahead of the April 1, 2013 effective date of a new FDIC rule that will increase regulatory capital requirements for banks investing higher risk securitizations.[15]

[14] Leveraged loan ETFs include the PowerShares Senior Loan Portfolio (BKLN) and the SPDR Blackstone/GSO Senior Loan ETF (SRLN), with a combined $4.5 billion in assets. Leveraged loan mutual funds include the Invesco Senior Loan fund (VSLAX) and the PIMCO Senior Floating Rate Fund, amongst many others.
[15] 76 Federal Register 10672.

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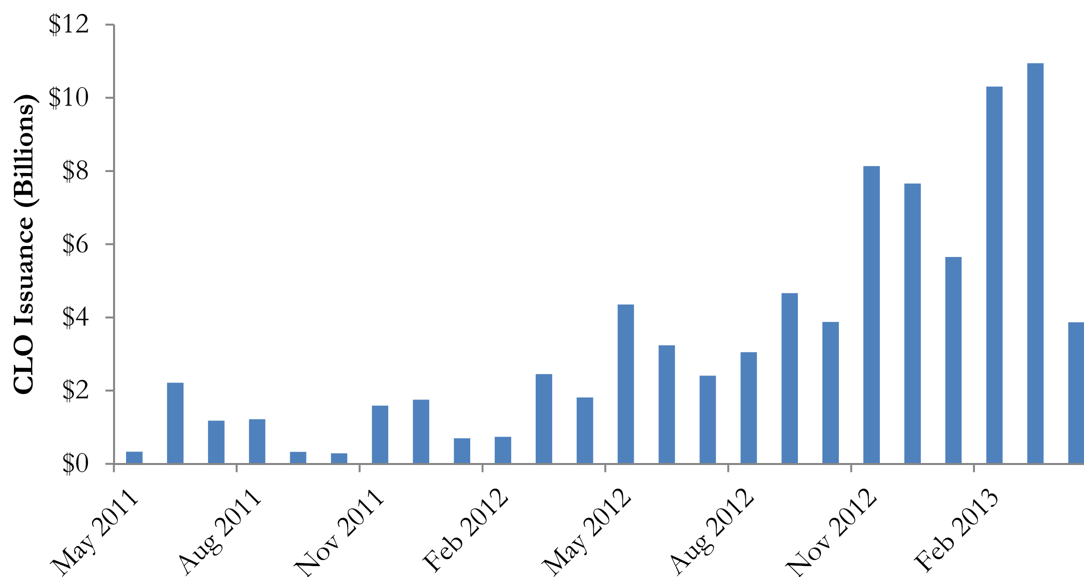
Figure 4: Recent Volume of CLO Issuances[16]



PSSI's prospectus states that during the investment period, the proceeds will be invested "cash, cash equivalents, U.S. government securities, money market funds, repurchase agreements and high-quality debt instruments maturing in one year or less from the time of investment".[17] Because the fees on PSSI are much higher than the yields on such instruments, the net asset value on the fund will likely decrease substantially during this period. The prospectus also states that regular cash distributions are to be determined quarterly and paid monthly starting within one calendar year of the completion of the minimum offering.[18] Any distributions made before significant CLO assets could be purchased would either be a return of investor principal or proceeds from borrowing.

The PSSI prospectus makes the following claim regarding CLO assets and their relative risk and return tradeoff:

> The most junior tranches of all U.S. CLOs (typically referred to as CLO equity tranches) have delivered nearly 21% annual average cash yields since January 2003, as shown in the chart below, and, according to Moody's CLO Interest (July

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[16] Bloomberg Leveraged Finance Brief, May 2, 2013
[17] PSSI PPM pg. 13.
[18] PSSI PPM pg. 17.

> 2012) no CLO issued since 2002 has suffered a principal loss on a rated debt tranche (including during the credit crisis).[19]

Many investors will not realize that while both statements may be technically accurate, they are misleading with respect to the PSSI portfolio.

