July 7, 2011

Dear Partner:

Greenlight Capital, L.P., Greenlight Capital Qualified, L.P. and Greenlight Capital Offshore (collectively, the "Partnerships") returned (2.5)%, (2.1)% and (2.2)%[1] net of fees and expenses, respectively, in the second quarter of 2011, bringing the respective year to date net returns to (5.0)%, (5.0)% and (5.3)%.[1]

This is a famous work of art by the Belgian surrealist painter René Magritte entitled "The Treachery of Images."

The caption in French translates into "This is not a pipe." When asked about the image, Magritte commented that of course it was not a pipe, just try to fill it with tobacco.

This brings us to the topic of the Greek debt situation. It is widely acknowledged that Greece can never pay back its debts. As it becomes more and more likely that Greece will simply default, efforts to find a resolution become increasingly desperate. Last year, in exchange for offering additional loans, the European Union and the IMF demanded austerity, insisting that the Greek government cut benefits and raise taxes. The government tried to comply, but this proved counter-productive as Greek citizens rioted in the streets, which along with the austerity, slowed the Greek economy and made the situation even worse. Now, Greece is being offered additional loans in exchange for even more austerity and the additional request that it privatize state assets (Siemens Acropolis, anyone?). Since it is understood that none of this will resolve the underlying insolvency, privatizations make no long-term sense for Greece.

The latest in this long line of attempts to sweep the problems under the rug is the effort to roll-over the loans on a voluntary basis. Unsurprisingly, it was only after sufficient

[1] Source: Greenlight. Please refer to information contained in the disclosures at the end of the letter.

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amounts of state coercion that these "volunteers," namely large French and German financial institutions that want to accommodate local regulators, stepped forward. In truth, the official efforts aren't really designed to prevent what most people would recognize as a default or losses to bondholders. They are designed to hide a much more ominous problem.

When the German leadership called for the private sector to contribute to the bailout, French President Nicolas Sarkozy declared that there could not be a "credit event." In layman's terms, a 'credit event' is generally a polite way of saying that you can't get blood from a stone, and good luck trying to collect. But more notably, as a financial term a 'credit event' is an event that would trigger the payout on credit default swaps (CDS).

It is very odd to hear a political leader use such technical jargon. Why would Mr. Sarkozy do this? Perhaps the French banks have enormous exposure to sovereign credit events, and it might not be just a Greek default that they are worried about. According to current banking regulations, sovereign credits are considered "risk-free." This means that banks can take on as much sovereign credit risk as they like without setting aside any capital. Under such a structure, selling short CDS protection is akin to free money for the banks.

Likely, the real worry is that the first default will expose the fiction that sovereign debt is risk-free. If the authorities permit one default, their credibility to prevent additional defaults will be lost. No one knows just how much aggregate exposure to sovereign debt and CDS is hidden in the banking system, and no one is itching to find out. The European regulators are trying to calm the market by conducting "stress tests" on the banks. This might be more comforting if the stress tests included testing for the possibility of a sovereign default. They do not. What is the point of a stress test that fails to test for the most obvious and visible risk facing the banks?

Meanwhile, the charade continues. With the banks agreeing to 'volunteer' to roll-over their debt, next up was a conversation with the rating agencies. When asked to opine as to whether the voluntary roll-over would be considered a default, the rating agencies initially indicated that if it looked like a default, they would label it as such. It was at this point that German Finance Minister Wolfgang Schäuble suggested that now might be a good time to break-up the credit rating agency oligopoly. Et voilà! The rating agencies are presently reconsidering their view that the voluntary roll-over of the Greek debt would be counted as a default. The ECB appears to be counting on at least one agency to cave in to the pressure. Having previously lowered its standard to accept Greek paper as collateral despite it being below investment grade, the ECB now says it will still accept Greek paper as long as even just one of the three rating agencies doesn't consider a restructuring as a default. As Magritte might say, "This is not a default. Just try to collect on your credit default swaps."

Here in the U.S., the rating agencies are making similar noises. S&P has indicated that if Congress doesn't extend the debt ceiling, and the government defaults on so much as a single payment, the U.S. credit rating could drop straight from AAA to D. Earth to S&P:

if you can foresee a near-term default scenario that is plausible enough for you to warn about it, AAA cannot be the correct current rating.

The authorities failed to ban credit default swaps and disarm the rating agencies through Dodd-Frank when they had the chance. Now the questions are whether the credit default swaps will cause another banking crisis, and what the governments will do about the loaded gun of the rating agencies pointed squarely at their heads.[2]

The U.S. economy continued to soften during the quarter. Higher energy and food prices are crowding out consumer demand for other items, and the market consensus is that QE2 has proven to be counter-productive. Unable to concede this, Mr. Bernanke nonetheless seems determined to have it both ways, remarking in a recent speech that monetary policy cannot be a panacea. For the moment, the Fed seems boxed into a corner and in an effort to prevent soaring commodity prices from triggering another recession appears determined to wean itself from further money printing. We won't know whether the Fed is serious until it withholds monetary easing in the face of a further softening of economic conditions or a falling stock market.

