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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS



WALL STREET'S GARBAGE MEN

Fortress Investment Group is getting its hands dirty salvaging value from a real estate opportunity with an estimated value of \$2 trillion. Through its credit business, the firm believes it has the right team and resources for the job. By Jonathan Brasse

When visiting the senior executives of Fortress Investment Group's credit funds business, don't expect to be greeted by Wall Street types. The suave, suited and booted 24/7 thing is not their style.

In fact, within minutes of meeting group head Peter Briger, co-chief investment officers Constantine 'Dean' Dakolias and Thomas Pulley and managing director Anthony Tufariello, the sense is more that, for these guys, such considerations are something of an afterthought. Blue collars, sleeves rolled up and pints of coffee on the go is more their thing.

That initial impression is compounded further within minutes of *PERE*'s first interview with the New York-based multi-sector alternatives business, high up in their office at 1345 Avenue of the Americas. Briger, the 350-strong division's no-nonsense leader, has something of a personal rhetoric for how he reads the current market, and it smacks of getting one's hands dirty. Indeed, over the course of one sunny July afternoon in his long, window-clad office, the 48-year-old readily repeats lines from his recently inked white paper *The Great Liquidation & Great Litigation*, in which he describes the current market opportunity as being akin to "financial services garbage collection." That has come after a period he coins as "broken plumbing," which started on the day Lehman Brothers collapsed. In Briger's opinion, there's a hell of a lot of garbage worthy of collection, and his team is perfectly positioned to clean up.

"Today, you're looking at \$2 trillion worth of assets publically announced for sale, based on the book value of the outstanding principal balance, and we think that number grows," Briger says, listing Royal Bank of Scotland, Citigroup, Eurohypo and Wells Fargo Bank as just some of the potential sources. "That doesn't even touch upon the shadow banking system," he adds. Those non-banking groups, such as hedge funds, are the current custodians of more than 60 percent of the world's "truly at-risk credit," he claims. "That world is a dominating part of the opportunity set for us." If there's one key message to take away from the almost three hour sit-down with Fortress' credit team, it is that the debt space is this group's playground of choice and that is precisely where it feels the most interesting real estate opportunities lie.

Indeed, the scope of the opportunity the credit team sees in real estate through debt investments is why *PERE* is sitting

with Briger and his team today. That's not to say that real estate investments at Fortress reside only in the credit business. The firm's original private equity business – headed by Wesley Edens, the ex-BlackRock Financial Management executive who founded Fortress alongside ex-UBS managing directors Robert Kauffman and Randal Nardone back in 1998 – has a long history in the space. The real estate-focused Castle businesses reside within Eden's stable of portfolio investments,

alongside a number of operating companies with substantial, though indirect, real estate holdings. It also has invested in real estate financial services businesses, particularly those that provide loan servicing and origination services.

For direct real estate investments, however, the opportunity today falls within the remit of the credit business, a platform that since its inception in 2002 has grown to comprise \$11.3 billion of Fortress' overall \$43.8 billion in assets of under management. Says Briger: "We all cut our teeth in the days of the Savings & Loan crisis and the Resolution Trust Corporation liquidation, so we are somewhat victims of our upbringings. We like making investments where the entry vehicle is debt."

The team's experience is undeniable. While at Goldman Sachs, Briger headed the bank's whole loan sales and trading business and co-headed its fixed income principal investments group, its Asian distressed debt and its special opportunities and private equity businesses. Dakolias, who joined in 2001, was managing director, chief credit officer and co-founder of specialty finance company American Commercial Capital and broker-dealer Coronado Advisors. Tufariello joined in 2008 from Morgan Stanley, where he worked in senior positions across its various lending and securitized product function. Arguably, only Pulley has been more exposed to the equity side of things, joining in 2007 from DLJ Real Estate Capital Partners, the private

equity real estate business of Credit Suisse.

