

April 2, 2015

Dear clients and colleagues,

Hunting for Easter eggs remains a novelty in China, though perhaps not for much longer.

The theme of emerging market consumers is a key investment philosophy at Global Alpha. According to the IMF, emerging markets will drive 70% of global growth in the coming years and are expected to grow two to three times faster than developed markets. Although all of the companies in our portfolios are listed in developed markets, they are increasingly exposed to emerging markets.

This week we feature Pigeon, a Japanese company with approximately 32% of sales and 44% of its profits coming from China. Since we initiated a position in December 2012, the stock has delivered a total return of over 440%.

**Pigeon Corp (7956 JP - ¥10,260)**

<http://english.pigeon.co.jp>

#### ***Business Overview***

Founded in 1949, Pigeon is a pioneer in baby care products and the market leader in Japan.

Pigeon has an 86% market share in Japan for baby bottles and a 65% share for breast pads. The frontrunner also provides baby bottle sterilizers, skincare products, baby wipes, and baby food. Pigeon has carved out a dominant 40% share of the higher-end market in China as well.

#### ***ESG***

Pigeon was recognized by the Tokyo Stock Exchange in 2014 and awarded the Excellent Company in Corporate Value Enhancement Award. It was also selected by Nomura Securities as one of sixteen Japanese companies that have accelerated their efforts in strengthening corporate governance.

The management team is very stable and together, they own 10% of the company. Two out of eight of the directors are independent.

Pigeon has obtained the ISO-14001 certification for environmental management systems, demonstrating a commitment to preventing global warming and realizing a sustainable society. The corporate culture at the firm encourages a healthy work-life balance, female career advancement, and involvement in the local community.

#### ***Market Data***

Market Cap \$3.5Bn, Net Cash \$115Mn, Div Yield 1.1%, P/E (2016/1) 36.0x, Ev/Sales 3.9x, Ev/Ebitda 20.0x, Gross Margin 46%, Operating Margin 15%, Profit Margin 10%, ROE 20%

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### ***Target Market***

The Japanese baby and child care product market is shrinking, largely due to the fact that the number of births has fallen to a record low of 1 million per year. Conversely, sales of baby and child care products in China are growing at a double digit pace. The number of annual childbirths in China is roughly 15 to 20 million. The fact of the matter is that most Chinese families only have one child, who naturally becomes the spending focus of the parents and grandparents.

### ***Competition***

- Japan: No major competitor
- China: No major competitor for baby bottles, though several smaller competitors for other baby care products

### ***Competitive Advantages***

- Superior product quality
- Innovation
- Strong balance sheet

### ***Growth Strategy***

- Distribution: Expand from Tier-1 into Tier-2 and Tier-3 cities in China. Enter into new markets such as India, Malaysia, and Korea.
- Product: Develop new products with higher added-value. Expand offering to diapers, car seats, and strollers.

### ***Risks***

- Foreign exchange: 1 yen depreciation vs. USD boosts operating profit by ¥120 million
- Macro consumer sentiment

We met Pigeon's President in Tokyo last month. He was very confident that sales this year should grow by at least 9%, driven by China. The company also plans to continuously increase its dividend. This week, Pigeon announced a 1 for 3 stock split, often a signal of further stock price appreciation. We like the excellent visibility of Pigeon's business; however, we also feel that its valuation is becoming rich. We are always in search of new ideas with better risk-adjusted returns.

Happy Easter!

The Global Alpha Team

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