

Absolute Values

Sub-Working-Capital & Low Multiplier-Buys

Greenwich Investment Research, Inc.

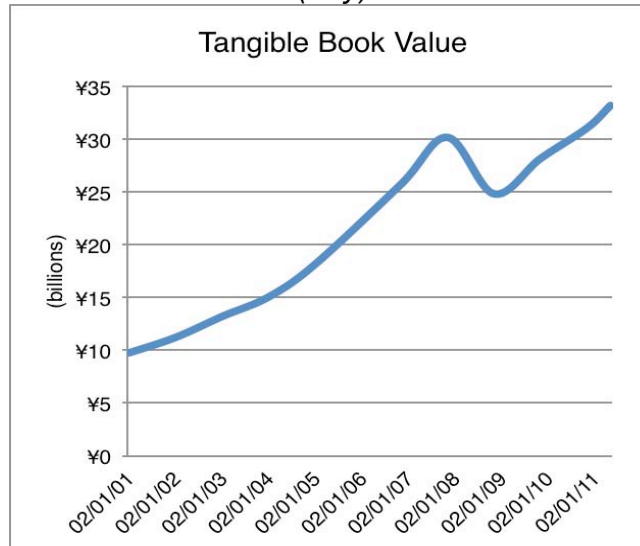
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September 12, 2011

203. 550. 2853

Nakanishi, Inc.

(buy)



Ticker:	7716, Osaka Stock Exchange
Share price:	¥7,150 (\$92.24)
Market cap:	¥43 billion (\$555 million)
EV:	¥23 billion (\$306 million)
2011 dividend / yield:	¥100 / 1.4%
Market cap. / earnings:	8.0
EV / EBITDA:	2.6
Price / tan. BV:	1.3

Thesis

Nakanishi, Inc. (7716) manufacturers and sells dental handpieces and handheld industrial cutting and grinding equipment. On a global basis, they have the second largest market share of dental handpieces (behind KaVo, owned by Danaher). Three facts to consider when thinking about Nakanishi:

- Nakanishi is extremely vertically integrated and makes all of its products in Japan, yet it has grown its business outside of Japan (79% of 2010 revenue were exports) despite a strong yen. The company is completing a plant in Vietnam this year, which may make them even more competitive.
- Nakanishi earns very high returns on capital (24% return on invested capital for the last 10 years) despite its over capitalized balance sheet (45% of its market capitalization is cash).
- Nakanishi pays a modest dividend and has reduced its share count by 14% since 2008.

Remarkably, Nakanishi may be purchased for 8x trailing earnings and 9.4x FCF. This is a bargain and we plan to buy Nakanishi shares in the near future.

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Capital Structure and Valuation

The following table summarizes Nakanishi's capital structure and valuation.

(000 except share price & dividend)	
Common stock outstanding, 6/30/11 ¹	6,284
Treasury shares, 6/30/11 ¹	(269)
diluted share count	6,014
Share price, 9/12/11	¥7,150
Market capitalization	¥43,003,539
Cash & securities, 6/30/11	¥19,704,387
Finance (capital) lease obligations, 12/31/10	¥195,081
Operating lease obligations, 12/31/10	¥97,337
Debt, 6/30/11	¥119,968
Enterprise value, net	¥23,711,538
2011 projected dividend (annual)	¥100
2011 dividend yield	1.4%
Net cash / market capitalization	45%

The table shows that Nakanishi has cash (net of debt and lease commitments) equal to 45% of its market capitalization; the company will pay a ¥100 dividend in 2011 and is 2/3rds of the way through implementing a 100,000 share buyback to be completed by 12/31/2011. The following table summarizes Nakanishi's share count since 2003.

