

Discovery Group

1Q Preview: Results Take a Back Seat to Activist Pressure—We Discuss Common Themes of Overhead and Debt Reduction, plus the Differing Plans to Create Value as Outlined by Mgmt. and the Activist

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Summary and Recommendation

Buy-rated HC2 Holdings (HCHC, \$8.30 PT) reports 1Q20 results after market close on Monday, 5/11, and will host its EPS call at 5:00PM ET (dial-in: 1.877.300.8521; ID: 10143550). We model revenues/adjusted EBITDA of \$371M/\$18M from HCHC's core operating subsidiaries (construction, marine services, telecom, and energy), and outline our 1Q expectations for the segments in Exhibit I: "Segment Level Estimates" on page 2. We are the only analyst with published estimates. While mgmt. provided a business update on 3/23 regarding COVID-19 impacts (refer to our [flash note](#)), we believe 1Q results take a back seat, as recent activist pressure is top of mind for stakeholders. Recall, MG Capital filed a 13D in January and sent a letter to shareholders expressing concerns about corporate governance issues, conflicts of interest, balance sheet mismanagement, and high corporate expenses. At this juncture, MG Capital is running a proxy contest, having communicated a detailed plan describing the case for change, as well as a strategy to restore shareholder confidence, which could narrow the discount between HCHC's NAV and market valuation. Mgmt. in turn has communicated its "growth & innovation" plan. Meanwhile, two additional 13D filers have appeared. At this stage, it is clear to us that HCHC has engaged stockholders with 'skin-in-the-game' calling for change, with MG Capital the most vocal agent. In this note, we not only discuss the common underlying themes of corporate overhead and debt reduction, but also the difference of opinion on asset monetization and go forward strategy. In sum, we believe shareholders should carefully evaluate mgmt.'s proposed "growth and innovation" story vs. the activist's "crown jewels" approach. We also emphasize the HoldCo's senior secured notes will be current in November. In that regard, shareholders must consider who is best positioned to access the capital markets to refinance the debt, at an appropriate cost of capital, should the shot clock expire before assets are monetized. We reiterate our Buy, as we believe there are multiple catalysts on the horizon that could unlock shareholder value.

Key Points

- **1Q20 estimates.** We model revenues/adjusted EBITDA of \$371M/\$18M from HCHC's core operating subsidiaries (construction, marine services, telecom, and energy). We model 1Q adjusted EBITDA of \$9M for the construction segment, which is lower than \$12M from the year ago period, due to our cautious posture on the current business environment given the pandemic. As of 3/23, mgmt. note the construction segment was still operating on projects, though certain job sites/operations were impacted due to COVID-19. We also model partial sales/EBITDA contribution from the Global Marine Group within the marine services segment, as HCHC completed to asset sale on 3/2. Specifically, we pencil in adjusted EBITDA of \$5M (including contributions from the JV stakes). We remind investors: per the company's 3/16 earnings conference call, mgmt. anticipated receiving ~\$60M of cash proceeds for the 30% Huawei Marine Networks (HMN) JV stake sold to Hengtong Optic-Electric in early 2Q, specifically, in the "first week or two of April". We look to update on status, as we anticipate the proceeds to be used to redeem HCHC's 11.5% senior secured notes due 2021. We further forecast (\$7M) of loss contribution from HCHC's life sciences, broadcasting, and other investments, and a pre-tax adjusted operating profit from the insurance division. Finally, we model corporate expenses of \$6M for the quarter. (Refer to Exhibit I: "Segment Level Estimates" on page 2 of this report for details.)
- **Continued on page 2.**

