FORTRESS INVESTMENT GROUP LLC

Moderator: Gordon Runté
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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 second quarter earnings call. All lines have been placed on mute to prevent any background noise.

After the speaker's 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 keypad. If you would like to withdraw your question, simply press the pound key.

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

Gordon Runté : OK, thank you, Stephanie. Good morning everyone, and welcome to the Fortress Investment Group second quarter 2015 earnings conference call.

We issued our earnings press release earlier this morning along with an earnings supplement which is available on our web site. The supplement provides an overview of our performance and our business initiatives including a focus update on our permanent capital business. We will begin our call today with brief opening remarks from Fortress Chief Executive Officer, Randy Nardone, and Chief Financial Officer, Dan Bass. And we will then hear from Co-Chairman and Head of Private Equity and Permanent Capital, Wes Edens, Co-Chairman and Head of Credit, Pete Briger, and Principal and Head of Liquid Markets, Mike Novogratz.

Following these business updates we will 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 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. I also remind you that statements are made as of today, July 30, 2015, and will not be updated subsequent to the call.

With that, let me hand off to Randy.

Randy Nardone: Thank you, Gordon, and thanks everyone for joining us. Financial performance was strong in the second-quarter and we feel very good about our prospects for the full year.

Here’s the highlights. Our pretax DE for the quarter was 30 cents a share, two and a half times our first quarter results. AUM closed the quarter at an all-time high of nearly $72 billion, up 13 percent year-over-year. We raised $3.2 billion in alternative capital in quarter, bringing us to $8.6 billion through June. That exceeds capital raised in any full year since 2008. With strong capital formation, we closed the quarter with over $10 billion in dry powder. Gross undistributed incentive income totaled $1 billion at the end of Q2. Net cash and investments on our balance sheet totaled $1.3 billion. Together, this embedded value represents over half our share price today on a net basis.

Let me give some more color on a few items. First, our results show the increasing significance of our permanent capital business. With the completion of the FTAI IPO, we now have six publicly traded permanent capital vehicles. In the aggregate, they account for almost $7 billion in AUM. That means nearly 20 percent of our total alternative AUM today resides in unlimited life vehicles.

Second point, our results continue to reflect the strength and consistency of a truly exceptional credit business. Outstanding investment performance and an uptick in realizations led to second quarter incentive income of $110 million. That's the second highest quarter of incentive income ever recorded by our credit business.

Third point, our financial performance was strong even with a net negative result from liquid markets. As recently as 2013, liquid markets contributed nearly 30 percent of our total DE. We’ve underperformed for the past 18 months and Mike is here and will walk through some changes made at the end of June to address that.

Looking ahead for the remainder of the year and beyond we’re very well positioned to build on our first half performance. We have ample dry powder to put to work across multiple strategies. We see great prospects for continued strong growth in our PCV business and we have very substantial embedded value on our balance sheet and in our funds that points the potential for significant DE upside and for outsized distributions as investments are realized.

So, with a very optimistic outlook, we look forward to building on a strong first half. And with that, let’s go to Dan.

Dan Bass: Thanks, Randy. Good morning, everyone. Let me start by giving some additional detail around the financial results. Fund management DE, the earnings derived from our core operating business, grew double digits compared to last year in both the quarter and on the year-to-date basis. The $133 million of fund management DE recognized in the quarter this year was up 75 percent compared to the same quarter last year. It was also the third-highest quarter of operating income in our history. Incentive income was the primary driver of this result.

On the last earnings call I noted that a second quarter incentive income was off to a strong start. I am pleased to say that same momentum continued throughout the quarter. Specifically we recorded $183 million of incentive income in the second quarter. That is the fourth highest quarter of incentive income in our 8 plus year history. Multiple businesses contributed to this result.

In the quarter we recorded $74 million of incentive income from our PCVs, a record high for that business, $60 million from our credit PE funds and $50 million from our credit hedge funds. The main driver of the record PCV incentive income was the exercise NRZ options that Randy highlighted. We sold about 3.6 million of our options in the June NRZ offering, leading to $57 million of gross incentive income. This sale leaves us with $44 million of undistributed incentive income across our PCVs as of the end of the quarter.

