GREENLEA LANE CAPITAL

Private Investment Partnership

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What I've Learned About Pricing Power

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

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

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
- …They are not, however, sufficient
  - For example, Coca-Cola raises prices with inflation, not in excess of inflation
- What else is necessary?

Necessary Conditions (continued)

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

<u>How Not to Look for Above-Inflation P.P.</u>

- I used to search for *above-inflation* pricing power in the same way that I looked for *inflationary* pricing power: look for a demonstrable history
- The problem with this method: The capacity to raise the real price of any good or service 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

<u>How I Look for Above-Inflation P.P.</u>

- Now, I look for above-inflation pricing power by trying to identify situations where *there is likely to be an inefficiently priced product*
- In the same way that value investors looks for mispriced stocks (52-week lows, spinoffs, post-bankruptcies), we can look for situations that are conducive to untapped pricing power

Recap

TWO KINDS OF PRICING POWER

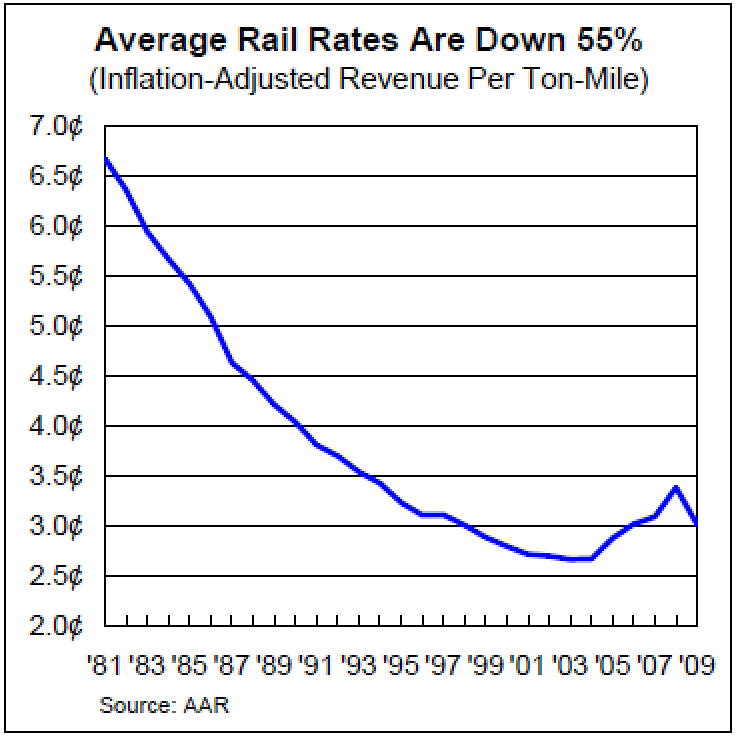
	Inflationary	**Above-inflation**
Prevalence	Common	Rare
Importance	Pre-requisite	Most valuble attribute
Yields margin expansion	No	Yes
Historical demonstrability	Provides confidence	Engenders skepticism

Two Types of Opportunity

- In the balance of the presentation, we will discuss two types situation that are conducive to above-inflation pricing power:
  1. Inflection points in business quality
     - US railroads, Scott's Miracle Grow
  2. Historical lack of incentive to charge full prices
     - Verisk Analytics

Inflection Point Example: US Railroads

- In 2004, US railroads reached an inflection point
  - Industry consolidation
  - Improved efficiency and service from technological improvements
  - Cost advantage over trucks
- The combination of improving conditions and *awful pricing trends* produced enormous latent pricing power



US Railroads (continued)

UNION PACIFIC - Selected Statistics											
											'04 - '10
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	CAGR
Revenue	**10,830**	**11,159**	**11,551**	**12,215**	**13,578**	**15,578**	**16,283**	**17,970**	**14,143**	**16,965**	**5.6%**
Y/y growth		*3.0%*	*3.5%*	*5.7%*	*11.2%*	*14.7%*	*4.5%*	*10.4%*	*-21.3%*	*20.0%*	
Rev. / thousand RTM*											
(ex-fuel surcharges)	**$20.63**	**$20.54**	**$20.54**	**$20.87**	**$21.86**	**$23.43**	**$24.89**	**$26.34**	**$26.65**	**$28.50**	**5.3%**
Y/y growth		*-0.4%*	*0.0%*	*1.6%*	*4.7%*	*7.2%*	*6.3%*	*5.8%*	*1.2%*	*7.0%*	
Opex / thousand RTM											
(ex-fuel surcharges)	**$17.49**	**$17.49**	**$17.50**	**$19.45**	**$19.72**	**$19.59**	**$20.30**	**$20.61**	**$21.17**	**$20.65**	**1.0%**
Y/y growth		*0.0%*	*0.0%*	*11.2%*	*1.4%*	*-0.6%*	*3.6%*	*1.5%*	*2.7%*	*-2.5%*	
Pricing less cost inflation		**-0.4%**	**0.0%**	**-9.6%**	**3.4%**	**7.8%**	**2.6%**	**4.3%**	**-1.6%**	**9.4%**	
Operating income	**1,750**	**1,656**	**1,665**	**1,686**	**2,922**	**3,521**	**3,486**	**3,912**	**3,262**	**4,504**	**17.8%**
% of revenue	*19.0%*	*18.4%*	*17.7%*	*15.4%*	*22.5%*	*23.5%*	*22.1%*	*21.7%*	*23.3%*	*26.7%*	
Y/y growth		*-5.4%*	*0.5%*	*1.3%*	*73.3%*	*20.5%*	*-1.0%*	*12.2%*	*-16.6%*	*38.1%*	
* RTM = revenue ton-mile = a ton of goods transported one mile											
Revenue per RTM is what customers pay to transport one ton of goods one mile											

