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White flag at Fortress

Ten years ago, Fortress Investment Group (FIG on the New York Stock Exchange) became the first private alternative-asset manager to go public. Last week, it became the first public alternative-asset manager to declare its intention to go private—at less than half of the 2007 IPO price. The public, "the dear public," as the brokers used to smirk, were the losers both coming and going.

Fortress was a *Grant's* pick to click. "Unaccountably cheap" we deemed the $7.33 share price in November 2014. "Unaccountably cheaper" was the verdict in these pages in September 2015, when it fell to $5.47.

On Feb. 14—this Feb. 14—Fortress announced it was set to sell to SoftBank Group Corp. (9984 on the Tokyo Stock Exchange) for $3.3 billion in cash, or $8.08 per share. Actually, management didn't have to announce a deal. The rocketing FIG share price indicated the news hours before the 6:08 p.m. press release hit the wires.

What did the pre-announcement buyers know, and when did they know it? Why a takeover price so seemingly meager? And, finally, do companies like Fortress—with their bespoke accounting, cumbersome tax reporting and lumpy earnings—have any business being in the public markets to start with? Speculation, if not answers, to follow.

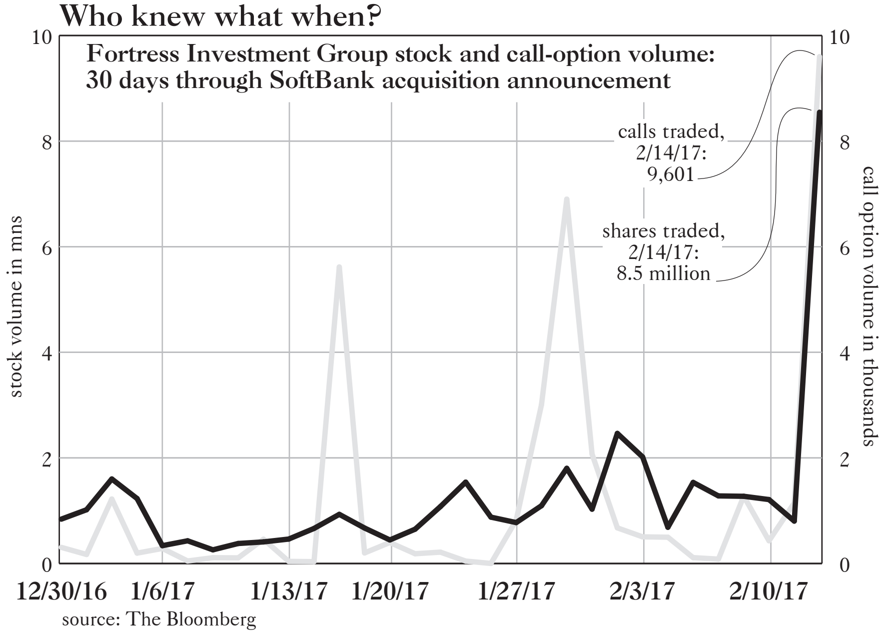
It's no front-page news that someone, corporeal or algorithmic, acted with uncommon foresight on Feb. 14. From a post-opening low of $5.79, the share price pushed higher all day to a $6.21 close on trading volume 8.6 times the daily average and on call-option volume 10.6 times the daily average. After which came the official valentine: SoftBank was prepared to pay a 38.6% premium to the Feb. 13 closing price.

Nobody else has stepped up to pay more, and Fortress is mum. Management has bit its lip even as to the timing of the next earnings release (Bloomberg says Feb. 23) or the earnings call that would follow (customarily, the company gives two weeks notice). With no management comment to go by, the market appears to expect the deal to close in the second half of the year; the stock is trading at $7.98, a percent below the offer price.

Barely two years ago, the Fortress chieftains called the valuation of the stock a "professional embarrassment"—our words, their sentiments. A litany of reasons help to explain Mr. Market's low appraisal of Fortress. The crisis-era gating of the Fortress Drawbridge Global Macro Fund dinged the corporate brand. So did the untimely accession of $800 million of debt in early 2008. Some of the company's investment partnerships have disappointed, others have been shuttered. More meaningful, though, than the flaws specific to Fortress are the ones that plague the public alternative managers as a class.

Fortress, like Blackstone Group LP (BX on the NYSE) and KKR & Co. LP (KKR also on the Big Board), speaks a non-GAAP reporting language. And it demands, also in company with BX and KKR, unusual tax-reporting protocols from its investors, which explains why the alternative managers are evidently off-limits to index funds. To illus-

Who knew what when?



source: The Bloomberg

trate the accounting complexities, we peel back the most recent (though not very recent) quarterly results. These figures we relate to the SoftBank bid.

Thus, in the September period, FIG reported $2.75 per share of cash plus investments less debt. Unrecognized incentive income (or carried interest) adds another $1.51 per share, following the deduction of employee profit-sharing provisions. The sum of those figures makes $4.26 per share, which constitutes cash immediately accessible to the buyer as well as cash available upon the liquidation of various funds.

Subtracting these amounts from the $8.08 buyout price gets you $3.82 a share. It's this sum that SoftBank is paying for the company's current cash flows. The amount is equal to four times pre-tax distributable earnings per share (or DES), which came in at 94 cents over the past 12 months reported. Assuming a 20% tax rate, in line with what the company paid in 2015, the takeout multiple is 5.1 times after-tax DES.

