

Discovery Group

Insurance Segment Receives \$90M Indication of Interest; Reducing PT from \$8.50 to \$5, Reflects Lower Insurance Segment Valuation and Rights Offering Dilution

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Summary and Recommendation

On 12/10, after the market close, Buy-rated HC2 Holdings (HCHC, \$5.00 PT) announced that an entity controlled by HCHC director Michael Gorzynski made a non-binding indication of interest to acquire HCHC's insurance segment for ~\$90M, which is significantly below our prior ~\$240M valuation assumption for this segment. Recall, the insurance division has been under strategic review since the beginning of 2020, and we reason with ~\$340M of senior secured debt going current, any proceeds from the potential divestiture of this asset could be used to reduce debt at the holding company level. Further, the successful completion of the company's previously announced ~\$65M common stock rights offering, partially backstopped by HCHC chairman Avram Glazer's Lancer Capital, helps alleviate the holding company's near-term interest/overhead expenses until a material asset monetization event occurs to reduce the debt load. In our view, the board/mgmt. team must demonstrate more urgency in the sale of one or more assets, as we prefer a better positioned balance sheet ahead of a refinancing event, with sufficient time on the shot clock. We also believe clearly articulating the holding company's strategy could also play an important role in closing the valuation gap between the company's net asset value and share price. That said, we reduce our PT from \$8.50 to \$5.00 as we update our sum-of-the-parts (SOTP) analysis to reflect the lower valuation considered for the insurance segment in the recent indication of interest bid, as well as the dilution associated with the common stock rights offering. We finally note recent insider buys could signal a vote of confidence in the path forward for the company, and the realization of equity value. In this regard, Avram Glazer's Lancer Capital accumulated ~2.9M additional shares at an average price of \$3.45 per share from 12/01-12/08 (bringing its ownership level to ~25%). With ~35% upside to our new \$5 PT, we reiterate our Buy and eagerly wait for a material asset monetization, debt refinancing event, as well as concise messaging from the board/mgmt. regarding the strategy to drive shareholder value.

Key Points

- HCHC director and 6.6% shareholder, Michael Gorzynski, makes \$90M non-binding indication of interest for the insurance segment.** On 12/10, after the market close, HCHC announced that Continental General Holdings made a non-binding indication of interest for the potential acquisition of HCHC's wholly owned insurance subsidiary for ~\$90M. The potential buyer making the indication of interest is an entity controlled by HCHC director, and 6.6% shareholder, Michael Gorzynski. At this juncture, HCHC's board and management must evaluate the offer, engaging an advisor to establish a fairness opinion on the transaction in question. Assuming the board accepts and approves the transaction, we expect a waiting period of at least several months for the receipt/clearance of regulatory approvals. While we welcome the potential for HCHC to divest the insurance segment, we are disappointed in the significant differential between our ~\$240M valuation for the segment, which is based on ~65% of total adjusted capital of \$374M, and the ~\$90M bid representing just 24% of total adjusted capital. We thus reduce our insurance segment valuation assumption to reflect the ~\$90M indication of interest bid received. However, the sale of the insurance segment could simplify the holding company and provide the board/mgmt. team an opportunity to set a clear, thoughtful, and concise roadmap for HCHC's overall go-forward strategy, which we believe both credit and equity investors are itching to learn in greater detail.
- Updating model to reflect the closure of HCHC's ~\$65M common stock rights offering.** On 11/25 the company announced the completion of its previously disclosed ~\$65M common stock rights offering. As a result, HCHC issued ~28.6M new shares of common stock at a subscription price of \$2.27 per share. (Continued on page 2...)

STOCK DATA			
Market Cap (mil)			\$269.7
52-Week Range			\$1.29 – \$4.32
3-Month ADTV			431,083
Shares Outstanding (mil)			73.1
Float (%)			58.3
Short Interest			2,863,646
Enterprise Val. (mil)			\$829.0
Adjusted Enterprise Value (mil)			\$816.8
Fiscal Year-End			December
EARNINGS DATA			
EBITDA (mil) Operating	2019A	2020E	2021E
1Q	\$2.8	\$1.4A	\$(2.0)
2Q	\$27.7	\$15.2A	\$2.3
3Q	\$23.6	\$11.9A	\$10.2
4Q	\$36.7	\$8.1	\$10.8
FY	\$90.8	\$36.6	\$21.3
EV/EBITDA	9.1x	22.7x	38.9x
<i>Total HC2 adj. EBITDA excluding "Insurance" segment</i>			
FINANCIAL DATA			
FY	2019A	2020E	2021E
Rev. (mil)	\$1,984.1	\$1,465.1	\$1,092.0
ROE	(0.1)%	(0.3)%	(0.1)%
Debt/Capital	64.3%	56.8%	58.7%
BV/Share	\$6.38	\$8.47	\$5.14
BALANCE SHEET DATA			
			3Q20
Cash & Equivalents			\$163.6
Accounts Receivable			\$252.3
Accounts Payable			\$298.6
Long-Term Debt			\$633.8
Total Debt			\$646.4
Shareholders' Equity			\$371.8
Debt/Cap			63.0%
<i>\$ in millions unless otherwise specified. Cash & equivalents includes ~\$115M in "Insurance" segment.</i>			

Analyst certification and important disclosures can be found on pages 6 - 9 of this report.