Now let me discuss AUM and capital formation. First let's talk about AUM. AUM finished the quarter at $72 billion. This is growth of 3 percent in the quarter and 13 percent from the same time last year. This growth in AUM was balanced across our businesses with both our alternative and our traditional AUM growing by double-digits over the last year.

On capital formation, for the year we've raised $8.6 billion in capital, including $3.2 billion in the second quarter. The quarterly raise includes $2.3 billion in our PCVs, which is almost as much as we've raised in the prior two years combined, and $750 million in credit, primarily from the closing of FRO2 at its cap of $1 billion. And finally, with that we have now raised over $11 billion in the last 12 months and almost $15 billion in the last 18 months.

Quickly on incentive-eligible NAV, at the end of the quarter we had nearly $21 billion of assets eligible to generate incentive income, up over $3 billion from the same point last year. It is important to point out that we had another $7.5 billion of capital very close to their respective high water marks at the end of the quarter. This includes the remaining $4.6 billion of NAV in Fund V and $2.4 billion from two PCVs, New Senior and FTAI. Should the entire $7.5 billion in capital move past their high watermarks, over 70 percent of our incentive eligible assets would be above their respective thresholds.

A quick point on the balance sheet. As I've stated previously, monetization from our balance sheet could provide for future distributions in excess of $2 per share to our investors. This is based upon the expected reduction to the size of our balance sheet over time and it does not include any assumption for further appreciation from this point. I would encourage you look at the balance sheet page in our quarterly supplement that we just posted for additional details.

Finally on taxes, no change to report here. I still expect our tax rate for 2015 to be a percentage in the mid to high-teens.

So in closing, let me reiterate why I expect a strong close to the year. First, we had a great start to raising capital for the year. We have raised $8.6 billion of capital in just six months, helping build our dry powder over $10 billion. Deployment of this capital should help us grow our AUM and management fees.

Second, the permanent capital business continues to grow rapidly and stands as an increasing contributor to our bottom line results. As recently as two years ago, the pre-tax DE contribution for this business was 7 percent and it has now grown to over 20 percent during the last 12 months.

And finally, the embedded value in our funds and in our balance sheet continues to be significant. Even with significant realizations this year, our gross undistributed incentive income remains in excess of $1 billion and our balance sheet value remains robust at nearly $3 per share.

Thank you. Now let me hand it off to Wes.

Wes Edens: Thanks, Dan. Just to give you a brief update on the private equity sector for the firm. We had a very good first half of the year. Assets under management for PE are just over $16.5 billion now, about $9.5 billion of that is from legacy, private equity funds, and nearly $7 billion of that is, as Randy mentioned, from the permanent capital vehicles which have been a big source of activity for us.

In the quarter we raised $2.3 billion for the permanent capital vehicles. The capital formation follows a robust level of investment activity. There are notable transactions really across the board in the different vehicles. A larger transaction, the HLSS transaction which closed in the quarter, you know, we got FTAI public, very good prospects for the second half of the year across the board.

So, highlights. For the quarter as was previously mentioned, we did take FTAI, which is our transportation infrastructure business, public in the quarter. Our total market cap now with all the PCVs is $7.6 billion. You look at the supplement that we provided on page 6, the title of the slide is “Why We Like Permanent Capital.” The diversity that is afforded us by having a variety of these different vehicles that address different sectors is something that we think is very powerful.

It's hard to find attractive investments in a challenging market environment, so having a diversified group of companies that are looking at different sectors is very important. I’m very optimistic about the growth prospects for this segment of our business.

If you look at the numbers in the bottom of the page, market cap, $7.6 billion for the Fortress PCVs. On the right-hand side we just took the largest peers’ market caps to give you some sense that if you were the largest in each one of these sectors, how big could they be? It’s $142 billion, so $7.6 billion is a long ways from $142 billion.

It's not a matter of growth for growth’s sake. We get asked that question all the time and it really is that the formation of the capital is a derivative of the investment activity. And on the next page you can see that we've had a lot of activity here over the course year - $6.9 billion of permanent capital, up nearly 90 percent from the year end of 2013.

