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 Fortress fourth-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 star then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

I will now turn the conference over to Gordon Runté, Head of Investor Relations. Please go ahead sir.

Gordon Runté: Thank you, Stephanie and good morning everyone and welcome to the Fortress Investment Group full-year 2013 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. After these remarks we will save most of our time today for your questions.

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

So just a few housekeeping items before we begin. I'll 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 they 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 handoff to Randy.

Randy Nardone: Thanks, Gordon and thanks everyone for joining us. I'm happy to report that a strong fourth quarter capped off an outstanding year for Fortress on every major front. 2013 was our best year since our first year as a public company in 2007.

With a lot of momentum carrying into 2014 we are feeling good about our prospects. We see ample opportunity to build on last year and to create long-term value for our shareholders.

Here are the highlights: AUM rose to nearly $62 billion, a record high even as we distributed $3.3 billion to LPs. Full-year revenues eclipsed $1 billion. Full-year distributable earnings were $434 million, or $0.88 per share. That's a year-over-year increase of nearly 70 percent.

For the first time in our history every one of our alternatives businesses generated over $100 million of DE for the year. As in the past few quarters, embedded value not included in DE continued to grow.

First, unrecognized incentive income, which will add to DE as investments are realized, increased to over $870 million at year end. That's up from $650 million at the end of 2012.

Second, net cash and investments on our balance sheet increased to $1.6 billion at year end. That's $3.26 a share compared to $2.40 at the end of 2012.

At year end, those investments were carried at about $600 million over basis and we still see upside from there. That embedded gain will turn into DE as the balance sheet is liquidated.

We close the year with ample liquidity and earlier this month we put it to good use. Fortress repurchased Nomura's 60 million shares at a price of $6 a share, a 25 percent discount to our share price at the time, a great value creation event for our shareholders.

Given the strength of our 2013 performance and outlook, our Board announced a 33 percent increase to our base quarterly dividend to $0.08 a share effective for the fourth quarter of 2013. Those are some of the headlines. Let me give you some more color before I hand it off to Dan.

As always, our results and prospects are driven by the returns we generate for our investors. Across virtually all funds and asset classes we had a strong investment performance in 2013.

In our Credit business, net IRRs in our main PE style funds ranged from 18 percent to 26 percent at year end. Our main Credit Hedge Fund, DBSO, recorded full-year net returns of 18 percent. This strong performance led to record gross incentive income of over $300 million for our credit business.

In Private Equity, main fund valuations increased by over 14 percent for the year. This translates to over $2.3 billion in value created in 2013 and nearly $11 billion since the low in 2009.

Funds III and IV gave up some ground in the fourth quarter mostly due to a decline in Nationstar's share price, which we think is overdone given our assessment of the Company's value and prospects. Fund V recorded substantial gains driven in large part by Springleaf's performance following its IPO.

The key point here is that we see significant valuation upside across our portfolio.

In Liquid Markets, our main funds delivered another year of top-tier returns. Fortress Macro recorded net returns of 14 percent for the year. Asia Macro delivered net returns of over 17 percent.

These funds generated gross incentive income of $150 million, our strongest full year of Liquid Markets incentive since 2007. We had a disappointing January but with 11 months remaining there's a lot of runway to make up lost ground and to deliver solid returns again for the year.

At Logan Circle, performance remained strong with 15 of 16 strategies outperforming benchmarks since inception. Of course, strong performance supports capital formation efforts and increases demand for existing and new strategies.

At the end of 2013 we are managing more capital on behalf of more investors than ever before. We raised $6.5 billion in alternatives, including $1.4 billion of equity raised in our permanent equity vehicles. Net inflows at Logan Circle approached $5 billion.

In Credit, we had $500 million in new commitments to DBSO and we launched the Japan Income Fund in December. In Private Equity we raised $1.1 billion for our second mortgage servicing rights fund and over $600 million for a new Italian NPL strategy.

We also continue to build our permanent equity platform with two spin outs from Newcastle: New Residential, which had its IPO in May, followed by New Media just two weeks ago. To put our progress here in context Newcastle had a market cap of about $9 million; that's million with an M, at the trough in 2009. Today, Newcastle, New Residential and New Media have a combined market cap of over $3.5 billion.

Moving to Liquid Markets, we raised $2.5 billion in 2013 and nearly $900 million in additional commitments already this year. Subsequent to year end, we also announced the launch of an affiliated managers platform which will allow us to take an economic interest in high potential managers and to generate additional revenue through a fee-for-services model.

