

March 11, 2011

Dear clients and colleagues,

As people around the world strive to improve their quality of life, effective utilization of natural resources is becoming vital. Efforts like constructing a sound material-cycle society are being made across the globe. As demand for products increases, the production and consumption of final goods generates huge amounts of waste. Industrial activities require a wide variety of inputs, such as energy, water, metals, plastics and wood. In an era of rising commodity prices and tighter resource constraints, industrial recycling is becoming widespread throughout the world.

This week we shall profile Daiseki (Japan 9793- ¥1586), a current holding in the portfolio.

<http://www.daiseki.co.jp>

Business overview and history

Founded in 1945, Daiseki has been active for over half a century in the resource recycling business, practicing its corporate philosophy of ‘making the best use of limited resources’. Headquartered in Nagoya, Japan, it operates a nationwide network of treatment facilities in its home base, as well as in the Hokuriku, Kansai, Kyushu, and Kanto regions. All facilities are ISO 14001 certified and licensed to recycle and treat major types of industrial waste. The company operates in two divisions, Environmental and Petroleum.

The Environmental division (95% of sales) undertakes intermediate treatment of industrial waste, such as waste oil, waste water, and sludge.

The Petroleum division (5% of sales) manufactures and sells concrete mold lubricant, industrial-use lubricant oil, and related products.

The market

Japan has seen progress in incineration technology because it is particularly difficult to secure landfill sites due to the lack of appropriate land. But the cost of waste management and recycling is high compared to the US because the proportion of incineration is high and the scale of individual waste management companies is small (as a result of complicated regulatory policies).

In Japan waste is generally divided into two categories, municipal waste and industrial waste. The amount of municipal waste produced annually is about 50M tons. Japans Ministry of Environment released on January 2010 the results of its surveys on the discharge and treatment of industrial waste nationwide in fiscal 2007. The amount of industrial waste was 419M tons. Of the total amount of the industrial waste, 219M tons (52%) were recycled, 180M tons (43%) were treated with intermediate processes for reduction, and 20M tons (5%) were sent to final disposal sites. The amount of waste recycled increased by 4M tons from 2006 with the recycling ratio improving by one percentage point.

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Competitive advantages and competition

Daiseki is the largest pureplay in Japan's waste management business and has approximately 10% of the industrial waste market. It uses chemical and biological treatment technologies as compared to competitors who use traditional intermediate treatments.

In Japan, the average waste management company is small as compared to much larger publicly traded companies in the US. To put that into perspective, revenues of Waste Management Inc. are more than 40 times that of Daiseki.

The largest waste management companies in Japan are from other industries, typically cement and mining like Taiheiyo Cement Corp and Dowa Kogyo Co., Ltd. There are several unlisted companies whose business is waste management.

Daiseki operates in an industry which has high barriers to entry namely due to licenses, land, and equipment. Obtaining licenses can take 2-3 years or longer for specific treatment types, and types of services offered. Land and equipment require capital outlays, which can be significant.

It has formed strong relations with customers, which gives it a significant edge over competitors by making it easier to gain the confidence of waste producers as the firm has a stable market for recycled products.

Growth strategy

Daiseki is experiencing continued improvement in its core business, due to its high-level recycling treatment technology, compliance and its plan to grow its regional share in Kanto and Kansai areas through active capital investment and business expansion. It is also looking for M&A opportunities to make the group a total planner for corporate environments, including surveying and treatment of polluted soil, environmental analyses, zero emissions support, and treatment equipment sales, etc.

Growth in the fragmented waste treatment industry seems to hinge on vigorous capital investment, even when demand is pulling back. Daiseki has been systematically expanding its network and gaining market share since going public in 1995.

Management

Hiroyuki Ito serves as the Chief Executive Officer and President. He joined the company in 1963 occupying various positions before taking on the role of president in 1996. Insiders own 10% of shares outstanding.

Risks

Slowdown in the manufacturing sector reduces orders of industrial waste collection. M&A's can pose integration challenges and price of recycle material is another threat.

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Market data

Market Cap US\$874M, net cash \$200M, P/E (02/2012) 15.75x, EV/EBITDA (02/2012) 5.9x, dividend yield 1.2%, gross margin 30.4% and profit margin 8.8%.

Investment theme and catalyst

Strengthening of regulations and more social concern over the environment create strong demand for the industrial waste treatment. Rising oil price also raises more enquiries on recycling of waste oil.

The industry is growing from an immature stage to a more concentrated and transparent business environment favoring larger and publicly-listed companies. M&A activities are also emerging helping acquirers bypass rigid licensing process in expansion to new regions. As the #1 pure play in the business, Daiseki is well-positioned to take advantage of growth opportunities.

Environment has always been part of our investment themes. Natural disasters, such as this week's earthquake in Japan, leave countries with a daunting task of reconstruction. We anticipate higher recycling efforts as they convert waste into material to rebuild the future and companies operating in recycling should benefit from it.

Valuation

We use a DCF model with a growth rate of 15% for the next 7 years, a growth rate at maturity of 6% and a risk premium of 9% to derive a target price of ¥2,512.

Have a good weekend.

Regards,
The Global Alpha Team

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