And we’re optimistic about a number of the different vehicles. In particular I’d say the investment activity in Italy is very robust for Eurocastle. Investment activity in the transportation infrastructure business, there’s some very good opportunities there. Also, in the mortgage space with New Residential, we see good things happening there as well.

Just to briefly touch on the segment overview itself and talk about the legacy funds on page 10. Fund V NAV for the first half of year up 16 percent and is driven primarily by Springleaf, but really we’ve had good activity and good returns really across the board and we're happy with the composition of the portfolio.

There's a number of investments that we think are nearing their natural life with us and so we do expect there to be good realization activity in the next 6 to 12 months. I can't forecast exactly which will be sold and what the time will be and the amount, but I'd say in general we feel very optimistic about the market that we are selling into.

The Florida investments, which are a very large pool of investments for us in particular, have done extremely well. That's not something we're looking to divest ourselves at this point, but it's notable just in terms of the activity level. The passenger train element of that is one that is nearing completion of the financing side, we're optimistic about that. The activity levels in Florida in general are very high and they're robust and we have a lot of capital deployed there.

So, so far a very good start to the year. The PCVs again, we have detail of that on page 11. It's, as Dan mentioned, a material contributor to the bottom line. More importantly than just the activity of the quarter where we harvested some of our option, is our run rate sustainable income from those vehicles is one that we think is going to rise, you know, fairly substantially. And as those funds get bigger, the margins get better and better.

And our goal for the business is meant to be a meaningful contributor to the bottom line of, you know, $100, or $200, or $300 or more of sustainable earnings. We think that that is a great base of earnings in the private equity sector and indeed is something that has more value than is being given at the moment.

So, all in all, a good quarter. And with that, I'll pass it over to Pete. Pete?

Pete Briger: Thanks, Wes. The credit and real estate businesses at Fortress have continued to do well in a market which is almost devoid of new investment opportunity. I mean, philosophically we're in a position where we continue to harvest our credit PE portfolios, we continue to harvest our real estate portfolios. We've raised quite a bit of capital but the investment pace continues to be slow.

On the credit hedge fund side, returns are muted given the context of the credit investing market, the market for financial and real assets generally. For the first time in a while we actually gave back capital in our credit hedge funds this month. And I would say from our perspective, while see a bunch of risk out there in the market, whether it's Puerto Rico, whether it's China, whether it's, you know, a potential secession in the European Union, we don't see the perception of risk really reflecting a good investment opportunity.

Obviously individual markets like energy have caused a fair amount of trauma for credit investors. Luckily we have not been impacted significantly in that particular area, but just the lack of perception of risk and the amount of capital on the sidelines has created few terrific opportunities even in that area.

We have had the opportunity to increase the size of our business by being a lifeline for certain businesses, Mount Kellet in particular. We're working to take that business over. It will add some resources to Fortress in the credit and real estate investing arena and hopefully there will be some new investment opportunities that come out of the sourcing channels from that business that we take on.

But overall I would say our business is probably in a contracting mode as it should be at this point where we're giving back more capital to investors than we're putting out.

I'll pass it on to Mike.

Mike Novogratz: Thanks, Pete. You know, unfortunately after two good stories from private equity and credit, the liquid market story is not so good. Starting to feel a little bit like Groundhog Day after these last three earnings calls.

But, you know, the macro fund has continued to have a disappointing year. We started the year with big losses in a Euro-Swiss position and have roughly gone sideways since then. At the end of June, actually starting July 1, took the decision to kind of restructure the business and restructure the fund where I become the sole risk taker, kind of going back to where we started.

It’s not as scalable of a business as it is when you have lots of risk managers, lots of portfolio managers. Hopefully it is a higher-margin business. Our focus now is solely on returns to our own capital and our LP investors’ capital. We’re rightsizing the business, scaling it down to an appropriate size for one risk taker. I feel pretty optimistic that the macro opportunity set is as rich as I've seen and that with kind of less complexity and more simplicity in our business we get back to generating good returns for our investors.