Having previously invested in bricks-and-mortar and real estate-related assets within the scope of its more general private equity and credit funds – historically, real estate and real estate-related investments typically could not exceed between 20 percent and 30 percent of a fund – it is Fortress' credit platform that today will be taking the company's appetite for real estate investing to the next level with the launch of investment



Briger: cleaning up Wall Street's mess



Pulley: spotting the hidden upside

funds dedicated to the sector. Indeed, the firm launched its first dedicated fund to the asset class, the \$800 million Fortress Japan Opportunity Domestic Fund, in 2009. It also has a smaller, US-focused net lease fund of about \$150 million, but the big news is yet to come.

Prior to this interview, *PERE* learned that Fortress brought a global private equity real estate fund to the market this summer, for which it hopes to raise up to \$1 billion. Fortress refused to comment on its fundraising efforts, but it is understood the vehicle will focus on debt investment opportunities in the markets where Fortress already has an established presence. In addition to its New York headquarters, the firm has offices in San Francisco, Los Angeles, Dallas, Philadelphia, Atlanta and New Canaan, Connecticut, as well as London, Frankfurt, Rome, Shanghai, Seoul, Tokyo, Singapore and Sydney. If you work in any of these cities, expect to see Fortress' credit business plying its trade.

Debt for control

While talk of Fortress' particular fundraising exploits is off the table, disseminating the platform's current approach to real estate investing is not. The central premise, as Tufariello explains, has evolved from linear debt purchasing and loan origination, albeit at higher margins than those of typical lenders, into one of debt for control. Of late, Fortress has been making debt-orientated investments where it can navigate its way into controlling positions, and this strategy is set to continue, especially with mature real estate markets as they are and emerging markets currently not part of its plans.

Fortress' current strategy also can result in simultaneously, subsequently or perhaps ultimately controlling the equity of an asset. "It's all about getting to the asset on a cheap basis," Tufariello says. Pulley, head of Fortress Japan, adds: "Right now, the debt is driving the opportunity, and it takes both the ability to figure out how to get to the asset in the most cost-efficient, expeditious manner possible and then also what to do with the asset."

When invited to describe recent deals that best reflect the current strategy, each man interrupts the next and their collective eagerness to talk through their particular choice investment is immediately evident. Briger describes how a \$1.2 billion bridge loan behind Harry Macklowe's height-of-the-market acquisition of New York's GM Building and other properties treated Fortress well, even when the entrepreneur himself was forced to sell his investments to repay his lenders. Briger explains: "In that case, we played the debt. We moved different forms of value, which were secured on the downside of the investment." Dakolias inserts: "We recovered our full principal and the contractual interest rate, while others in the capital structure didn't fare so well."

While he is proud of the Macklowe deal, Dakolias opts to draw attention to Fortress' \$140 million recapitalisation of The Sheffield, one of New York City's largest residential buildings. Over 54 days in 2009, the firm bought the \$79 million senior slice of the asset's mezzanine financing at a steep discount, prior to it falling into a Uniform Commercial Code auction. Hit by the global financial crisis and concurrent credit malaise, the property's previous owner, a group of investors led by New

York developer Kent Swig, defaulted on their original loan, which had been securitised via a CMBS structure. This enabled Fortress to push the asset into an auction process for the property, which it won as the sole bidder, while assuming the property's senior loan alongside the process. Dakolias describes the investment as the result of "active lending" and knowing how to be positioned in scenarios of foreclosure and enforcement.

Tufariello favours Fortress' recapitalisation of San Francisco multifamily complex Parkmerced. The 2010 transaction saw the firm acquire a preferred equity portion while restructuring and renegotiating the positions of several constituents in a capi-

Fortress Investment Group

Established: 1998

Public listing: 2007

Market capitalisation: \$1.75 billion (as of August 12)

Headquarters: New York

Other offices: London, Frankfurt, Rome, Shanghai, Seoul, Tokyo, Singapore, Sydney, San Francisco, Los Angeles, Dallas, Philadelphia, Atlanta and New Canaan, Connecticut

