Fortress Investment Group LLC

Moderator: Gordon Runté
May 1, 2014
10:00 a.m. ET

Operator: Good morning. My name is Stephanie, and I will be your conference operator today.

At this time I would like to welcome everyone to the Fortress Investment Group First Quarter Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers remarks there will be a question and answer session. If you would like to ask a question during this time, simply press star then the number one on your telephone key pad. If you would like to withdraw your question press the pound key.

Thank you. I would now like to turn the call over to Gordon Runté Head of Investor Relations.

Please go ahead sir.

Gordon Runté: Thank you, Stephanie.

Good morning everyone. Welcome to the Fortress Investment Group First Quarter 2014 Earnings Conference Call.

We will begin our call today with opening remarks from Fortress Chief Executive Officer, Randy Nardone, and Chief Financial Officer, Dan Bass. And after these remarks we will save most of our time today for your questions.

Joining us for that portion of our call we have with us Co-Chairman and Head of Credit, Pete Briger; Co-Chairman and Head of Private Equity, Wes Edens; Principal and Head of Liquid Markets, Mike Novogratz, along with other members of our management team.

A colleague just handed me a list of folks on the line with us today, and flipping through it a lot of familiar names along with a good many new names, which is terrific to see.

We appreciate your interest, and I would encourage anyone on the line who would like to arrange a follow up meeting or call to contact me directly, and that number is on our press release.

Lastly, just let me cover a few housekeeping items before we begin. I would remind you that statements made today that are not historical facts may be forward looking statements, and these statements are by their nature uncertain, and may differ materially from actual results. We encourage you to read the forward looking statement disclaimer in today's earnings release in addition to the risk factors described in our quarterly and our annual filings.

With that let me hand off to Randy.

Randy Nardone: Thanks Gordon. And thanks everyone for joining us.

We had a solid first quarter. Distributable earnings were $97 million or $0.21 a share. That is our highest DE first quarter per share since 2007.

Let's get right to the highlights. AUM closed the quarter at an all-time high of $62.5 billion dollars. Total revenues were over $250 million. We raised $1.6 billion of capital across alternative strategies, and had nearly $500 million of net inflows at Logan Circle.

Undistributed incentive incomes grew to almost $930 million, or $2.10 a share, even with a substantial increase in credit realizations in the quarter.

Net cash and investments on our balance sheet closed the quarter at over $1.3 billion, or $3 a share. That is after funding the Nomura share purchase, which totaled over $360 million.

These last two items represent a substantial store of embedded value that we've built over time totaling about $5 gross and $4 net per share on a share price that was just over $7.

The base dividends of $0.8 a share that we announced today equates to a dividend yield of over four percent.

As we've discussed in previous calls our regular dividend is a function of net management fees. We expect to make periodic top up payments, not necessarily waiting until the end of the year, especially as we monetize our balance sheet.

Those are some of the highlights. Let's add some color on the business.

In our credit business we continue to deliver outstanding investment performance. Net IRRs in our main PE style funds range from being only 19 percent to 26 percent at quarter end. Our main credit hedge fund, DBSO, had net returns of over three percent for the quarter, and a five year annualized return of about 20 percent.

A pick up in investment realization led to the return of over $800 million in capital to LP's, and $98 million of incentive income with a second highest quarter ever recorded by our credit business.

Significantly, 100 percent of NAV in our main credit funds is above incentive thresholds. That is over $14 billion in NAV able to generate incentive on the next dollar of realized gains.

We are also in the market today raising capital for our hedge fund, a new fund focused on income generating assets in Japan, and our second global real-estate fund.

So, another great quarter, and continued great prospects for credit.

In private equity, main fund valuations were essentially flat for the quarter, but looking at the bigger picture we've had a remarkable steady march of value appreciation – about $11 billion since the first quarter of 2009.

And most importantly we see a lot of potential for further gains, particularly in some of our largest investments.

Our capital raising expectations for the year remain high even after a subdued first quarter. Our Italian NPL fund surpassed $700 million in total commitments, and we expect accelerated deal flow in the coming quarters. At the same time, we returned about $1.2 billion to fund LPs this year including about $900 million in April.