We believe our own Asia Macro team transitioning onto this platform will provide strong proof of concept.

So, across our businesses we've maintained a lot of momentum on the capital raising front and just as important with New Residential, New Media, Italian NPL, Japan Income, affiliated managers, we are introducing new growth engines for which we have high expectations. Our business and our revenue streams are more diverse and more balanced than ever before. Our results in 2013 began to reflect the upside that can come from strong investment performance.

With over 120 percent of DE over the past two years put towards dividends and accretive buybacks, our commitment to optimizing shareholder value is clear. We believe our businesses are very well positioned to continue generating strong cash earnings. We also expect an increase in realizations of our balance sheet investments.

As we've said before, we intend to return this value to shareholders as we liquidate the balance sheet. These are fundamental elements of a compelling value proposition.

We had a great year in 2013. We have high expectations for 2014 and we see tremendous upside potential for Fortress and our shareholders. With that, let me hand it off to Dan.

Dan Bass: Thanks, Randy. Good morning, everyone. We had a record fourth quarter that provided a great close to a very good year for Fortress. Strong investment performance drove our results and we've demonstrated growth in all key financial metrics during the year.

Pre-tax DE was $121 million, or $0.24 per share, in the fourth quarter making it our highest fourth quarter of EPS on record. DE grew 86 percent compared to the third quarter and 13 percent compared to the fourth quarter of last year. This brought pretax DE for the full year to $434 million, or $0.88 per share, again a 70 percent increase per share over 2012 and our second-highest year of DE.

Let me now discuss some of the drivers of those results. Four key metrics stand out as we assess our current and future performance.

These include AUM, capital raised, NAV eligible for incentive income and undistributed incentive income in our funds. As I said to open, all exhibited growth last year.

First on AUM. AUM grew by another 7 percent in the fourth quarter, finishing the year at a record high $61.8 billion. This pushed AUM growth to over $8 billion, or an increase of 16 percent for the year.

Our alternative assets grew by 11 percent and our traditional assets grew by 23 percent. It marked the second consecutive year of double-digit AUM growth and pushed our five-year CAGR for AUM to over 16 percent.

It is important to note that this AUM growth does not include substantial dry powder in our funds. At year end we had $5 billion of dry powder in our Credit PE Funds, and an additional $2 billion in our Private Equity Funds. Of that total about $5 billion is available for general investment purposes. This is all after putting nearly $3 billion of work across all of our funds in 2013.

Next on capital formation, for the year we raised $6.5 billion of capital including another $1.5 billion in the fourth quarter. For nine straight quarters now we have raised more than $1 billion of capital each quarter. Of that $6.5 billion raised last year roughly half was in Hedge Fund structures and the other half in PE Funds and permanent capital vehicles.

And in just the first two months of 2014 we had already raised another $1 billion of alternative capital. All of that was added to our AUM in the first quarter.

Included in the quarter is $740 million raised in our Asia Macro Fund, $110 million in FMF, and $145 million in DBSO. Additionally, after the spin out of New Media we currently have four publicly traded permanent capital vehicles. These vehicles have $3.5 billion of AUM and are all eligible to raise capital in 2014 and beyond, so a promising outlook on capital raising front as we start the year.

Now moving to Incentive Eligible NAV. At the end of the year, we had nearly $22 billion of capital eligible to generate incentive income. This is up 30 percent from last year and has doubled over the past two years.

Finally, at the end of the year we had $876 million of gross undistributed incentive income in our funds. This amount grew by 35 percent in 2013 and has now nearly tripled over the past two years.

Now let me switch to the balance sheet. Let me make three points here. One, the value of our balance sheet continues to grow. In less than four years the value of our net cash investments has more than doubled to $1.6 billion, or $3.26 per share as of the end of the year.

Second, we see a potential for large realizations in the next few years based upon the profile and vintage of our investments. Around 70 percent of our $1.3 billion of balance sheet investments is invested in funds with vintages of 2007 or earlier or indirect public equity investments.

And finally, balance sheet earnings have started to become a material part of our distributable earnings. For the year we recognized $31 million, or $0.06 per share of earnings, from our balance sheet compared to just $1 million in 2012.

Now let me talk briefly about the financial impact of the Nomura transaction. Our dividend paying share count after the buyback is approximately 435 million shares, a decrease of approximately 12 percent from year end.