Nakanishi Share Count: 2003 - 2011¹

Year	Average shares outstanding (000)	Treasury shares, end of year (000)	Net shares outstanding, period end (000)	Delta, prior period
2011	6,284	(369)	5,914	-2%
2010	6,284	(269)	6,014	-2%
2009	6,284	(145)	6,139	-2%
2008	6,984	(745)	6,239	-11%
2007	6,984	(1)	6,983	
2006	6,983	(1)	6,982	
2005	6,983		6,983	
2004	6,983		6,983	
2003	6,983		6,983	

As of this writing, Nakanishi has bought back 68,900 shares of the 100,000 shares management said they would repurchase during 2011. Assuming the 2011 buy back is completed, Nakanishi will have reduced its share count by 15% since 2007. Note the large share buyback in 2008; the company repurchased 745,000 shares from Takasuke Nakanishi, the company's previous chairman and CEO, who retired at age 70. We would have preferred that he not sell his shares; however, the Nakanishi family currently owns 24% of the shares and subsequent share buy

¹ Source: Nakanishi Flash Reports, Hackett analysis.

backs have been conducted in the open market. When he retired in 2008, Mr. Nakanishi's son, Eiichi, was promoted from COO to CEO and he currently runs the business.

Background & Business

Nakanishi was founded in 1930 in Tokyo by Keiichi Nakanishi to make dental handpieces. The company ceased production during World War II and was reestablished in 1953. In addition to dental handpieces, Nakanishi sells variations of their dental handpieces for industrial grinding and intricate cutting applications; industrial applications represented 10% of 2010 revenue. The company generated 3% of its revenue from repairing handpieces. Nakanishi recently introduced a surgical hand piece but does not disclose sales, so we assume this product line is nascent. Nakanishi entered the U.S. market in 1984 and went public in 2000. Here is an example of one of the company's handpieces.



There are two types of dental handpieces and Nakanishi makes both (every dentist needs both):

- **High-speed:** These rotate up to 400,000 revolutions per minute (RPM) and are used for drilling.
- **Low-speed:** These rotate from 5,000 to 20,000 RPM; these are used for cleaning.

There are two motive technologies used for handpieces and again, Nakanishi makes both:

- **Pneumatic:** Pneumatic handpieces cost \$300 - \$1,600 and may be rebuilt for \$200. They require a compressor, which costs \$1,000 - \$2,000. One compressor can support many dental workstations and compressed air is typically used for other dental applications.
- **Electric:** Electric handpieces cost up to \$5,000 (including controls and cords) and a typical repair cost \$700. Electric handpieces have better torque characteristics than pneumatic, so some dentists are willing to pay the premium.

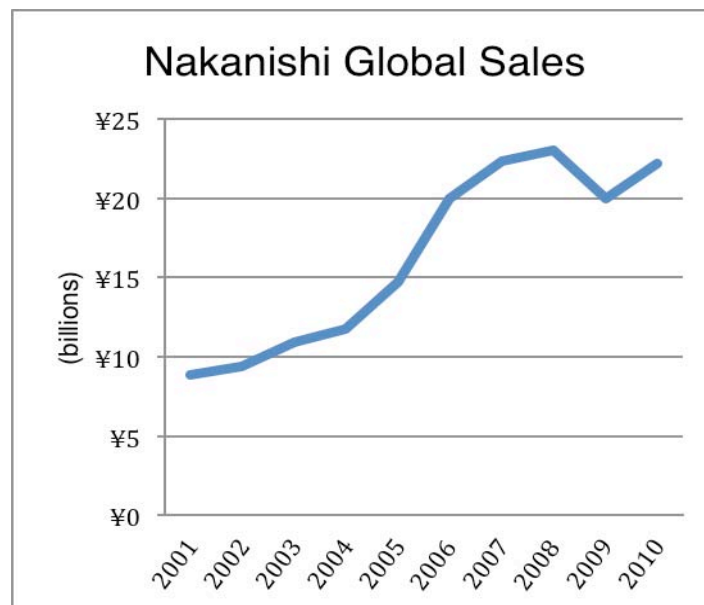
Nakanishi, as do most manufacturers, offer handpieces in different geometries, e.g., straight and contra-angle. Dentists typically have three to five handpieces per dental workstation; this allows for cleaning time between patients and provides back-ups in case a handpiece fails. Nakanishi sells its products under the brand name NSK. Sales are made through a direct sales force, which calls on dealers and distributors which, in turn, sell to dentists.