Looking at our permanent capital vehicles, we completed the spinoff of New Media from Newcastle in the first quarter. Just last week, we raised over $170 million at New Residential. Our global Transportation and Infrastructure fund has raised nearly $470 million, and is hard wired to transition to a public company.

It's worth pointing out that our permanent capital franchise is becoming a meaningful part of our business with enormous potential for growth and value creation.

To underscore a few key points on this strategy:

We now manage four permanent capital vehicles. Total AUM is over $3.5 billion, with transportation in the works, and potential of senior living looking ahead.

Our goal and expectation is to manage a significant multiple of that in just a few years' time.

Our earnings for this business should command a premium multiple.

In Liquid Markets, our main focus is on generating a solid full year of performance for LPs, and turning incentive income back on. Obviously, we are disappointed with our 2014 results to date.

Fortress Macro is down about six percent net, and Asia Macro is down about five percent net through last Friday.

We have eight months left in the year, though, and a hole to fill and we think we will fill it. The guys have had down quarters before, and have rebounded smartly. Our investors seem to agree with that outlook.

In the first quarter we had new commitments of $1.3 billion in our main Liquid funds, and an additional $340 million in April.

At Logan Circle, investment performance was exceptional in the quarter. All 16 fixed income strategies outperformed their benchmarks, with 15 strategies also outperforming benchmarks since inception.

Logan AUM reached an all-time high of $26.5 billion. That's a more than 20 percent increase in the last 12 months. With strong investment performance and a robust pipeline, we see good traction and prospects for the remainder of the year.

Across Fortress we're busy. We have a broad array of new engines for growth in place, New Resi, New Media, Italian NPL, Affiliated Managers, our new Japan fund, a second credit real estate fund. We see ample opportunity to further diversify and expand our business.

The first quarter was a solid start to the year, and demonstrates the power of our business model, which allows us to deliver strong results even when all of our revenue drivers are not firing at the same time.

We are well positioned to generate substantial cash earnings for the year, and expect an increase in realizations. These dynamics bode well for generating value for shareholders.

We see considerable upside in each of our businesses with more avenues for value creation today than in any point in our history.

With that let me hand it off to Dan.

Dan Bass: Thanks Randy. Good morning everyone.

First quarter DE was $0.21 per share, up slightly from last year, but with higher contributions from management fees and balance sheet P&L. Management fees, incentive income, and balance sheet P&L are the three components that shape our DE results.

Let me discuss each in a little bit more detail.

First on management fees. For the quarter, we recorded management fees of $147 million. This is an increase of three percent from the fourth quarter, a year to year increase of 11 percent, and a two year increase of 25 percent.

On incentive income, during the quarter we recorded $104 million of gross incentive income. As you know our incentive income has some variability on a quarterly basis. As such, I prefer to evaluate our results over a longer time horizon, which shows a very encouraging trend. Over the past eight quarters we have now averaged over $100 million of gross incentive income. This demonstrates long term sustainability in our incentive income, which is a very significant component of our earnings profile. Based on our current stock price, we believe that this sustainability is not fully appreciated by the market.

We also have great diversity in our sources of incentive income. During the quarter we had significant realizations in credit PE, and our credit hedge funds continued to perform well. We also have several emerging sources of incentive income. In particular: New Residential has contributed over $20 million of incentive income since spinning out of Newcastle last May, and with the spinoff of New Media in February, we now have another permanent capital vehicle to potentially generate incentive income.

All of these developments leave me very optimistic about our prospects for 2014 incentive income, even with our Liquid funds dipping below their high water marks.

Finally, on the balance sheet. As I mentioned last year, DE from our balance sheet is becoming a meaningful contributor to our bottom line. This trend has continued into this year. During the first quarter we recorded DE of $10 million from our balance sheet primarily through gains on realized private equity style investments. This DE equals roughly one third of the amount that we recorded for the full year of 2013. And with the sale of an additional 1.3 million GAGFAH shares in April, we will record a gain of $13 million in the second quarter from this one transaction.

Now let me discuss some of the drivers of DE in more detail. First on AUM. During the quarter our AUM was up nearly $800 million even after returning 1.2 billion of capital to our investors, and paying out over $700 million in redemptions and RCA distributions.