STOCK DATA			
Market Cap (mil)			\$130.5
52-Week Range		\$1.29 – \$4.33	
3-Month ADTV			375,528
Shares Outstanding (mil)			46.6
Float (%)			76.2
Short Interest		3,358,217	
Enterprise Val. (mil)			\$936.9
Fiscal Year-End			December
EARNINGS DATA			
EBITDA (mil) Operating	2019A	2020E	2021E
1Q	\$14.3	\$17.9	—
2Q	\$34.8	\$6.0	—
3Q	\$34.2	\$17.1	—
4Q	\$43.5	\$27.2	—
FY	\$126.8	\$68.2	\$80.9
EV/EBITDA	7.4x	13.7x	11.6x
<i>Core subsidiaries EBITDA (Construction, Marine Services, Telecom, and Energy segments).</i>			
FINANCIAL DATA			
FY	2019A	2020E	2021E
Rev. (mil)	\$1,984.1	\$1,714.7	\$1,671.6
ROE	(0.1)%	(0.3)%	(0.3)%
Debt/Capital	64.3%	68.3%	71.8%
BV/Share	\$6.38	\$3.56	\$2.76
BALANCE SHEET DATA			
			4Q19
Cash & Equivalents			\$239.0
Accounts Receivable			\$337.8
Accounts Payable			\$339.6
Total Debt			\$839.3
Shareholders' Equity			\$349.8
Debt/Cap			0.0%
<i>\$ in millions unless otherwise specified. Cash & equivalents includes ~\$170M in "Insurance" segment.</i>			

Analyst certification and important disclosures can be found on pages 10 - 13 of this report.

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Exhibit I: Segment Level Estimates

B. Riley FBR, Inc. Estimates			
1Q20 (E) (\$Ms)	Revenues	Adj. EBITDA	Adj. EBITDA Margin %
Construction	\$170.0	\$9.0	5.3%
Marine Services	\$31.3	\$4.6	14.7%
Telecom	\$160.0	\$0.7	0.4%
Energy	\$9.3	\$3.6	38.7%
Core Total	\$370.6	\$17.9	4.8%
Life Sciences	\$0.0	(\$5.0)	NM
Broadcasting	\$10.5	(\$1.7)	-15.7%
Other	\$0.0	\$0.0	NM
Corporate	\$0.0	(\$6.3)	NM
Total, ex. Insurance	\$381.1	\$5.0	1.3%
	Revenues	Pre-tax AOI	
Insurance	\$80.0	\$10.0	