The counterbalance to the troubled global macro backdrop has been strong corporate earnings. The result was a stock market that fell by a fraction of a percent during the quarter. Our portfolio performed slightly worse. Our longs declined a fraction of a percent, our shorts rose by about a percent and we lost a little bit on macro investments.

The main problem with our performance was a lack of winners in the quarter. The biggest winner was one of the energy-technology shorts that spiked during the first quarter after the Japanese earthquake. In the second quarter, we recouped that loss. The second biggest gainer was Arkema (France: AKE), which advanced 10%.

On the losing side, the consumer cyclical short that hurt us most in the first quarter hurt us again in the second quarter. In this bifurcated market, there are a small number of stocks that seem to be going up simply because they are going up. Stock price momentum investing is not a new strategy; we saw how it worked in the extreme during the internet bubble. One difference between then and now is that during the internet bubble, the market categorized stocks into "new economy" and "old economy." It was relatively easy to pick out the dangerous stocks. This time the distinction is less clear. A number of the momentum stocks have good stories, but many others really have very little going for them, except for a rising stock price. Earnings disappointments, dilutive acquisitions, slowing growth rates, regulatory problems, heavy insider sales, rising competition and even SEC investigations seem to have no impact on the handful of momentum stocks leading the market at this time. Despite trying to carefully pick our spots and to size the positions appropriately, we continue to have exposure on the short-side to a couple of these freight trains. Though we don't know when the turn will come, we believe that there is substantial downside to the prices of these short positions.

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[2] This is the same issue created by ratings that every borrower faces, as rating agencies' behavior at its best is pro-cyclical and, therefore, destabilizing. We have remarked before that the needed structural change is to end the rating agency system.

The second biggest loser in the quarter was our Japanese Yen position. After the earthquake, we believed that Japan would be unable to sustain a positive savings rate or trade surplus and its already frightening fiscal position would deteriorate. Accordingly, we increased our exposure to an expected weakening of the Yen. Though our fundamental analysis proved correct – in fact, Japanese tax collections fell even further than we expected – the Yen nonetheless strengthened by roughly 3% against the dollar during the quarter.

We established one medium sized long position during the quarter in Seagate Technology.

Seagate Technology (STX) is a manufacturer of hard disk drives. Hard disk drives are used in desktop and notebook PCs, external storage devices, enterprise storage, digital video recorders, and other consumer applications. The market is concerned that prospective hard drive unit demand will be weak due to macro weakness, substitution to flash (solid-state) storage, cannibalization of PC sales by tablets, and greater storage efficiency in the cloud. Though we don't expect unit demand to fall anytime soon, the hard drive companies have flexibility in their business models and should be able to adjust their operations to protect profitability should unit demand decrease. Hard disk drive technology represents the cheapest, highest capacity storage solution in a world where data needs continue to grow exponentially.

STX is currently in the process of acquiring Samsung's hard drive operations. Western Digital, its leading competitor, is currently in the process of acquiring Hitachi's hard drive operations. Following these transactions the industry will have 3 rather than 5 major players, which should increase operating stability. STX management has a large equity interest in the company and appears to be focused on shareholder return. STX repurchased $710 million of stock (~10% of shares outstanding) in the last 2 quarters and has $1.6 billion of capacity remaining under the current repurchase authorization. In April, the company also initiated an $0.18 per share quarterly dividend, providing a 4.5% yield. The Partnerships established their position at $16.06 per share. We estimate that STX has at least $3 per share of earnings power. STX shares ended the quarter at $16.16 each.

We exited several significant positions worth noting during the quarter.

The Partnerships bought Cardinal Health (CAH) just prior to its spinning off CareFusion (CFN). At the inception of our investment, CAH shares traded at 10x apparent earnings. In the subsequent two years, our investment thesis played out, as earnings grew ~40%, the P/E expanded to 15x earnings, and we were able to recognize a significant gain. Incidentally, we continue to hold a large position in CFN.

The Partnerships bought CIT debt prior to its bankruptcy. Some of the debt was converted into equity. After CIT emerged from bankruptcy, we bought additional shares believing that its balance sheet understated its value. We further believed that CIT would make a successful deal with regulators, achieve a competitive cost of funds, and improve its earnings. Management proved not to be very shareholder oriented, and none of these

things occurred. Nonetheless, the shares appreciated nicely from their very cheap starting point, and we've decided to move on with a solid gain.