The following summarizes Nakanishi's revenue by region since 2003.

	2010	2009	2008	2007	2006	2005	2004	2003
Japan	21%	21%	21%	22%	23%	23%	24%	26%
North America ²	19%	20%	19%	21%	20%	22%	22%	27%
Asia ³	15%	13%	12%	14%	17%	19%	22%	25%
Europe ⁴	28%	32%	34%	29%	29%	25%	20%	11%
Rest of world ⁵	17%	14%	14%	14%	11%	11%	12%	11%
	100%	100%	100%	100%	100%	100%	100%	100%

Sources: Nakanishi data files; regional definitions from 2010 AR translated by Google translate, 2003 data from *Flash Report* 4/2/2004.

Note that Europe's contribution to revenue grew from 11% in 2003 to 28% in 2010; now take a look at the company's overall revenue since 2001.



Two factors contributed to Nakanishi's remarkable sales growth and its success in Europe over the last ten years.

- Nakanishi established a sales and service office in Frankfurt, Germany in 2003; this was their first dedicated sales office in Europe.
- Danaher Corp. acquired Kaltenbach & Voigt GmbH (KaVo)⁶ of Biberbach, Germany in May 2004. At the time, KaVo was the largest handpiece manufacturer and their product was considered the highest quality. Shortly after the acquisition, Danaher laid-off 325

² USA & Canada.

³ China, Taiwan, Korea, Singapore & India.

⁴ Germany, France, Italy, Switzerland.

⁵ South America, Middle East, Australia, Russia, South Africa.

⁶ Danaher paid €350 million for KaVo which equated to 2.1x tangible book value (excluding cash) and about 1x revenue.

KaVo employees (about 1/3rd of KaVo's workforce).⁷ With the benefit of hindsight, many industry participants think that the layoff was a mistake and, as a result, KaVo lost market share to competitors, including Nakanishi.

Nakanishi and its competitors

Competition among handpiece manufacturers is based on product design, manufacturing capability, and distribution channels. Nakanishi has made the following choices:

1. **Vertical integration** – Nakanishi is likely the low cost producer of high-quality handpieces. Nakanishi's 600 employees manufacture 85% of the 17,000 parts needed for their product line; they even make their own tooling and test equipment. Traditionally, their manufacturing was done in Japan. The yen's appreciation in recent years has created an obstacle which, for the most part, they have surmounted: their gross margin was 60% in 2010, down from 62% in 2008. During 2011, they are opening a manufacturing plant in Vietnam. Some of their competitors outsource large portions of the manufacturing, e.g., Sirona outsources most of its manufacturing to third parties and concentrates on component assembly.
2. **Design / focus on handpieces** – Nakanishi concentrates (almost exclusively) on handpiece manufacturing - most of their competitors make a broader range of products, some make a much broader range (dental chairs, X-ray machines, software for dental office management). As a result, Nakanishi handpieces offer some unique features, e.g., Nakanishi offers a line of titanium-housed handpieces, which are lighter (dentists prefer lighter) than traditional stainless-steel handpieces.⁸
3. **Export distribution** – Nakanishi established its NSK brand and began exporting products in 1979; they opened NSK America in 1984. As a result, while it trails its two Japanese competitors (Morita and Yoshida) in the domestic Japanese market, on a global basis, Nakanishi is the second largest handpiece supplier (behind KaVo).⁹

The following are Nakanishi's key competitors:

Domestic competitors

J. Morita Corp. – Japan, privately held, 1,220 (employees on a consolidated basis). Morita makes a broad line of dental equipment including chairs, laser treatment equipment, diagnostic image equipment, and a full range of dental supplies including handpieces.

The Yoshida Dental MFG.CO. LTD. – Japan, privately held, 428 employees. Yoshida makes a broad line of dental equipment including chairs, handpieces, X-ray equipment, laser and MRI equipment.

