



March 29, 2013

Dear clients and colleagues,

We have spent the last two weeks in Japan attending the Daiwa 2013 Annual Investment Conference in Tokyo as well as visiting more than 10 companies on site in Nagoya, Kobe, Osaka and Tokyo. In total we met more than 60 companies. The conference was well attended with over 1,500 attendees, including 600 portfolio managers and 300 presenting companies. There were 110 investors from the U.S. and 60 from Europe. There was a 25% increase in attendance this year, especially international investors.

The increase in attendance can be attributed to the fact that Japan is one of the best performing markets with the Nikkei 225 Index up 19.9% YTD in local currency. Since June 2012 Japanese market may have entered a bull market, highlighting the end of the bear market which lasted 22 years and six months. So what changed?

The “lost 20 years” have been attributed to deflation and yen appreciation. The biggest difference now is Bank of Japan (BOJ) has introduced an inflation target of 2%, namely due to the pressure from the new Prime Minister Shinzo Abe. His administration is focused on business and economic growth as opposed to its predecessors who focused on consumer interest and wealth distribution policies such as expanding the social security.

‘Abenomics’, as it is come to be known, aims at (i) aggressive monetary easing leading to a weaker yen, (ii) an increase in public spending centering on social infrastructure and (iii) measures to spur up growth such as deregulation and opening up the country. Haruhiko Kuroda, the incoming BOJ governor, is a strong proponent of monetary easing, and has been called a “dream choice” for Prime Minister Shinzo Abe.

So how does this impact Japan? The aggressive measures by BOJ should result in a rise in the expected inflation rate, leading to yen depreciation and stock rallies. Wealth effect would be felt as balance sheets improve for households and corporations, which should improve sentiments. A weaker yen also benefits exporters, leading to an increase in domestic production and improved corporate earnings. This could further trickle down to increased wages and increase consumption.

International investors are still skeptical as the BOJ has disappointed them in the past. We believe that the strategic approach has changed this time, demonstrated in actions such as setting aggressive monetary policies. The weakness in the yen will help corporate earnings. According to FactSet consensus estimates for FY13 Topix constituents EBITDA and EPS are estimated to rise 20% and 40% yoy respectively, the highest seen in other major indices. Continued weakness in the yen could see the estimates improve further and act as a major catalyst for increased confidence among investors.

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What do we think about the Japanese market?

In the next decade it will continue to be a very important stock market for global investment. Being selective in terms of industry and stock is the way to go. Japan's aging population and weak domestic demand are real; however, opportunities also arise for two types of companies: 1) domestically-oriented companies that benefit from increasing healthcare needs. (e.g. medical equipment, pharmaceuticals and senior housing; and 2) globally-oriented companies with strong brands.

During our stay, we met with very dynamic entrepreneurs who are seeking to emulate the previous generation of leaders such as Toyota and Honda. We came away impressed from our meetings and expect all our companies to more than double earnings in the next 3 to 5 years.

Our global small cap portfolio owns eight companies in Japan and we had the opportunity to meet six of them during this trip.

- ✓ **Horiba:** A high-tech based measuring equipment company with leading global market share. Over 70% of sales from overseas. A diversified product portfolio in 5 industries (automotive, medical, scientific, environmental and semiconductor), which supports sustainable growth through the economic cycle. It expects topline to grow double digit this year.
- ✓ **Nabtesco:** An equipment provider specializing in motion control technology with leading global market share. Over 70% of sales from overseas. A diversified product portfolio in 4 industries (precision, semiconductor transportation, and aircraft and hydraulic). The company expects to more than double its revenue in the next 10 years, while improving profitability.
- ✓ **Seven Bank:** A licensed bank that operates the biggest ATM network in Japan, with over 16,000 ATMs in all 47 prefectures. It expects to have more than 24,000 ATMs in the near future. Seven Bank's ATMs are conveniently located in convenience stores and supermarkets owned by Seven & I Holdings, and the remainder in financial institutions, airports, train stations, hotels, hospitals, office buildings, and shopping centers. It also has 2,431 ATMS in the U.S.
- ✓ **Daiseki:** Industrial waste management with over 5,400 customers, of which 250 were added last year. The company aims to add 300 more this year. Their waste management business should benefit from pick-up in industrial production. It is a niche leader gaining market share. Other businesses are also doing well; lead recycling is anticipated to double this year and the company is also experiencing strong demand for soil treatment solutions.
- ✓ **Message:** Japan's largest operator of fee-paying senior homes, with 223 facilities and over 10,000 units. We visited two of its facilities and came out impressed by the cleanliness, noting that overall that the facilities are well maintained. It takes on average less than 6 months to reach full occupancy after opening. It is the niche leader in a market with huge demand.

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- ✓ Kamigumi: One of the biggest logistics service operators in Japan. It offers port transportation, warehousing, freight forwarding, ship chartering, packaging, and road transportation services. It operates in Japan, China, Hong Kong, Indonesia, Malaysia, Singapore, Thailand, Taiwan and Vietnam.

Despite the aging population, Japan still has the 4th largest purchasing power valued at \$4.6 trillion. What is more, we noted that some retailers and convenience stores are increasing their overseas expansion.

In summary, we see great growth opportunities among Japanese companies and our visit to Japan confirmed our positive view. We were impressed by their technology edge, experienced management, strong balance sheet and clear growth strategy.

Have a nice weekend.

The Global Alpha Team

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