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Unaccountably cheaper

What's a bear market? Surely nothing so cut and dried as a 20% decline in a price index. You know it's a bear market when you feel an almost irresistible urge to pull the covers over your head and spend the day (a weekday, that is) in bed.

Now unspooling is a bullish analysis of Fortress Investment Group (FIG on the Big Board), or we should say, another bullish analysis of Fortress. "Unaccountably cheap," was the headline over the first installment, which ran in the Nov. 14 issue of *Grant's*. The new headline indicates the direction of the share price in the interim.

It isn't just Fortress. Any stock that derives its value from a portfolio of assets has taken a pratfall. The list includes closed-end funds (a subject to which we return in this issue of *Grant's*), mortgage real estate investment trusts (quoted at 20% discounts to net asset value) and brick-and-mortgage real estate investment trusts (quoted at 18% discounts to NAV). As to the latter, according to Green Street Advisors, only the discounts at three previous junctures—the early 1990s, the early 2000s and 2008—match or exceed today's.

Fortress, KKR & Co. LP (KKR on the New York Stock Exchange) or Blackstone Group LP (BX on the NYSE) are not quite the same as the above-named punching bags. They are similar in their dependence on asset values. They are dissimilar in the way they are valued. The alternative managers are quoted in relation to fees and earnings rather than in relation to net asset value.

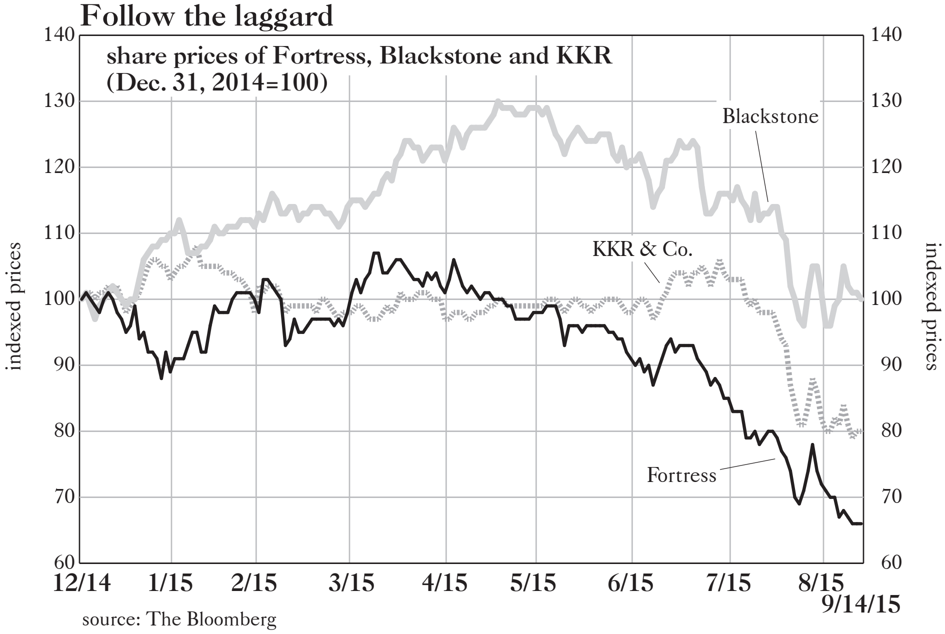
"The earnings power of FIG et al. ultimately stems from the financial markets—from investors' expectations about the likely future movement of the financial markets," colleague Evan Lorenz observes. "Judging by the track of the respective stock prices—since April 30, KKR and Blackstone have tumbled by 16% and 15%, respectively, Fortress by 33%—investors don't expect much."

Neither do we expect much, though we try not to dogmatize about the financial future. What we do expect is that the value inherent in Fortress will be acknowledged and capitalized by a set of people more numerous than the doughty bulls who hang on today for dear life. We don't know when.