The growth in AUM was fueled by raising $1.5 billion of capital in our hedge funds, which were directly added to AUM during the quarter. Additionally, we deployed about $400 million of our dry powder, and had nearly $500 million of net inflows into Logan Circle.

On to capital raising, where in the first quarter we raised $1.6 billion in capital, $1.3 billion of which came from our Liquid funds. In April, we raised another $670 million of capital, bringing our year to date total of capital raised to $2.3 billion.

Importantly, nearly 90 percent of the April capital raised has been added to AUM in the quarter—in the second quarter.

Moving to undistributed incentive income... At $928 million, the value of our undistributed incentive income is now almost two and a half times higher than it was just two years ago. The value consists of $831 million embedded in our funds, and $97 million from options in our permanent capital vehicles.

In aggregate, the value grew nearly $200 million, or 27 percent year over year. This growth came all while recognizing nearly $150 million of incentive income from this pool in that same time period.

All of these facts demonstrate that we have a good balance between funds with more mature assets that are ready for or are approaching harvest, and later vintage funds that have a long runway for future potential appreciation.

Now, on the balance sheet. I want to make two points here. First, the value of our net cash investments was $2.97 per share at quarter end, even after the large Nomura share repurchase. Two, our debt balance was $125 million at the end of the quarter, and now stands at $75 million[1]. We consider this debt to be short term in nature, and expect to fully pay off the balance over the next couple of quarters.

On taxes, for the year we expect our tax rate to be a percentage in the mid-teens. This is an increase form our nine percent 2013 tax rate due to lower equity based compensation deductions.

So, in closing a few final thoughts. At $0.21 per share in the first quarter we are off to our strongest start since 2007. We have a diverse business model with three DE components, all of which are contributing in a meaningful way to the bottom line. And with substantial embedded value, and capital raising momentum, we feel very good about our prospects for the full year.

Thank you. We will now take your questions.

Operator: At this time if you would like to ask a question, please press star then the number one on your telephone key pad. Again, that is star then the number one on your telephone key pad to ask a question.

We will pause for just a moment to compile the Q & A roster.

Your first question comes from the line of Craig Siegenthaler with Credit Suisse.

[1] Debt balances exclude Non-Investment Manager (New Media)

Craig Siegenthaler: Thank you, good morning.

First question here for Pete. I am wondering, Pete, if you can provide us a with a macro update, specifically, are you seeing better opportunities especially given the recent turmoil in Europe or is high monetary stimulus still keeping valuations and credit relatively unattractive here?

Pete Briger: The macro view on credit is still that it is very difficult to find good investments, and nothing in Eastern Europe has changed my opinion on that.

Craig Siegenthaler: Got it, and just as my follow up here for Wes.

Private equity incentive fees are still running very, very low versus what the potential could be here, and now that a few funds and co-investments are fairly close to pref rates, are we close to seeing higher private equity incentive fees here, or this more of a 2015 event?

Wes Edens: Well, it's a little hard to predict, the timing on what we think is going to happen over the year. I do think we are going to have substantial incentive fees come out of a number of the funds, and we are off to a good start on liquidations of more mature investments this year. I think total liquidity of the funds is just over $1.2/1.3 billion, and we think that's going to go up substantially, and there are a handful of funds that could generate some big incentive returns. So, I think the timeframe that's relevant is kind of this year or next year or so, that's a little hard to predict.

Craig Siegenthaler: Great. Thanks for taking my questions.

Wes Edens: Thank you.

Operator: Your next question is from Robert Lee with KBW.

Robert Lee: Thanks, good morning everyone.

I am just curious, so the transportation fund is raised, and has been filed for a while. So, what's the thinking there about trying to take that public, I know that is the intention, but it has been on file for a while, so besides just the near term ups and downs of the capital markets, do you feel like that is prepared to go public, or do you feel like you need some more—it needs to be private a little bit longer to get it more up and running? How should we be thinking of that?