A Recent Inflection Point: Scott's Miracle-Gro

- Scott's Miracle-Gro (SMG) is the dominant manufacturer of branded lawn and garden products in the US
  - Fertilizer, grass seed, weed killer, dirt
  - Brands include Scott's, Miracle-Gro, Ortho
- Over the past 15 years, the company has:
  - Assembled a collection of strong brands
  - Invested heavily behind the brands to build dominant franchises
  - Cultivated close relationships with retailers (Wal-Mart, Lowe's, Home Depot)
- Recently, there was an episode that may have revealed untapped pricing power

Scott's Miracle-Gro (continued)

- In 2009, the price of the main raw material in fertilizer, urea, spike up 4x
- SMG decided to take pricing in order to maintain margins, implying a *30% price increase*
- Management was uncertain about the reaction from retailers and customers
- Retailers viewed SMG products as such strong drivers of store traffic that SMG should able set prices as it saw fit
  - Retailers absorbed a portion of the increase, but pricing at retail was still up 20-25%
- *Volumes dropped by only 2% (during a deep consumer recession)*

<u>Scott's Miracle-Gro (continued)</u>

- What produced this untapped pricing power?

1. A gradual build up of market power (leverage with retailers and customer loyalty)
2. Taking pricing only with inflation, *not in excess of inflation*
   - The products are still affordable: You can buy enough fertilizer for an acre of lawn for under $100, and people only fertilize 2x per year on average

- Management is newly aware of SMG's untapped pricing power, but it is unclear what they do with that information
  - Managements are generally reticent about pricing!

<u>Verisk Analytics (VRSK)</u>

- I believe VRSK is an example of above-inflation pricing power resulting from an historical lack of incentive to charge full prices *because it was a non-profit corporation*

VRSK (continued)

- Some relevant history:
  - 1866: National Board of Fire Underwriters established by 75 leading insurers to pool claims and policy data to help analyze risk and set rates
  - 1869: US Supreme Court rules the insurance industry is not subject to antitrust law
  - Subsequently, hundreds of regional “ratings bureaus” formed
  - 1942: Justice Department sues rating bureau Southeastern Underwriters Association for anti-trust violations
  - 1944: Southeastern case reaches Supreme Court, which reverses course: the industry *is* subject to antitrust law
  - State regulation is preserved and by the 1960s most states had adopted open competition
  - 1971: The Insurance Services Office (ISO) is formed through the merger of the major ratings bureaus

<u>VRSK (continued)</u>

- The ISO possessed unique policy and claim databases that had been accumulated by ratings bureaus over decades
- The ISO was non-profit corporation owned by the major P&C insurers and run for their benefit, by offering data and analytics that aided in the estimation of prospective losses, as well as providing standardized policy language and forms and essential regulatory compliance services
- In 1988, insurance companies relinquished control of ISO’s board as part of a settlement of antitrust litigation
- ISO’s management began to shift the strategic direction of the company to include broaden its activities, culminating with the conversion to a *for*-profit corporation in 1997

VRSK (continued)

- As part of the conversion senior management was given 5% ownership of ISO and the Employee Stock Ownership Plan 10% ($75 million of total value)
- Quoting an insurance industry trade publication:

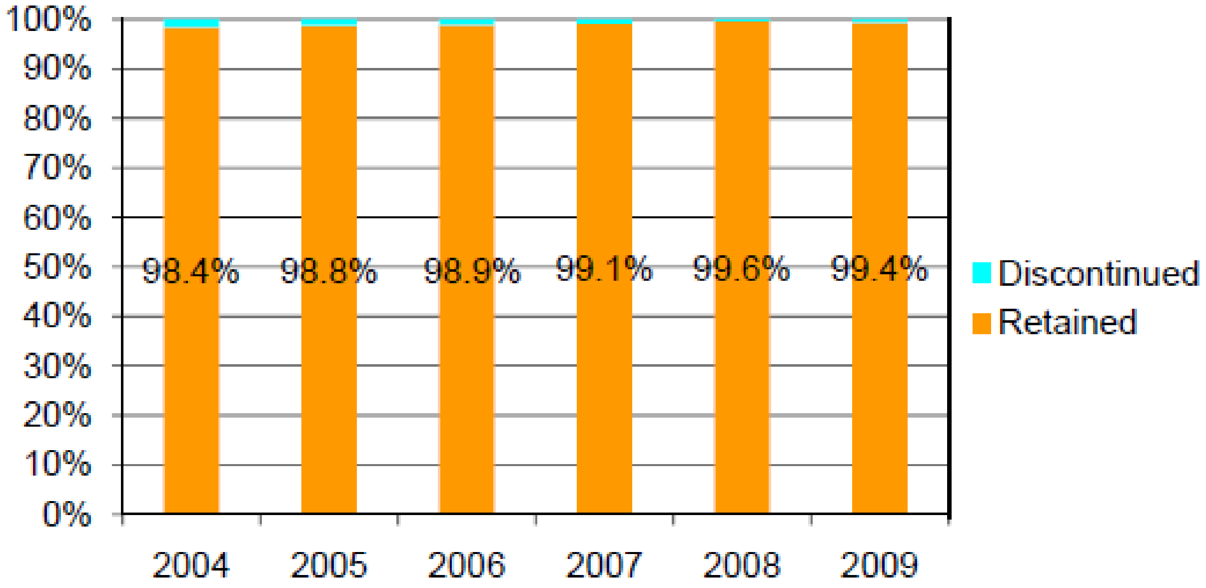
One person familiar with the voting told us that some of the larger companies that might have opposed the plan were nervous about doing so because they were dependent on ISO's information and didn't want to incur its wrath.

--Schiff's Insurance Observer, April 1997

- ISO went public in 2009 with a new name: Verisk Analytics (VRSK)
- The offering was 100% secondary; the only shareholder that did not sell any of its stake: Berkshire Hathaway

VRSK (continued)

- Favorable competitive dynamics:
  - Unique position based on proprietary, non-replicable data sets, analytic capabilities, regulatory status
  - Provides mission-critical services that are highly integrated to customers' businesses



Source: Verisk Analytics 2010 investor day slide presentation

VRSK (continued)

- Despite its market power, VRSK's prices are low on an absolute basis

1. VRSK's revenue as percentage of customers' premiums is only *20 basis points (0.2%)*
2. Enormous gap between the price and value of VRSK services
   - For most basic industry-standard services, the company estimates it would cost insurers at least 5x more to provide functions themselves
   - For higher value-add services, VRSK estimates 20-37x ROI for customers

VRSK (continued)

- Management is relatively reticent about pricing
- Quoting from 2011 investor day:

Questioner: …*Now with a different constituency, no longer 70% owned by the customers but owned 50% by public shareholders, how do you look at the bargain that the customers are getting?*

Frank Coyne (CEO): …*I agree with you that it's a good value proposition and it would be a good value proposition to the property casualty industry if we raised our prices. We think that the best interest for all of our shareholders today, and before, was that we maintain this kind of unique position that we have within the property casualty industry by treating that position with a high degree of respect.*

<u>VRSK (continued)</u>

I think I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it.

--Charlie Munger

VRSK (continued)

	Shares of Class A Common Stock Beneficially Owned	
	Number of Shares	Percentage of Class
NAMED EXECUTIVE OFFICERS		
Frank J. Coyne(1)	5,954,538	4.07%
Scott G. Stephenson(2)	3,297,000	2.29%
Mark V. Anquillare(3)	1,185,000	*
Kenneth E. Thompson(4)	558,500	*
Vincent d. P. McCarthy(5)	36,250	*
DIRECTORS		*
J. Hyatt Brown(6)	61,360	*
Glen A. Dell(7)	356,235	*
Christopher M. Foskett(8)	95,622	*
Constantine P. Iordanou(9)	396,910	*
John F. Lehman, Jr.(10)	749,802	*
Samuel G. Liss(11)	115,321	*
Thomas F. Motamed(12)	34,772	*
Andrew G. Mills(13)	359,207	*
Arthur J. Rothkopf(14)	343,944	*
David B. Wright(15)	217,917	*
ALL DIRECTORS AND NAMED EXECUTIVE OFFICERS AS A GROUP (15 PERSONS)	13,762,378	9.03%

VRSK (continued)

2010 Variable Compensation Performance Goals

The Compensation Committee established the following revenue growth and EBITDA Margin goals as the primary factors for determination of aggregate award pools available to all eligible employees, including our NEOs, under both the LTI and STI programs for 2010:

	Revenue Growth	EBITDA Margin
Maximum	15%	43%
Superior	12%	41%
Target	10%	39%
Threshold	6%	37%

Thank You

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