FORTRESS INVESTMENT GROUP LLC

Moderator: Gordon Runte
October 29, 2015
10:00 a.m. ET

Operator: This is conference # 57023583.

Operator: Good morning. My name is Steve and I will be your conference operator today. At this time I would like to welcome everyone to the third-quarter earnings 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 then the number one on your telephone keypad. If you would like to withdraw your question, please press the pound key.

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

Gordon Runte: OK. Thank you, Steve. Good morning, everyone, and welcome to the Fortress Investment Group third-quarter 2015 earnings conference call. We issued our earnings press release earlier this morning along with an earnings supplement that provides an overview of performance and business developments. Both of these documents are available on our web site.

We will begin our call today with brief opening remarks from Fortress Chief Executive Officer, Randy Nardone, and Chief Financial Officer, Dan Bass. We will then hear from Co-Chairman and head of Private Equity and Permanent Capital, Wes Edens, and Co-Chairman and head of Credit, Pete Briger.

Before we begin let me cover the usual housekeeping items. 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 annual filings.

I also remind you that statements are made as of today, October 29, 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 today. We're 10 months into a very active and productive year. Highlights include record AUM, strong capital formation, and substantial embedded value in our funds and on our balance sheet.

Before I address our performance and outlook, let me make a few points on our recent announcements — the closing of our Macro Fund and Mike Novogratz's retirement from Fortress. Of course, we regret that Mike will be leaving the Firm after more than 13 years, and we're disappointed to close the Macro Funds, which had been productive in the past. But we're confident this decision was made in the best interest of both our LPs and our shareholders.

From a business perspective, the closing of the Macro Funds will have no impact on our outlook for earnings, growth, or value creation. Macro Funds represent about 2 percent of our AUM and contributed negative DE over the past year.

In connection with Mike's retirement, we'll repurchase about 57 million shares at a price that we believe represents a fair discount to the liquidity provided and a productive use of capital for our shareholders.

The transaction will not affect our dividend policy. We remain committed to delivering substantially all of our after-tax DE to shareholders either as dividends or, as we've demonstrated when the right opportunity arises, as buybacks.

Obviously, future DE will be driven by the strength of our core businesses which is clearly evident in our results year-to-date. AUM closed the quarter at an all-time high of $74 billion, up 13 percent over last year. We raised nearly $9 billion in alternative capital through the third quarter; that's more than any full year since 2007 and 40 percent higher than last year's total. Dry powder stood at nearly $9 billion at the end of the quarter. Embedded value remains substantial. Net cash and investments on our balance sheet was $1.4 billion at September 30. Gross undistributed incentive income totaled nearly $940 million. Together, that's over 70 percent of our share price today on a net basis.

So, we move forward focused on the strongest, highest-growth, and most valuable elements of our Company – a world-class Credit business with over $17 billion in AUM, over $8 billion in dry powder and exceptional performance across all main strategies; a $7 billion Permanent Capital business that now includes six public companies, each positioned for growth in enormous addressable markets; a Private Equity business with over $9 billion in AUM and significant catalysts for value creation across our largest portfolio companies; and a $33 billion traditional asset manager with terrific performance and a strong growth outlook.

Over the past three years these core businesses have delivered annualized growth in DE and AUM of 20 percent and 12 percent, respectively.[1] We have great expectations for continued strong performance and growth across these core businesses going forward. With that, let me hand it off to Dan.

Dan Bass: Thanks, Randy. Good morning, everyone. This morning I will discuss our financial results and outlook, including some additional details on recent business development.

First on earnings, pre-tax DE was $69 million, or $0.15 per share, in the quarter. This is EPS growth of 25 percent compared to the same quarter last

[1]Annualized growth in AUM and DE represents the CAGR between the third quarter of 2012 and the third quarter of 2015 (in each case, LTM for DE) for the PE Funds, PE Permanent Capital Vehicles, Credit PE Funds, Credit Hedge Funds and Logan Circle, excluding Liquid Markets. Does not include corporate allocable expenses that were previously included in Liquid Markets DE.

year. The quarterly result brings our year-to-date pre-tax DE to $261 million. This result is comprised of fund management DE of $251 million and investment income of $10 million. Importantly, fund management DE, or operating income from our fee-based business, is up 9 percent compared to the same period last year.

