FORTRESS INVESTMENT GROUP LLC

Moderator: Gordon Runté
May 7, 2015
9:00 a.m. ET

Operator: Good morning. My name is Johna and I will be your conference operator today. At this time I would like to welcome everyone to the first-quarter 2015 earnings call.

Gordon Runté Head of Investor Relations, you may begin your conference.

Gordon Runté : Okay. Thank you, Johna. Good morning, everyone, and welcome to the Fortress Investment Group first-quarter 2015 earnings conference call. I want to point out that in addition to our earnings press release, we also issued this morning an earnings supplement which is available on our website. The supplement provides an overview of our performance and our business initiatives and the many developments that have marked a very active start to the year.

We will begin our call today with brief opening remarks from Fortress Chief Executive Officer Randy Nardone. We will then hear from Co-Chairman and Head of Private Equity Wes Edens; Co-Chairman and Head of Credit Pete Briger; Principal and Head of Liquid Markets Mike Novogratz; and CEO of Logan Circle Jude Driscoll. Following these business updates, Chief Financial Officer Dan Bass will provide a financial overview, and we will then open the call up for your questions.

Lastly, just let me cover the usual housekeeping items before we begin. First, statements made today that are not historical facts may be forward-looking statements. These statements are, by their nature, uncertain and may differ materially from actual results. So 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 annual filings. I also remind you that statements are made as of today, May 7, 2015, and will not be updated subsequent to the call.

With that, let me hand off to Randy.

Randy Nardone: Thanks, Gordon, and thanks, everyone, for joining us. I'll keep this brief to make time to go through our businesses before Q&A.

On our last call I pointed to the potential we saw to build on a very strong 2014. Four months into the year and we're in a great position to deliver on that potential.

Capital formation has been outstanding. Investment performance in Credit and PE has been very strong, and momentum in our Permanent Capital Vehicles has been tremendous.

Our pretax DE for the quarter was $0.12 a share. This number doesn't reflect two meaningful sources of future earnings power: undistributed incentive income, which grew substantially in the quarter, and the embedded gains in our balance sheet.

Let me cover some of the highlights. AUM grew to an all-time high of just under $70 billion.[1] We raised a record $5.4 billion across our alternative businesses in the quarter and an additional $1.4 billion in April.

We've already surpassed total alternative capital raised in all of 2014. As a result, dry powder has grown to a record $10.7 billion.

Gross undistributed incentive income grew in the quarter by $250 million and now totals over $1.2 billion. We ended the quarter with net cash and investments on our balance sheet of $1.3 billion. On a net basis, embedded value represents about half our share price.

[1] All AUM data as of March 31, 2015 includes $4 billion related to Affiliated Managers.

Overall, we are very pleased with our start to the year. With strong LP demand, significant capital raised year-to-date, and continued marketing in every business, we see great prospects to build on record AUM.

With valuation gains across our main PE and Credit funds, we continue to amass embedded value that should have a meaningful positive impact on future DE. And with an outsized balance sheet, including large and mature investments marked substantially above our basis, we anticipate DE and distributions will benefit meaningfully as investments are realized.

Very much looking forward to building on our progress so far this year. We are very optimistic about the value we can create as the year progresses. With that, let me hand it off to Wes.

Wes Edens: Great. Thanks, Randy. Welcome, everyone. So as Randy said, the quarter that just finished was a terrific one for my part of the business.

A couple notable transactions that had big impacts. First and foremost, we announced the merger of Springleaf into or along with OneMain; it creates a $20 billion consumer finance business expected to close in the not-too-distant future, and really creates a powerhouse for earnings for us.

So the Springleaf story, which is a big part of the success of Fund V, had a big boost. The Fund was up 22% for the quarter, and we think that there are many, many bright days ahead for that. That is a big transaction for us.

Second of all, NRZ bought the assets of HLSS, added significantly to the size of that business; raised in conjunction with that a little over $850 million in capital, so it was a big business-building exercise for us and a very profitable one. We announce results for NRZ tomorrow, but we are excited about both the scale and also the economics of that business has a big impact for us.

Lastly in Europe, we announced that we had bought into our Eurocastle as well as our Italian private equity fund the bad bank of UniCredit, called UCCMB, a very, very notable bad bank transaction; bought a few billion dollars in distressed loans; and also acquired another significant platform. We have a very, very dominant position as a Firm in Italy. We think it's one of the best, if not the best, distressed market in the world. So, all hallmark transactions. We also raised capital in conjunction with that and about doubled the size of Eurocastle, so all good.

