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Complexity made simple

Presented to the *Grant's* throng as a specialist in abstruse and illiquid—or, at the least, misunderstood—securities, Jody LaNasa, founder and managing partner of Serengeti Asset Management, did not disappoint. Buy Apollo Global Management LLC (APO on the New York Stock Exchange), he said, AP Alternative Assets LP (AAA on Amsterdam) and, in a roundabout fashion, unlisted Athene Holding Ltd., too.

"To fully understand the story I am going to tell you," LaNasa led off, "you would have had to do a lot of digging, a lot of analysis, and really understand insurance company accounting. Despite the fact that one of these companies is incredibly well covered by the Street, no one has properly described the value created by its affiliated company and how it flows through to the first company. I am going to talk about Apollo and Athene."

Apollo, with its $9 billion market cap and $113 billion of assets under management, is not exactly an unknown quantity. But, a little like Serengeti, Apollo makes a specialty of complexity and illiquidity.

Consider, LaNasa proceeded, that Apollo has expanded its AUM at a compound rate of 33% since 2008, and since its inception, its funds have delivered average annualized returns of 39%. Not that Serengeti is assuming anything like those rates in the years to come.

"What do you think a company growing organically at 30% per annum should trade at?" LaNasa asked the audience. "I would think that it should trade at better than 6.5 times earnings," he said. "Now, you would think that a company growing faster and performing better than its peers would trade at a higher multiple than those peers but, nope, here again Apollo trades at 6.4 times earnings while its peers trade, on average, at 7.8 times earnings." And they yield, or will yield in 2013, 11%, up from 8% in 2012, the jump attributable to the fact that one of Apollo's largest funds, the 2006 model, recently cleared a preferred return threshold.

"Interesting—let's make it even more interesting," LaNasa pressed on. "Let's talk about Athene. So far, everything I've spoken about you could piece together from company presentations and research reports. What we are going to go through now is not written anywhere in any research report, even though Apollo is incredibly well covered. It required a lot of reading, a lot of diligence and a great understanding of insurance company accounting to come up with."

Athene is a buyer of the kind of stranded, fixed-rate annuity obligations that life insurance companies are eager to be rid of in this zero-percent interest rate world. Pre-ZIRP insurers would confidently promise beneficiaries interest income in the future—say, at the rate of 4%—in exchange for a cash payment today. Well and good until the life companies' bond departments could no longer find decent securities yielding a satisfactory increment over 4%. Gladly are the insurance companies prepared today to sell these annuity contracts just to be out from under the liability. And gladly is Athene prepared to buy them—at a 40% or 50% discount to book value.

"So far," said LaNasa, "Athene has acquired $15 billion of assets supporting these fixed annuity liabilities with an average remaining life of seven years.... [It] takes these assets and sells all of the government bonds and investment-grade bonds and repositions the books into higher-yielding but still safe assets. It buys lots of structured finance. It buys lots of floating-rate bank debt. It buys lots of commercial real estate debt. By doing so, it transforms the portfolio that, in the hands of most insurance companies, is earning 5% into a portfolio that is yielding 7.4%. Interesting." Last year, Athene produced a return on equity in excess of 30% because of better portfolio construction—and better management, too, LaNasa added. Jim Belardi, the president of Athene, led SunAmerica to its meteoric growth in the 1990s.

Well and good, except that Athene is closely held. How to buy it? Enter now AP Alternative Assets, a.k.a. AAA, a closed-end fund that Apollo raised in 2006. It has $2 billion of assets and a market cap of $1.4 billion. Domiciled in Guernsey and listed on the Euronext bourse in Amsterdam, AAA last year was converted into a holding company that owns shares in the very same Athene—72.5% of the company, to be exact.

"So," said LaNasa, "now you have a way of buying Athene stock before Athene goes public. In addition, as part of this complicated transaction, Apollo agreed that by the end of November 2015, Athene will either be public or the stock of Athene will be distributed to the holders of AAA."

Complicated? AAA contributed its

investments in Apollo's private equity and hedge funds—over $1 billion in total—to Athene. AAA received Athene stock in exchange. Thus fortified, Athene bought two large books of annuity businesses. In December, it closed on the purchase of a $4 billion book of business from Presidential Life Corp. and agreed to purchase a collection of fixed annuities with $40 billion of assets at 0.5 times book value from Aviva Plc.

"Now, this is where insurance company accounting comes in," LaNasa went on. "These purchases—at large discounts to book value—will more than double Athene's book value to $3.5 billion without Athene having to issue any more equity. Let's talk about that. Why is that? One is the bargain purchase-price discount, and two is because of a complicated insurance law that allows you, the acquirer of these assets, to recognize unrealized gains in the acquired investment portfolios that the seller is unable to recognize.

"By buying AAA, how cheaply are you creating Athene? Today, before the Aviva transaction closes, AAA trades around $17 to $18 a share and the NAV of Athene was valued at book value today at about $21 a share. So you are creating it at about a 15% discount to its business before folding in the Aviva transaction. When you fold in the Aviva transaction and the accretion to book value, it creates for Athene and, hence, for AAA if Athene was just to trade at book value, it would be worth $35 per share. Pro forma the Aviva transaction, Athene will be earning about $6 of EPS. That means that looking through Athene, which is a different price than AAA, you are creating Athene at $35 per share at only five times earnings. Its peers today trade at 10 times earnings, and it is growing faster than its peers and earning a lot more than them. If Athene were to be worth 1.5 times book value, which by the way is only seven times' earnings multiple, then the stock would be worth $47 per share before factoring in any growth in earnings, and again you are creating it at $17. I am buying something at $17 or $18 that arguably is worth more than $47 in two years when this gets listed on an exchange. Seems pretty interesting."

Apollo, too, stands to gain, LaNasa said, because it manages Athene's assets. Owing to the prospective growth in management fees, Apollo's fee-related earnings stand to rise to $1.10 from 73 cents a share. Before giving effect to Aviva, Apollo is trading at 6.5 times earnings. After factoring in Aviva, it trades at 5.8 times earnings. "If you value the management fee earnings at 13 times (most traditional asset managers trade north of 13 times)," LaNasa wound up, "then you are creating the performance fee of Apollo at two times vs. four times previously. Finally, and most importantly, in 2014, this results in yet more growth in Apollo's dividend where, come next year, pro-forma for Aviva, Apollo should be paying out a 12% dividend yield. So what does this mean for Apollo in terms of appreciation when you fold all of this through and add in two years of dividends? It means that Apollo is looking like it should return 60% over the next two years to its investors. So, a win for Apollo and a win for Athene."

There was a question from the audience:

"What's your second-biggest position?"

"This is actually not our biggest position," LaNasa replied over the laughter. "Our biggest positions are in liquidations. We have a larger investment in KKR."

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