Staff: 900+

Leadership: Daniel Mudd, chief executive officer and director; Peter Briger, principal and co-chairman; Wesley Edens, co-founder, principal and co-chairman; Robert Kauffman, co-founder, principal and director; Randal Nardone, co-founder, principal and director; Michael Novogratz, principal and director

Assets under management: \$43.8 billion (as of June 30)

Alternative asset management businesses:

Private equity

Established: 1998

Assets under management: \$13.3 billion

Investment vehicles: 17 funds and other vehicles

Investment sectors: Transport, financial services, senior living, media/telecommunications, leisure, energy and real estate

Credit

Established: 2002

Assets under management: \$11.3 billion

Investment vehicles: 12 main funds, including its two flagship Fortress Credit Opportunities Funds and its Drawbridge Funds, which include hybrid hedge funds, real assets funds, long-dated value funds and various tailored separate accounts. The platform also is responsible for the firm's only dedicated private equity real estate funds, Fortress Japan Opportunity Fund, which closed on \$800 million, and its US-focused Fortress Net Lease Fund, which closed on \$150 million.

Liquid markets

Established: 2002

Assets under management: \$6.3 billion

Investment vehicles: Three hedge funds - Fortress Macro Fund, Fortress Asia Macro Fund and Fortress Commodities Fund - and the Fortress Partners Funds, which invests in both Fortress and third-party managed funds.



Parkmerced, San Francisco: slated to double in size

West Coast quagmire

Fortress entered the convoluted capital stack behind one of the largest neighbourhoods west of the Mississippi with a strategic investment that has positioned the firm to control its destiny

The executives at Metropolitan Life Insurance responsible for the development of Parkmerced would have turned in their graves if they knew just what a quagmire the financial structure behind the 3,221-unit San Francisco residential compound had become when Fortress acquired the asset in October 2010.

By then, the “city within a city,” as Tufariello describes it, had fallen into the hands of special servicer Aegon Realty Advisors. A combination of faltering real estate market conditions brought on by the global financial crisis and, more locally, the decaying of California’s state coffers meant the 155-acre site suffered from occupier attrition – many residents were students at San Francisco State University, which had suffered severe tuition budget cuts. Parkmerced’s occupancy fell from 96 percent in 2005 when it originally was purchased by Stellar Management to a far more worrying 87 percent, plunging the financing behind the asset into trouble.

Describing the relationship between the various constituents of the asset’s capital structure as dysfunctional, Tufariello recalls that any opportunity for Fortress depended on first successfully satisfying the various stakeholders behind the asset’s \$550 million securitised senior loan, its \$52 million mezzanine loan and its \$300 million and \$235 million preferred and common equity pieces. “Each constituent had different inter-creditor rights, so understanding where the control parts were was an important first step,” he says.

Being a fly on the walls of Fortress’ various negotiations would have been fascinating, given how the firm managed to create a replacement capital structure dependent on a decreased valuation of the asset from \$1.137 billion in 2008 to \$735 million. Post-intervention, Parkmerced is backed by a finance structure comprising a \$540 million first mortgage and just \$195 million of equity, \$160 million of which was preferred equity from the firms’ credit funds.

Dakolias underlines how important it was to work with Aegon,

something that was made smoother thanks to Fortress owning its own special servicer CW Financial Services. “We didn’t even have to pay off the senior debt and we were able to extend it for five additional years to give us time to put in place more permanent financing or, if we like, optimize the asset and sell it down the road,” he says. The senior debt was even renegotiated with a \$10 million discount.

“People were asking how Fortress negotiated a five-year extension on a \$10 million pay-down,” Dakolias notes. “The workout process could have taken a long time, so having the new capital come in more than made up for it [for the constituents].” One could surmise that Fortress’ involvement and willingness to inject its capital was worth the extension/small pay-down.

To Fortress, everything boiled down to risk perception. “In this case, the perception of risk was higher than the actual risk,” Dakolias says. “We took the execution risk out of the process.” Fortress’ reading of the asset appears vindicated as today Parkmerced is back to 95 percent occupancy, increasing net operating income by 15 percent.