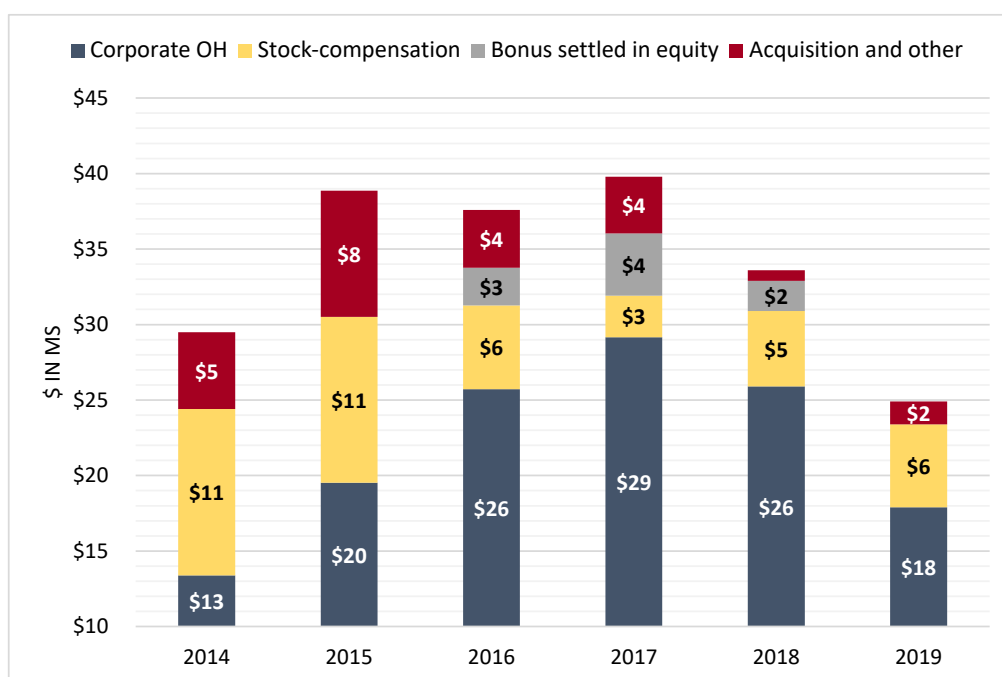
Source: B. Riley FBR Research

Three 13D's, two shots on goal, one boardroom. Recall, on 1/27 MG Capital filed a 13D and sent a letter to shareholders expressing concerns about corporate governance issues, conflicts of interest, balance sheet mismanagement, and high corporate expenses. On 2/18, MG Capital nominated a full slate of candidates for election to overhaul the company's BOD, and on 3/13, the activist launched a consent solicitation to remove the company's CEO and current directors. The company subsequently separated the roles of Chairman and CEO, both of which were held by Phil Falcone, and installed current board member Warren Gfeller as interim Chairman on 4/1. CEO Phil Falcone sent a letter to shareholders outlining the "vision" for creating value at HCHC, including acquiring companies the mgmt. team believes are undervalued and uniquely positioned to achieve growth and profitability. On 4/3, MG Capital furnished a consent statement and green consent card seeking shareholder votes for the "Bylaw Restoration Proposal", "Removal Proposal", and "Election Proposal". MG Capital submitted an updated letter to shareholders on 4/7 in connection with its solicitation to remove the company's directors and refresh the BOD with MG Capital's nominees. JDS1 (an entity managed by Julian Singer) filed a 13D on 4/7, expressing its intent to engage with HCHC's BOD and CEO regarding representation on the slate of nominees for the upcoming annual shareholder meeting. In the same filing, JDS1 opined that other large stockholders should do the same, instead of pursuing a consent solicitation. On 4/13, MG Capital disseminated a comprehensive 97-page plan describing the case for change as well as a strategy to restore shareholder confidence and to reduce the discount between the company NAV and market valuation. At a high level, the plan describes: (1) eliminating conflicts of interest, (2) cutting costs, (3) focusing on EBITDA-generating assets, (4) monetizing non-core assets, (5) systematically reducing HoldCo debt, (6) implementing disciplined asset management, and (7) recovering "misappropriated resources". (For a full overview, we encourage reviewing the filing.) The company's BOD responded by submitting a letter to stockholders, highlighting the merits of HCHC's existing BOD and opposing MG Capital's nominees. In response to MG Capital, HCHC filed a 65-page presentation describing mgmt.'s plan to unlock value through "growth & innovation", including: (1) reducing debt, (2) reducing overhead, and (3) improving governance by refreshing the BOD. The company further categorized the activist's consent solicitation as a smear campaign on 4/16. MG Capital followed up on 4/17 with a "reality check", outlining that (1) the company is attempting to disparage the activist and disingenuously claiming intent to improve governance, (2) there is a growing case for wholesale change at HCHC, and that (3) a better BOD and plan is in reach for shareholders to consider and act on. Shortly after, on 4/21, HCHC announced that Avie Glazer will be included on the company's slate of director nominees for the annual shareholder meeting. If elected, Avie Glazer will be appointed chairman of the board. Following this announcement, JDS1 filed an amended 13D on 4/22 communicating that JDS1 is engaged with the company on further board refreshment actions, and is encouraged by the nomination of Avie Glazer to HCHC's annual director slate. For background, Glazer is the Executive Co-chairman and a Director