With that, let me dive a little deeper into the results. Management fees were up 5 percent in the quarter, largely from growth in our PCV and Credit Hedge Funds businesses. This more than offset a decline in our Liquid segment management fees.

Total incentive income this quarter was $70 million. This is about 60 percent of our average quarter over the last three years. For the year, we have recorded over $300 million of incentive income, up 13 percent from the same period last year.

Operating expenses were down 7 percent quarter to quarter, largely a result of headcount reductions in our Liquid markets business. Please note that operating expenses this year include $18 million of one-time noncash charges, including $11 million in the third quarter alone.

These charges relate to write-offs of certain software and technology assets in our Liquid markets business. Adjusting for these one-time charges, our pre-tax DE would have been $0.02 higher in the quarter and $0.04 higher on a year-to-date basis.

Moving to AUM, AUM finished the quarter at a record high $74.3 billion. This is growth of 3 percent in the quarter and 13 percent from the same time last year.

The quarterly growth in AUM was driven by the addition of Mount Kellett to our Credit Hedge Fund business. This added just over $3 billion to our AUM during the quarter.

Through September, our AUM has grown by 10 percent or about $7 billion in aggregate, including 16 percent growth in our alternative assets AUM.

Adjusting for the closing of the Macro Funds, our AUM growth still would have been 7 percent on a year-to-date basis.

With that let me give you some additional insight on recent announcements at Fortress. First, regarding the decision to close our Macro Funds, from an economic perspective we are removing an underperforming business from our P&L. This business was actually dilutive to earnings in the first nine months of this year, losing around $8 million.

As you heard, we will lose some AUM from this decision, approximately $1.8 billion, or about 2 percent, of our total AUM. As a practical matter, this AUM was far from any potential to generate incentive income, and prospects for P&L contributions in the coming year were uncertain.

Next, a few points on the announced share repurchase. The anticipated transaction total of $256 million is expected to have two components – $100 million upfront payment at closing and a note payable for the remainder.

Adjusted for the transaction, the value of our net cash and investments will go from $3.06 per share to $2.85 per share. In our view, we are using the $0.20 of balance sheet value now to gain an additional $0.10 of annualized pretax earnings on a year-to-date – on 2015 basis. At any multiple applied to those earnings over 2 times this transaction adds significant value and is a trade our shareholders would want us to make.

A quick comment on taxes before I close. No significant change here. I still expect our tax rate for 2015 to be a percentage in the mid to high teens.

So in closing, I'm confident in our prospects moving forward. AUM is up double digits this year, and operating income from our fee-based business has demonstrated strong growth as well.

We still have $9 billion of dry powder to deploy, and this is after putting nearly $2 billion of capital to work in the first nine months this year. As a reminder, for every $1 billion of capital deployed, we expect to generate about $15 million of annual management fees alone.

Also, the embedded value in our funds and on our balance sheet continues to be significant. Our net cash and investments per share has grown by nearly 30 percent in the last three years. Additionally, gross undistributed incentive income has grown by over 70 percent during that same time, even after recognizing a substantial amount of value.

So in summary, our core businesses are strong, our outlook for growth is very positive, and we have significant catalysts across our businesses that point to substantial upside for DE and valuation going forward. Thank you. I will now turn it over to Wes.

Wes Edens: Thanks, Dan. Welcome, everybody. Q3 was a very steady quarter for us in my part of the Firm. Operating performance across all the major sectors that we deal with was actually quite good.

Equity performance of some of the public companies was challenging. The silver lining of that, of course, is that it's created an investment environment that is maybe the best that I've seen in many, many years across a number of different sectors. So it's been a very, very interesting quarter.