The Partnerships bought Yahoo! (YHOO) earlier this year based on a sum of the parts analysis, which included putting substantial value on its Chinese assets. Shortly after the purchase, the value of the Chinese assets came into doubt as the CEO of the Chinese unit hived-off a valuable subsidiary into a corporation that he personally controls. From there, the finger pointing started going in every direction. This wasn't what we signed up for. We exited with a modest loss.

The Partnerships bought cement maker Vicat SA (France: VCT) on its IPO in 2007 based on a low multiple of what we believed to be understated earnings given its business prospects. We held the shares through the downturn, as they fell to a price where it no longer made sense to consider selling. The management team did a reasonable job of cutting costs in the face of the macro downturn. We have exited the position with a break-even result as the shares have recovered even as the business has slowed again.

The Partnerships bought Xerox (XRX) last year on the view that its acquisition of Affiliated Computer Services would be much more accretive than generally understood. However, the Japanese earthquake took the upside out of our earnings forecast. We exited the position with a modest gain.

The Partnerships shorted Cree (CREE) last summer when it was a growth darling based on the expectation that most of the world's light bulbs were about to transition from filament to LED. While we agree with the macro trend that solid state lighting will become a large share of overall lighting in coming years, we were much more cautious about the prospects of companies like CREE which make the chips that go into those light bulbs. We shorted the shares on the thesis that the chips are a commodity, and that people were conflating a good story (LED lighting) with a mediocre business (CREE). Since then, oversupply has trashed industry pricing, and CREE's margins, earnings, and share price have all fallen to more reasonable levels. We covered our position at a nice gain.

The Partnerships bought MI Developments (MIM) in 2003. Almost immediately, management changed its business plan to be completely shareholder unfriendly. Seeing value in the assets, we decided to become activist shareholders. We met privately with the Chairman and controlling shareholder Frank Stronach. The meeting was unsuccessful. We conducted a proxy contest where about 90% of the shareholders agreed with our recommendations. The company ignored our advice. We sought remedy in Canadian court. We lost. Meanwhile, the company continued to funnel resources away from shareholders. Seeking one last legal remedy, we contested the action with the Ontario Securities Commission. We lost again. Finally, in what can only be described as a hostage negotiation, the other minority shareholders got together and agreed to transfer more than half a billion dollars to Chairman Stronach in exchange for him surrendering the company. Even after paying this exorbitant ransom, there remained enough value for this investment to be profitable for us. Nonetheless, this one goes down as our least favorite investment (with a positive return) of all time.

Finally, we exited our last few remaining shares of MDC Holdings (MDC). We bought the original stake in MDC on the day that Greenlight opened in 1996 and sold most of our position a couple years ago. Despite the ups and downs, this investment was mostly ups. It was one of the biggest contributors to the Partnerships' returns of all time. We wish Larry Mizel and his team the best of luck.

We have one new addition to the team, Aric Steffen. Our Assistant Controller joins us from Ernst and Young where he was a manager in the Asset Management group. Aric is Greenlight's second team member from the beautiful state of Wisconsin. However, unlike David, Aric grew up working on a farm so he knows first hand the "dairy air" smell of Wisconsin. Welcome Aric!

We have recently upgraded our Customer Relationship Management (CRM) system to an investment management-centric system called Clienteer, which will further improve our ability to seamlessly communicate with you and service our partners' needs. If you got this letter, the new system is working!

At quarter end, the largest disclosed long positions in the Partnerships were Apple, Arkema, gold, Microsoft, Pfizer and Vodafone Group. The Partnerships had an average exposure to equities and fixed income (excluding credit derivatives, gold and foreign currencies) of 101% long and 77% short.

"Common sense is not so common."

-- Voltaire

Best Regards,

Greenlight Capital

Greenlight Capital, Inc.

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Each Partnership's performance returns reflect the total returns, net of fees and expenses, for an IPO eligible partner. The returns for Greenlight Capital, L.P. and Greenlight Capital Qualified, L.P are net of the modified high-water mark incentive allocation of 10% and reflect the returns for partners who were invested on or prior to January 1, 2008. The returns for Greenlight Capital Offshore reflect our standard 20% incentive allocation. Performance returns for 2011 are estimated pending the year-end audit. Past performance is not indicative of future results. A partner's actual returns may differ from the returns presented.

Positions reflected in this letter do not represent all the positions held, purchased, or sold by the Partnerships, and in the aggregate, the information may represent a small percentage of activity in the Partnerships. The information presented is intended to provide insight into the noteworthy events, in the sole opinion of Greenlight, affecting the Partnerships.

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