

First Quarter 2010 Long/Short Strategy comments

The investing environment over the last two years has been like night and day. Signs of financial strains, which began in the second half of 2007, became more acute as 2008 progressed and turned into a full-blown financial crisis in the fall of 2008, making the year a disaster for nearly every asset class and investor. The 2008 financial crisis drove global economies into deep recessions late in 2008 and into the first half of 2009, but unprecedented global fiscal and monetary actions pulled economies and financial assets strongly out of the Great Recession.

What will 2010 bring? We were not among the few who predicted these events. However, by sticking to our knitting and identifying attractive investment opportunities one at a time, we are among the few who managed to avoid denting investor capital over 2008 and 2009. We therefore think it appropriate that our first quarterly letter of 2010 focuses not on macro predictions but instead on some significant long and short positions held in our long/short strategy. Finally, we briefly review first quarter investment performance for CAA Partners LP.

STOCKS

The big picture issues of Europe and the PIIGS (Portugal, Ireland, Italy, Greece and Spain), the pace of domestic economic recovery and the sustainability of China's expansionary policies are on our minds, but our decisions are driven primarily by company-specific opportunities. The specific situations described below, plus many others in our portfolio, give us comfort that attractive investment opportunities are available to those who slog through the details—much the way football teams of the 1920s moved up the field in a “three yards and a cloud of dust” offense.

Verisk Analytics

Llenroc's long investment strategy is to purchase a limited number of quality companies at reasonable prices, and hold them over a long period of time. We believe this approach allows managements of these companies to grow their revenue and earnings at above average rates and therefore deliver attractive returns to our investors. Early in the second quarter, we initiated a position in Verisk Analytics which, at this writing, is our fourth largest long holding.

Verisk is the largest aggregator and provider of detailed actuarial and underwriting data pertaining to U.S. property and casualty insurance risks. Founded in 1971 by a consortium of insurance carriers to provide property and casualty (P&C) insurance data to state insurance regulators, Verisk currently generates about 70% of its revenue from the P&C insurance industry. Customers include the one hundred largest US P&C insurers who purchase some combination of the company's risk assessment, fraud identification, loss prediction and loss quantification solutions. The company also maintains data on more than 13 million mortgage loans and over 312 million criminal records. About 75% of revenues come from subscriptions or long-term contracts which are typically prepaid.

Verisk exhibits nearly all of the characteristics we believe define a quality company. We believe the eight factors below are not adequately understood by Wall Street analysts and therefore that the company's earnings power and growth rate are materially higher than is reflected in its share price.

Long and proven track record: Verisk was founded in 1971, and has therefore been operating for nearly forty years. Over the five years ended in 2009, the company increased revenues and earnings 13% and 18% annually, respectively. Importantly, sales and operating earnings rose 8% and 39%, respectively, during the Great Recession from 2007 to 2009.

Pricing power: We believe Verisk's services are nearly irreplaceable for a large percentage of its customers which will allow the company to increase prices to drive revenue and earnings growth in excess of what is currently reflected in the stock price. Over the previous five years, an impressive 99% of the Verisk's customers renewed their services with the company. Verisk charges an average of only 0.2% of the gross written premium of its P&C customers for a service which is critical to those customers' primary function of managing and minimizing risk of loss. Verisk's own customers tell us that they would have no other choice than to pay substantially higher rates for their Verisk services if Verisk decided to raise their prices. The fact that there are no break points for pricing as customers get larger is testament to the company's pricing power with even its largest customers.

High barriers to entry: Verisk has a database which covers 14.5 billion P&C insurance policies written since its 1971 founding and represents virtually every US P&C insurance policy written over this period. Verisk believes it operates one of the largest private databases in the world which we believe would be extraordinarily difficult for any other firm to duplicate without spending billions of dollars and the passage of many years. The company maintains data on more than 678 million P&C insurance claims filed over this period, which similarly represents virtually every claim filed since 1971. Verisk maintains data on 2.7 million insured US commercial buildings which, at the rate Verisk reviews buildings, would take approximately eight years to duplicate.