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We therefore expect the company to have ~76.6M shares of common stock issued and outstanding (prior to accounting for dilution associated with HCHC's ~\$55M 7.5% convertible senior notes due in 2022 and ~\$10M participating preferred stock). We believe the company could use the proceeds from the rights offering for debt service and corporate expenses/working capital, until a more material asset monetization event occurs to reduce balance sheet leverage. As such, we revise our model to reflect an incremental ~\$63M of cash (after transaction fees/expenses) added to HCHC's balance sheet, and the dilution associated with a ~60% increase in common shares after this offering, which was completed at a share price substantially below our previous \$8.50 per share SOTP valuation analysis.

- **Reducing PT from \$8.50 to \$5.00.** We decrease our PT from \$8.50 to \$5.00 as we refresh our SOTP valuation analysis to reflect: (1) a lower valuation assumption for HCHC's wholly owned insurance segment from ~\$240M previously (based on ~65% of total adjusted capital) to ~\$90M, which reflects the bid made to acquire the insurance unit from an entity controlled by an informed buyer; and (2) updates to our pro forma cash balance (adding ~\$63M of cash at the holding company, net of transaction fees/expenses), plus increasing the shares outstanding balance (adding ~28.6M newly issued shares) to reflect the common stock rights offering. (Refer to "Sum-of-the-Parts Valuation Analysis" below for details.)

Valuation

Our price target of \$5 is based on a sum-of-the-parts analysis.

Sum-of-the-Parts Valuation Analysis:

Business Unit	Financial Statistic Description	Statistic (Ms)	Multiple	Est. Valuation
DBM Global	FY21E EBITDA - 92.5% ownership	\$65	7.0	\$455
HMN JV 19% stake put-option	19% interest under 2-year put-option (\$285M or FMV)	\$285	19%	\$54
Pansend Life Sciences	Cost basis of total investments below (per HCHC filings):			
Medi Beacon	42% ownership	\$300	42%	\$125
R2 Technologies	56% ownership	\$80	56%	\$45
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 \$374M	\$374	0.2	\$90
American Natural Energy (ANG)	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				\$1,090
Minus:				
Corporate expenses	FY21E Corporate Expenses	\$15.0	6	\$90
Total debt (3Q 2020)				\$665
Less: cash, cash equivalents, restricted cash, ~\$115M insurance co. cash, & ~\$63M proceeds from rights				\$112
Net debt (cash)				\$553
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
Noncontrolling interest				\$53
Total HCHC equity value				\$450
Est. diluted shares	Includes ~14.8M shares of HCHC stock assumed from conversions above			90.6
Est. HCHC Net Asset Value				\$4.96

\$ 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.

Pandemic. The global spread of the novel coronavirus (labeled COVID-19) has created significant uncertainty and economic disruption (both in the near term and, potentially, long term). The extent to which a pandemic could affect the company's operations, financial condition, and supply chain is difficult to predict and depends on evolving factors, including: duration, scope, government actions, and other social responses. The company could, therefore, experience material/adverse impacts to its business and financial results.

HC2 Holdings, Inc. - HCHC

Model (\$ in 000s)