You know, the world is rife with both risk and opportunity. We think the Federal Reserve will raise rates even though they probably shouldn’t, come September. The Fed has never raised rates with a commodity sell-off like we are seeing today, but they seem hell bent on doing so, and so I think you’ll probably get a rate raise in September. China is going through really its first crises in a long time and navigating how they're going to deal with that is going to provide a lot of opportunity. And Europe, I think, continues to be interesting in that we’ve solved Greece for the short term but by no means even in a medium term is that issue over.

So we think the macro opportunity set is rich. We like our chances going forward. You know, we’ve lost assets. I told you the last call the great thing about the hedge fund business is that it’s Darwinian; you do well and you raise assets, do poorly and you lose assets and we’ve lost assets. We feel pretty comfortable that with these changes that we’re going to bottom out in redemptions and have been in contact with most our LP investors and we have a runway ahead of us.

We’ll continue to invest and hopefully, you know, by end of 2016, liquid markets is a contributor to the DE at this place again.

Gordon Runté : So, Stephanie, let’s turn it over to Q&A.

Operator: At this time I would like to remind everyone, in order to ask a question please press star then the number one on your telephone keypad. We’ll pause for just a moment to compile the Q&A roster.

And our first question comes from Devin Ryan with JMP. Your line is open.

Devin Ryan: Hey, thanks. Good morning, everyone. Congratulations on the nice quarter.

Maybe a couple questions here on permanent capital, you know, really nice momentum there and we can talk about kind of the outlook, but just given some of the maybe additional stability in those earnings and expectations for management fees, you know, how should we think about the ability or opportunity to increase the base dividend and where that can go as a result of the growth in permanent capital?

Wes Edens: Well if you look on a page that I skipped over, I was thinking I'd address it in the Q&A, it's on page 8, the illustration of the permanent capital economics. It's a good snapshot of what the business can do for us. So, you look on the left-hand side, the current assets under management $7 billion.

Our earnings are a function of both the amount of capital that we manage and obviously the returns. And you can see at 14 percent on our gross return, it generates a $70 million result for us, at 20 percent return it generates $154 million, so there's a big incentive of course obviously to focus on this business.

And then as those businesses grow, you know $10 billion to $15 billion, and of course we have said the peer of cohorts for us is $140 billion, so this is far from what the size could be. You can see that grow fairly substantially and keep that pre-pretax DE going $114 million to $234 million then the $10 billion example, $224 million to $404 million.

And obviously objectives are to grow the business where investment opportunities can yield these results for ourselves and shareholders and by doing so create a very sustainable, and steady, and growing stream of earnings that then can be reflected in the dividend rate and share price. But when you look at companies that manage very long-term streams of assets like this, they tend to trade at very high P/Es, EBITDA multiples, you know, 12, 14, 15 plus times, P/E multiples of 20 plus times. So, obviously when we trade at net of our balance sheet at a four times earnings multiple, we think there's a tremendous amount of growth in front of us if we could just, you know, hit the numbers.

Devin Ryan: That’s very helpful. And I know this has been touched on, on prior calls, but I guess following up to that point, you know, is there a level or maybe size of, you know, critical mass where if the market’s not rewarding the strategy within Fortress that you feel like it makes more sense to spit it out in and it can be supported kind of on its own two feet because it just seems that, to your point, the multiple of the company is well below any multiple that this business will be trading at on a stand-alone basis?

Wes Edens: Yes, I think it’s premature obviously to speculate about that. We've done spin outs on our other businesses where we felt like the value of the business was not being reflected in the share price and we’re obviously, you know, over 50 percent of the shares are held by insiders so we couldn’t be more aligned with outside shareholders on the issue.

But, you know, I’m hopeful that by creating the transparency and the consistency in growth that we’ll get the right valuation for the company, but obviously those are the kind of things we talk about.

Devin Ryan: Got it, OK. And then maybe without getting into specifics on the various vehicles, you know, in general when you look at the pipelines of the different permanent capital vehicles, you know, are you looking at any other large deals like the HLSS or would you characterize the pipelines for each of the companies as more granular and maybe, you know, singles more than home-runs?

Wes Edens: Yes, there are a couple of sizeable transactions that are in the market, but as Pete touched on, which I echo that it is a challenging investment environment, but it's not one that’s bereft of investments entirely.