$24 million of income out of the sector; it's $119 million year to date. The PCV's year-to-date now is $75 million; our goal is for that to be north of $100 million for the overall year. We feel very good about that from a guidance perspective.

The performance on the Private Equity side is obviously reliant upon a handful of investments, our consumer businesses, our infrastructure investments, etcetera, which from an operating standpoint did very well. And we’re optimistic about what the outcome of those are going to be.

From the Fund V perspective, we're basically right at the high-water mark with that. Given the handful of large investments there that we're optimistic about, we feel very good about the prospects for that over the short to intermediate term.

The sectors, one by one. The energy and infrastructure sectors, our strategy is to basically be agnostic with respect to commodity prices, so we're not making big bets on the energy sector or in the moving businesses, not the owning businesses, in a lot of those cases. There's just a tremendous amount of interesting things going on. We had big news in a handful of the investments over the quarter, and I'm feeling like the investment environment there is very good.

Financial services both domestically and in particular in Italy we feel great about. We've got a large platform in Italy on the distressed side that there has been a lot of activity with, which again we'll look to report news as we have it. We feel good about that.

Financial services stuff, obviously, here we've got companies reporting in the next week or two that will report on that, so I can't get in front of that. But we're very happy with the progress there.

On the senior housing front, although again the equity valuations have been challenged, people continue to get old, and that's a good thing for us – except for ourselves, obviously. With that the performance has been really steady and I feel better about those businesses than I have in a number of years.

So, operating performance, net-net good. We feel good about the outlook for the year.

Our goal for the Permanent Capital Vehicles is to generate returns. That's how we make the money.

Across the Firm we have well over $300 million in personal capital invested in those vehicles[2], and so we're disappointed in some of the equity performance over the last quarter, but we're very, very – do feel very good about the fundamentals of the business and we think that will bear fruit in times to come.

So with that I'll turn it over to Pete. Pete?

[2] Includes amounts invested in permanent capital vehicles (NCT, NRZ, NEWM, SNR, ECT, FTAI) and amounts invested and committed for investment in Fortress Equity Partners Fund.

Pete Briger: Thanks, Wes. I think the story in Credit is much of the same. We've had relatively good experience in harvesting our invested Private Equity Credit Funds. The credit environment continues to be uninteresting.

The beginning of this year we thought there were really very little opportunities in the credit markets, and pricing in the credit markets was awful. You've seen a little bit of volatility throughout the year in the credit markets, slightly better pricing, but still uninteresting on the whole.

People got into the energy credit piece of things early. You have a bunch of folks who've gotten hurt. I think for the most part we've stayed away from that and are really still biding our time.

Again I don't see a huge opportunity on the horizon. Everything that we're doing from a new investment perspective is really idiosyncratic. Nothing thematic, but we are investing some capital.

I would expect over the next year we'd continue to do relatively well in realizations in our portfolio, but caution that we're not replacing those realizations with new investments that we think are spectacular. So it's a – the Credit business continues to tread water. We've done reasonably well on a relative basis this year, but our absolute returns in our Credit Hedge Fund are minimally positive, something like 5 percent, and in our Private Equity Credit Funds continue to do very well but we're really realizing yesterday's investments. That's it for me.

Gordon Runte: OK, Steve, let's open it up 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 a moment to compile the Q&A roster.

Your first question comes from Devin Ryan with JMP Securities.

Devin Ryan: Yes, thanks; good morning. The first question on Permanent Capital. Some of the funds had been maybe victims of the recent market volatility. But with that context, it doesn't seem to be a great capital-raising backdrop.

So when we think about the platform as a whole and maybe opportunities to grow, is there anything else we should be thinking about as ways that these platforms can grow, even if markets don't recover?

Wes Edens: Well, it has not been a great quarter in terms of the equity performance, but it's been a good quarter in terms of performance. Relative performance of some of the sectors has been actually quite good.

I'd say the mortgage space, if you look at NRZ and all the stock that's not where it was at the peak, their earnings have been great. They'll report here next week.