Fortress would not confirm it, but PERE understands that the firm currently is in the midst of refinancing the senior loan into a seven-year loan for up to \$450 million and a \$175 million preferred equity piece with another third party. Perhaps more relevant to returns, however, Fortress does confirm it has managed to gain planning permission for a long-term plan to develop another 5,600 homes on the site.

“[Housing] is an asset class where there generally are impediments to development within San Francisco proper,” Dakolias says. “These entitlements were part of our analysis going in.” Ultimately, a strategic \$160 million capital stack investment has enabled Fortress to commandeer and grow one of the largest neighbourhoods west of the Mississippi River.

tal stack that needed to shrink from \$1.137 billion to \$735 million after faltering market conditions saw the structure backing the 3,221-unit scheme unravel alongside the relationships of the parties involved (see West Coast quagmire, opposite page).

Perhaps predictably, Pulley chooses Fortress' purchase of a \$230 million corporate loan to Japan's largest private equity real estate firm, KK daVinci Holdings (see Smooth landing, page 34). That was a deal that baffled some of Fortress' rivals when previous owner BNP Paribas brought the loan to the marketplace at the end of 2009. At the time, *PERE* had heard how firms questioned the upside of assuming the burden of lending to a business that, through overly aggressive practices, had soured many of its business relationships. Pulley adds: "Practically understanding what needed to be done, what could be done and what the pitfalls were, that is what has allowed us to be one of the more active acquirers in [the Japanese market]."

Today, the Fortress Japan Opportunity Domestic Fund is substantially drawn down, Pulley notes. In the days following the interview, the fund also was used to complete another investment, the recapitalisation of Invincible Investment, a Tokyo-based REIT, and its asset manager. "Again, we had to negotiate with a CMBS creditor," Pulley says, adding that the fund invested in the deal both as an equity and debt investor, "albeit a high-yield debt investor."

In all, the seven-year fund has been used to acquire approximately 2,000 loans with a total face value of approximately \$2.5 billion (including loans from units of collapsed bank Lehman Brothers) – equal to an average price of 35 cents on the dollar. Consequently, investors familiar with the fund report that it is on course to generate IRRs of north of 30 percent. "We've already returned more than 20 percent of the capital," Pulley states proudly.

Tufariello says it's important to distinguish between actual risk and perceived risk, the latter of which can frighten other firms away from an asset but that Fortress understands to be attractive. "As such, we are often early investors in areas where others don't see the value, only the risk," he adds.

Indeed, within the credit funds business, Fortress has raised and deployed more than \$5 billion since the global financial

crisis. "We didn't pause," Dakolias says. "While not necessarily in real estate, one of our most active periods was between late 2008 and 2009."

That being so, when asked how much dry powder is left for new investments, Dakolias reveals the credit funds have approximately \$3.1 billion, of which roughly \$1 billion can be funnelled into real estate investments under the current allocation limits of its existing multi-sector funds. "Let's clarify," Pulley adds. "That's from an equity perspective." Fortress also can originate new loans from other parts of the business.

Stinking roses

Not every real estate exploit of Fortress Investment Group smells of roses. For examples of those investments that have become challenging for the firm, *PERE* sources point to some

of the more real estate-heavy investments executed by the firm's private equity division. While investments in real estate services businesses like mortgage servicer Nationstar and consumer finance and mortgage provider Springleaf Financial have fared well, certain real estate-heavy investments have been tarred with the same brush as many other leverage-heavy deals to have suffered since the start of the global financial crisis. These include its 2006 purchase of Canadian ski resort owner and operator Intrawest for \$2.8 billion at the peak of the leveraged buyout boom and Gagfah, a Dresden- and Berlin-centric residential property business that Edens dubbed at the time "the biggest private equity deal ever completed in Germany." Bought for €3.5 billion, that firm has seen its shares decline in value significantly below that of its underlying real estate despite consistently solid operating results.

Fortress' private equity division is not the only culprit.