So I think the three sectors that I would point to, transportation, infrastructure, there has been some distress in the energy side. We think that that's interesting. We’re looking into a number of things there including a couple that are sizable. The Italian situation is a terrific one. It’s a country that’s launched their big restructuring. So, we’ve got a very dominant market share there, so that could be a big source of growth.

And then, the residential real estate, 7 plus years after a financial crisis there's still, a fair bit of consolidation to go through there. So, very hard to predict if any of those things are economically interesting enough to transact on, but it's a very, very robust investment pipeline that we're looking at.

Devin Ryan: OK, got it. Great. And then just last for me, want to make sure I just heard the comment correctly, so the expectation is that based on current markets and what you see in the private equity investments today that you would be hopeful to have some realizations over the next call it 6 to 12 months there? Is that – is that accurate or did I mishear that.

Wes Edens: No, that's very accurate. Again, you can't predict exactly the timing or what will happen, but you look at the legacy investments there and there are a handful, I think by my count 7, that, you know, are very large and meaningful. They're all in various stages being evaluated right now and those funds for the most part are, you know, nearing the end of their, you know, their existing lives.

So, over the next year or two I expect the bulk of those investments to be liquidated and hopefully at very favorable levels. And, you know, we could expect some activity in the second half of the year if things go as planned.

Devin Ryan: Great. Thanks for the update and thanks for taking my questions.

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

Our next question comes from Robert Lee with KBW. Your line is open.

Robert Lee: Thanks. Good morning, and thanks for taking my question.

I guess the first one is maybe on capital - the new capital formation. Obviously you've talked at length about, you know, the Castles and that will be dependent on any specific situation, but you raise a lot of capital in credit, that feels like that's kind of through a cycle. You finished the real estate fund, obviously your hedge funds are having their issues.

So, you know, where is right now the, outside of the Castles, the increment – do you think incremental capital formation will be on the alternative side, you know, over the second half the year into 2016?

Randy Nardone: We’re still raising some money in FJOF. And on the permanent capital side, Wes commented obviously we focus on opportunities and we think capital will follow the opportunities. We think there are some things going on there that will attract some capital.

Robert Lee: OK, and maybe on the liquid side, you know, and understanding that you know kind of restructured the business to kind of maybe take it back to its roots but, you know, if you think about it the business and what Fortress is, Fortress manages I guess less than half the size of what it was at the IPO a bunch of years ago, obviously you’ve struggled recently.

To what extent do you think that, quite frankly, that’s a business that is even appropriate for a public company at this point, you know, single manager, clearly the market doesn’t seem to be giving you much credit for it. I mean, to what extent do you think a decision could be made that maybe that’s just better off not being part of the public entity?

Randy Nardone: Well, I think the market’s giving us no credit for the business right now and if you look historically, Mike has been, the business has been a meaningful contributor to our, you know, our results. You know, we have a lot confidence Mike is going to turn this around and it will become a meaningful contributor again.

Robert Lee: Yes, I know – I know it’s not an easy question. Maybe my last one, just on the distribution policy. I’ve probably asked this in the past but, you know, why not go to the policy that most of your I think all your peers have adopted where they kind of pay-as-you-go. You know, you earned it in the quarter and you kind of distribute it in the quarter?

Randy Nardone: I would say that's almost our policy. Our pay-as-you-go is, you know, net management fees and balance sheet realizations and we wait until the end of the year to distribute our net incentive. And that's, you know, that is our policy today and that's what we're sticking to.

I'd point out that our, you know, our overriding goal is distributing substantially all of our DE on a annual basis and I think last year we distributed all, which is more than substantially all. If you look at the last couple years, if you count share buy-backs we've distributed more than 100 percent of DE. I think on the last 12 months it's about 90 percent of DE. So, that's our policy.

And as Wes pointed out, more than half of the shares are owned by insiders who are very aligned distribution wise.

Robert Lee: OK. Well, thank you for taking my questions.

Randy Nardone: Well, thanks everyone for joining us today. We had a strong quarter and capping a strong first half. Move into the third quarter with momentum on a number of fronts and we feel good about our prospects for growth and value creation in the quarters and years ahead. We look forward to providing an update on our progress in October. Thanks.

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

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