That sector has been hit pretty hard, and I think that one of the things that we are very focused on are some of the corporate opportunities that arise as a result of this. Again, we don't like periods of instability and volatility in the stock market, but that is also the process that creates asymmetric opportunities.

There's a handful of sectors that have been particularly hard hit. Without naming names, there's one sector in particular that we're very focused on.

I think that over the long run this is about the business of making returns on capital. And while it's not a great time to raise capital, we have a lot of dry powder and we have actually a very, very good balance sheet. So it's the kind of environment that we like from an investment standpoint, and I'm optimistic that we'll find lots of things to do.

Hard to predict exactly the timing of it, but we feel good about that. I think when you look at the numbers of it, obviously, our goal – and this we stated all along – was to make this a meaningful sector for the Firm, have a very stable performance for it, and give a real bedrock in terms of the financial performance that we all rely on. North of $100 million in earnings we think is very, very achievable; and in fact we expect to do better than that.

Over time, as that can grow and rely less on individual outcomes of a specific investment but more a collection of these six different companies performing well in their various sectors, I think it gives a tremendous valuation profile to the Firm. So we feel good about it.

Devin Ryan: OK, got it. I guess just following up, to the extent there is dislocation in the market where some of those firms are investing, you would think about maybe issuing equity if the economics work? So you could still grow through maybe an acquisition to the extent there was something compelling and the math still worked, even though the equity values of the Permanent Capital Vehicles are a little bit lower.

Wes Edens: Yes, obviously, we're less focused on issuing capital this time and more looking to acquire investments. I think if you look at again the mortgage space, about a quarter of the firms trade between 50 percent and 60 percent of book, so those are all companies that trade at substantial discounts. We're not in the hostile tender business at this point, nor do I expect to be; but those are the kinds of things that we think do result in opportunities.

So again it's hard to predict exactly. I don't see us issuing equity without a material event. In fact if you look at the history of what we've done over the years, large equity raises have been the accompaniment of large individual investment opportunities.

So the HLSS transaction was a big catalyst early this year for NRZ. I think that pattern is likely one that will continue.

Devin Ryan: Got it; OK, great. That's very helpful color.

With respect to the Mount Kellett AUM that you will be co-managing, how should we think about maybe the economics of that AUM?

And then the investment professionals that are joining, should we think that they will also create maybe sourcing opportunities in the Credit PE business?

Pete Briger: The way I would respond to that is the AUM means very little to Fortress economically. We made an investment in the Mount Kellett Funds which hopefully should be a good relatively small investment; I think it was roughly

$200 million of assets that we purchased across funds. The actual net management fees should be relatively small with respect to that.

The amount of folks that we'll ultimately add long-term from Mount Kellett on the investment side won't be a lot. There weren't a lot that started with us day one, so it will be relatively muted, a bunch of asset management professionals.

There already has been some sourcing benefits from adding Mark McGoldrick and Mount Kellett to Fortress, and we'll just have to see how it goes. But I wouldn't say that it's going to be a material item in any respect to Fortress.

Devin Ryan: OK, great; that's helpful. Then just last, on the Macro business I believe the closing of that fund is net accretive to the Firm. Just trying to think about whether there is any other legacy infrastructure costs in the Liquids business that maybe are not going to go away as this fund shuts down. I'm just trying to think about the math of that just to make sure that we're thinking about it correctly.

Randy Nardone: Hey, it's Randy. Well, the Macro business as we pointed out earlier, it's about $1.8 billion of AUM. That goes away.

The DE contribution was negative, so certainly shutting down the business and shutting off the expense is a positive thing from Fortress's perspective. I think for the most part, the one-off charges that you'd see with respect to the closing have all been taken into account, so we're not anticipating anything really further on that.

Devin Ryan: OK. All right, great. Thanks. Helpful. Appreciate the answers.

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

Robert Lee: Great; good morning. Thanks for taking my questions. I guess maybe just going back to the Mount Kellett, just to make sure I understand, it's not going to have much of an economic impact, but just least optically should we be thinking that that $3 billion-odd that came on is a run-off portfolio?