First, PSSI will invest mainly in equity tranches. Most US CLO equity tranches are *unrated* and therefore the fact that rated tranches have not suffered principal losses is irrelevant to assessing the riskiness of PSSI. Second, equity tranches are typically not secured, and technically have no principal amount that could be written down *even if* its mark-to-market value of the tranche has declined. Put differently, CLOs are often under no obligation to return the amount invested in an equity tranche, only income remaining after paying all other tranches (if any). In a similar sense, most distressed bonds do not suffer principal losses as defined in the context of a CLO, even though there is a significant chance an investor may lose some of their investment. The important point is that equity and junior CLO tranches are typically very highly leveraged and "are subject to a higher risk of total loss".[20]

[19] PSSI PPM pg. 61.
[20] PSSI PPM pg. 49.

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VI. Fees and Expenses

PSSI embeds significant fees, both upfront and on an annual basis, summarized in Table 3 below. [21]

Table 3: Upfront Fees and Annual Expenses of the Priority Senior Secured Income Fund.

Stockholder Transaction Expenses (Upfront Fees)	
Selling Concession	6%
Dealer Manager Fee	2%
Other Expenses	1.5%-5%
Total upfront expense:	9.5%-13%
Annual Expenses	
Management Fee	2%
Acquired Fund Fees and Expenses	4.75%
Other Expenses	1.65%
Total annual expense:	8.4%

There are additional expenses not included in Table 3. An example is the incentive fee, which is contingent upon the performance of the underlying assets exceeding the fixed fees for the fund by an amount that exceeds PSSI's hurdle rate of 6% annually. In addition, performance fees charged on the underlying assets would also increase annual expenses depending on returns.

Expenses are increased through the use of leverage. For example, if PSSI's Advisor borrows 10% of fund assets, this borrowing increases the base management fee by 10%. This borrowing would also incur interest costs that are not included in the annual expense estimates. If the interest rate is 5%, these two expenses alone would increase the annual expenses to over 9%.

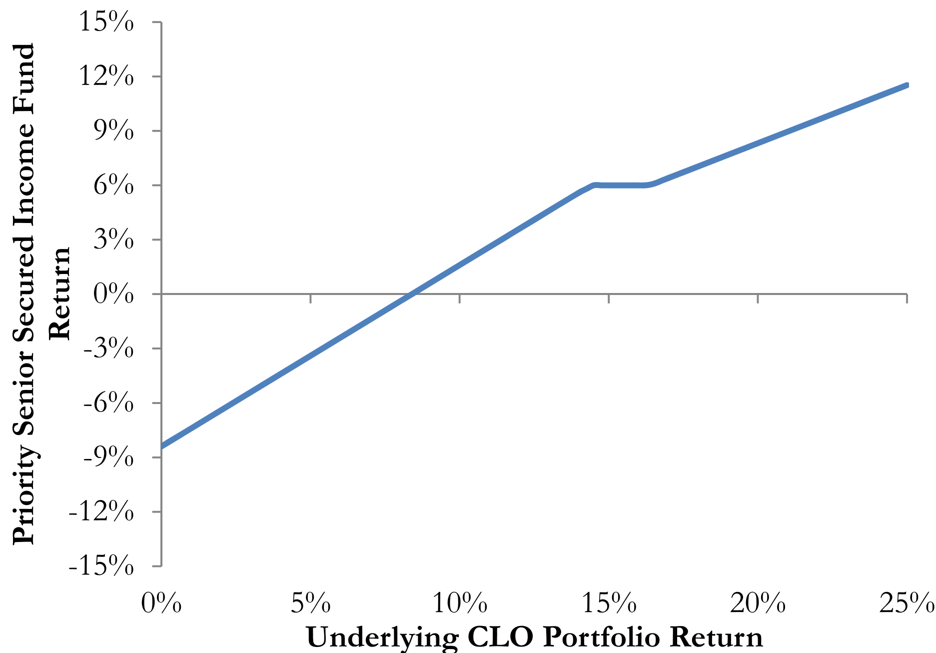
To illustrate the detrimental effect of these fees on investors, we assume that the fund invests all net proceeds into CLOs with uniform base expenses.[22] We assume that

[21] We use the "Fees and Expenses" table (PSSI PPM pg. 19).
[22] This is not an unreasonable assumption given the following quote: "The foregoing estimate assumes that 95% of the net proceeds of this offering are invested in CLOs" from PSSI PPM pg. 21.

incentive fees for the underlying CLOs are also uniform in their structure and that fees are based upon a hurdle rate of 14% and at a marginal rate of 20%.[23]

In Figure 5, we plot the annualized return an investor realizes as a function of the underlying CLO portfolio return. Due to the significant annual fees, the investor does not realize positive returns unless CLO assets return at least 8.4%. As the level of CLO asset returns increases, the net return also increases until the 6% hurdle rate is reached (CLO return of about 14.5%) for PSSI's incentive fee. After that point, the returns do not increase again until the net return reaches approximately 16%. When the investor returns do increase again, they do so at a slower pace as a result of the performance fee structure of PSSI. These annual fees make it more difficult for the investor to recoup the upfront fees charged by PSSI.

