

December 17, 2010

Dear clients and colleagues,

On my recent trip to Japan, I visited one of our holdings, Disco Corporation. It is a world leader of precision equipment used in the semiconductor manufacturing process, with an important exposure to the fast-growing LED market. This week we would like to provide you with an update of the LED industry and profile Disco.

LED Industry

Evolution

As many of you may know, a LED (Light-Emitting Diode) is a semiconductor light source used for lighting in many devices. In simple terms, it is a physics process. When a LED is switched on, electrons are able to recombine with electron holes within the device, releasing energy. Although the technology was introduced back in 1962, early LEDs emitted quite low intensity red light. The new version of LEDs with very high brightness only became available in recent years.

Advantages

LEDs present many advantages over incandescent light sources, including lower energy consumption, longer lifetime, improved robustness, smaller size, faster switching, and greater durability and reliability.

Applications

LEDs are used in a wide range of applications such as aviation lighting, automotive lighting (particularly brake lamps, turn signals and indicators) as well as in traffic signals. The compact size, the possibility of narrow bandwidth, switching speed, and extreme reliability of LEDs has allowed new text and video displays and sensors to be developed, while their high switching rates are also useful in advanced communications technology.

Industry Outlook

After being installed in mobile devices and TVs over the last few years, LEDs have finally matured into a third - and arguably the biggest - end market: general lighting. Experts believe that LED lighting will hit an inflection point in 2011/12, driven by both improved economics and regulatory changes such as ban of incandescent lights in many countries and Restriction of Hazardous Substances directive putting pressure on Compact Fluorescent Lamps (CFLs).

LED unit demand is expected to increase over 50% in 2009-2015e. Besides continuous backlighting demand (for TVs and monitors), general lighting applications' early phase should kick in next year. The number of tools needed to supply general lighting could be >10,000 in ten years with a likely peak between 2013 and 2015, when experts expect the highest growth rates for LED bulb adoption by households.

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Disco Corporation (6146 JP - ¥5280)
www.disco.co.jp
Business Overview

Disco is a Japan-based manufacturer of precision cutting, grinding and polishing equipment used in the semiconductor manufacturing process.

Four business segments:

Segment	% of revenue	Key products
Precision Processing Equipment	61%	Dicing saw, grinder, polisher; mainly used in memory, packaging and LED production
Precision Processing Tools	17%	Dicing blade, grinding wheel, and dry polishing wheel
Industrial Grinding Products	2%	Grinder
Others	20%	Parts and Services

Revenue by region:

60% Asia ex-Japan: mainly Taiwan, Korea and China

30% Japan

10% North America and Europe

History

The company was originally founded in 1937 as a manufacturer of industrial abrasive wheels. 1975 was the milestone year when it started to produce dicing saws for semiconductor. It became public in 1989.

Management

The founder's family has 40% of ownership, and is still on the board of directors.

Market Data

Market cap ¥180B (US\$2.1B), net cash: US\$115M, div yield 1.1%, ev/t12 sales 1.85x, p/e (03/2012): 14.9x, ev/ebitda (03/2012) 6.4x, gross margin 46.5%, operating margin 18.9%, profit margin 12.1%, 1-year return - 3%.

Target Market

Worldwide shipment of semiconductors is expected to reach U\$320B in 2012. The semiconductor market had been growing rapidly before the financial crisis and is experiencing a strong recovery. Sales of semiconductor manufacturing equipment during 2002-2007 grew at a CAGR of 11%.

LED market size was U\$4.9B in 2008, and is forecasted to reach U\$10.3B in 2012. LED unit demand is expected to increase over 50% in 2009-2015e.

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Competitive advantages

- Technology expertise: Disco has leading-edge technology in cutting, grinding and polishing.
- Unique position: It is the only manufacturer of abrasives in the world that can cover all three segments including application engineering, equipment and tools.
- Strong R&D capability: The company spends 10% of sales on R&D each year. Its 77 application labs in Tokyo conduct about 2,000-2,500 tests a year, creating high entry barriers.
- Dominant market position:
 - ✓ 70-80% world market share for dicing saws.
 - ✓ 60-70% world market share for grinders.
 - ✓ 70-80% world market share for precision processing tools.
- Excellent product quality: It has won Intel's SCQI (Supplier Continuous Quality Improvement) Award for ten consecutive years.

Competition

Disco has various competitors in different business segments.

- Dicing saws: Tokyo Seimitsu, ADT, New Wave, Laser Solutions, Xsil.
- Grinders: Tokyo Seimitsu, Okamoto Machine Tool Works.
- Precision processing tools: Mitsubishi Materials, Asahi Diamond Industrial, Shinhan, Ehwa, Semitec, Norton.

Growth strategy

- Distribution expansion: To increase overseas sales, especially in Asia.
- Strategic focus on LED market.

Risks

- Weak demand due to economic slowdown, notably constrained capital spending in the semiconductor industry.
- Yen appreciation.

Investment Theme

We expect strong growth in the semiconductor industry, and in particular the LED market. LED adoption rates for general lighting purposes are set to increase sharply in the coming years. As LEDs become a commodity, the challenge of LED production is likely to follow the path of silicon, its elder sibling, to cut costs. This will have two major implications:

- Increasing automation and production standards are expected to lead to higher yield.
- Asia will become the major production base due to cheap labor, notably in China, which aims to build its LED hubs.

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We believe such implications will have a very positive impact on Disco, which is the world-leading producer of highly-automated laser dicers used in LED manufacturing. What's more, 60% of its sales are from Asia ex-Japan, and this portion is increasing rapidly.

Valuation

Target price = ¥7,813, using DCF model at growth rate of 10% for the next 7 years, 6% at maturity, risk premium of 9%, and payout at maturity of 50%.

Regards

The Global Alpha Team

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