So at least optically it's going to flow out of fee-paying AUM, even if there's not going to be much of an economic impact?

And when you mentioned you invested $200 million, was that in the – I'm assuming that was into the Fund, not the GP of whoever ran Mount Kellett.

Pete Briger: On your second question, yes. It was $200 million that were invested by the funds that we manage in Credit. And with respect to how the AUM is going to work over time, yes, it will get harvested and go out to investors similar to all of our Credit PE Funds.

Robert Lee: OK, great. Maybe more broadly, stepping back, you mentioned in the press release post-quarter-end you closed the FJOF III, I guess you call it. Can you maybe highlight – you hit your targeted cap of $1.1 billion, but how much is actually closed in the quarter? I think if I remember you may have closed some – had some closings before that.

And then also if you could update us, outside of Permanent Capital, what other fundraising initiatives are currently in the market.

Dan Bass: Yes, the $200 million was closed in the quarter at the final close. Pete, do you want to talk about the second question?

Rob, could you repeat your question – the last part of your question again, please?

Robert Lee: I was really just – what other strategies across the Firm are you currently fundraising for?

Randy Nardone: I think you've heard what we're up to. Obviously in Credit there's been a number big closings over the course of the year. FJOF's in the process of closing; I think Credit raised around $7 billion this year.

And, on the Permanent Capital stuff, as Wes pointed out, those are really opportunity-based, searching for growth.

Robert Lee: OK. Maybe one last question. Just the structure of the note on the share buyback, I think in the last go-round a couple years ago it had been a 14-

month payout, which you actually ended up paying a little quicker. Is this a similar kind of schedule, 14-month payout with payments due every quarter or so?

Dan Bass: No, it's anticipated to be a two-year note with two annual payments: first anniversary, second anniversary.

Robert Lee: OK, great. That was it. Thanks for taking my questions.

Operator: Your next question comes from Eric Berg with RBC Capital Markets.

Rosa Han: Hi, good morning. This is actually Rosa Han standing in for Eric Berg. Our first question is the large share repurchase you did in the third quarter would suggest that you feel that current values in Fortress shares is attractive. What do you think that the market might be overlooking with respect to your business?

Randy Nardone: Well, I mean if you take out the balance sheet and the accrued embedded incentive, we're trading at low-single-digit multiples to earnings. I think that would suggest that the stock is pretty cheap. And when you're able to buy your stock back at a discount to that, I think that that's a pretty attractive transaction for shareholders.

Rosa Han: Right, but why would the other market be – why would the market not assign a value to your balance sheet? I guess that's it.

Randy Nardone: Well can't really speak to why the market wouldn't assign a value to the balance sheet, other than you could speculate that people are wondering about the timing, for example, of the monetization of the balance sheet.

As we pointed out in prior calls and I think as our supplement points out, a big chunk of that balance sheet is in Private Equity, fairly older vintage funds, and represents some maturing investments that we are working on monetizing. So hopefully some of the uncertainty, to the extent there is any, comes out as the balance sheet gets converted to money.

Rosa Han: OK, got it. Thanks very much.

Operator: Your next question comes from Chris Kotowski with Oppenheimer.

Chris Kotowski: Hi, I guess a question for Wes, and that's – like I understand the Permanent Capital Vehicle stocks haven't done so well in the most recent quarter. There are lots of high-yield vehicles that didn't.

But how does that – or does that – impact the incentive fees that you earn? And how should we think about forecasting incentive fees?

Because I assume the incentive fees off the Permanent Capital Vehicles are based on the cash flows that the vehicles themselves receive, rather than how the market's treating them. Right?

Wes Edens: Yes, that's 100 percent right. The fees earned on the Permanent Capital Vehicles are a combination of a management fee, an incentive fee, and then options on stocks. The latter two are obviously a function of performance and then stock market performance. And to the extent that we have good fundamental underlying performance, we still generate the incentive fees.

This quarter was a little bit noisy. We end up reporting at Fortress prior to the reporting on some the other companies, and so we make estimates, and they move around a little bit. So there's a little bit of noise for this quarter.