Durable competitive advantage: Verisk and two substantially smaller companies are licensed statistical agents which collect statistical data from P&C insurance companies and report these statistics to state insurance regulators. Neither of these competitors has gathered additional information on these policies or claims while Verisk has gathered additional data points representing approximately 2/3 of policies written and claims made since 1971, which gives the company a substantial competitive advantage.

Leadership company: Verisk is the U.S. industry leader for industry-standard insurance programs that help P&C insurers define coverage and issue policies for 24 insurance lines. The company is also far and away the largest licensed statistical agent providing policy and claims data to U.S. P&C insurers. Approximately 60% of all U.S. homeowners' claims are settled using the company's loss assessment solutions. Company catastrophe modeling solutions have been used in approximately 70% of the dollar value of catastrophe bond securitizations. And more than 80% of insurance repair contractors and service providers use Verisk building and repair pricing data.

Little or no debt: Verisk has a modest \$400 million in net debt at March 31, 2010. The company could repurchase all of its debt in less than six quarters assuming it generates excess cash at the same pace as in 2009. Verisk 2009 interest expense was a modest 12% of its \$302 million in operating income.

Cash flow well in excess of capital spending requirements: Verisk capital spending requirements over the last five years have averaged about 3.5% of revenue while operating income has averaged nearly 35% of revenue. This substantial excess cash generation has allowed the company to generate a return on invested capital in excess of 30% which permits Verisk to return substantial amounts of cash to shareholders.

Open ended markets: Although Verisk has already highly penetrated its core U.S. insurance market with traditional risk assessment data and standard policy language, the company could increase domestic insurance industry revenue by approximately 70% by cross-selling its Decision Analytics segment products (loss prediction and quantification & fraud prevention and detection) to its current insurance industry customers.

For-Profit Education Companies

CAA Partners LP has over a (-7%) short exposure to for-profit education companies Apollo Group and ITT Educational Services. Companies in this sector recently received attention in the mainstream media with the airing of a [Frontline](#) television spot. In addition, the shares of Apollo Group and ITT are held by many experienced value investors who are drawn to what appear to be strong business models and compelling valuations. However, these business models and valuations do not take into account potentially severe regulatory changes and their ensuing impact on operating results.

At first glance Apollo Group and ITT appear to have strong business models: operating margins in excess of 25%; consistent double digit revenue growth; and high returns on invested capital. But the high margins and returns on capital in the for-profit education industry are not what they seem, as these returns occur due to a wealth transfer from U.S. taxpayers to the aforementioned companies via federal government student loans and loan guarantees.

Under Title IV, the federal government guarantees student loans against default, therefore, the government absorbs the cost of student loan defaults. For-profit education companies report *cohort default rates* for the first two years after students graduate which have been in the range of 10%. Cohort default rates must be below 25% for prospective students to continue to receive Title IV funding. The government is therefore apparently willing to accept 25% student default rates in the interest of the higher good of education. Interestingly, this limit puts the overall for-profit business model at about a 0% profit margin (+25% for the companies plus -25% for the government).

Industry experts estimate the *lifetime default rate* at for-profit education companies is in excess of 44% versus numbers as low as 10% at traditional four-year colleges. We believe this higher default rate is behind the late 2009 DoE increase in the measurement period for cohort default rates from two years to three years. We further believe the DoE is likely to publish lifetime default rates for for-profit and other colleges in the next year which will put pressure on Congress to cut lending to for-profit schools which currently results in billions of government

loan losses each year. If for-profit schools absorbed some portion of the losses from defaulted student loans, the operating margins of many of these companies could be negative.

We do not believe the Department of Education (DoE) intends to put for-profit education companies out of business. We do, however, believe there is a high probability the DoE will enforce greater accountability for high default rates, evidenced by our review of a series of negotiated rulemaking meetings between the DoE and educators late last year and early this year known as neg-reg.