For the year thus far, $1.4 billion in capital formation on the permanent capital side, more than we raised in all of last year. The prospects for the business are terrific.

We are in the markets right now, pursuing an IPO for our infrastructure business which we formed back in 2011 called FTAI,[2] and hoping to raise that capital successfully and close it sometime in the middle of next week. Pro forma, that, we'll have a total of six different companies, all of which have, we think, the ability to scale very substantially and create tremendous growth for that sector.

The goal for that business from my standpoint is for it to be $12 billion to $15 billion in capital by the end of the year. It's $6 billion right now. It sounds aspirational, but there's a handful of very sizable things that are out there.

So the results for the quarter and for last year, when we look back at it, for the Private Equity and Permanent Capital Vehicles collectively we had a result of $224 million last year; that was up from $121 million the year before.

The base load of that, so the distributable earnings portion of the funds, $127 million for last year. Our goal with all this capital formation is to be at a place on a run rate basis of 2X by the end of the year. So very aspirational, but we think with the momentum that we have right now there is a lot of good stuff in front of us.

Pete Briger: Thanks, everybody. A muted quarter in Credit due mostly to lower realizations in our PE Funds. I think that, as we've said before, the timing on realizations is going to be a function of when our investments are realized; and that will come when they come.

[2] Also referred to as WWTAI.

From our perspective, we've got just under $9 billion of dry powder. We raised a new distressed opportunistic credit fund, a Japanese real estate fund, and are still, as Randy mentioned, raising capital for some of our other businesses.

I would say the easy money has certainly been made in credit and real estate. On the credit side the markets are really almost devoid of opportunity for new investment, so that dry powder will probably sit around for a while, waiting for the environment to change.

I would say that thematically there is not a lot to do in credit around the world, i.e., getting paid for the risk that you are taking in the credit markets. We're still making investments on an idiosyncratic basis in situations that we like; but for the most part, this is a low new investment period, and we are very focused on exiting what we have.

On the real estate side, slightly brighter picture. Still investments that we think are worth making thematically across the US and Europe and Japan, primarily. From our perspective the hedge fund, the Credit Hedge Fund: less opportunities, less capital that's going to be invested in the short to medium term. From our perspective, a lot more risk in the markets than opportunity.

Mike Novogratz: Thanks, Pete. Listen, in Liquid Markets, let me start with the good news. First of all, our investment in Graticule, Adam Levinson's fund, has done well. They both raised capital and had good performance, and so that is kicking into the DE pot.

Second, Centaurus, our event-driven fund which got launched in London with Randy Freeman, is off to a decent start. They had a 4% first quarter; performance continues to be fine. I think we've got commitments for up to $250 million starting May 1, and the pipeline there looks good.

Unfortunately, the flagship fund, the Macro Fund, which I run, like I said last quarter or last call, got off to a tough start. We had a bet in euro-Swiss that went wrong; that cost us. Since then, we've broadly gone sideways.

The good news there is that we are living in a macro world. The opportunity set is rich and fertile.

In the last two weeks you've had a major sell-off in European rates and global interest rates. We've got central banks around the world that are all active. The Chinese have embarked on an aggressive monetary stimulus.

And so I couldn't be more optimistic in the opportunity set. We've tightened up our risk parameters some. We're working with and in touch with all our investors and are optimistic that by the end of the year we've not just gotten back to flat but we've turned the ship.

Jude Driscoll: At Logan the story remains strong, with investment performance, continued growth, and a tremendous opportunity set going forward. Logan closed the quarter with a record $33.4 billion under management, up 26% from 12 months ago. [Anything missing? I thought he mentioned a bunch on numbers]

Investment performance remains robust, with 15 of the 16 strategies outperforming the benchmark since inception, and we expect Logan to record record profits in the second quarter. And from there, expectations for growth and margin expansion are very high.

Dan Bass: Yes, I'll keep my remarks brief. First off, AUM was up 12% year-over-year, 3.5% in the first quarter. Headlining this growth was the mark in Fund V's investment in Springleaf. This alone contributed nearly $1 billion to AUM in the quarter.

Subsequent to the quarter end we raised another $1.4 billion of permanent and hedge fund capital, all of which have now been added to our second-quarter AUM. Two key factors that can drive AUM higher from here: dry powder, which increased 62% year-over-year to a record $10.7 billion; and that we are actively marketing in all of our businesses.

Looking closer to our P&L, management fees were $139 million for the quarter. Adjusting for the Affiliated Managers move, management fees were essentially flat on a year-to-year basis.