Wes Edens: That's the way to think about it, that fund is doing extremely well. The private capital we had raised was approximately $400 million, and then we had the registration statement on file, and we were thinking about taking it public at that point. We got a lot of really reverse inquiry from existing investors and new investors, and so made the decision to hold off the public listing of it. As Randy said, we've organized some additional capital for it. I think that all that capital formation for the vehicle will be completed by the end of the second quarter. I think our expectation is that we will get at or around the cap of a billion dollars. It looks like a pretty readily available number right now, and once that capital is deployed substantially then we would go ahead and list it.

I think the prospects for the company as a listed vehicle given the nature of what it invests in, and the performances they've generated is really, really substantial, and it's a gigantic market. So, that is one of the vehicles I am most optimistic about both in terms of performance and size. And hopefully we will see all that come to pass this year.

Robert Lee: OK, great.

And just one follow up question, I know I've asked this before, but I guess I'm trying to get it clear in my own head. And so if I look at the success of the credit funds, and obviously they're credits, there is a high, presumably, some high interest income components to what you do there. Some of your peers do talk about their credit businesses having this kind of generally - some have described their incentive being predictable, reasonably predictable, because there is this kind of high recurring component to the return profile.

So, why is your credit business somewhat different than some of the others that your peers talk about? I am just trying to get that square in my own head.

Pete Briger: I guess those guys must be more confident and optimistic about the regularity of those interest payments occurring than I am.

But I don't know. I really don't talk to those guys about how they articulate their businesses.

A lot of what we do in our hedge fund is direct lending, and that creates more interest income on a relative basis. Our hedge funds are about one third the AUM of our credit PE funds. So, that probably speaks to some of it, but this is a—we make loans to difficult borrowers, we make loans in difficult situations, and so we're counting on getting our return as part of the total package rather than just interest income.

Robert Lee: OK, appreciate the additional color. Thank you.

Operator: Your next question comes from the line of Devin Ryan with JMP Securities.

Devin Ryan: Hi, good morning. Thank you, and congratulations on the strong quarter.

I just want to make sure I heard the commentary correctly. So, it sounded like you said that you would look to potentially make periodic top up payments not just wait till year end. Just want to make sure I heard that correctly, and if that is the case then how would you think about doing that, what would be the methodology there if there is one, and what might drive those top offs?

Randy Nardone: Hi, it's Randy

You did hear it right. When we talked at the board meeting last night, we talked about does it make sense to wait till the end of the year, or is it better to be flexible, and look at it over time periodically? And of course it makes sense to look at it periodically, and it is going to be driven primarily by balance sheet realizations. And so that is the plan—to take a look at our cash position, what is happening on the balance sheet, etc., and make the call each quarter.

Devin Ryan: OK great, appreciate that. That will be good to see.

And I guess with respect to credit PE, I think maybe it was touched upon with the commentary around Europe, but has there been any other change or nuances within the deployment outlook? I guess I'm just trying to think about opportunities to accelerate some of the investment of the dry powder, and if not what you think needs to change. Whether it be change in rate, or rate shock, or just some pick up in market volatility. Just trying to get a little bit more color there around what may start to loosen the ability to invest a little bit more.

Pete Briger: Well, first I don't see a big change coming in the credit environment. Some of my competitors publicly have called the current environment a credit bubble that could explode in the short term. I actually don't think that is true. I think we are just living in a miserable credit investing period where a heck of a lot of deleveraging has taken place, especially in the US financial services industry, so the financial services industry is strong, well-capitalized.

They may own a lot of expensive credit, but they are also involved in lots of other businesses that seem to be doing reasonably well right now. So the financial system seems to be very strong at a time when credit is expensive. So, I am not looking forward to some change. Of course a short term violent rise in interest rates could cause things to shake up, but we are not expecting that.

There could be some kind of geo-political event that could shake things up. Certainly Russia's activities could become more aggressive than they are today, and potentially be greater cause of concern for what's happening in terms of the recovery in Europe. But all of that is not factored into the market today, and we certainly are not economists. In our garbage collection business, we wait for things to happen and then try to sort them out. So, I am not making a prediction here.

Devin Ryan: OK, understood. Appreciate the commentary.