of one of the most popular, successful, sports teams in the world - publicly traded Manchester United (of which the Glazer family owns a ~7% economic interest in, while controlling ~97% of the voting power). We note: The Glazer family also owns the Tampa Bay Buccaneers (an NFL team). Avie Glazer is also the principal of Lancer Capital, which filed a 13G on 1/28 stating an ownership stake of ~6.5% of HCHC, with Lancer Capital changing the filing to a 13D on 4/23 to reflect his nomination to the company’s slate of directors. We finally note: Glazer served as President and CEO of Zapata Corporation from 3/1995 to 7/2009. Recall, Zapata Corporate became Harbinger Group (HRG) after the Glazer family sold its controlling interest in Zapata Corporation to Phil Falcone’s Harbinger Capital in 2009. MG Capital called into question the company’s move in the following release, pointing to a culture of “mismanagement and self-dealing”, as well as Glazer’s “documented ties to at least three directors”. As part of HCHC’s presentation, the company noted: Zapata Corporation was a public shell, the sale was facilitated through brokers and lawyers, and that Avie Glazer has not sat on a board with current HCHC board member Warren Gfeller since 2009. On 4/28, the company’s CEO committed to forgoing any potential bonus payments until HCHC’s stock price reaches an average price of at least \$7.50 per share over a 30 day period, while on 5/4 the BOD decided to reduce fees paid to directors by 25%. In the same release, the company announced the annual meeting will be held on 7/8, with stockholders of record entitled to vote as of 5/22, as well as the addition of two new nominees to the company’s slate: Shelly Lombard and Jeffrey Tuder, based on JDS1’s engagement with the company. We note: MG Capital’s consent solicitation deadline is set for 5/12, with consent cards accepted through 5/11. We encourage shareholders to review the proxy advisory firms (ISS, Glass Lewis, and Egan-Jones) respective voting recommendations. It is clear to us that HCHC has three engaged stockholders with ‘skin-in-the-game’ calling for change at the company, with MG Capital the most vocal agent.

Common themes. When reviewing the company’s plan and MG Capital’s plan, the common underlying themes include (1) a reduction to corporate overhead, (2) debt reduction, and (3) asset monetization. First, annual corporate overhead, including stock-based compensation and acquisition-related charges, have averaged ~\$34M per year for the past five years. Stock-based compensation and other bonus in equity has averaged ~\$8M in the same period. Excluding stock-based compensation and acquisition-related charges, adjusted annual corporate overhead expenses have averaged ~\$22M per year since 2014. We note adjusted corporate overhead peaked at ~\$29M in FY17 and has subsequently declined to ~\$18M in FY19. (Refer to Exhibit II: “Corporate OH Expenses” below for details.)

