GREENLEA LANE CAPITAL
Private Investment Partnership

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Agenda

1. A mistake: Ambassadors Group
2. An investment idea: Ambassadors Group
3. A lesson: What I’ve learned about pricing power
4. An interesting company: Verisk Analytics

Ambassadors Group (EPAX)

- EPAX is an educational student travel company, based in the United States
  - Its primary products are 2-3 week educational trips for teenage students to international destinations
- Was one of Greenlea Lane's largest investments from late 2007 through late 2010
- Initial purchases made for ~$17 per share (12% position)
- Presented as my stock idea at VIS in 2009 at $14 (20% position)
- Recently traded for under $9 (8% position)
- Has been Greenlea Lane's most significant investment mistake

The Initial Thesis

- Unique franchise based on the People To People brand
  - Associated with a separate non-profit organization called People to People International (PTPI)
  - PTPI was founded in 1956 by President Dwight Eisenhower to support cultural exchange and remains associated with the White House
  - One of its core programs is The Ambassadors Programs, founded in 1967 and outsourced to EPAX since the early 1980s
  - The Programs have operated continuously for over 40 years

The Initial Thesis (continued)

- The People To People brand is unrivaled
  - Enriching itineraries include home-stays, community service, meetings with local political figures
  - Students complete a study program and usually earn college credit for their participation
  - EPAX is accredited and viewed as a resume builder
  - Only widely recognized student travel brand in the US, which is especially important because trust is a critical issue with parents
  - Strong network of EPAX alumni participate in the marketing process
  - Virtually no direct competition for high-end ($6,000+) educational international travel experiences

The Initial Thesis (cont'd)

- Inherently attractive economics
  - Solid operating margins: Range from 6% (recent trough) to 15% (2007 peak)
  - Generates free cash flow throughout the cycle: $8 million (recent trough) to nearly $30 million (2007 peak)
  - Little tangible capital: $30 million of tangible capital employed (mostly an owned office building)
  - Extremely high returns on tangible capital: 25% - 100% after tax
  - Float generated by prepayment of trips averaged $45 million over the last year
- But, more cyclical than I initially expected…

What Happened

						Estimated
	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Enrollments	**43,062**	**52,661**	**42,190**	**34,248**	**26,657**	**25,000**
Y/y growth		*22%*	*-20%*	*-19%*	*-22%*	*-6%*
Gross receipts	**219,500**	**277,346**	**229,200**	**203,700**	**158,900**	**154,133**
Y/y growth		*26%*	*-17%*	*-11%*	*-22%*	*-3%*
EBIT	**34,123**	**41,828**	**25,469**	**30,179**	**10,096**	**9,112**
Y/y growth		*23%*	*-39%*	*18%*	*-67%*	*-10%*
Free cash flow	**23,560**	**28,129**	**16,498**	**18,989**	**7,110**	**8,000**
Y/y growth		*19%*	*-41%*	*15%*	*-63%*	*13%*
FCF per share	**$1.31**	**$1.56**	**$0.92**	**$1.05**	**$0.39**	**$0.40**

What Happened (cont'd)

Source: barchart.com

Postmortem

- The primary mistake was to underestimate the impact of continued economic deterioration on enrollments
- A secondary mistake was the failure to recognize that past price increases had been too aggressive
  - What I interpreted as above-inflation pricing power would actually exacerbate the underlying challenges caused by the recession
  - Anecdotally, I encountered signs that pricing had become over-extended, but I did not pay enough attention

The Thesis Today

- EPAX's franchise is intact, but normal earnings power is likely somewhat lower than initially believed
- The stock trades for $8.80 per share; net of $1.30 of excess cash the EV per share is $7.50
- This represents:
  - 5x peak FCF ($1.56)
  - 7x 2009 FCF ($1.05)
- These figures *ignore* $2.50 per share of float
- I believe 2009 is a conservative proxy for "normal," though the recovery to normal demand may take several years
- EPAX is buying back stock: ~5% of the company over the trailing 2 quarters

A Larger Lesson

The single most important decision in evaluating a business is pricing power.