So looking at last year on a pro forma basis, this transaction would've added about $0.11 to our 2013 after-tax earnings. This demonstrates that the buyback should have a significant economic impact both now and in the future with immediate effect in the first quarter of 2014.

Finally, a few quick points on taxes. For the full year 2013 our tax rate for DE purposes was 9 percent. This puts our after-tax DE at $0.80 per share.

For 2014 we still expect our tax rate to be a percentage in the upper teens or low 20 percent range including a small benefit from the share repurchase.

Let me share some final thoughts before we get to Q&A. First of all, in my now 10-plus years here at Fortress I have never felt more confident about our business.

AUM is at an all-time high and continues to grow. We continue to raise a significant amount of capital. The embedded value both on our balance sheet and in our funds is substantial and over the past year we have put in place new engines for expected growth in all of our businesses.

Finally, our actions should have made very clear that we are committed to deploying cash to the greatest economic benefit of our shareholders. In two separate transactions we have deployed over $540 million to repurchase nearly 112 million of our outstanding shares.

Following these transactions our share count is now down nearly 20 percent from its peak midway through 2012. And at a weighted average cost [of?] $4.85 per share, these were enormously accretive transactions that will continue to deliver substantial and ongoing value for our shareholders.

In addition, today we raised our quarterly dividend by another 33 percent, this following a 20 percent increase last year. Taken together, these decisions underscore our continuing commitment to create value for our shareholders in various forms.

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 keypad. Again, that is star, then the number one on your telephone keypad to ask a question. Your first question comes from the line of Marc Irizarry with Goldman Sachs.

Marc Irizzary: Wes, maybe you can help just give us some perspective on the private equity portfolio performance, maybe we think about the pace of realizations and sort of the forward outlook there. Any color in terms of how you are seeing the harvesting environment for your investments. Thanks.

Wes Edens: So last year, the Private Equity Funds were up 14.4 percent. This is the fifth straight year of increases. They have averaged just under 20 percent a year for each one of these years.

So it is been a very consistent string of good performance numbers and I think we are very much moving into a cycle of realizations. Last year we had a modest amount of activity. We got a little busy at the end of the year on some of the distributions.

I think the total of the year was about $1.2 billion. I think it is likely to be a significant multiple of that is what we anticipate seeing this year.

We've got a lot of investments that have been terrific that are in the end stages of where we think we can add value and we will move along. So without being able to provide a specific number what we've been stating is that it is going to be a pretty productive year on the distribution side there.

Marc Irizzary: And then the balance sheet is in great shape here and obviously the transaction and the dividend raise is welcome. As you think about the $1.3 billion in investments in the harvesting of your own balance sheet, how should we think about that, the return of capital there?

You're going to stick with the annual true-up distribution, or maybe how should we think about the return of the one point ... as those investments come in where are you going to redeploy that balance sheet capital?

Wes Edens: I think that we've been really clear, Dan, Randy, have been very clear in signaling we have got more capital on balance sheet, more investments than we need to run our business productively. As Dan said we have had two really terrific opportunities to take capital and buy back stock at what we think are terrific levels.

I think the balance sheet is in great shape right now and to the extent we get a lot of liquidations I think our goal would be to return capital to shareholders. We always reserve the right to buy back stock if we think that's sensible, or make investments in businesses or assets that we have if we think that is sensible but I think in general my expectation is that if we do have the kind of liquidations that I anticipate, that will result in a lot of capital coming back to shareholders on kind of an asymmetric basis.

We have the ordinary course earnings to distribute in the form of income, payout in the dividends and then the true-up and whatnot. But there are the idiosyncratic liquidations that we think could produce lots of capital and send that back when we get it.

Marc Irizzary: Okay, great. Thanks.

Operator: Your next question comes from the line of Craig Siegenthaler with Credit Suisse.

Craig Siegenthaler: Thanks, guys. Good morning. First question here just maybe for Mike or Stu, I'm wondering can you talk about how recent conversations have gone with clients given January global macro performance and maybe any perspective on the potential impact to capital raising and redemptions here in the first half of 2014, maybe also full year 2014.

Mike Novogratz: Listen no one is happy when you lose 5 percent in a month and clients have been spectacularly supportive. We've been in touch with most of them, if not all of them.

The next six months of course is important for us. We are coming off two very strong years where we were a top quartile macro performer and so we've built up a lot of goodwill with our clients.