Unlike the previous Administration which appointed a former for-profit education lobbyist to head the DoE, the current Administration appointed several reformers to run the agency. These individuals have made numerous comments suggesting that the federal government is not receiving an adequate return on its investment—the cost of guaranteeing Title IV loans—from students who graduate from for-profit schools. We believe the decisions by the DoE later this year could either require for-profit education companies to lower the cost of their education (and indirectly lowering the debt burden of their students) or require a higher percentage of graduates to be gainfully employed (forcing schools to enroll only qualified students and thus slow their growth rates).

It is worth noting that we do not believe the recent resignation of Robert Shireman as U.S. Education Deputy Undersecretary can be construed as a positive development for this sector. Mr. Shireman returned to Washington D.C. (he served in the DoE during the Clinton administration) from San Francisco on a temporary basis and, according to our sources, the desire to significantly increase regulation is widespread among Department of Education officials, not an anomaly in Washington these days.

Although Apollo and ITT shares are currently trading at what appears to be low valuations, these valuations do not reflect the very real possibility that both Apollo Group and ITT could experience slowing or negative revenue growth due to the aforementioned increases in government regulation, and the government's decreasing desire to absorb the industry's losses through loan guarantees.

INVESTMENT PERFORMANCE

CAA Partners LP returned +2.2% net of fees in the first quarter of 2010 versus a +5.4% return for the S&P500 and a +3.5% return for the Barclay Hedge Equity Long Bias index. Low quality cyclical companies continued to outperform the broad market during the quarter while high quality remained relatively inexpensive. The table below details the performance of our long/short strategy over the last three years. More detailed performance data is available upon request.

	2010		2009					2007–
	Q1	Q4	Q3	Q2	2009	2008	2007	2009
<i>Long / Short Strategy Returns</i>								
Long equity only (gross of all fees)	5.2%	18.7%	17.4%	18.3%	69.5%	-38.5%	-0.4%	3.8%
Short equity only (gross of all fees)	-2.7%	0.2%	-20.1%	-21.4%	-29.5%	103.3%	-5.9%	34.9%
Total Portfolio Net (after fees & performance fee)	2.2%	12.5%	11.4%	10.8%	36.3%	-27.0%	-3.9%	1.6%
<i>Index Returns</i>								
S&P 500 (total return, including dividends)	5.4%	6.0%	15.6%	16.0%	26.5%	-37.0%	5.4%	-16.0%
CS/Tremont Long/Short Benchmark Index	2.8%	2.4%	7.8%	7.9%	19.5%	-19.8%	13.7%	9.0%
Barclay Hedge Equity Long Bias	3.5%	3.3%	11.4%	14.2%	29.4%	-29.0%	10.6%	1.6%

CONCLUSIONS

Although it is unclear what path domestic and global economies will take over the next year, stock prices in cyclical and low quality names appear to be pricing in strong economic growth and a [return to near-record profit margins](#). In spite of the high valuations of these types of companies, many quality businesses continue to sell at compelling purchase prices and there is no shortage of companies with poor prospects available to short. The recent market volatility can feel unsettling but for those who are not looking to time the market but instead search for compelling long-term investments, increasing volatility can offer opportunities to invest in great companies at temporarily distressed valuations.

Please feel free to call us at (415) 785-3670 if you have any questions or comments.

Llenroc Capital LLC

This letter should not be construed as investment advice and should be kept confidential. Past performance is not indicative of future returns. The historical performance information reflected above has been prepared by Llenroc Capital, LLC and has not been compiled, reviewed or audited by an independent public accountant. The results for the current partial year are based on internal books and records for CAA Partners LP, which are subject to year-end audit adjustments. Net performance results include performance fees and allocations accrued but not yet payable or allocable. Returns experienced by individual investors will vary depending on their date of investment and their eligibility to receive "new issue" profits and losses. CAA Partners LP launched on September 1, 2006.