February 17, 2011

Dear clients and colleagues,

Stock markets around the world have now recovered all or most of their losses suffered during the crisis. A return approaching 100% since the bottom in March 2009. Optimists think the market will continue to march higher, driven by a still improving economic outlook coupled with low valuations and relatively benign interest rates.

We do not forecast short-term movements in the markets. Those short-term movements, however, are driven by expectations. China has been one of the worst performing markets in the last year, despite very strong economic data. Rising inflation coupled with Central Bank tightening has tempered expectations.

Over extended periods of time, if one believes in long-term progress and growth, there is no doubt that equity returns should be positive. For the short term, we are cautious. The flood of liquidity injected by Central Banks around the world in the last three years has been a major factor driving the recovery and the rise in the market. At some point, the liquidity will be withdrawn. We think it will be soon. In addition, many of the imbalances we saw in 2008 are showing again. Very few financial reforms have been implemented, setting the stage for a new crisis. Finally, geopolitical risk is at its highest in at least a few decades. We believe that investors are ignoring all these factors at the moment.

Our portfolio is well positioned to benefit from continued growth in the economy; we have a lower risk profile than the market if it were to have a correction.

A good example is the company we want to profile this week. It is a world leader in its field. Its products touch our lives very closely although you probably have never heard of the company before. The company is Nakanishi (7716 JP - ¥8800)

www.nsk-nakanishi.co.jp/

Business overview and history

Founded in 1930 and still controlled by the Nakanishi family, the company manufactures hand pieces for the dental industry.

In 1930 Keiichi Nakanishi founded NSK in Tokyo to manufacture dental hand pieces. Closed during the war, the company reopened in 1951 in Tochigi, 100 km north of Tokyo where it still is today and where we had the pleasure to visit the company last year. In 1971, production of air turbines began and in 1979 overseas exports started. In 1997, the company obtained its ISO 9001 (Quality Assurance Standard) and in 1999 it became ISO 14001 (Environmental standards). In 2000, the company became publicly listed on the Tokyo exchange. Today, the company is one of the largest suppliers of gyration equipment (drills and grinders) to the dental market worldwide with over 75% of its total sales outside Japan in over 120 countries.

The market
We estimate the dental market for gyration equipment (drills) at around US$1 Billion, growing at around 6% per year.

Competition and Competitive advantages
The US and Europe are equivalent markets in size for dental equipment. The fastest growing markets, however, are China and India where the number of dentist per capita is much lower than in developed countries and the importance of dental hygiene is now part of the life routine. There are many competitors with the main ones being much larger companies: Dentsply of the US, and Kavo in Europe, a subsidiary of Danaher; and increasingly Chinese companies.
The company's competitive advantage is its quality-price ratio.

Growth strategy
In the last few years, the company has gained market share and grown at about twice the rate of the industry as a whole. Its growth strategy has been driven by international distribution.

The company is also focused on new product innovation, spending around 6.3% of revenues on R&D,

Management
Eiichi Nakanishi, the company president, is the grandson of the founder. 46 years old, he holds a MBA from the University of Michigan and started with the company in 1990 occupying various positions in the US, Europe and Asia before taking on the role of president in 2000. Other family members also occupy positions with the company and own around 20% of the company. The rest of the management team is very stable.

Risks
The company's competitors are large multinational companies with substantial resources and distribution. Chinese companies are entering the market with low-end copycat products. The company is responding to those threats by innovating and has started to offshore some of its manufacturing in China. Labor, however, is less than 10% of the product costs. The Yen/Euro ratio is a much bigger factor.

Market Data
Market Cap US$600 M, no net debt, cash $166M, and fwd P/E (12/2011) 10.9; fwd ev/ebitda (12/2011) 5.1x; dividend yield: 1.2%; 5-average sales growth: 11%

Investment Theme and catalyst
After consumer spending, healthcare is the largest sector of the economy. It is also the fastest growing worldwide, driven by the aging of the population, increased life expectancy, and the need for developing economies to put in place their own social safety net. Dental hygiene is a fast growing industry. Emerging markets are growing at double digits.

Valuation

We use a growth rate of 11% for the next 7 years and a growth rate at maturity of 6%. We assume a payout ratio of 15% during the growth years and 50% at maturity. A discount rate of 8% is used to derive a target price of ¥15360.

Have a good week.

Regards,

The Global Alpha Team