--Warren Buffett to Financial Crisis Inquiry Commission, February 2011

What I've Learned About Pricing Power

- "Pricing power" is an often-used term
- Rarely do people talk about *different kinds* of pricing power
- I think it is useful to distinguish between two types of pricing power:
  - ➢ Inflationary pricing power
  - ➢ Above-inflation pricing power

Inflationary Pricing Power

- The ability to pass along inflationary cost increases to customers without adverse consequences: inflationary pricing power
- Inflationary pricing power is often cited as the hallmark of a good business
- Inflationary pricing power is good…
  - It is certainly better to be able to pass along cost increases than not to be able to
- …But not *that* good
  - If I were a business owner the *least* I would want is for my income to maintain purchasing power over time, otherwise I would probably try to sell my business
  - It is not that unusual: inflation *is* the general increase in price levels

Above-Inflation Pricing Power

- The ability to raise prices in excess of inflation without adverse consequences: above-inflation pricing power
- Above-inflation pricing power is extremely valuable because the "above inflation" incremental revenue is pure profit
  - Consider company with an operating margin of 15%, and which can raise prices at inflation +1%
  - This 1% above-inflation price increase *will produce operating income growth of 7%* (1% * reciprocal of operating margin %)
- However, it is *unusual* to find a company with the ability to raise prices in excess of inflation for a sustained period of time

Necessary Conditions

- Favorable competitive dynamics are necessary for above-inflation pricing power…
  - Brand franchise
  - Customer captivity
  - Rational competitive behavior
- …These are not, however, sufficient
  - For example, Coca-Cola raises prices with inflation, not in excess of inflation
- What else is necessary?

Necessary Conditions (cont'd)

- The second necessary condition is *a gap between the price and value of the good*
  - ➢ It is hard to imagine how raising the real (as opposed to nominal) price of a good would not hurt demand, unless it is *underpriced* to begin with
- Underpriced goods are rare because markets are generally efficient: companies are generally able to take what they can get for what they sell
- Therefore, there is a parallel between looking for a value investment and looking for above-inflation pricing power
  - ➢ We are looking for a mispriced good in the same sense that a security analyst looks for a mispriced security
  - ➢ We are trying to find inefficiencies in markets that are generally, but not always, efficient

How Not to Look for Above-Inflation P.P.

- In the past, I searched for *above-inflation* pricing power in the same way I did for *inflationary* pricing power: look for a demonstrable history
- The problem with this method: The capacity to raise the real price of any good is finite (temporary), and it is very difficult to tell in advance when the potential has been fully exploited
  - By contrast, the competitive advantages that confer inflationary pricing power can last decades or forever, and the best way to identify this is to see a history of it
- Ideally, what we want is a company at the beginning—not the end—of the finite period during which it exploits its latent pricing power
  - EPAX is a prime illustration!

A Better Way

- Now, I look for above-inflation pricing power by trying to identify situations where *there is likely to be an inefficiently priced product*
- One area of opportunity: inflection points in business quality
  - US railroads in 2004 (and perhaps still today)
- Another type of opportunity: Non-profit corporations that convert to for-profit corporations
  - Historically there was no incentive to charge full prices; now there is
  - Example: Verisk Analytics

Verisk Analytics (VRSK)

- A company with the potential to increase prices in excess of inflation over the long term
- One of the best and most interesting companies I have ever seen
- Not statistically cheap at 22x forward free cash flow (but is this meaningful?)
- Greenlea Lane does not currently own shares of VRSK
- My research on VRSK is ongoing…

Relevant History

- Until 1944, the US property & casualty (P&C) insurance industry was exempt from antitrust law
- *Rating bureaus* were a central factor in the industry
  - Rating bureaus were cooperatives formed by insurers
  - Insurers pooled policy and claims data to aid in actuarial analysis
  - Rating bureaus issued “advisory rates”—pricing that member insurance companies were required to follow
  - This mitigated competition; underwriting profits were the norm
- In 1944, the Supreme Court ruled that insurance was interstate commerce and therefore subject to antitrust law

Relevant History (cont'd)

- Although the McCarran-Ferguson Act (1945) preserved state regulation, the stage was set for increasing competition over time
- Rating bureaus began to consolidate as their influence was reduced
- In 1971, the Insurances Services Office (ISO) was formed through the merger of the five major rating bureaus
  - The ISO possessed unique databases consisting of decades of policy and claims data accumulated by rating bureaus
  - It provided the P&C insurance industry with critical prospective loss-cost information, standardized forms, policy language, and other services
- The ISO remained a non-profit entity controlled and owned by its members (insurance companies)