Figure 5: Priority Senior Secured Income Fund net return as a function of the return of the underlying CLO portfolio gross returns.



If the underlying CLO investments return 10% a year, every year, it would take more than 6 years for PSSI to return the investors' initial investment after the fees of the

[23] This is consistent with Footnote (9) on PSSI PPM pg. 21 and in line with the Madison Park CLO and Halcyon CLO discussed above.

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underlying CLOs are taken and PSSI fees are applied. If the underlying equity CLO tranches return 20% a year, it would take about 2.5 years to realize a 4% internal rate of return. Table 4 summarizes the result of these calculations for various levels of underlying CLO equity tranche returns and various internal rates of return.

Table 4: Number of Years Required to Obtain an Internal Rate of Return Given a Level of Underlying Asset Returns (NP = Not possible).

		Fund Asset Return			
		10%	15%	20%	25%
Internal Rate of Return	0%	6.3	1.7	1.2	0.9
	2%	NP	2.6	1.7	1.1
	4%	NP	5.2	2.5	1.4
	6%	NP	NP	4.6	2.0

Such high, consistent returns are not possible without extraordinary risk. In order for PSSI to return 6% per year to investors in two years—the average total return of the S&P/LSTA Leveraged Loan 100 index—the underlying assets would have to return at least 25% according to Table 4. This suggests that PSSI would have to leverage their exposure to leveraged loans, likely through the use of risky first-loss tranches of CLOs.

VII. Liquidity and Transparency

Shares of PSSI will likely be very illiquid. The prospectus states that "you should not expect to be able to sell your shares regardless of how we perform" and "[i]f you are able to sell your shares, you will likely receive less than your purchase price".[24] On the other hand, the issuers intend to implement a limited share repurchase program in which the total amount of shares that can be repurchased is limited to 20% of the weighted-average shares outstanding.[25]

There will be limited price transparency for the underlying assets purchased by the fund. If there is no secondary market data available for the underlying CLO assets, the fair value of the securities in the PSSI's portfolio will be estimated. PSEC, Priority

[24] PSSI PPM pg. 1.
[25] PSSI PPM pg. 13.

Capital Management's traded BDC, uses the discounted cash flow model to estimate the fair value of their CLO assets. Presumably, they would use similar approaches to value PSSI's assets as well. However, like other non-traded investments, they may not report this value to investors, either at the time of purchase or on an ongoing basis, and the price investors pay will likely not be based on this analysis.

VIII. Conclusions

The Priority Senior Secured Income Fund is the first so-called "40 Act" fund that will primarily invest in leveraged loans and CLOs. PSSI, like other non-traded investments, is an extremely high cost, illiquid, and risky offering. Its upfront fees (at over 9%) rival that of non-traded REITs, while its ongoing fees are very similar to the 2/20 fee structure employed by hedge funds. PSSI will not be listed on a public exchange and therefore have no observable market price nor any opportunity to sell shares in the secondary market. PSSI's portfolio of leveraged loans and junior and equity tranche CLO assets must be highly leveraged to overcome the onerous fees and expenses.

The question for investors is whether the enormous fees are worth the increased risk that comes from that leverage, as well as the risks inherent to equity and junior tranches of CLOs. Given that the CLO market consists of mostly institutional investors, it is unclear whether retail investors or their brokers could collect sufficient market data to accurately answer that question. To our knowledge, there are currently no publicly available indexes that track equity or junior mezzanine tranche CLO returns, and most market research and analysis of this type of security is not publicly available. Therefore it is unclear whether PSSI would be suitable for retail investors, even if they were willing to accept the enormous fees embedded in this product.

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