B. Riley Securities

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	2017(A)	2018(A)	2019(A)	Q1-Mar	Q2-Jun	Q3-Sep(A)	Q4-Dec(E)	2020(E)	Q1-Mar	Q2-Jun	Q3-Sep	Q4-Dec	2021(E)
Net revenues	1,634,124	1,976,700	1,984,100	444,800	377,000	393,300	250,000	1,465,100	251,700	272,400	283,100	284,800	1,092,000
Cost of revenue - services	0	0	0	0	0	0	0	0	0	0	0	0	0
Cost of revenue - sales	1,313,069	1,585,205	1,424,900	346,100	262,100	278,700	128,400	1,015,300	135,300	150,400	153,400	154,500	593,600
Insurance benefits and acquisition expenses	108,695	197,324	234,400	72,400	63,000	59,600	65,000	260,000	65,000	65,000	65,000	65,000	260,000
SG&A expenses	182,880	218,442	214,300	52,300	48,100	45,200	45,000	190,600	48,375	49,675	49,475	49,475	197,000
D&A	31,315	31,669	32,000	600	1,100	2,400	7,100	11,200	8,200	8,200	8,200	8,200	32,800
(Gain) loss on sale or disposal of assets	(704)	(86)	(5,600)	200	(2,200)	9,500	0	7,500	0	0	0	0	0
Lease termination costs	0	0	0	0	0	0	0	0	0	0	0	0	0
Asset impairment expense	0	0	55,000	0	0	0	0	0	0	0	0	0	0
Total operating expenses	1,635,255	2,032,554	1,955,000	471,600	372,100	395,400	245,500	1,484,600	256,875	273,275	276,075	277,175	1,083,400
Income (loss) from operations	(1,131)	(55,854)	29,100	(26,800)	4,900	(2,100)	4,500	(19,500)	(5,175)	(875)	7,025	7,625	8,600
Interest expense	(55,098)	(75,662)	(95,100)	(21,300)	(21,400)	(19,700)	(18,331)	(80,731)	(18,331)	(18,331)	(18,331)	(18,331)	(73,325)
(Gain) loss on extinguishment or restructuring of debt	0	102,141	0	(5,800)	(3,400)	(4,200)	0	(13,400)	0	0	0	0	0
Contingent rights valuation	0	0	0	0	0	0	0	0	0	0	0	0	0
Other income (expense), net	(1,361)	196,309	7,100	2,800	64,000	7,300	0	74,100	0	0	0	0	0
Income (loss) from equity investees	17,840	15,355	2,200	(2,500)	(200)	(1,300)	0	(4,000)	0	0	0	0	0
Income (loss) from continuing operations, before taxes	(39,750)	182,289	(56,700)	(53,600)	43,900	(20,000)	(13,831)	(43,531)	(23,506)	(19,206)	(11,306)	(10,706)	(64,725)
Income tax benefit (expense)	(10,740)	(2,363)	20,600	12,600	(15,400)	(1,600)	3,458	(942)	5,877	4,802	2,827	2,677	16,181
Income (loss) from continuing operations	(50,490)	179,926	(36,100)	(41,000)	28,500	(21,600)	(10,373)	(44,473)	(17,630)	(14,405)	(8,480)	(8,030)	(48,544)
Gain (loss) from discontinued operations	0	0	0	(60,000)	0	0	0	(60,000)	0	0	0	0	0
Net income (loss)	(50,490)	179,926	(36,100)	(101,000)	28,500	(21,600)	(10,373)	(104,473)	(17,630)	(14,405)	(8,480)	(8,030)	(48,544)
Attributable to noncontrolling interests	3,580	(17,915)	4,600	17,900	(15,400)	4,300	1,000	7,800	1,000	1,000	1,000	1,000	4,400
Net income (loss) to HC2 Holdings	(46,910)	162,011	(31,500)	(83,100)	13,100	(17,300)	(9,373)	(96,673)	(16,630)	(13,405)	(7,480)	(7,030)	(44,544)
Less: Preferred stock dividends and accretion	2,767	6,409	0	400	400	400	400	1,600	400	400	400	400	1,600
Net income (loss) to common stock	(49,677)	155,602	(31,500)	(83,500)	12,700	(17,700)	(9,773)	(98,273)	(17,030)	(13,805)	(7,880)	(7,430)	(46,144)
Basic shares	42,824	44,300	44,800	45,900	46,800	46,900	49,286	47,222	76,587	76,687	76,787	76,887	76,737
Diluted shares	42,977	46,800	54,857	58,400	46,900	47,353	49,739	50,598	77,040	77,140	77,240	77,340	77,190
GAAP EPS	(\$1.16)	\$3.32	(\$0.70)	(\$1.82)	\$0.27	(\$0.38)	(\$0.20)	(\$2.08)	(\$0.22)	(\$0.18)	(\$0.10)	(\$0.10)	(\$0.60)
Adj. EBITDA By Segment:													
Infrastructure	51,588	60,853	75,700	9,000	19,100	17,700	15,000	60,800	9,500	13,500	21,000	21,000	65,000
Clean energy	2,911	5,457	17,000	3,800	4,200	3,700	4,000	15,700	2,625	2,725	2,825	2,825	11,000
Telecom	6,929	5,258	3,400	400	200	400	0	1,000	0	0	0	0	0