And I guess just lastly, with respect to the capital raising outlook, $1.6 billion of alternative capital raise that kind of seems within the range of what you guys have been doing, so a good a number, but just trying to get a little bit better sense around the pipeline and expectations clearly to get to that doubling of – we're in the ballpark of doubling – in permanent capital. I would assume that the pace throughout the year would be picking up, so just any additional color there would be helpful as well.

Wes Edens : Sure.

On the permanent capital side, as Randy said, we have four vehicles, about $3.5 billion dollars in capital at the moment, but we will have more than that in dry powder in the Transportation fund that we think will turn into AUM, and we've got lots of ambitions for the year.

I think that in the current plans I expect the four public companies will grow to six, possibly by the end of the year, and we do think that there is going to be an increase in the rate of capital formation in the second half of the year—second two thirds of the year. So, it's all a function of trying to match up capital formation with investment activity, and as Pete said, it's been a challenging investment environment, but there have been some interesting and sizeable things that are on the horizon. And as those come to pass, they will evaluate those investments, as well as the need for additional capital.

So, I am still pretty optimistic that we are going to have a robust year on the capital side for the permanent guys.

Devin Ryan: OK, great. Thanks for taking all of my questions.

Operator: Your next question comes from the line of Marc Irizarry with Goldman Sachs.

Marc Irizarry: Oh great, thanks.

Pete can you give us some sense on the credit PE funds. Obviously it was a big—looked like it was a bigger quarter in terms of the incentive income there, and also maybe distribution activity to your LPs. Can you give us a sense of how you think the rest of the year could play out, and what could maybe suggest that the return of capital from the credit PE might accelerate or maybe slowdown from here?

Pete Briger: Well, as I've said before, everything that is not nailed down is for sale. We like the credit markets. Real-estate markets there may have further to run, but from our investment perspective we certainly would like to create realizations, and so as I've said before we could surprise on the upside in terms of a realizations. But as far as predicting realizations, I have no predictions whatsoever, and I don't want to have to shoot for any numbers in terms of maximizing return in multiple for our investors.

So, we will wait till we have the right offer on a particular investment to execute on it, but I do think that there is some potential for upside in terms of the speed at which we are doing things, because this is a good environment to sell stuff.

Marc Irizarry: OK, great.

And then just on Logan Circle, I appreciate any update there in terms of how you expect the business diversification there to evolve over the next year or so.

Randy Nardone: It's Randy.

$26.5 billion of AUM and fixed income, as I mentioned, that's up 20 percent year over year. Pipeline is robust. The results are terrific, and we are optimistic that we are going to see continued good results on a fixed income side.

The growth equity side we've obviously talked about a bunch, happy to report they actually wrote their first ticket a couple of weeks ago. It is too small to even talk about what the number is, but I think with the pedigree of those guys we are optimistic this is the first of many.

Marc Irizarry: OK, great. Thanks.

Operator: Again, if you would like to ask a question, please press star then the number one on your telephone key pad. Again, that is star then the number one to ask a question.

Your next question comes from Bulent Ozcan with RBC.

Bulent Ozcan Hi, good morning.

I have a quick question on the Italian nonperforming loan market. Could you give us an update on that, and your pipeline there? And also maybe speak about how combining Italfondiario's asset management and loan servicing units and those of Prelios impact your competitiveness in that market.

Wes Edens: Well, the Italian NPL market is robust. We had a couple of small transactions that have been completed in the first third of the year. There is a sizable pipeline of prospective deals between now and when they hit at summer break. In Italy, I think there is a potential for some very, very sizable transactions. There is a lot of competition for that, but we think our competitive dynamic is a really strong one. We have been in the business for a long time, and have a very capable group in Italy, so I think there is a good chance that it is a very, very active area for the firm in the second two thirds of the year.

The second part of your question I am sorry I didn't understand. Could you repeat it please?

Bulent Ozcan: Oh, sure.

So, my understanding is that you've combined the asset management and loan services of Italfondiario with that of Prelios. And I just want to understand how that changes the competitive landscape, and basically the reasons for doing that.

Wes Edens: Well, we had actually looked at Prelios when they recapitalized the company a couple of years ago, and have a high regard for those guys. They have a very substantial asset management business on the funds business. And really the notion of the industry for a tie up is to take advantage of the best of both parts of the two companies.