Relevant History (cont'd)

- In 1988 the ISO's members relinquished control of its board as part of a settlement of antitrust litigation
- For the first time, ISO became an independent entity, and management began to broaden its activities by developing new products and services
- In 1997, management engineered a conversion to a *for-profit* corporation
    - ➢ As part of the conversion, management took 5% and the ESOP 10% of the company (a total of $75 million of value)
- *Now, by historical accident, the P&C industry's centralized actuarial function had become housed in a single, fully independent entity*

ISO's Market Power

- Quoting an insurance industry publication covering the conversion to for-profit status in 1997:

One person familiar with the voting told us that some of the larger companies that might have opposed the plan were nervous about doing so because they were dependent on ISO's information and didn't want to incur its wrath.

--Schiff's Insurance Observer, April 1997

ISO’s Market Power (cont’d)

- Quoting a study commissioned by the California Insurance Commissioner in 1996 to study the competitive effects of advisory organizations:

To assume that each insurer could replicate the entire prospective loss cost development and analysis process that an advisory organization undertakes to produce these data, is, on its face, unthinkable. If each insurer individually incurred costs even remotely approaching ISO’s costs, all save a few of the largest insurers would be driven from the market….

--Re Regulations Governing the Filing, Contents and Approvals or Disapprovals of Advisory Organization Manuals, Hearing Docket #RH-346, California Department of Insurance, January 12, 1996

ISO’s Market Power (cont’d)

- Quoting Kevin Thompson, SVP of ISO—testimony before United States Senate Committee on the Judiciary, 2006:

If every insurer had to incur even a fraction of the total ISO cost for providing these services, it would have a significant impact on each insurer's ability to stay in or enter many markets. For example, a typical insurer operating in 25 states with an annual general liability insurance premium volume of $50,000,000 pays approximately $75,000 a year for all of ISO’s general liability prospective loss *costs, rules and forms – less than two tenths of one cent for every dollar of general liability premium the insurer writes. For just one line of insurance, it cost ISO more than $11 million in 2005 to produce those products. That figure represents only ongoing operating costs for this line of business; ISO has incurred significant expense over the years in developing the infrastructure, computing power, and expertise to develop these products.*

--The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption

ISO's IPO

- ISO went public in 2009 with the new name "Verisk Analytics"
  - The offering was 100% secondary; the only shareholder that retained its entire stake: Berkshire Hathaway
- VRSK today:
  - $1.1 billion of revenue, $440 million of EBIT (39% margin)
  - $6.4 billion market cap
- Two segments:
  - **Risk Assessment (legacy ISO business)**
    - Roughly ½ of revenue and EBITDA
    - Mid-single-digit top-line growth
  - **Decision Analytics (loss prediction / quantification, fraud prevention / detection)**
    - Mid-teens to 20% top-line growth
    - In addition to the P&C vertical, serves mortgage (13% of revenue) and healthcare (5%) verticals

Unique Assets

Verisk Insurance Solutions

Unique Data Sets

- More than 500 terabytes of time series P&C insurance data
- Natural catastrophe data covering more than 50 countries
- More than 700 million property/casualty insurance claims for fraud
- More than 75% of U.S. property claims settled using our estimation tools
- Building characteristic data for more than 57 million residential buildings
- Property information on more than 3 million commercial buildings
- More than 95% market share for UW claims history database
- Fire-suppression capabilities for approximately 47,000 communities

THE SCIENCE OF RISK[SM]

Verisk Analytics

Source: Verisk Analytics 2011 Investor Day presentation

Attractive Business Characteristics

- VRSK’s products directly impact the ability of its P&C customers to generate revenue (premiums) and estimate the cost of that revenue (claims)
- VRSK’s solutions are highly integrated into customer workflow
- 70% of revenue is under subscriptions or long-term contracts
- Negative working capital cycle; customers typically pre-pay on a quarterly or annual basis
- Capex is minimal (~3% of revenue) and less than D&A

VRSK Is Conservative On Pricing

- Despite its market power, VRSK's prices are low at about 20 basis points (0.2%) of its P&C customers' revenue (gross premiums)
- VRSK estimates that its customers' ROIs for industry-standard services are 5x and for value-added services are 9x - 37x
  - This is the gap between price and value referenced before
- Although VRSK *could* raise prices aggressively, it chooses instead to grow primarily by cross selling and developing new solutions (Decision Analytics)
- VRSK's business plan is to achieve 10-12% organic revenue growth annualized, with margin expansion, which would imply low- to mid-teens compounding of free cash flow