⁷ Danaher 2004 10-K, PDF p. 47. If we assume KaVo generated about the same amount of revenue per employee as Nakanishi, 325 employees would equate to about 1/3rd of KaVo's labor force.

⁸ Titanium is 30% lighter than stainless steel. Titanium is more expensive and more complex to shape and machine than stainless. Titanium handpieces are not 30% lighter than stainless (not all parts are titanium) but they are noticeably lighter.

⁹ Hashiguchi, Kazuaki, *Nakanishi (7716) Initiating Coverage*, SMBC Nikko Securities, 7/22/11, p.5.

Global competitors

W&H Dentalwerk Bürmoos GmbH – Austria, privately held. W&H's product line is slightly broader than Nakanishi's. On a global basis, W&H is thought to have slightly less market share than Nakanishi.¹⁰

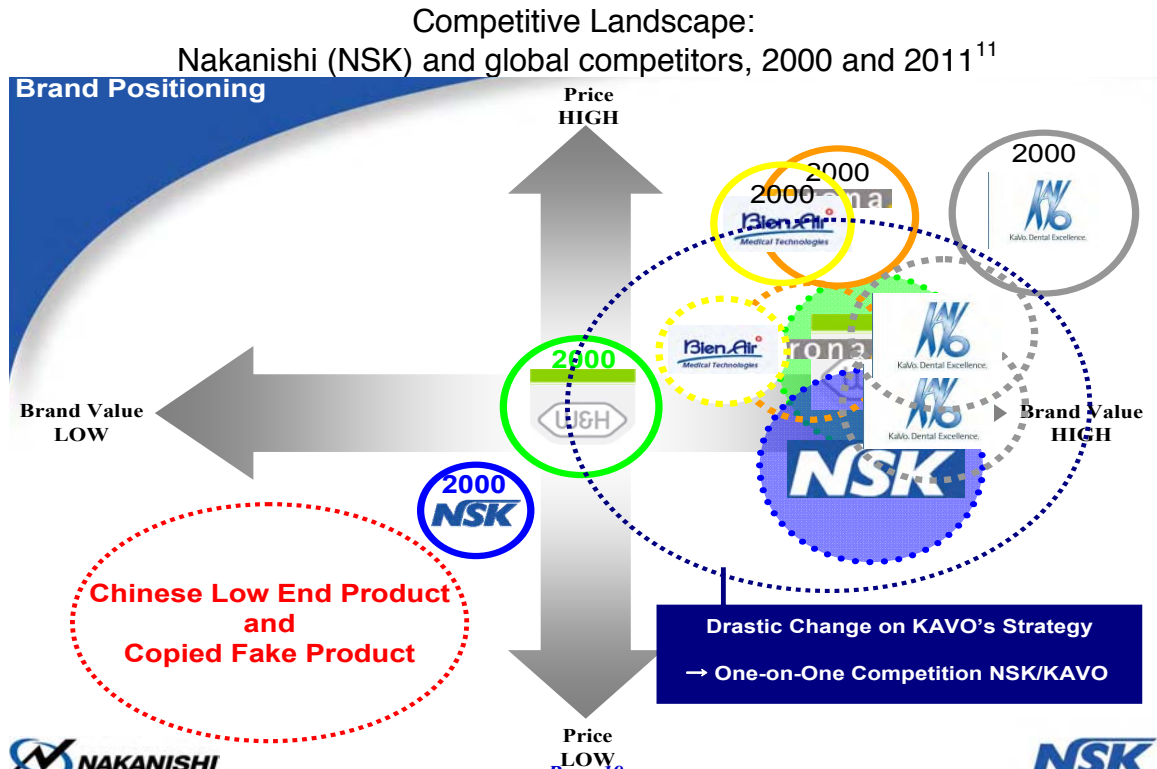
Kaltenbach & Voigt GmbH (KaVo) – Germany, owned by Danaher Corporation (DHR, \$31.5 billion market capitalization). KaVo has the highest handpiece market share. Like Nakanishi and W&H, KaVo is primarily focused on making and selling handpieces and related items.

