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Unaccountably cheap

If efficient-market doctrine were correct, the price of a share of Fortress Investment Group (FIG on the New York Stock Exchange) would likewise, necessarily, be correct. Doubting the doctrine, we judge that the price is incorrect. With respect to Fortress, *Grant's* is bullish.

The memories you have of Fortress are likely to be harrowing ones. It was the first of the alternative investment managers to go public. The date was Feb. 8, 2007, and the price was $18.50 a share. There ensued a leap to $33 a share, followed by a plunge to 95 cents a share. For the giddy heights and despairing depths, many blamed hubris.

So maybe it's the gods who've made Fortress the runt of the alternative-manager litter. On Sept. 30, the company counted $66 billion in assets under management—a quarter the size of Blackstone—with another $7.5 billion of funds committed but not yet deployed. Private equity accounted for $14.2 billion of AUM, credit funds for $13.2 billion and liquid hedge funds for $7.5 billion; a more conventional stable of low-fee credit and equity funds chipped in $31.1 billion.

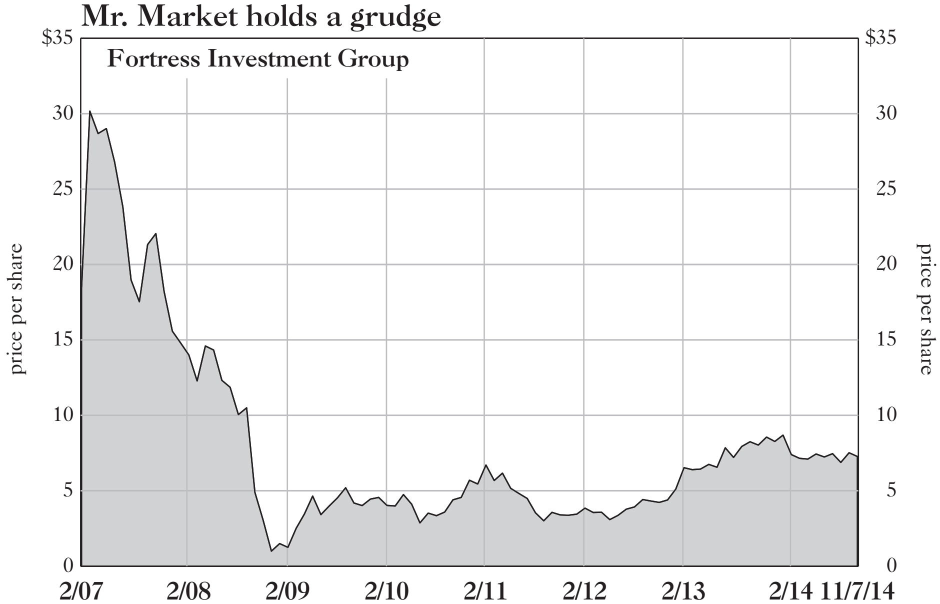
Blackstone is the largest, most diversified and fastest growing of the private equity-cum-hedge-fund-cum-real-estate managers; out of the $284 billion it oversees, $100 billion signed on in only the past two years. KKR, the most concentrated of the group in private equity, manages $96.1 billion. In the diversity of its asset composition, Fortress resembles Blackstone more than KKR. In valuation, it resembles KKR, which is cheaper than Blackstone; Fortress is cheaper than KKR.

The Fortress front office, including the CEO co-founder, Randal A. Nardone, and another co-founder and co-chairman, Wesley R. Edens, make no secret of their displeasure with the share price, and they say they mean to do something about it. In conversation with colleague Evan Lorenz, Edens put it this way: "We are involved with a lot of different public companies we manage, both directly and indirectly, and someone asked me the question recently: 'What do I think is the most undervalued stock?' It was easy to answer. I really think that Fortress is." As the insiders hold 53% of the common, their interest is more intense than that of the other shareholders, but it is otherwise identical.