Fortress is in the investment-management business. Its $72 billion of assets comprise private equity funds, credit funds, institutional fixed-income mutual funds and hedge funds. It earns management fees and, in some cases, performance fees and pays a quarterly dividend. Its interests range far and wide: a Miami-to-Orlando railroad link, an Italian debt restructuring business, a liquefied natural gas export terminal, an American subprime mortgage lending unit. It has a small exposure to emerging markets. One little LNG terminal constitutes the great bulk of its energy exposure.

In an efficient market, cheap stocks are generally cheap for a reason, even if one must guess at what that reason might be. Some possibilities in the case of FIG: unnecessarily complex accounting conventions, the obligatory bother of dealing with K-1 tax forms, the unpopularity of alternative managers as an asset class (which is a plain fact if a somewhat circular pretext), the

Follow the laggard



source: The Bloomberg

conspicuous difficulties of a not very important Fortress business segment, Fortress's less than glittering record in the public market, the sense that private equity's glory days are over.

Fortress was the first alternative manager to go public. The IPO, in February 2007, was priced at $18.50 a share. Next thing you knew, the price was $33 a share. The next, next thing you knew—the Great Recession was in progress—the price was 95 cents a share. What was behind this evisceration of value? Management had gone into debt, $800 million's worth in 2008, long after the point at which more wide-awake practitioners were getting out of debt. And, during the crisis, Fortress refused to honor a crush of redemption orders, rather erecting "gates" to keep its disaffected clients where they didn't want to be.

Since the date of the IPO, the S&P 500 has generated a cumulative return of 23.8%, including reinvested dividends. Over the same span, FIG has generated no return but, rather, an enormous dwindling: down by 76.8%, including reinvested dividends.

You might suppose that the company is still over its head in debt. Not so. As against $75 million in borrowings, the firm shows $234 million in cash and holds $1.2 billion in investments in the funds it manages. If only the financial reporting were this straightforward.

"Distributable earnings per share" is the bespoke Fortress accounting metric. It encompasses realized performance fees plus management fees minus costs and taxes.

"Economic net income" is the Blackstone and KKR bespoke accounting metric. It encompasses realized performance fees plus management fees minus costs and taxes, the same as Fortress. To this it adds unrealized performance fees and mark-to-market portfolio gains or losses. Highmindedly excluding the latter items, Fortress forever seems as if it were lagging the competition.

Last fall, Fortress was trading at three times trailing DES. We judged it unaccountably cheap. Blackstone and KKR at the same time traded at 10 and four times trailing DES. (In each case, we adjusted the share price for cash and investments, net of debt, and for unrealized performance fees, net of future employee compensation). Now look: With respect to trailing DES, Fortress is quoted at two times, Blackstone and KKR at 7.5 times and 3.8 times. Inside a cheap industry group, FIG comes almost, if not quite, for free.

Fortress Investment Group LLC
(figures in $ millions)

	12 mo. thru June 30, 2015	2014	2013	2012	2011	2010
Assets under management						
Private equity	$16,535	$13,933	$15,583	$14,271	$12,466	$14,960
Liquid hedge funds	7,377	8,128	7,398	5,060	5,515	6,355
Credit funds	14,491	13,128	13,383	13,414	12,208	11,590
Logan Circle	33,564	32,342	25,386	20,685	13,524	11,708
Total	71,967	67,531	61,750	53,430	43,713	44,613
Distributable earnings						
Private equity	152	224	140	115	118	145
Liquid hedge funds	9	22	117	45	14	64
Credit funds	204	208	191	126	138	168
Logan Circle	-4	-5	-9	-10	-17	-15
Unallocated	0	-3	-5	1	-11	11
Total	361	446	434	278	242	372
Shares outstanding	454	448	493	533	528	518
Distrib. earnings per share	$0.82	$0.99	$0.88	$0.52	$0.46	$0.72
Dividend per share	$0.62	$0.80	$0.26	$0.21	$0.05	$0.00

source: company reports

Neither does Fortress do itself any competitive favors with the manner in which it presents its dividend. Alternative managers pay out most of their distributable earnings. As Bloomberg presents the results, Fortress yields 5.9%—not bad in this zero-percent interest rate world, but hardly dazzling in comparison to the 8.5% and 8.9% yields on offer from Blackstone and KKR.