This was a bad month but it wasn't a catastrophic month. We've made some of that money back already and so our goal is pretty straightforward. You spend the first four months of the year getting back to zero and then you have an eight-month year, and we've done that in the past. I think our clients have confidence we will do it.

Certainly, we continue to see a pretty robust pipeline of inflows. It would be logical for some of that to slow down until clients see us regaining some momentum, so I think it probably slows the capital raising some but not dramatically.

Craig Siegenthaler: Thank you, helpful. And then a question for Pete. I am just wondering if January and February was enough to get you at least a little bit interested in several of the credit markets especially looking at several of the emerging markets in Eastern Europe and I'm just wondering if we could see you start to pull in the large uncalled capital balance this year, just thoughts there, please.

Dean Dakolias: It's Dean, Pete's not on the phone. I don't think much has changed in terms of our perspective on the geographies that we invest in. We still think it's a better environment for selling versus buying.

That said we are seeing pockets within Europe where we are finding interesting transactions. We have not gone further than the developed markets in terms of our business into the emerging markets where you mentioned before.

So our business traditionally has been focused on the developed markets ... North America, Europe, Japan, and Australia. So, again cautious, not a great environment to invest, so still that theme is still consistent.

Craig Siegenthaler: Great. Thanks, guys.

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

Robert Lee: Couple questions. Maybe looking at the new Hedge Fund platform in the Asia Fund I just wanted to clarify a couple of things around that. I guess the first thing is, with the spin out of the Asia Fund can you just maybe briefly talk about what a financial impact that is? I'm assuming it is relatively neutral to some extent. But can you maybe update us on that. And I'm also assuming there's no consideration for the majority stake that is being spun out?

How does this also impact your appetite to create in-house new Hedge Fund strategies? You went through the trouble of building this, it was successful, and now you have to give up the majority stake in it.

So should we think going forward you are more likely not to create new liquid strategies in-house and more likely to try to find outside managers you can put on the platform?

Dan Bass: So I will take the first one and then I will hand it off to Stu to deal with the second question. Our view is that this is going to be of real no significant reduction here.

In fact, we think it has a lot of upside from here due to the growth in this platform. So at the end percentage ownership we feel like this is going to be a positive for us.

Stu Bohart: And on the second question, keep in mind that our in-house teams have a high degree of alignment through synthetic equity or points so that even though we have spun Adam out, he is giving up some internal points in order to get more equity in the external. As we go forward we will focus both on the opportunities with external managers through the affiliated manager's platform and the goal there is to attract great managers who are independent but need help in building out their back office and accessing clients.

So, by partnering with Fortress we can commercialize our back office for a fee and be profitable on our infrastructure. We have a tremendous infrastructure here.

And two, we can get an additional path for growth and diversity by embracing external managers who need the partner. I will point out our platform is intended to have permanent partnership. Unlike some of the other platforms you read about, funds that have been raised where the manager has to buy back the stake later with after-tax compensation they have received, we have, we think, a much better plan.

Real partnership in perpetuity supporting their development of the back office, or taking over their back office, but leaving the PM position to focus on their performance while we help them raise assets. It does not mean we are focused solely on that. We want to be open for growth and diversity in the liquids markets business in multiple ways.

And certainly having new funds inside of Fortress is important to us and we will find those funds. That will take second place to focusing on the Fortress Macro Fund, which can certainly grow. It is been a terrific fund. And it is performing well in February. We think there is a lot of room for that fund to grow and continue to contribute like it did last year.

But you'll see us focus on growth and diversity in both ways. Internal funds and the new affiliated manager's platform.

Robert Lee: Okay, great. And maybe just on some fundraising. Outside the liquid products, I know you mentioned in the press release you had $600 million first close on the Italian NPL Fund and then there's the Japan Income Fund.

Can you maybe update us what your general targets are for those two funds? And maybe any other funds you may have in the market or expect to be in the market soon?

Wes Edens: The Italian NPL Fund we have a cap. I don't know if we can disclose what our cap is.

Randy Nardone: But we are still fundraising.

Wes Edens: Yes, we're still in the process of fundraising. I think we are very confident that we will be oversubscribed and kind of at the cap given the level of activity in that market and kind of the dominant position we have in Italy.

There seems like ... the opportunity is set there. I was over there a week ago. The opportunity set there seems tremendous.