But for the year in aggregate, we think that you're going to get a very steady-state on the management fees. And the return on equity across the different vehicles has been quite good, and we're going to great lengths to break that out and give people visibility so they can just simply add it up.

But I think that we feel very good about the prospects for generating incentive fees on a very consistent basis. That's the foundation of the financial profile that we want with those vehicles.

And they are now large enough and they are at scale enough that you should be able to make good predictions with it, and we're going to try and assist that with the supplements we're going to provide for each one of them over the course of the next week or so. But that's really the way to think about it.

Obviously to the extent that we have good stock performance and we own a lot of options, that also lends itself to generating fees. That is more idiosyncratic, and it's more a function of over a long period of time it generates meaningful amounts of money, but it's harder to predict than both the performance fee and the base management fee.

Chris Kotowski: OK. I guess if we just look at the last four quarters, right, $25 million, $3 million, $74 million, minus $1 million it just – what factors should we be looking at, at the end of the next quarter? What should we be looking at to try to flesh out what to estimate for that line item?

Wes Edens: I think that those quarters are less reflective of what we expect going forward because they are, again, periods of growth (…) I think that the fourth quarter, I believe, based on where we are right now, will be more representative of the steady-state of this thing. We'll try and help make some forecasts across the different vehicles to assist in that.

But as I said I think we're $75 million, roughly, in the Permanent Capital Vehicles thus far this year. We think that we're going to be well north of $100 million for the year.

And our goal is to establish a base run rate of $100 million-plus next year and look to move that up measurably. That's a reflection of some optimism about our performance and investment opportunities which then lead to capital formation.

But I think that the task that we have is to make yours and investors' jobs easier in understanding the consistency of those. And then we think the valuation for that I think will be a lot better.

Randy answered the question about valuation. My view about it is our valuation is ridiculously low. When you look at the foundation business on the Credit side and the consistency of earnings there, and the foundation of what we have in the Permanent Capital Vehicles as well as our Private Equity, that plus our balance sheet we think is really a ridiculously low valuation. I think the way to address that is to try and create as much simplicity and transparency as we can.

To the extent that there was noise associated with the Macro business or other things that were going on, we think that is taken out of it, and we'll try as a firm – make it our job – to make it a lot more transparent for everyone to understand what we're trying to do, and I think that the price of the Company will reflect that over time.

Chris Kotowski: OK. All righty, thank you. That was very helpful.

Operator: Your next question comes from Daniel Fannon with Jefferies.

Jerry O'Hara: Good morning, thanks. Jerry O'Hara actually stepping in for Dan this morning. With respect to the Macro Funds, do you anticipate any changes in demand from clients that may have had exposure to other Fortress products? I guess put another way, can you provide a sense of LP overlap with the Macro Funds and other products across the platform?

Dan Bass: We don't anticipate any shortfall demand due to that, due to the Macro Fund. There was very limited overlap. There was some, but very limited.

Jerry O'Hara: OK. Fair enough. Perhaps a follow-up with respect to modeling. Understandably and for various reasons, the blended fee rate has come in for the Liquid Hedge Funds as a segment or a group as a whole. Can you maybe take a moment to refresh us as to how the economics work for the Affiliated Managers portion of that AUM bucket?

Dan Bass: Yes, we own 30 percent of Adam Levinson and Graticule, and it comes in as 30 percent of what he earns on a quarterly basis. Management fees, incentive fees, net, we have 30 percent of that.

Jerry O'Hara: OK. That's helpful. Thank you.

Operator: Thank you. There are no further questions at this time. Presenters, I turn the call back to you.

Randy Nardone: Terrific. Thanks, everyone, for joining us today. Had a strong and eventful first three quarters, and our core businesses are running very well. Record AUM, a lot of capital available to invest on behalf of our LPs, and a substantial amount of embedded value. So we feel very good about our prospects for growth and value creation going forward.

Look forward to updating you on our next call. Thanks.

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

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