Fortress, in fact, yields a great deal more than 6%. Whereas Blackstone and KKR distribute all but a little every quarter, Fortress pays a steady quarterly dividend: eight cents a share. It distributes whatever remains at year-end. Over the past 12 months, enough has remained to deliver a total of 62 cents a share, which, at the current stock price, indicates a dividend yield on the order of 11.3%.

"Can a private equity firm LBO itself?" Matthew Klecker, eponym of Klecker Capital Management, Chicago, and a Fortress shareholders, playfully asks. Good question, as Lorenz observes: "In some ways, Fortress makes an ideal LBO target. It produces its income from durable franchises. Its funds have multi-year lockups (not the gated kind). It has lots of cash. It's out of favor. The sum of net cash, investments and net undistributed incentive income amounts to more than two-thirds of the $5.47 share price."

Well, Fortress isn't going to LBO itself, Wesley R. Edens, a co-founder, co-chairman and principal of Fortress, assures Lorenz. Neither is it likely that the company will undertake an aggressive buyback program, though Edens likes to say that FIG is the cheapest stock he knows of and he himself has just bought 200,000 shares at an average price of $6.05.

FIG is almost as thin as it is cheap: Against its $2.4 billion market cap, the stock trades an average of just $4.3 million worth a day. What makes the float so thin is the heavy insider ownership; officers and employees own slightly more than half of the outstanding shares.

At $5 and change, the FIG share price languishes just where it did in the waning months of 2009. Six years ago, the company had $31.8 billion under management as opposed to $72 billion today. Six years ago, its private equity assets stood at $14.6 billion, as opposed to $16.5 billion today. Six years ago, the Fortress credit division, today's crown jewel, managed $12.9 billion; today, it manages $14.5 billion. Six years ago, Fortress generated distributable net income of $126 million; in 2015, it will likely produce $425 million. Six years ago, Fortress paid no dividend; in 2015, it stands to distribute as much as $318 million.

The transformation of the company goes deeper. Since the horrific raising of the gate in 2008, Fortress has funded itself with a growing number of so-called permanent capital vehicles. A permanent capital vehicle is a listed, closed-end-type fund that makes private equity-style investments. Fortress's stable—there are six—includes New Residential Investment Corp. (NRZ on the New York Stock Exchange), New Media Investment Group (NEWM, also on the Big Board) and Eurocastle Investment Ltd. (ECT on the Amsterdam bourse). In sum, the six manage private equity assets of $6.9 billion, up 88.3% in the past year.

"The beauty of a permanent capital vehicle," Lorenz points out, "is that Fortress is under no obligation to close it. The conventional p.e. fund has a 10-year life. On these permanent vehicles, Fortress earns a 1.5% management fee and, if the stars align, performance fees, too." All told, the private equity division kicked in $152 million in distributable earnings, or 42% of the total, in the 12 months till June 30.

Of the aforementioned $72 billion under management, a goodly chunk—almost $34 billion—is housed in open-end mutual funds earning fees of only one-fifth of 1% per annum. To the typical index fund, 20 basis points would seem a king's ransom. It does not seem so in the Fortress context. Logan Circle, as the Fortress mutual fund group is called, specializes in institutional fixed-income investment. The group has excelled in money gathering—assets under management climbed by 15.2% in the past year. It has likewise given satisfaction to its clients—15 of its 16 funds have beaten their respective benchmark since their inception. Only in the article of earnings has it not yet redeemed the hopes of the front office.

Even that is changing for the better. In the second quarter, Logan Circle broke even. From here on, management tells Lorenz, incremental revenue will drop to the bottom line, with the next $10 billion of AUM likely to contribute $20 million in distributable income, equal to four cents a share.

Credit is the Fortress strong suit. Buying, selling, managing and restructuring the kind of assets you won't find at Charles Schwab is the particular expertise of the division led by Peter L. Briger. The most profitable division, it delivered $204 million in distributable earnings ($52 million more than private equity) in the 12 months through June 30. Assets under management jumped by 11.6% to the aforementioned $14.5 billion over the same span.