Recognized incentive income was light at $51 million for the first quarter. That's below our average of $120 million for the past eight quarters; but there are many levers that would drive additional incentive income in the near term, including realizations from our $1.2 billion of embedded incentives across our funds and PCVs, and future investment gains on the $25 billion of capital currently at or above their high-water marks.

Second-quarter incentive income is already off to a good start. In April, we realized about $30 million of incentive income in our credit business; and the $860 million of equity capital raised by New Residential is also incentive income-eligible right now.

Now let me talk about a few other financial metrics. NAV above high-water marks was up nearly $9 billion, or 53%, year-over-year and now stands at over $25 billion. This now accounts for nearly two-thirds of our capital that is eligible for generating incentive income. Importantly, another $1.4 billion in capital in our PCVs is within 1% of their respective high-water marks at the end of the quarter.

Undistributed incentive income grew by 35% year-over-year, including 25% in the first quarter alone. The primary catalyst was the movement of Fund V past its high-water mark and into its incentive income catch-up phase.

With this movement, Fund V alone now has around $190 million of embedded incentives. Everything else being held constant, a 10% increase in the NAV of Fund V would generate approximately $300 million of additional unrealized incentive income, and a 17% increase to NAV would get the Fund fully through its 60/40 catch-up phase.

On the balance sheet, looking to the future, we think the low-case size of our balance sheet could be net cash and investments of around $300 million. This is about one-quarter of its current size.

Monetization of our balance sheet could mean distributions of up to $2.15 per share, assuming no future appreciation to our investments. And we feel there is still opportunity for significant appreciation in some of our largest investments from here.

Finally on taxes: four months into the year we expect our tax rate for 2015 to be a percentage in the mid-teens.

In closing, let me reiterate a few reasons why I am very confident about our prospects moving forward. First, our AUM continues to grow. AUM grew 12% in the last year, and we have almost $11 billion of dry powder to put to work as well.

Second, the amount of embedded value in our funds continues its rapid ascent. The overall trend has been remarkable, doubling the value in just over two years, and quadrupling it in just over three.

Our balance sheet value remains undervalued. Distributions from our balance sheet alone could provide upwards of $2.00 per share over the next couple years.

Finally, our capital-raising efforts this year has positioned us very well for the future. In just over four months this year, we've raised nearly $7 billion of capital, more capital than we raised in any full year since 2008.

Thank you. We'll now take your questions.

Operator: Devin Ryan, JMP Securities.

Devin Ryan: Yes, thanks. Good morning, everyone. I guess just starting on Permanent Capital side, and you clearly have a lot going on there in scaling a number of the platform. So appreciate the update around the $12 billion to $15 billion by year-end. Can you help us maybe think about bridging the gap between the $5 billion today and getting to that $12 billion to $15 billion, and the buckets that you expect to be the biggest drivers?

And then second part of that is: are you still contemplating any other avenues for this business to maybe create additional shareholder value? Just thinking, is there more value for the Permanent Capital now that it's scaling on a standalone basis?

Wes Edens: Well, first of all, the capital in the Permanent Vehicles today is about -- is a little over $6 billion, not $5 billion, to start. When you look at page 8 of the supplement, we've listed the vehicles there.

So look on the right-hand side of the page, New Residential, Newcastle, New Senior, and New Media, Eurocastle, and WWTAI. The market caps of the companies are showed there. The capital that is under management is somewhat less than that, because a number of the vehicles trade above invested capital because they've had great results. But $6 billion is the number today.

The column on the right-hand side is the one that I would point you at. The addressable market gives you some measure of the size of those businesses.

You can see that, in particular, the transportation infrastructure business, the residential mortgage business are very, very large markets. But the -- if we simply became the number one company in each one of the sectors, I think if you added these all up you would be north of $200 billion in capital.

So $6 billion is not going to grow to $200 billion overnight, but it gives you some sense of the upside if you are an excellent performer. All these businesses are really about performance. They are not about asset collections or capital collections, but it's really about performance.

What has led us to have the success, for example, in New Residential over the last year is that we've had a 35%, 40%, 45% increase in value in the share price of the stock, so we've created a lot of value for shareholders. That's what allows us to attract capital and continue to grow the business.

So in terms of connecting the dots, we've got aspirations for all these businesses. There's a handful of other things that we think also have the same kind of attributes: big addressable markets, asset-based businesses, stable cash flows, and we think a good opportunity to grow.

So those are all the things that we look at. But I think right now our goals are exactly as I said.

Devin Ryan: Okay. That's great; really appreciate that color. Then second question, just with respect to Fund V, great to see across incentive eligibility, Springleaf was a really nice story in the quarter. So maybe just the big components.