Exhibit II: Corporate OH Expenses

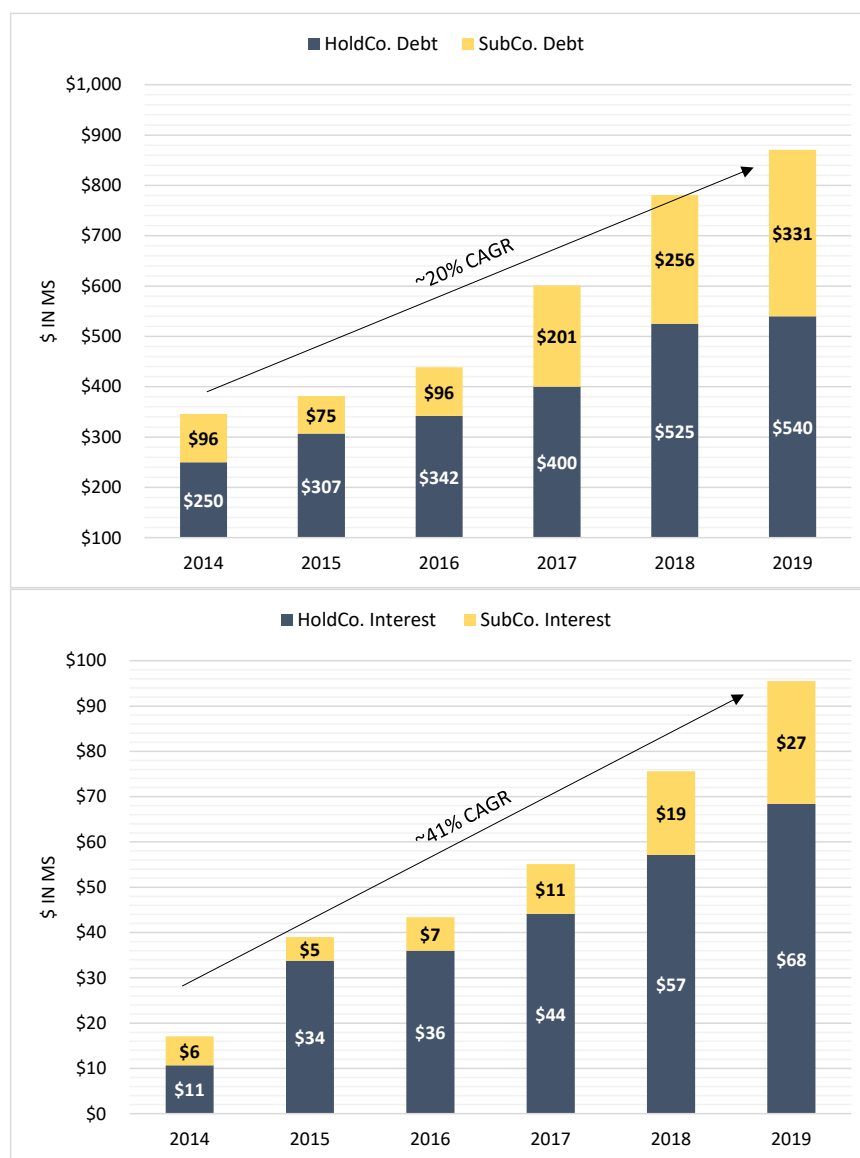


Source: SEC filings, company press releases, and B. Riley FBR Research

Mgmt. has accepted the need to reduce corporate overhead, including compensation, and has worked to reduce expenses from peak FY17 levels. The company expressed additional potential overhead reduction, including real estate expenses, without providing targets/milestones for shareholders to benchmark. MG Capital agrees on the need to reduce corporate spending. In this regard, the activist plans to reduce executive compensation by \$10M-\$15M per year, cut annual director fees and BOD costs by 50%, and reduce real estate, related party fees, as well as other administrative expenses. Thus, a reduction to corporate overhead is a material component to both plans.

A second common theme is debt reduction. In our view, the company’s debt and interest load has swelled to uncomfortable levels under mgmt.’s watch. In this regard, total debt has grown at a ~20% CAGR from 2014 to 2019, with HoldCo debt increasing from \$250M to \$540M, primarily fueled by acquisitions to build HCHC from one asset to a diversified holding company. In pursuing this path, total annual interest expense ballooned at a ~41% CAGR during this period, from ~\$17M to ~\$96M, with HoldCo interest expense of ~\$68M in FY19. (Refer to Exhibit III: “Debt and Interest Expense Growth” below for details.)

Exhibit III: Debt and Interest Expense Growth



Source: SEC filings and B. Riley FBR Research

We believe mgmt. finally received the memo and is now committed to reducing leverage. In this regard, the company undertook an asset monetization plan, including the sale of Global Marine Group, which generated ~\$100M of net cash proceeds and reduced HoldCo debt by ~\$77M. As discussed above, the company expects to use the ~\$60M of cash proceeds from the previously announced 30% HMN JV stake sold to Hengtong Optic-Electric for additional debt reduction. Further, the company must continue to monetize assets to accomplish mgmt.'s stated objective of fully paying down the outstanding 11.5% senior secured notes. As a reminder, our SOTP valuation analysis contemplates the construction segment's value at \$455M (of which HCHC owns 92.5%) and the insurance segment's value at \$225M. The sale of one or both assets could substantially alter the balance sheet/interest expense profile. Yet, we ponder if buyers would rush to transact in the current business environment, or wait for a more opportune time, especially since HCHC's senior secured notes go current in November. Further, at this stage of the economic cycle, we prefer mgmt. retain a clean leverage profile at the construction segment. In this regard, we would err on the side of caution and not opt-for a leveraged recapitalization strategy – effectively pushing HoldCo debt down to the SubCo level. Thus, we view asset monetization as a key strategy to both the company's and activist's proposal in reducing debt, however, the two plans differ in which assets are harvested.

