

October 29, 2010

Dear clients and colleagues,

This week we would like to profile one of our top 10 holdings in the Global Small Cap Portfolio – Nabtesco. It has been in the portfolio since inception. We visited the company last December in Tokyo, and will meet the management again this November.

Today the company announced better-than-expected half-year earnings results for the period ended September 30, 2010. Sales increased 35% y/y, and net income jumped over eightfold. YTD the stock price has gained 35%, while the Nikkei 225 has dropped 13% and the Topix Machinery sector index has declined 8%.

Nabtesco Corporation (6268 JP - ¥1425)

www.nabtesco.com

Business Overview

Nabtesco is a Japan-based manufacturer highly regarded for its unique motion control technology. It is present in eight countries with about 4000 employees. The company slogan reflects well the heart of the business: “moving it. stopping it.” Its technology and products are widely used to ensure safety, security and comfort in people’s lives, ranging from the transport sector such as railways, airplanes, marine vessels and automobiles, to industry, daily life and the environment sector such as robots, construction machines, and automatic doors.

Four business segments:

Segment	% of revenue	Key products
Transportation equipment	33%	Brakes and door systems for railroad vehicles
Aircraft and hydraulic equipment	33%	Travelling motors for hydraulic excavators
Industrial equipment	22%	Automatic doors for buildings
Precision equipment	12%	Precision reduction gears for robot joints

A product example we experienced firsthand in Japan would be the Shinkansen bullet trains. Nabtesco’s brakes and doors are installed on the trains. And its technology is used in the inclining system that allows the train to manage curves at high speed, and in platform doors built between rail tracks and platforms for the safety of passengers getting on and off trains.

Nabtesco’s overseas business has grown rapidly to 30% of total sales last year from 23% within three years, mainly driven by China. China represents about 20% of total sales, North America 7% and Europe 3%.

Nabtesco supplies parts to many leading industrial manufacturers. To name a few: the world’s top industrial robot makers Fanuc (Japan) and Kuka (Germany); the world’s top hydraulic equipment makers Komatsu (Japan) and Kobelco (Japan); and aircraft builder Boeing. Its key customers in other Asian countries include

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dominant local makers in hydraulic equipment such as Sany (China), LiuGong (China), and Doosan Infracore (Korea).

History

The company was set up in 2003 through the merger of Teijin Seiki Co. Ltd. and Nabco Ltd. Teijin Seiki was founded in 1944, and Nabco in 1925.

Management

Management is very experienced and stable. The CEO and most other senior directors have been with Teijin Seiki or Nabco since 1970s.

Market Data

market cap ¥180B (US\$2.3B), net cash: US\$213M, div yield 1.26%, ev/t12 sales 1.25x, p/e (03/2012): 13.0x, ev/ebitda (03/2012) 6.0x, gross margin 25.2%, operating margin 11.6%, profit margin 7.7%, 1-year return 35%.

Target Market

Nabtesco has a diversified product portfolio, with the transportation equipment segment growing the fastest while its precision equipment segment is the most cyclical.

The market for transportation equipment has been growing rapidly thanks to the infrastructure boom in China. Nabtesco has 25% market share in China for speed train brakes and travelling motors. In March 2010 China announced plans to more than triple its high-speed track to 13,000 km by 2012 with an investment of 900 billion yuan (about US\$135B). In May 2010, it also announced it will invest 1 trillion yuan (about US\$150B) in subways to more than triple urban subway networks over the next five years. The networks are expected to cover 3,000 km by 2015.

The markets for other business segments have rebounded strongly this year. During the non-crisis period of year 2002-2007, these markets had grown at low-double digits annually.

Competitive advantages

- Technology expertise: Nabtesco's motion control technology is unique in the world, which creates high-entry barrier for competitors and keeps customer confidence on the rise.
- Dominant market position: It is the world's number one player for many products.
 - ✓ 60% world market share for the precision reduction gears in joints of industrial robots
 - ✓ 30% world market share for traveling motors in hydraulic excavators
 - ✓ 40% world market share for engine control systems in marine vessels
 - ✓ 95% domestic market share for platform screen doors
 - ✓ 50% domestic market share for automatic doors
 - ✓ 50% domestic market share for brake systems in railroad vehicles

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- ✓ 100% domestic market share for flight control actuation system in domestically-produced aircrafts

Competition

Nabtesco has various competitors in different business segments.

- In the precision equipment market, it competes with Sumitomo Heavy Ind. and Harmonic Drive Systems. The three Japanese players control nearly the entire global market.
- In the transport equipment market, it competes with Knorr (Germany) and Melco (Japan), Wabtec (US) for brakes, and with Faiveley Transport (France), IFE (part of Knorr), and Bode (Germany) for door engines.
- In the aircraft equipment market, KYB (Japan), Goodrich (US) and Rockwell Collins (US).
- In the travelling motor market, KYB, Kawasaki Precision, Nachi Fujikoshi and Toshiba Machine.
- In the automatic door market, Japan's Teraoka, Fuso Denki and YKK, Stanley (US), Horton (US), and Besam (Sweden), a subsidiary of Assa Abloy AB.

Growth strategy

- Distribution expansion: To increase overseas sales, especially in Asia. The transportation business segment is expected to be the key driver.
- Product innovation: To develop new products based on the motion control technology.

Risks

- Weak demand due to economic slowdown, notably constrained auto industry's capital spending, and fewer infrastructure projects
- Yen appreciation
- Increasing raw material costs

Investment Theme

Nabtesco has been a dominant leader in many of its businesses, consistently gaining market share. In the next few years, we believe it can continue to benefit from the infrastructure boom in China. Meanwhile, the strong recovery of industrial robot demand and civilian aircraft demand worldwide also bode well for the company in longer term.

Valuation

Target price = ¥2404, using DCF model at growth rate of 15% for the next 7 years, 6% at maturity, risk premium of 10%, and payout at maturity of 60%.

Have a nice week.

Regards

The Global Alpha Team

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