But it really originally stems from the time we spent a couple of summers ago looking hard at the business, and staying in touch with those guys is a good opportunity for us to consolidate, and we think it adds to our capability, and probably solidifies our competitive position in the country.[2]

[2] No definitive agreement has been entered into between Italfondiario and Prelios.

Bulent Ozcan: Could you give us any guidance on—it's probably difficult, but in terms of capital raising for these NPLs?

Wes Edens: You know the range could be a very substantial one, because the total amount of distressed loans in Italy, depending on how you count it, is probably 150/175/200 billion euros. If the current experience mirrors that of what has happened in past cycles, then we think 25/40/50 percent of that could end up being sold in the market over time, and if that were the case, the capital need for that would be very, very substantial, but it's hard to predict what they are going to do.

The one thing I would say is that I think the government bank of Italy is very focused on getting the NPL's off the banks' balance sheet, and this is the third cycle we've been involved in over fifteen years in Italy in the NPL business, and I would say this is the one that has the prospects to be by far the largest. But we will have to see how it plays out. But I am quite optimistic about it.

Bulent Ozcan: My final question would be regarding the affiliated manager platform. Could you give us an update on the pipeline?

Mike Novogratz: Yes, so we are still in the process of getting the Asia Macro fund ready for the January 1 spin off. We are meeting with lots of teams, and I think we are going to be patient. There are lots of good opportunities, and hopefully in the next quarter or two we will have something to report.

Bulent Ozcan: Excellent. Thank you very much.

Operator: Your next question is a follow up from Robert Lee with KBW.

Robert Lee: Thanks. Thanks for taking my follow up. Just wanting to make sure I am understanding the distribution correctly. So, if I think of it I think in the past you've talked about the $0.08 being roughly approximate what you are generating from management fees, and then on realized gains from the balance sheet the goal would be to more or less distribute as realized the gains from there in the quarter realized, and then at year end should we expect that

that's where we will get a true up distribution that may reflect the incentives generated over the course of the year. Is that the right way to think about it?

Randy Nardone: Fair question, right? I think so. Let me just make sure it is clear.

The base dividend is sized off of our net management fees. We will look periodically during the course of the year how we are doing in terms of balance sheet. We will certainly take incentive income into account. And yes, since the end of the year is the end of a quarter as well, we would look at that as we will have the best information on the whole year. And we would expect that if the top up is appropriate there would be a top up at the end of the year as well.

Robert Lee: OK, great. Just wanted to clarify. Thank you.

Operator: Again, if you would like to ask a question please press star then the number one on your telephone key pad.

Your next question is a follow up from Bulent Ozcan with RBC.

Bulent Ozcan: Actually two questions.

One on the $1.3 billion of new capital that you've raised for hedge funds. Could you give us a sense of the timing, and which funds got the capital allocation, because my thinking is that given fresh capital that there shouldn't be any high water marks on that amount that you've raised.

And then I will have a follow up question.

Randy Nardone: $1.3 billion was raised for hedge funds during the quarter, yes. Most—some of it was raised pre-January, and some of it was raised post January. So, there is a significant chunk that is closer to its high water mark due to the timing.

Bulent Ozcan: OK, and then you mentioned that you've raise about $670 million in April. I am assuming that includes the $170 million or so for the permanent capital vehicles. Could you give us a sense of the balance of that $500 million, which funds or strategies, which business has raised the capital?

Randy Nardone: It is mostly the Liquid markets and some in the private equity business.

Wes Edens: We raised $170 million in New Residential last week.

Bulent Ozcan OK, great. Thank you.

Operator: Again, to ask a question please press star then the number one on your telephone key pad.

At this time there are no additional questions in queue. I would like to turn it back over to management.

Randy Nardone: Thanks everybody for joining us today.

Just to wrap up. Solid quarter of financial results, and we think a very good start to the year. Business and investment activity is robust across the company. Continue to build a store of embedded value that will benefit performance in future periods.

Again, with our prospects for the full year we are very optimistic, and see substantial upside in every one of our businesses.

We look forward to providing an update in a few months.

Thanks.

Operator: Thank you. This concludes today's conference. You may now disconnect.

END