COMMENTARY

December 16, 2016

Dear clients and colleagues,

We are approaching the end of another year. 2016 was not without surprises, and 2017 should bring its own uncertainties and surprises. Stock markets around the world have had diverging luck. In US$, Brazil was a top performing major market at 57%, despite its President being impeached. The US markets did reasonably well with double digit returns bringing all indices into record territory. European markets and Asia were negative, partly due to weakening currencies, and Japan was slightly positive. We are optimistic for 2017. We do not see a recession. Supply-side reforms should be enacted, stimulating growth. Deflation as a risk has diminished. All factors are generally positive for small cap stocks.

Demographics is an important theme in our portfolio. Many companies in our portfolio are well-positioned to benefit from demographic changes.

An aging Japan, Europe or North America is a well-known fact. Just for the US, the number of Americans aged 65 and older is **projected to more than double** from 46 million today to over 98 million by 2060, and the 65-and-older age group's share of the total population will rise to nearly 24% from 15%.

China has the most rapidly aging population among Asian countries. In the next 10 years, the number of 0-39 year-olds will decline by almost 90 million people. Meanwhile, the number of people above 65 years old will increase by 70 million and will reach its peak of 400 million by 2055 or 27.2% of its population.

The company we are profiling this week has been in the portfolio since its inception in August of 2008. In that period, it has returned 15.6% annualized versus 11.9% for the MSCI World Small Cap Index. That performance came with lower volatility and better capital protection. During the global financial crisis, from August 2008 to March 2009, it went up 8.0% compared to the index at –28.1%. That company is a world leading company in the field of eye diseases, Carl Zeiss Meditec (AFX GR - €16.05) http://www.meditec.zeiss.com/.

Business overview and history

Carl Zeiss Meditec is a subsidiary of Carl Zeiss AG (65% owner)**,** a German manufacturer of optical systems, industrial measurements and medical devices, founded in Jena Germany in 1846 and listed in Frankfurt since its 2000 IPO.

The company is divided in Ophthalmic Devices (Surgical Ophthalmology, Refractive Laser, Intraocular lenses), and Microsurgery (Neuro, ENT, Dentistry and Radiotherapy/Gynecology).

In the field of ophtalmology, the company offers complete solutions for treating the four main eye ailments: vision defects: refraction; cataracts; glaucoma; and retinal disorders.

In the field of Microsurgery, Neuro/Ear, Nose and Throat (ENT) surgery, a fast growing market, the company is the world's leading provider of surgical microscopes and visualization solutions for these treatments, Finally, in the field of radiotherapy and cancer, the company has promising new technologies such as intraoperative radiation therapy which allows the targeted treatment of breast cancer and brain cancer during the operation stage itself.

The market

The markets that Carl Zeiss Meditec participates in are growing at rates varying between 4% and 20% per year. The company is focusing on three trends that are affected by a rapidly aging population: loss of mobility; loss of vision; and loss of cognitive abilities.

The number of older people is increasing significantly worldwide. By 2025, around 20% of the world's population will be over 65. A growing number of people are thus reaching an age at which eye diseases, for example, become inevitable. One of the most frequently performed operations on human beings is for cataracts. 40% of the population will develop cataracts. Another 15% will develop glaucoma or AMD, with 1 person going blind every second from it. And for cancer, it is the leading cause of death in the developed world and it is estimated that around 30% of people will suffer from cancer during their lifetime.

Competitive advantages and competition

Carl Zeiss Meditec competes in a market with few but very large companies such as Novartis, Alcon, Phillips, GE Medical, etc.

In the area of ophthalmic devices, the company is a leader with a market share in excess of 50% in some areas. In other areas, it is an emerging player competing for a niche or with a small market share.

One of its competitive advantages is its focus on eye diseases, helped by over 100 years of research and innovation. The company is also an innovator with over 10% of sales spent on R&D, not including the ties to the mother company. Finally, the company maintains a global presence of customer focused experts.

Growth strategy

New products are an important component of the growth strategy. As an example, the most common refractive eye surgery method today is Lasik. In 2011, the company introduced SMILE (Small Incision Lenticule Extraction), noted for achieving similar effects as LASIK but with some possible benefits such as faster recovery of post-op dry eye, reinnervation of corneal nerves, and a potential biomechanical advantage. Outside of the USA, there are 400 clinics in more than 60 countries that perform the procedure which have treated 600,000 eyes to date. The FDA approved SMILE for use in the USA, the largest world market for refractive surgery, just last September. In the next 24 months, the company will introduce many new products that will maintain or expand its market share. And another important approval in the US will be of intraocular lenses, a business that is growing at double digits outside the US.

The other vector of growth for the company is to increase its distribution capabilities, particularly in emerging markets, its fastest growth area. Revenues are evenly split today, 33% in America, 32% in Europe and 35% in Asia. In the last quarter, Asia grew at 15.5%, driven by China, which is now the company's second largest market.

Management

Dr. Ludwin Monz, CEO, is 51 years old, has been with the Carl Zeiss group since 1994 and joined Carl Zeiss Meditec in 2000, managing two of its three business units before being named CEO in 2008. Most senior managers have been with the group for many years. In addition, the company benefits from its ties with the much larger Carl Zeiss AG, its controlling shareholder.

Risks

As for most medical technology companies, the risk is of technological obsolescence, highly unlikely in this case.

Market data

Market Cap €2,828M, net cash €335M, P/E (09/2012) 25.3x, EV/EBITDA (09/2012) 15.2x, dividend yield 1.5%, gross margin 53%, profit margin 10%.

This will be our last comment for 2016. We will resume in January 2017. Our team would like to wish you a Happy Holiday Season and a Wonderful 2017, filled with health, happiness and success.

The Global Alpha Team