Team Briger's interests are varied and far-flung. They encompass Italian debt restructuring and Italian solar power, both via Eurocastle, one of the half-dozen Fortress permanent capital vehicles already mentioned. Other Fortress funds seek undervalued and distressed situations in North America, Europe and Asia, including Japan. Direct lending, real estate, structured finance, orphaned and illiquid assets are among the Briger points of focus. The Drawbridge Special Opportunities Fund, oldest of some 28 Fortress credit funds, has delivered a compound 11.1% after fees since its 2002 founding.

It's the plaint of the Fortress bulls that Mr. Market chooses not to focus on the company's successes, but rather on its principal disappointment. The Drawbridge Global Macro Fund is that corporate problem child. Year-to-date through June 30, it produced a loss of 11%. In the salad days of 2007, it, and related funds, managed upwards of $8 billion. Then came the gating, and following that humiliation, years of mediocre performance. Global Macro itself (excluding related funds) today manages just $210 million.

The division of which the Macro Fund is the vanguard, the liquid markets division, contributed $117 million to company-wide distributable income as recently as 2013. In the 12 months ended June 30, it chipped in just $9 million, or 2% of the whole.

It would be easier to ignore the Macro Fund if it weren't managed—and, as of now, managed exclusively—by Michael E. Novogratz, one of the four Fortress founders. A star high school wrestler, alumnus both of Princeton and Goldman Sachs, where he was elected partner in 1998, and a member of a Federal Reserve Bank of New York's financial market advisory committee, Novogratz was a temporary IPO billionaire. Today, with an integer lopped off his net worth, he's picking up the pieces of his fund, telling dialers-in on the second-quarter conference call that he's decided "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."

We know an owner of Fortress who listened to the call. "There was a lot of good news," our source, who asks to go unidentified, tells Lorenz, "particularly around private equity and the permanent capital vehicles and the balance sheet and the credit business. As I was listening to the call, I was watching Bloomberg headlines. The minute that Novogratz said that we are down 12% or whatever on the year, five headlines popped up on Bloomberg. It was the first thing that popped up.

"The credit strategy has brought in $5 billion this year," our source goes on. "The permanent capital vehicles have raised $3.3 billion this year. Even if the worst-case scenario happens, that Novogratz goes away and leaves the business, [the money he manages] has been overwhelmed in terms of asset raising and therefore prospective economics from either the credit business or the permanent capital business. It doesn't seem to be the operative driver, yet the stock is down 33% since June."

Our friend winds up: "There is a reflexive, or non-valuation-sensitive sell impulse that says get me out of anything cyclical, might be illiquid, might be related to interest rates, might be related to credit markets. It might be the tail end of the whip of the equity markets. It doesn't matter what the price is, just get me out." Fortress, at least, has entered a bear market.

It might just be that the market knows something we don't. Possibly, "get me out" is the very stratagem for these troubled times. Then, again, times change and long-term investments—some of them—do come to fruition. We hold out this prospect with respect to Fortress Fund V, the fund that made the earlier cited investment in the Miami-Orlando rail connection.

The first thing to note about Fund V, the company's biggest p.e. fund, with $5 billion of assets, is that it's finally cleared its high-water mark. The meaning of that fact is that the fund's investors—and Fortress's investors, too—may now begin to receive carried interest on the fund's successful investments, including, should it redeem management's high hopes, the Florida railroad project.

"It's a rail and real estate project," Lorenz relates, "though let's just focus on the rail portion. If Fortress captured 5% of the 100 million annual automobile trips between the two cities and charged a rate one-third of the fare that Amtrak exacts in the Northeast, the rail link would generate several hundred million dollars in EBITDA. If the train garnered 10% of the traffic at a ticket price equal to Amtrak's, the investment would throw off $1.5 billion in EBITDA. That would imply that the train alone, never mind the associated real estate, would be worth upwards of $10 billion."

Complex though Fortress might be in design and financial presentation, the bullish case on Fortress shares is simplicity itself. To wit: Here is a bundle of call options that nobody seems to want. They are extremely cheap. Some of them might pay off.

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