Springleaf, maybe think about the longer-term views for that position and where value exists there. Then separately, if there's any updates you can provide on the Florida portion of the investment.

Wes Edens: Well, Springleaf has got, we think, a tremendous opportunity in the consumer space with the OneMain acquisition. I think that 88% of the population of the US now lives within 5 miles of a branch, so we've got a pretty big footprint across the US.

It's a very, very large market. The consumer finance industry is a $3 trillion market, so $20 billion is a very small piece of that. But it's a notable company in and of itself, and it serves a big part of the population, we think, in a very, very good way.

I think our view is that once the companies are put together and you can see the realized synergies between them, you've got a tremendous potential for earnings growth. That will be the point in time we will probably look to evaluate the investment a little more carefully. But I think if you paid attention to the Springleaf earnings remarks, they do a very good job of laying out what their prospects are, and we are a big fan of the company.

With respect to Florida, there is a lot of exciting news that's going on down there. The core businesses of the freight railway, the industrial real estate businesses have done great. The big, new, aspirational businesses, the passenger railway, we have started construction on that down in the south. There is a ton of real estate development as part of that, and we think that over the next three, four, five years that there is just a limitless amount of upside with it. So that's the updates.

Devin Ryan: Okay, great. Appreciate it, and I'll hop back in the queue.

Operator: Robert Lee, KBW.

Robert Lee: Great. Thanks for taking my questions, guys. Just one question just on Logan Circle. I know it's had very strong asset growth the last several years, and it's certainly very strong flows, good performance. But I guess I'm still struggling a bit, even with all that and understanding you think there's room for margin expansion. But it still operates at a modest loss.

Within your broad, overall terms of the business, could you really refresh us where you see this strategically fitting in with the rest of the business?

Dan Bass: Yes, in the quarter we have some close-down charges for the growth equities business in Tampa. Jude's comments made reference to the breakeven and record second quarter, as those one-time costs won't reoccur, and that the fixed income business is operating on a profitable basis right now.

Randy Nardone: And the business is very scalable, right, in terms of the platform. We don't have to add a lot of expense as you add AUM, so we see this thing ramping up.

Robert Lee: Okay. Then maybe just a quick question. I guess a fair amount on the balance sheet and accrued incentives relates to options and some of the Permanent Capital Vehicles. And understanding from Wes's comments you think there is a lot of upside across a lot of those vehicles.

But are any of those options getting to a point where you're going to have to start exercising them before they expire, and we'll maybe start to see some of those realizations? Or is that still a ways out, do you think?

Wes Edens: Yes, the options are generally 10 years at the time of issuance, and so there is a long runway from here forward. I think it's something we evaluate all the time.

There has been -- I think Dan pointed it out -- there has been a lot of appreciation in the last couple years, so it is a big asset on balance sheet. It's something that has got a tangible amount of value to us. And I think that from time to time in a measured way we will look to harvest some of that and bring it into earnings.

We haven't done so thus far, but obviously with the performance of those vehicles, it's something that we are keeping an eye on.

Robert Lee: Okay. Then maybe one last question if I could, you have had the nice increase in accrued incentives or undistributed incentive income, certainly helped by Springleaf. But of the $1 billion, call it $1.3 billion of gross right now, just roughly speaking, what should we assume -- what piece of that as realized will go to comp? Is it 55%? What's the right way to think of that on a net basis?

Dan Bass: Yes, on a net basis, I think you should assume 40% to 50%, depending on the business, will go to comp.

Robert Lee: All right. Great. Thanks for taking my questions.

Operator: Chris Kotowski, Oppenheimer & Company.

Chris Kotowski: Yes, great. Thanks. I have one for Pete and one for Wes. For Pete, I guess I am thinking you are sounding -- I didn't think it was possible but you're sounding even more bearish than you have in the prior 18 months or so. I guess we see -- read in the press release that you are sitting on $848 million in unrealized incentive fees.

I guess the big question for me is: what are you waiting for? Why not monetize that in a very aggressive way, like what we've seen with Apollo or some of the other funds?

Pete Briger: Well, I think if you go through the numbers, we have been realizing aggressively, and in the last year something like $200 million plus in realized incentive; and then we've added a bunch of unrealized. So we are moving through our portfolio as expeditiously as possible, I can assure you.

That being said, not everything that we have is readily saleable. The things that were bonds or asset-backed securities are, for the most part, out the door;

and everything that we have is idiosyncratic. When there is an opportunity to exit from a risk, we will.

I think that those numbers are generally conservative that we've laid out. So I do think that, even if the environment turns down from here and we have some big disruption in the credit markets, I think we will realize those numbers.