Choose your destiny. Since inception HCHC pursued a barbell strategy of acquiring controlling stakes in leading, stable, cash flow-generating businesses, and pursuing growth assets with significant equity upside (option value opportunities). In fact, the now infamous 4Q18 debt refinancing event prominently showcased the same strategy in this [presentation](#). That said, mgmt.'s pivot to a “growth and innovation” tactic is fairly recent. In this regard, the company now prefers to focus on the growth assets, which in our view could take several years and require significant capital to properly build out. With mgmt. in advanced discussions to sell the insurance subsidiary, and the company having hired an advisor to explore strategic options for the construction segment (including a potential sale), assuming both transactions are consummated, the company would retain the OTA broadcasting, energy (CNG fueling stations), life sciences portfolio investments (MediBeacon, R2 Technologies, Genovel, Triple Ring, and the BeneVir milestone payment), and wholesale telecom assets. From the remaining assets, the CNG fueling stations and wholesale telecom segment would be the only cash generating businesses. Remember, the life sciences investments and OTA broadcasting assets could require significant growth capital investment for successful commercialization and value creation. While the pivot to a growth and innovation story sounds exciting, attracting an investor base with a mixed portfolio of broadcasting, life sciences, and industrial assets, without a baseline of reliable cash flows, is a difficult task, in our view.

MG Capital's plan focuses the portfolio on the assets generating EBITDA and cash flow, including the construction, insurance, and energy segments. We view this plan as the “crown jewels” approach. As a reminder, the construction segment is the largest EBITDA contributor, generating ~\$76M of adjusted EBITDA in FY19, while the energy segment posted ~\$17M of adjusted EBITDA in FY19 (includes ~\$11M in AFTC tax credits). Meanwhile, the insurance unit distributed ~\$12M in net management fees to the HoldCo in FY19. Assuming MG Capital positions the core portfolio with these assets, one could categorize the company as an industrial holding entity with a cash flowing run-off insurance platform. Therefore, MG Capital's non-core assets would include: OTA broadcasting, the life sciences investment portfolio, and the wholesale telecom business. The activist believes the broadcasting segment could be sold to interested parties, or enter into a JV agreement, with a value net of debt in the \$75M-\$125M range (our estimated net of debt value is ~\$90M – as the ~\$180 valuation in our SOTP is before subsidiary level debt). Further, the life sciences investment portfolio could be sold (~\$200M in a secondary sale, which is in line with our life sciences portfolio SOTP), retain a GP stake (should the portfolio raise outside capital for example), or alternatively reposition to compete with other healthcare PE/VC firms.

In sum, HCHC shareholders should carefully evaluate the proposed plans: mgmt.'s “growth and innovation” story vs. the activist's “crown jewels” approach. With mgmt. pivoting to the growth assets, we believe the strategy could require significant capital investment, and could take several years to properly build out, to realize the upside in the value of the assets. We also highlight execution risk and potential capital allocation missteps (e.g., mgmt.'s history of using inappropriate levels of leverage). On the other hand, the activist's plan focuses the business on two sources of cash flow and a growth asset. We further emphasize the HoldCo senior secured notes go “current” in November.

In this regard, shareholders must also consider who is best positioned to access the capital markets to refinance the debt, at an appropriate cost of capital, should the shot clock expire before assets are monetized.

Valuation

Our price target of \$8.30 is based on a sum-of-the-parts analysis.

Business Unit	Financial Statistic Description	Statistic		Est. Valuation
		(Ms)	Multiple	
DBM Global	FY21E EBITDA - 92.5% ownership	\$65	7.0	\$455
HMN JV 30% stake sale	30% interest sold to Hengtong Optic-Electric	\$285	30%	\$86
HMN JV 19% stake put-option	19% interest under 2-year put-option (\$285M or FMV)	\$285	19%	\$54
ICS Group Holdings	FY21E EBITDA - 100% ownership	\$3	3.0	\$8
Pansend Life Sciences	Cost basis of total investments below (per HCHC filings):			
MediBeacon	42% ownership	\$300	42%	\$125
R2 Dermatology	58% ownership	\$50	58%	\$29
BeneVir Biopharm Inc.	Potential payments to HC2 from milestone achievements	\$512	10%	\$51
Genovel Orthopedics	75% ownership	\$4	0.0	\$0
Triple Ring Technologies	27% ownership	\$3	0.0	\$0
Continental Insurance Group	Total adjusted capital of \$338M	\$338	0.7	\$225
American Natural Gas	69% ownership; valuing at investment cost	\$92	1.0	\$92
HC2 Broadcasting Holdings	Cost basis of total investments (per HCHC filings)	\$179	1.0	\$179
Total Sum of the Parts				\$1,302
Minus:				
Corporate expenses	FY21E Corporate Expenses	\$25.0	5	\$125
Pro forma total debt (incl. capital lease obligations; ex. Global Marine Group sub. debt)				\$713
<u>Less: cash, cash equivalents, restricted cash, and ~\$170M insurance co. cash</u>				<u>\$61</u>
Net debt (cash)				\$653
Less: \$55M conv. notes	Assume conversion into ~12.6M shares of HCHC stock			(\$55)
Preferred stock (\$10M)	Assume conversion into ~2.2M shares of HCHC stock			\$0
<u>Noncontrolling interest</u>				<u>\$73</u>
Total HCHC equity value				\$507
Est. diluted shares	Includes ~14.8M shares of HCHC stock assumed from conversions above			60.8
Est. HCHC Net Asset Value				\$8.34

