

January 9, 2015

Dear clients and colleagues,

Happy New Year!

This week, two Japanese companies in our portfolio announced operating results. Disco Corp is the world leader of precision cutting, grinding, and polishing equipment used in the semiconductor manufacturing process. Its fourth quarter sales grew 29%, beating estimates. OSG Corp is the world leader of solid cutting tools. Its FY2014/11 sales grew 14% and operating profit grew 36%, also beating estimates. Both companies hold the #1 global market position in their respective niches, and have each benefited from a better product mix and the weaker yen.

Here we will profile OSG, a new addition to the portfolio last year.

OSG Corp (6136 JP - ¥1,898)

www.osg-global.jp

Business Overview

Founded in 1938, OSG is the largest manufacturer of solid cutting tools in the world. Its main products are taps (to cut threads), end mills (to shape metal in finishing operations), drills (to make holes), rolling dies (to cut external threads), and indexable cutters (to shape metal in roughing operations). Sales are generated from a wide range of manufacturing industries. The majority of exposure is to the automobile and aerospace industries. Approximately half of OSG's sales are from Overseas.

OSG dominates the high-end market. Its pricing is 20-30% higher than western peers and 2x that of its Asian competitors.

You may have noticed a very attractive feature of its products – 100% consumables. Product life cycles range from a couple of hours to one month, depending on the material being cut. This means its revenues are highly recurring.

ESG

The founding family (Osawa) owns 7% of the company, and the other management team owns 8%. Mr. Teruhide Osawa is the current Chairman & CEO. We appreciate management's bold global expansion, a step generally not taken among Japanese Small Cap names. OSG entered the USA in 1968. It now has 19 plants globally and sales & service networks in 29 countries.

The company has strived to develop environmentally friendly products. By 2000, it had obtained ISO 14001 certification. Each year, it issues an environment report to highlight activities and social contributions.

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.



Market Data

Market Cap \$1.5B, little net debt, div yield 1.9%, p/e (2015/11) 16.6x, ev/sales 1.8x, ev/ebitda 7.2x, gross margin 44%, operating margin 19%, profit margin 11%, roe 12%.

Target Market

The global cutting tools market is roughly \$18B, 30% of which is solid tools. OSG's target industries are primarily auto and aerospace. Target market features include: high precision, small quantity, expensive. OSG estimates that the target market is to grow 5-6% annually, based on conservative assumptions.

Competition

Solid tools: Yamawa, Hitachi Tool Engineering, Nachi-Fujikoshi, and NS Tool.

Indexable tools: Sandvik, Kennametal, Iscar, Mitsubishi Materials, Sumitomo, and Tungaloy.

Competitive advantages

- #1 in solid cutting tools market. For example, its Tap product has a 30% market share globally and 53% in Japan.
- Superior quality: Thread grinding requires a very precise operation, given how critical safety is for the auto and aerospace industries.
- Excellent after-sales service: Re-sharpening and re-grinding, new coating. OSG's coating service has more than 20 coating funnels, #1 globally in terms of scale and technology.

Growth strategy

- Distribution: Geographic and industry expansion
- New product development
- M&A: This has been an effective way for OSG to gain further share in its markets.

Risks

- Forex: 1 Yen fluctuation vs. USD affects operating profit by ¥100M.
- Manufacturing trend in the auto and aerospace industries

For this year, OSG forecasts sales to grow by 8% and net profit by 13%. Its dividend will continue to increase. It expects strong demand from the aircraft sector and a rise in market share for its core products. OSG's management has been very conservative in their forecasts historically. We strongly believe it can beat the guidance and continue to deliver solid results.

Have a nice weekend.

The Global Alpha Team

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS[®]) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.