Life Sciences	(22,366)	(14,909)	(11,800)	(4,200)	(4,500)	(5,900)	(8,000)	(22,600)	(10,000)	(10,000)	(10,000)	(10,000)	(40,000)
Spectrum	0	(16,884)	(6,300)	(1,000)	(1,100)	(200)	(200)	(2,500)	(1,075)	(875)	(575)	25	(2,500)
Other	(3,139)	(2,180)	0	(1,600)	900	(100)	800	0	700	700	700	700	2,800
Corporate	(29,153)	(25,785)	(17,900)	(5,000)	(3,600)	(3,700)	(3,500)	(15,800)	(3,750)	(3,750)	(3,750)	(3,750)	(15,000)
Total adj. EBITDA, ex. Insurance	50,797	44,534	90,800	1,400	15,200	11,900	8,100	36,600	(2,000)	2,300	10,200	10,800	21,300
Common Size:													
Gross margin	13.0%	9.8%	16.4%	5.9%	13.8%	14.0%	22.6%	13.0%	20.4%	20.9%	22.9%	22.9%	21.8%
SG&A	11.2%	11.1%	10.8%	11.8%	12.8%	11.5%	18.0%	13.0%	19.2%	18.2%	17.5%	17.4%	18.0%
D&A	2.2%	2.0%	2.1%	0.7%	0.9%	1.2%	2.8%	1.2%	3.3%	3.0%	2.9%	2.9%	3.0%
Adj. EBITDA margin, ex. Financial Services	3.4%	2.5%	5.5%	4.4%	5.1%	3.8%	4.8%	3.2%	9.7%	1.2%	5.0%	5.3%	2.8%
Tax rate	-27.0%	1.3%	36.3%	23.5%	35.1%	-8.0%	25.0%	-2.2%	25.0%	25.0%	25.0%	25.0%	25.0%
Selected Balance Sheet Data:													
Cash, cash equivalents, and restricted cash	97,885	325,000	239,000	186,900	203,800	163,600	105,367	105,367	95,420	100,088	96,666	96,732	96,732
Accounts receivable, net	322,446	379,200	337,800	333,300	261,200	252,300	204,569	204,569	173,087	180,815	174,983	178,889	178,889
Accounts payable and other current liabilities	347,492	344,900	339,600	334,400	283,000	298,600	244,260	244,260	210,960	228,560	218,736	221,688	221,688
Total debt (incl. capital lease obligations)	593,172	743,900	839,300	686,000	633,800	646,400	648,467	648,467	650,533	652,600	654,667	656,733	656,733
Preferred stock	26,296	20,300	10,300	10,300	10,300	15,900	16,300	16,300	16,700	17,100	17,500	17,900	17,900
HC2 stockholders' equity	73,171	88,100	349,800	14,100	319,300	371,800	428,810	428,810	415,264	404,942	400,546	396,600	396,600
Total stockholders' equity	216,027	222,000	465,200	79,100	383,900	435,600	493,010	493,010	479,864	469,942	465,946	462,400	462,400
Valuation:													
Price	\$3.69	\$3.69	\$3.69	\$3.69	\$3.69	\$3.69	\$3.69	\$3.69	\$3.69	\$3.69	\$3.69	\$3.69	\$3.69
Market cap	158,586	172,692	202,423	215,496	173,061	174,734	183,539	186,707	284,277	284,646	285,015	285,384	284,831
Total debt (incl. capital lease obligations)	593,172	743,900	839,300	686,000	633,800	646,400	648,467	648,467	650,533	652,600	654,667	656,733	656,733
Less: cash, cash equivalents, and restricted cash	<u>97,885</u>	<u>325,000</u>	<u>239,000</u>	<u>186,900</u>	<u>203,800</u>	<u>163,600</u>	<u>105,367</u>	<u>105,367</u>	<u>95,420</u>	<u>100,088</u>	<u>96,666</u>	<u>96,732</u>	<u>96,732</u>
Net debt (cash)	495,287	418,900	600,300	499,100	430,000	482,800	543,099	543,099	555,113	552,512	558,001	560,001	560,001
Preferred stock	26,296	20,300	10,300	10,300	10,300	15,900	16,300	16,300	16,700	17,100	17,500	17,900	17,900
Noncontrolling interest	<u>114,951</u>	<u>105,600</u>	<u>93,800</u>	<u>46,400</u>	<u>45,900</u>	<u>40,900</u>	<u>40,900</u>	<u>40,900</u>	<u>40,900</u>	<u>40,900</u>	<u>40,900</u>	<u>40,900</u>	<u>40,900</u>
Enterprise value	795,120	717,492	906,823	771,296	659,261	714,334	783,838	787,007	896,990	895,158	901,416	904,185	903,631
Net debt (cash) per share	11.52	8.95	10.94	8.55	9.17	10.20	10.92	10.73	7.21	7.16	7.22	7.24	7.25
EV/Sales (TTM)	0.5	0.4	0.5	0.4	0.4	0.4	0.5	0.5	0.7	0.8	0.9	0.8	0.8
EV/EBITDA (TTM)	15.7	16.1	10.0	8.6	8.6	11.0	21.4	21.5	27.0	44.1	48.5	42.4	42.4
P/BV - HC2 stockholders' equity	2.2	2.0	0.6	15.3	0.5	0.5	0.4	0.4	0.7	0.7	0.7	0.7	0.7

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

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