Source: B. Riley FBR Research

\$ in millions.

Risks

Acquisition/Integration. The company actively evaluates potential acquisitions as part of its growth strategy. Acquisitions pursued by the company could be dilutive to financial results and result in a difficult, dilutive, or expensive integration.

Acquisition/Integration. The company recently completed acquisition(s). If the company fails to successfully integrate the acquisition, the deal may lead to disappointing returns.

Growth plan. There are many factors that may impact the company's ability to achieve its stated growth objectives.

Insider ownership. Directors and executive officers collectively own a significant percentage of the company. While this may align interest with other shareholders, investors might view a future sale by any director or officer negatively.

Liquidity and solvency. The company has a significant debt load and interest expense, which may hamper its ability to invest in the business. Also, the company may need to raise additional capital in the future, and access to such capital is difficult to predict.

General industry. The company could miss our estimates and/or its financial guidance.

Competition. The company operates in a highly competitive environment for acquisition opportunities, including from public companies with similar business strategies, investment partnerships, blank-check companies, private equity firms, among others.

Economy. A decline in economic growth or economic disruptions could have a negative impact on the company's operating units and financial results.

Foreign currency risk. The company has operations outside of the U.S., primarily in the U.K., exposing the company to foreign currency exchange rate fluctuations, which could adversely impact the company's operations and/or financial condition.

Holding company. The company is a publicly traded holding company, and its equity interests in operating subsidiaries and other investments comprise primarily all of its assets. As a result, the company's principal revenue and cash flow is distributions from subsidiaries, which may be limited by law or by contract in making certain distributions to the holding entity. Further, the holding company's ability to service debt and/or to finance future acquisitions are dependent on the ability of subsidiaries to make upstream cash distributions.

Insurance operations. The company's insurance operations are subject to legal restrictions and regulatory requirements, including the amount of statutory capital that must be held to maintain financial strength. Further, financial results from the insurance operations could be negatively affected if actual performance differs from management's assumptions and estimates.

International operations. The company operates in international markets and could in the future pursue additional investments in foreign entities. Exposure to international laws, regulations, politics, taxes, and currency poses risk to the company's operations.

Minority investments. The company owns a minority interest in a number of entities, over which the company does not exercise control and/or has little to limited influence. As a result, the company may be unable to direct or manage those operations to drive value.

Loss of key personnel. The current management team will be instrumental in executing the company's growth strategy. The resignation or loss of a key member of management would have a negative impact on the company.

Significant stockholder security sales. Future sales of substantial amounts of common stock by holders of preferred stock, or by other significant stockholders, could adversely impact the market price of the company's common shares.

*Closing price of last trading day immediately prior to the date of this publication unless otherwise indicated.

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Rating	B. Riley FBR Research Distribution ¹	B. Riley FBR Banking Services in the past 12 months ¹
BUY [Buy]	68.85%	31.63%
HOLD [Neutral]	29.98%	23.44%
SELL [Sell]	1.17%	20.00%

(1) As of midnight on the business day immediately prior to the date of this publication.

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