To the bulls, ourselves included, what holds back Fortress is not so much what lies ahead as what came before. Edens et al. did not distinguish themselves in the Great Recession except by surviving it. They borrowed $800 million in early 2008 when the bearish handwriting was already on the wall. Conventionally, they suffered sharp drawdowns in the value of their in-house hedge funds. A little less conventionally, they raised a gate on one of those funds, the Fortress Drawbridge Global Macro Fund. The mocking cry, "They raised the drawbridge!" rang in their ears. Wall Street reputations are years in the making, moments in the unmaking. Fortress is still reassembling its broken pieces.

The work seems largely completed. The Sept. 30 balance sheet shows $75 million of debt—much shrunken from

Mr. Market holds a grudge



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the highs—as against $1.4 billion in cash and investments. The debt has financed a reduction in the share count to 442 million from 520 million before the first big buyback two years ago. On a per-share basis, net cash and investments come to $3.18. Unrealized performance fees add another $1 a share (after netting out the portion of fees due to employees). Compare to the current price of $7.33 per share, and you see a cheap stock.

Apart from recession-era missteps, a bear on FIG is likely to mention the firm's gratuitously complex accounting conventions. Fortress keeps score with a metric of its own devising, "distributable earnings per share." DES consists of realized performance fees plus management fees less all expenses and taxes. Excluded are unrealized incentive fees and mark-to-market portfolio gains, items that Blackstone and KKR do tally up and report (under the rubric "economic net income"). The omissions do not flatter Fortress's reported results. Nor do they simplify comparisons between Fortress and the rest of the alternative management field.

The bill of complaint against Fortress also touches on its functional, or effective, market cap. Because the majority of the shares sit in the strongboxes of the founders and partners, FIG is an unusually thin $3.2 billion stock. On an average day, $11.6 million worth of shares change hands. Big cap funds must necessarily steer clear.

So much for the warts, such as they are. On to the businesses and the values therein. First under the lens is the Fortress private equity effort. In August 2010, Edens et al. paid $124 million to AIG for an 80% interest in Springleaf, a subprime lender (whose public stub trades on the Big Board under the ticker LEAF). "We see really extraordinary opportunities for growth at Springleaf, and terrific upside in value creation from here," Edens tells Lorenz. "That's a big catalyst to the private equity returns of Fund V. That's probably the biggest one." Worth $2.7 billion today, the value of the stake could be further enhanced by a merger with OneMain, a Citibank finance subsidiary that the parent is currently shopping.

Fund V is one of three principal Fortress private equity funds. None is producing an internal rate of return to match or beat its 10% hurdle rate. Clear that rate—and Funds III and V are close, at 8% a piece over the past 10 and seven years, respectively—and Fortress can begin to book performance fees. A Springleaf price of $45 or so (vs. Tuesday's close of $37.34) would push Fund V into pay dirt.

Florida is another focus of the Fortress p.e. visionaries. They've invested $2.5 billion in a projected passenger railroad connecting Miami and Orlando along the route laid down by Henry Flagler in the late 19th and early 20th centuries, and in an existing freight railroad operating a mainline track between Jacksonville and Miami. Preliminary work on the passenger line began in August after long delays; the new timetable calls for operations to begin in two phases: Miami to West Palm Beach in 2016 and West Palm Beach to Orlando in 2017. No passenger trains have operated in the region since the 1960s.

"Passenger rail in this country is small relative to anywhere else in the world that's industrialized," says Edens. "But where it is done well it is wildly successful. If we are thinking about going to Philadelphia this afternoon, sitting here in New York, I think there is a 100% chance we'd say, 'Let's take the train.'"

South Florida is a tailor-made passenger rail opportunity, Edens goes on. The distances are too short to fly, too long to drive. Fortress is counting on its "All Aboard Florida" to succeed on two separate tracks. No. 1 is the earnings that the train will generate. Assuming it can capture 5% to 7% of the alienated drivers and disaffected flyers, the company could generate $250 million per annum of earnings before interest, taxes, depreciation and amortization.

No. 2 is real estate development. The owner of one-third of the industrial land in Dade and Broward counties, much of it contiguous to the rail lines, Fortress is banking on lucrative development opportunities. As of Sept. 30, $3.2 billion was the value assigned to its $2.5 billion investment. "In our base case assumptions, if that all comes to fruition, we see tremendous upside in our investment," Edens tells Lorenz. "Those are assumption-laden forecasts, so who knows? But I think there is so much more upside than there is downside in those numbers."