The men leading the credit business hold their hands up to some wrong calls as well. "We obviously have losses," Briger concedes. "You can't be involved in a thousand different transactions – \$12 billion of real estate – and not have losses."

Of its real estate ventures, Briger nods to Fortress' non-cash-flowing assets, which had no support from recurring income but significant debt obligations when the crisis hit in 2008. "We ended up having to walk away from some of those," he

Fortress timeline

- **1998** – Fortress is founded by ex-BlackRock Financial Management partner Wesley Edens and ex-UBS managing directors Robert Kauffman and Randal Nardone. Starting as a private equity firm, the value of its initial assets under management is \$400 million.
- **1999** – Fortress launches its inaugural private equity fund, Fortress Investment Fund I, the first in a series of five flagship private equity funds to come.
- **2002** – Fortress' credit and liquid markets businesses are launched with the arrivals of former Goldman Sachs partners Peter Briger and Michael Novogratz, helping to bring the firm's assets under management to \$2.5 billion by year's end.
- **2007** – Fortress completes its initial public offering on the New York Stock Exchange. At that point, the firm's assets under management are valued at \$32.6 billion.
- **2009** – Under the leadership of Japan head Thomas Pulley, Fortress launches its first dedicated private equity real estate fund, the Fortress Japan Opportunity Fund, closing on approximately \$800 million.
- **2011** – Fortress' credit business launches its first global private equity real estate fund, targeting up to \$1 billion in capital commitments.



Pacific Century Place, Tokyo: one of the deals that overstretched KK daVinci

Smooth landing

Fortress' ability to locate upside where others could not is demonstrated in its purchase of a corporate loan to Japan's biggest private equity real estate firm

At the end of 2009, when BNP Paribas marketed for sale a \$230 million principal balance loan behind Japan's largest private equity real estate firm, Tokyo-based KK daVinci Holdings, not everyone could see the upside. "The deal isn't 100 percent obvious," commented one chief executive who considered the investment at the time. But after scouring its way through daVinci's 50-plus partnership agreements covering some 89 different assets, predominantly Tokyo offices, Fortress felt differently.

"We will make a lot of money from this investment," says Pulley. "The values are there, and I'm convinced we'll generate substantial distributions. There will be a smooth landing for this company."

For daVinci's investors, lenders, operating partners and, perhaps most importantly, its occupiers, a "smooth landing," as Pulley terms it, is essential. According to sources who spoke with *PERE* for an analysis of daVinci, which was published in December 2009, the firm's story was one of aggressive investing gone awry – it grew to a hefty \$15.6 billion in assets under management at one stage thanks largely to outsized plays for assets like Pacific Century Place, an office for which it paid a Japanese record of \$2.2 billion.

Described as an "elephant hunter" by peers, daVinci at one stage pumped \$5.9 billion into just four offices buildings over a 15-month period immediately before the global financial crisis. The ensuing collapse of real estate values coupled with soured relationships meant the firm fast became a target for opportunistic houses – a notion not lost on Pulley. Pointing to the prospect

of bankruptcy, he recalls: "There was no foreseeable way they could pay back this loan."

Fortress saw an opportunity to attain control of daVinci's jewels, essentially a series of co-investments of between 10 percent and 20 percent in total equity across its various opportunity funds, at a severely discounted price. The price for the loan is believed to have been agreed upon at about \$30 million, equivalent to a discount of around 85 percent on its aggregate unpaid principal balance.

Pulley admits the analysis required for the deal was intensive but well worth it, particularly when considering how Fortress could leverage the Japanese market intelligence of the firm's 60-strong team, which remained for what essentially has become a workout company with no prospects of launching more funds. Indeed, Fortress was so keen to learn from daVinci staff that it moved the firm into an adjacent office at its Roppongi Hills headquarters, and Pulley expects some of the staff to wear Fortress badges one day. Even daVinci's founder, Osamu Kaneko, the man whose name is considered synonymous with the firm's previously aggressive tactics, remains involved in an advisory capacity.