Fortress has long since recovered from the self-inflicted financial wounds of 2008. The Sept. 30 balance sheet showed $351 billion in cash and equivalents and $919 million in investments against $183 million in debt. The shares pay a base dividend of 36 cents per year, good for a 4.5% yield on the deal price. Fortress paid special dividends totaling 48 cents in 2014 and 11 cents in 2016. Share repurchases, from 2012 through the close of the third quarter of 2016, reduced the share count by 32%.

Chuck Royce, eponym of the Royce Funds (and featured speaker at the one and only *Grant's* Conference on March 15 —*advt.*) is on record with a bullish view on the alternative-asset managers and, according to Bloomberg, is a holder both of Fortress and KKR. "If the products are successful," says Royce, "you participate in the performance fees; if they are unsuccessful, you participate in the managment fees."

Among the three alternative managers already mentioned, Blackstone is the most diversified and commands the highest multiple of price to DES. KKR is the leader in private equity and—before SoftBank came along—was the second most highly valued, though at an extreme discount to Blackstone. Fortress is foremost in credit and, up until Valentine's Day, the least esteemed. Among the categories in which Fortress lags is growth.

First IPO, then crisis

source: The Bloomberg

Assets under management (or AUM) total $70.1 billion, down by 5% from their peak of $74.3 billion recorded a year ago. Compare to Blackstone, where fee-paying AUM was up by 13% in 2016, to $277 billion, or to KKR, where fee-paying AUM rose by 11%, to $101 billion. Managed fee-paying assets in credit funds, which are Fortress's bread and butter, totaled $18.3 billion as of Sept. 30, up by 5% from a year earlier. However, assets in the company's "liquid markets" funds, which trade in public and private assets, fell by 38% to $4.5 billion from $7.4 billion over the past 12 months. Fee-paying assets in leveraged buyout funds dropped by 23%, to $7.1 billion from $9.2 billion the year before.

"It's not so farfetched to imagine that the Fortress insiders, mindful of the firm's dependence on credit—in the first nine months of 2016, credit funds furnished 72% of distributable earnings—and on the credit cycle, decided to sell the business before interest rates started rising in earnest," colleague Alex Hess muses. "In a Jan. 18 memo, analysts at Keefe, Bruyette & Woods noted that, for alternative managers, 'confidence in future asset performance and the realization outlook [for carried interest] need to remain positive and improve in order for these stocks to work.' Put another way, asset values must remain high enough for unrealized carried interest to be realized and drop down to distributable earnings. For insiders at credit-centric Fortress, the possibility of multiple Fed rate hikes in 2017 or a rising default rate might have presented significant risks to its accumulated carry and balance-sheet investments."

Whether or not the SoftBank bid is insufficient (nobody's come along to top it), it's not what the market expected in 2007. Priced at $18.50 a share, the stock opened for public trading at $35. The SoftBank bid, at less than a quarter of that $35 print, values the company at the aforementioned 5.1 times trailing after-tax DES, adjusted for net cash, investments, carried interest and future employee payouts. Blackstone commands 13.9 times trailing DES, likewise adjusted. KKR trades at 4.3 times DES, again so adjusted, which is 16% below the takeout offer Fortress received. (There's been not so much as an upside twitch in KKR since the SoftBank bid for Fortress.)

Who might propose a superior offer? "Perhaps, say, Franklin Resources, Inc. (BEN on the NYSE; see *Grant's*, July 11, 2014)," Hess speculates. "Franklin's assets have been shrinking. As of Jan. 31, they totaled $729 billion, down 21% from a peak of $921 billion in the second quarter of 2014. FIG's assets over the same span have risen to around $70 billion from $64 billion, the aforementioned recent decline notwithstanding. Buying Fortress might present Franklin with an alternative source of growth. Then, too, Franklin has the means: $8.2 billion in cash on the balance sheet compared to $1.4 billion in debt. In those circumstances, a deal would not need to be financed from debt or additional equity. And while Fortress' tax rate is far lower than Franklin's, FIG trades cheaply enough so that a deal would likely be accretive under most scenarios. Just a suggestion, free of charge to Franklin and its bankers."

So, why is SoftBank—a conglomerate with stakes in Japanese telecommunications, Sprint (on whose capital structure *Grant's* is bearish), chipmaker ARM Holdings, Alibaba and Yahoo Japan—interested in Fortress? One explanation: The acquirer needs expertise in private-market deal-making. Softbank has announced, to much fanfare, plans to launch a $100 billion technology fund called the SoftBank Vision Fund. It has said it would contribute $25 billion of its own money to the fund, and invest $50 billion in Donald Trump's United States. According to the Reuters blog Breakingviews, "While the deal [for Fortress] doesn't directly involve the $100 billion Vision Fund . . . the two are clearly related. That fund's manager, former Deutsche Bank trader Rajeev Misra, spent a year at Fortress before joining SoftBank in 2014. And [SoftBank's investment in Fortress] was arranged by F.A.B. Partners, a boutique set up by three of Misra's former Deutsche colleagues last year, which is also helping with the Vision Fund."

Maybe the SoftBank bid is the harbinger of higher valuations for Blackstone and KKR. After all, as an interested party reflects, it's not as though the people who run those institutions are indifferent to money. They wake up every morning thinking about how to infuse value into the investments their companies hold. It would be strange, indeed, if they did not eventually figure out a way to infuse value into the equities of which they themselves are very long, i.e., the tickers BX and KKR.

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