Drivers of Growth: Cross Selling

- ISO's longstanding relationships and premier industry stature facilitate cross selling opportunities to Risk Assessment customers
- VRSK estimates the opportunity to cross sell *existing* solutions to be $900 million
  - ➢ This represents ~80% of the current revenue base
  - ➢ Does not include potential to develop new solutions

Drivers of Growth: New Solutions

- Insured risks are constantly evolving and expanding, providing the opportunity to expand offerings:

Risk Assessment

Standardized insurance programs

Commercial

- Automobile
- Equipment Breakdown
- Businessowners
- Property
- Crime
- Farm
- General Liability
- Inland Marine
- Medical Professional Liability
- Package Policy
- E-commerce
- Employment-related Practices
- Fidelity
- Financial Institutions
- Umbrella
- Capital Assets (Output Policy)
- Management Protection (D&O)
- Market Segments
- Lawyers' Professional Liability (2010)

Personal

- Automobile
- Dwelling Property
- Homeowners
- Inland Marine
- Personal Liability
- Umbrella
- Watercraft

New Programs since 1996

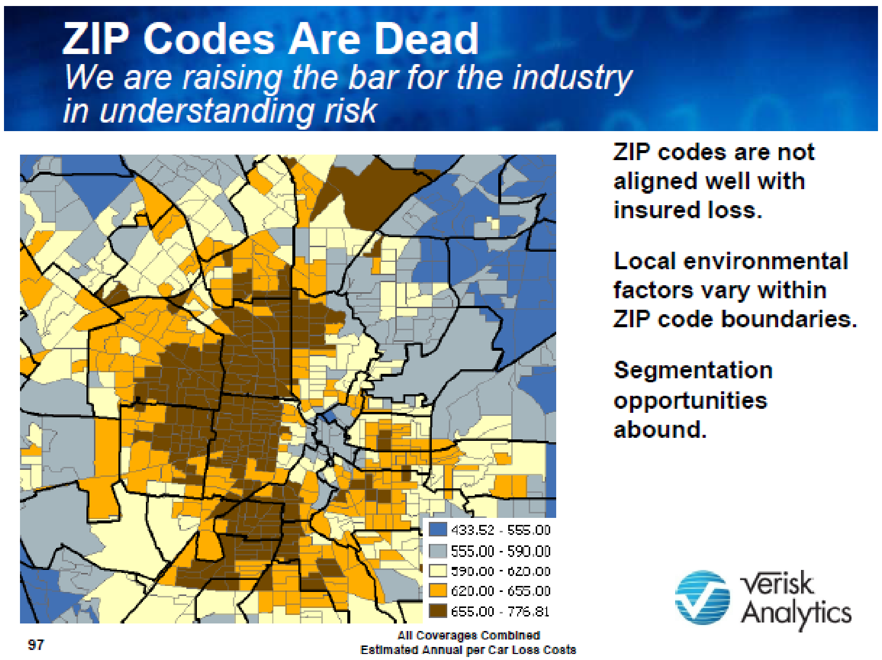
Verisk Analytics

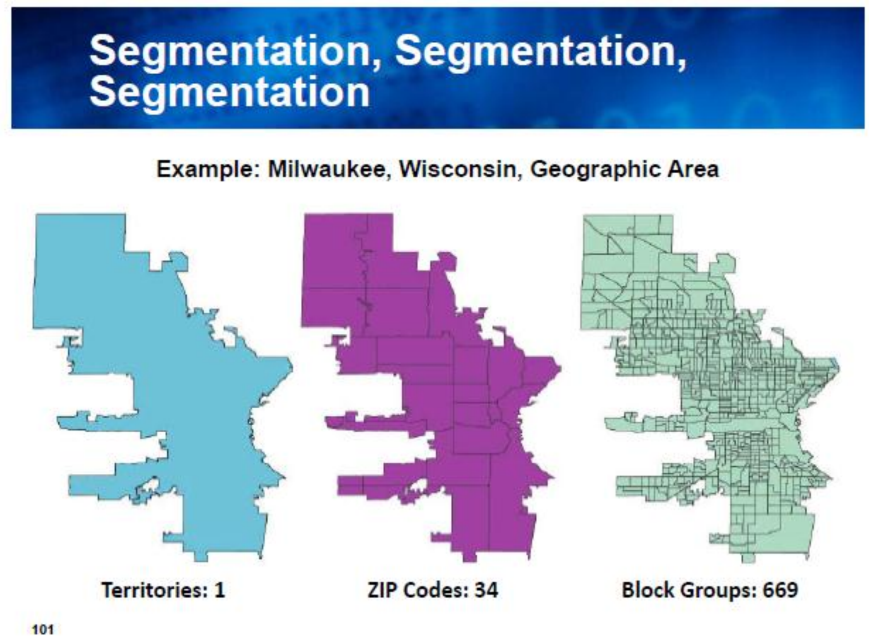
25

Source: Verisk Analytics 2010 Investor Day presentation

Drivers of Growth: New Solutions (cont'd)

- There appears to be ample room to provide increasingly sophisticated products based on the same proprietary data sets





Source: Verisk Analytics 2010 Investor Day presentation

How Can VRSK Be Attractive At 22x FCF?

- Is it significant that VRSK is not "statistically cheap"?
- "Statistically cheap" refers to rules of thumb that apply to stocks on average:
  - 5x is dirt cheap
  - 10x is modest
  - 15x is average
  - 20x … "You're not a value investor!"
- These judgments are valid on average, but can only be applied to individual cases *to the extent the population is homogeneous*
- *In fact, businesses are unique and vastly different from one another*
- This implies that statistical rules of thumb will often be inapplicable to individual cases (in fact, it is in theory possible for no company to be average)

How Can VRSK Be Attractive At 22x FCF? (cont'd)

- Thought experiment: What multiple would VRSK be worth if…
  - It were *not* to cross sell existing products,
  - *Nor* were it to continue developing new solutions,
  - But *instead* it were to raise prices in real terms (i.e., in excess of inflation) by 3% annually over the long term?