But I do think that you have captured my lack of interest in the market correctly, that it has gotten even worse. And you know, what I would say from our perspective is this is an environment that is really not interesting from an investment perspective.

Usually, when you have the frothiness in the credit markets that we have today, you can expect a high default environment to occur in some relatively short period, 12, 18, 24 months down the road. And I think that we certainly in the corporate sector expect that to occur in the middle market corporate sector.

The problem is that the financial services sector around the world, for the most part, is very healthy. And for this to be a really great opportunity set for us from a distressed perspective, there has got to be a big perception of risk when that high default rate environment occurs.

And with the financial services sector, the regulated commercial banking sector healthy, I think that you may have that high default rate environment without an environment where there is high perception of risk, and just a lot of people working through a lot of restructurings but not necessarily getting paid for it. So it could be a while before we see truly great opportunity in our business.

That being said, you have these events like what's going on in the energy sector, where there may be some stuff to pick through, even though the environment for credit is frothy.

Chris Kotowski: Okay, thanks.

Dan Bass: Chris, just on the numbers that Pete referenced. Last year we generated over $250 million of incentive from Pete's Credit PE business. So that's almost 30% of his embedded incentive today; so that's the reference point.

Chris Kotowski: Right, but it's not as though you could go out and monetize $600 million of it?

Pete Briger: If I could, I would.

Chris Kotowski: Okay. Fair enough. Then for Wes, I guess, the question was, how should we think about and model the carry generation in the Permanent Capital Vehicles? Meaning in Private Equity, it's easy to figure out: you do a Dealogic run, see what's been sold. And in the Hedge Funds you look at the monthly performance numbers and you can figure it out.

But when you look at the incentive in the Permanent Capital Vehicles, 4, 21, 16, 25, 3, how -- what kind of guidance can you give us on how we should think about modeling that?

Wes Edens: Well, think that the contracts for the most part are actually quite similar, and it's probably -- go through with Dan and with Gordon you can go through this stuff specifically. But they are not that hard to model out.

In the simplest of terms, if you take the return on capital in the vehicles, if you look at NRZ, which has had, I think, a 29% return on equity since the day that they went public, in very simple terms you would say the fees are 1.5% on equities; that would be a deduct from the 29%. Then you calculate a performance fee of 25% of the difference between 10% compounded and the 27.5%, if that was the example.

As the vehicles get larger and as they actually experience a bit more history and get more fully invested, they become easier to predict. So I think as the quarters go by and the capital becomes a little bit more steady state, it will be easier for you and the rest of the investors to predict.

But you can look across that. Obviously, what we are trying to do is generate 20%-plus returns in each one of the vehicles. That's the nature of the activities that we pursue.

There is some lumpiness with that, to be sure; but I think over time it will seem less lumpy. And as you get more of a portfolio effect of six of them or prospectively more, that will also have a smoothing effect.

But really I think the right and direct answer would be spend time with Dan and with Gordon and myself. We're happy to spend time on it. And you can go through and create a pretty good financial model for each one of them; and then as the quarterly numbers come in, you will be able to reconcile to that.

Chris Kotowski: Okay, thanks. That's it for me.

Operator: Daniel Fannon, Jefferies.

Gerry O'Hara: Thanks. This is actually Gerry O'Hara sitting in for Dan this morning. But just had a question on the Affiliated Managers platform, and if you could perhaps give us a little sense about how you see that portion of the business growing, and whether the fee structure -- it looks like 30% of earnings will be earned throughout the remainder of 2015. But will that change going forward? Or as other managers are, I guess, brought on will that be a similar fee structure? Or how we should think about that. Thanks.

Mike Novogratz: Sure. That number really right now is predominantly or actually solely from our investment in Graticule Asset Management, Adam's fund. We have a large stake in it, and the fund is doing well. We'll opportunistically look for other potential investors to put on the platform.

Right now we don't have any right in the queue. But we are certainly always looking.

Gerry O'Hara: Okay. That's it for me. Thank you.

Operator: There are no further questions at this time. I will turn the call back over to the presenters.

Randy Nardone: Great. Well, thanks, everyone, for joining us today. To sum up, we feel great about our start to the year: record AUM, momentum continuing from a record first quarter of capital raising. We are very optimistic about prospects for organic growth.

Tremendous embedded value in our funds and on our balance sheet, we feel very strong about -- very good about our prospects for meaningful upside to both DE and distributions looking further into the year. So thanks again, and we look forward to updating you again on our next call.

Gordon Runté : Thank you, everyone.

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

END