Considering the investment today, Pulley says the deal aptly epitomises Fortress' ability to assess and navigate both the real estate fundamentals of a proposition, as well as the financing and the relationships surrounding it. His convictions appear to be vindicated as he reveals the investment currently is returning approximately 17 percent on invested capital. "That's consistent across our entire [Japanese] portfolio," he adds.

says. One example involved a large land purchase on the outskirts of Phoenix, for which Fortress teamed with a large US retirement system with a view to developing real estate over the medium to long term. Fortress originally committed to attaching a \$250 million debt piece to the system's \$100 million in sponsor equity. That piece was reduced to a \$100 million B note reflecting less than 1 percent of the investing fund's equity, but Briger admits he didn't expect what came next.

"The global financial crisis happened, and the retirement system decided this was one piece of land they didn't want to support for the next 15 years, which was the original thesis," Briger says. "Obviously there was a misjudgement on housing prices and land prices, but more so, there was bad judgement on our part on whether or not the borrower would stay the course." Not convinced the deal should have been doomed given the retirement system's original investment thesis, Dakolias adds: "Whether its 10 years or 20 years, eventually the demand will be there."

An inside track

There may well be future errors, but Fortress believes it has taken measures that will enable it to have the "first line of sight" on most of the opportunities in the real estate credit space. Specifically, it is referring to the July 2010 purchase of CW Financial Services, the second largest loan servicing business in the US, which was bought from Canadian pension fund Caisse de dépôt et placement du Québec for \$292 million after beating rival bidders – understood to include Starwood Capital Group and Vornado Realty Trust – at auction.

Tufariello recalls the "hotly contested bidding process" and the importance Fortress placed on obtaining the 350-staff business. "We had a view on the platform and what it meant to own it," he says. Crudely put, Fortress saw CW Financial Services as a window to \$160 billion of named special servicing rights and special servicing mandates currently stretching across about 11,000 loans valued at about \$23 billion.

As an example of this inherited insight, Tufariello says: "The market views the US' average loan delinquency as about 9 percent. The delinquencies in CW's portfolio are more like 13 percent." When you consider that CW Financial Services is working on approximately a quarter of all the country's loans in special servicing, understanding such a disparity helps For-

tress better mould its plans.

Fortress describes the market information afforded by the investment as a welcome supplement to the opportunity to grow the business itself. Indeed, that growth is firmly on track, with CW Financial Services on course for a "record-breaking year" of loan originations. Fortress believes loan performance in commercial real estate is on a "downward trajectory," which should provide its portfolio company with exponentially in-

creasing business and both the credit and private equity funds that jointly acquired it with a profitable exit when the time comes.

When that happens, both Briger and Edens are likely to be there to see it. Last month, the pair, alongside fellow principals Kauffman, Nardone and Michael Novogratz, signed new employment contracts tying them to the company for five more years. The announcement came as the firm published its second quarter 2011 results, which it described as "off expectations." Chief executive Daniel Mudd acknowledged that Fortress' distributable earnings of \$46 million in the second quarter, down 37 percent from the prior year's second quarter earnings, were "further off what we expect from ourselves."

If extending the principals' contracts wasn't enough, Fortress cushioned its disappointing second quarter results by stating it would reinstate its dividend distributions to shareholders. Mudd described the move as underlining "the board's confidence in the financial strength and earnings potential of the company."

Of course, the firm's credit business is expected to be a key engine in capturing that potential, particularly when you consider that the division's contribution to total revenue increased from 29 percent to 52 percent between 2008 and 2010. That looks all the more impressive when you consider it manages just 35 percent of Fortress' total assets (private equity manages 45 percent, while liquid

markets manages 19 percent.)

If the current return projection of its first private equity real estate fund in Japan is anything to go by, the omens look good for its more global follow-up. Perhaps blue collars, rolled-up sleeves and pints of coffee should be considered signs of productivity – a team focused on the job at hand. Then again, what else would a team engaged in "financial services garbage collection," as Briger put it, look like anyway? □



Tufariello: distinguishing between actual and perceived risk



Dakolias: promotes the use of "active lending"