After a 2008 much too bad to be forgettable, Fortress's in-house funds bounced back. From 2009 to Sept. 30, 2014, the Drawbridge Global Macro Fund produced a compound annual average return of 7.7%. Like other funds of its class, it has struggled with central bank-managed markets. The star of the Fortress investment stable, the Drawbridge Special Opportunities Fund LP, is a credit and workout fund under the management of Peter L. Briger. "Financial services garbage collection," the former Goldman Sachs partner styles his lucrative vocation. After suffering a 26.4% drawdown in 2008, Special Opportunities has posted a compound annual average return of 18.2%. Briger's specialty is "the kind of investing that people can't do from a Bloomberg terminal," as a satisfied Fortress stockholder (name withheld at the owner's request) tells Lorenz. "He has a team of over 400 people. He has servicing arms all over the world. He is basically buying things that don't exist in the mark-to-market Bloomberg world."

Briger, our Fortress fan goes on, "invested a ton of money in 2008, 2009 and 2010. Those investments have appreciated dramatically. He has not harvested any of them, so he has really $1 billion of accrued carried interest that—if he had been running it through the P&L—we would have seen as revenues. There are costs associated with that, so let's call it $500 million of earnings that he would have reported had he been marking-to-market his investments."

For now, Briger's funds are the beating heart of Fortress, but there are other anatomical points of interest. They include a collection of publicly traded investment vehicles that Fortress manages for fees, including incentive fees (New Senior Investment Group [SNR] and New Media Investment Group [NEWM] are two examples); a private equity business funded with permanent capital called the Next Generation of Private Equity Fund (Edens is personally seeding $150 million of a $200 million investment); and a "traditional," meaning low-fee manager of institutional debt and equity portfolios by the name of Logan Circle.

Fortress paid $19 million for Logan Circle in 2010, when it managed $11.4 billion; now it has $31.1 billion. So low are the fees (and so high the necessary investments to facilitate growth to the necessary scale) that, over the past 12 months, the business has subtracted $11 million from distributable earnings. Fortress says it's banking on a doubling or tripling of assets in the not too distant future. With scale will come profitability, it predicts. Break-even is in sight for this quarter.

A pretty good sign that Fortress is putting its reputational problems behind it is the continued inflow of dollars to be invested. In the third quarter, assets under management grew by 14%, in line with the 15% and 7% year-over-year growth in AUM at Blackstone and KKR, respectively. Distributable earnings are another matter: for the first nine months, Fortress logged growth of just 13%, well behind the 85% and 68% year-over-year gains turned in by Blackstone and KKR. Then, again, Mr. Market is well aware of the earnings disparity. After netting cash and investments on the balance sheet (and recognizing the aforementioned $1 per share of unrealized performance fees), FIG is valued at roughly three times trailing DE. On the same basis, Blackstone and KKR command multiples of 10 and four, respectively.

"Spend some time with senior management, as I have done," Lorenz says, "and you come away with a very clear sense that, to them, the valuation is a professional embarrassment. In the third quarter, the company presented more detail about its divisions to encourage a sum-of-the-parts approach to valuation. More such sunlight is planned, my hosts told me. Dividends are on the agenda, too. Management pledges to pay out most of distributable earnings as well as excess cash and investments as it harvests gains. Even without an improvement in the liquid hedge-fund business or in Logan Circle, the company should be able to pay around $1 in operating earnings, which would represent a 14% dividend at the current share price. Then, too, investors stand to realize additional dividends when portfolio investments are liquidated."

In conversation with Daniel Bass, chief financial officer of Fortress, Lorenz asked how much capital the company needed to run its business? Much less than the cash and investments that are currently on the balance sheet was the answer. Perhaps $400 million to $600 million would do, Bass says.

To which Edens adds: "We have $1.3 billion or $1.4 billion going up to $2 billion. We have an abundance of capital. If you don't get valued for it, once it gets liquidated—and expect a lot of liquidation out of the private equity fund in the next couple of years—that's something we can turn back into dividends." Drawbridge down.

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