- At this pace, it would take 24 years for real pricing to double, versus current customer ROIs of 5x+
  - To illustrate, pricing would go from ~$2 per $1,000 of premiums to ~$4 per $1,000 of premiums, gradually over the course of more than 2 decades
  - Insurer expenses are *greater* than premiums (they generally lose money on underwriting); VRSK would remain a very small part of the overall cost structure
  - Customer ROIs would remain 200%+

How Can VRSK Be Attractive At 22x FCF? (cont'd)

- Perform a DCF exercise with the following assumptions:
  - Inflation = 3% (trailing 19-year industry premium inflation = 3.4%)
  - Operating margin of 40% implies that the 3% above-inflation price increase in the first year produces operating income growth of 7.5%
  - Year-1 FCF growth of 10.5% (= 3% + 7.5%) decreases over time as margins expand
  - Conservative terminal multiple (Year-26) = 10x
  - Discount rate = 10%
- DCF yields FCF multiple of 26x

Valuation

- Conclusion:
  - VRSK's latent pricing power can be viewed as a hidden asset
  - On this basis, the current stock price of ~$34 represents a modest discount to intrinsic value
  - Although this asset is not being utilized currently, eventually it will be
    - Management and employees are highly incented to create value
    - Officers and directors own 9% (~$575 million)
    - Employee stock ownership trust owns 15% (~$960 million)
  - In the meantime, cross selling opportunities and potential new solutions represent upside

Valuation (cont'd)

- Another way to think about valuation:
  - Current multiple is fair
  - Therefore, comprehensive return from owning the stock is:
    - 5% FCF yield, +
    - Low- to mid-teens compounding of FCF (if VRSK achieves its business plan), + or –
    - Capital allocation
  - Capital allocation:
    - Acquisition program (~40% of cash flow) focused on new verticals (healthcare and mortgage) is hard to assess, but the record is good (23% IRR over the past decade)
    - Stock buyback program (~60% of cash flow) is attractive

Valuation (cont'd)

- Bottom line: VRSK appears to represent high-teens compounding over the long term
  - Consistent compounding regardless of external environment (economy, insurance market conditions)
  - Benefits from turmoil: Higher real and perceived value of risk management
  - Will benefit from a turn in the insurance market

Thank You

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