So we have great hopes for that business both in our part of the private equity side as well as on the credit side because we think there's lots of opportunities to go around over there. The other capital formation I can talk about is on the permanent capital side, which as Randy said, we've gone from being a modest part of our business, we are plus or minus around $4 billion in capital on the permanent side.

I think we think in the natural course of events we'll roughly double that over the course of the year if things play out as we expect. And those are lofty expectations but there are six different vehicles that are being in the market raising capital on a periodic basis, so we think there's a lot of potential there.

Dean Dakolias: Japan income, we're just starting that process. We have a great franchise in Japan, have raised and invested two private equity style funds there and this is really an offshoot, kind of a natural progression of our business in Japan as it matures, so we see a lot of opportunities for that fund, but just early stages in the capital raising for that.

Robert Lee: I'm sorry, just one follow-up. Is the Japan Fund, is that in incentive generating fund or is that mainly a management fee?

Dan Bass: Is it generating incentive?

Robert Lee: Yes.

Dan Bass: Yes, it generates incentive.

Robert Lee: Great. Thanks for taking my question.

Operator: Again, if you would like to ask a question, please press star then the number one on your telephone keypad. Your next question comes from the line of Bulent Ozcan with RBC.

Bulent Ozcan: I just have a question regarding Newcastle post the New Media spinoff. Can you give us a sense of what you want to do next? Are you thinking about collapsing the CDO as higher or are you thinking about spinning off the senior living properties?

Wes Edens: Yes, actually we have an earnings call tomorrow so we'll probably wait for that earnings call to go through it in detail but the answer is there continues to be tons of activity there and we have a bunch of specific thoughts on it but I think we will hold off until tomorrow at our regularly scheduled time to talk about that. So just tune in for that, please.

Bulent Ozcan: Okay. My second question would be on the distributions. I'm just thinking, absent of the repurchase of the Nomura shares at a 25 percent discount which was a great deal, how should we have thought about the distribution? You paid $0.08 in the quarter, should we have assumed that about $300 million or so would've gone into paying out dividends in the current quarter? Just to kind of project out what might happen in the fourth quarter of 2014?

Randy Nardone: I'll take a whack at that. So the Nomura buyback was about $360 million ... it was more. So over the past couple of years we have paid out in both dividends and buybacks about 120 percent of total DE.

We raised our quarterly dividend from $0.06 to $0.08 and our quarterly dividend is intended to approximate what we think is a reasonable net management fee. There is still some room there but given our prospects for the year and the year we had, we decided to raise our quarterly dividend. And as Wes mentioned, as the balance sheet is liquidated we will revisit episodic payouts with respect to balance sheet proceeds.

Bulent Ozcan: And my final question would deal with Logan Circle. Could you give us an update on the growth equities franchise, what is happening there?

Randy Nardone: Yes, Logan Circle, as you know two businesses, fixed income and growth equities. Fixed income kind of turned the corner and right now we're at about a run rate of breakeven.

Their AUM is about $26 billion, $27 billion and good pipeline in that business and lots of activity. On the growth equity side the portfolio they are running has performed well.

Pipeline for new investors still robust. Haven't closed the first investor in yet, first outside investor, they are optimistic that something will happen soon but it hasn't happened yet.

Bulent Ozcan: Thank you much for taking my questions.

Operator: Your next question is a follow up from Robert Lee. Mr. Lee, if you will speak up.

Robert Lee: Another question on the balance sheet. Just in terms of near-term capital priority. I know I think you said in the press release you did draw down about $75 million of debt I assume to fund some of the share repurchase, so at least in the short term, since you were debt free at least for a year or so, how do you currently feel about that debt level? Is there a desire to get back down toward zero, or are you comfortable running with that kind of level of debt, not that it is that much, but running with any debt for the next couple of years or some period of time?

Dan Bass : Yes, we view that debt to be really insignificant and we anticipate it's really just a short-term borrowing and we will be paid down over the course of the next couple of quarters.

Robert Lee: That was it, thank you.

Operator: Again, if you would like to ask a question, please press star, then the number one on your telephone keypad. We'll pause for just a moment.

At this time there are no additional questions in the queue. I will now turn it back over to management for closing remarks.

Randy Nardone: Thanks. Thanks everyone for your questions and your interest in Fortress. It's a great year at Fortress and a great year for the shareholders.

We are well-positioned to build on our performance so far and have high expectations for 2014 and the years ahead. We look forward to updating you on our progress on our first quarter call about eight weeks from today. Thanks.

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

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