Bien-Air Dental SA – Switzerland, privately held. Bien-Air manufactures dental handpieces, surgical handpieces and also makes and sells equipment to make dental prosthetics.

Sirona Dental Systems – U.S., publicly held (SIRO, \$2.6 billion market capitalization). Sirona was Siemens Dental Systems until 1997 when Permira (a U.K. based private equity firm) acquired it. The company was subsequently sold to EQT (a Scandinavian based private equity firm) on 2/16/04 and resold again to Madison Dearborn on 6/30/05. Sirona went public in a reverse merger on 6/20/06. Sirona offers a very broad array of dental equipment and outsources most of its manufacturing.

Chinese manufacturers – There is a large, poorly documented group of companies in China that make inexpensive handpieces that retail for less than \$300.

The following graphic summarizes the competitive positions of the key players in the handpiece business.



¹⁰ Ibid.

¹¹ Nakanishi slide deck. 2/16/11. P. 19.

Note that the NSK brand (Nakanishi) has moved up-market over the last ten years while KaVo has moved down market, i.e., the brands are converging. Interestingly, Nakanishi is thought to be the largest supplier of handsets within China with a 50% market share,¹² though there is little evidence that China is a profitable market for them.

While we are on the subject of competitors, the following table compares Nakanishi's current valuation with those of Sirona and Danaher (the best publically traded comps).

Company	Nakanishi	Sirona	Danaher
Share price, 9/12/11	¥7,150	\$41.31	\$43.41
Time period	6 ME 6/30/11	9 ME 6/30/11	6 ME 6/30/11
Market capitalization / earnings	8.0	18.3	14.2
Market cap - (90% cash + securities) / earnings	5.2		
Market capitalization / FCF	9.4	14.9	12.8
Market capitalization / book value	1.3	2.5	1.9
Market capitalization / tangible book value	1.3	NA	NA
Market capitalization / (CA-all liabilities)	1.9	NA	NA
EV / EBIT	2.8	14.3	13.0
EV / EBITDA	2.6	9.9	11.3

The data in the table indicate that Nakanishi's share price could double and the company would still boast a more modest valuation than comparable companies by most metrics. Here are links to our Sirona and Danaher worksheets:

www.hacketts.com/hackett-DHR.xls

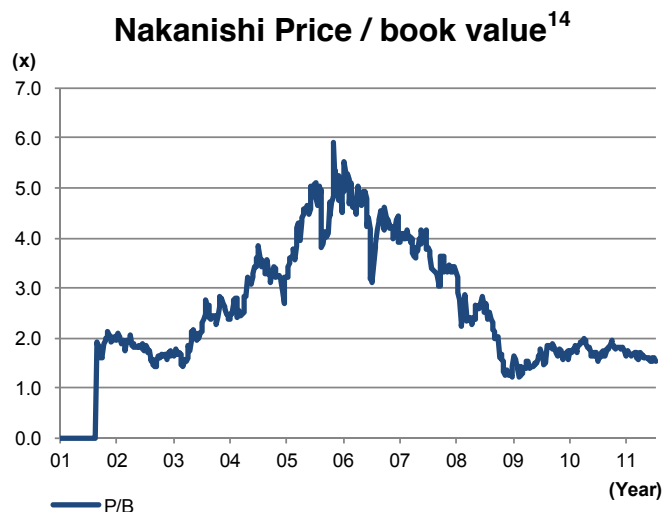
www.hacketts.com/hackett-SIRO.xls

To reality-check Nakanishi's valuation, the following table summarize Nakanishi's valuation at ¥7,150 compared to its results since 2001 (2011 data has been annualized).

	Mrk cap / earnings	(Mrk cap - 90% cash) / earnings	Mrk cap / FCF	Mrk cap / BV	EV / EBIT	EV / EBITDA
6 ME 6/30/11	8.0	5.2	9.4	1.3	2.8	2.6
2010	9.2	6.0	10.5	1.4	3.2	2.9
2009	9.9	6.7	9.2	1.5	3.5	3.2
2008	11.1	8.5	11.5	1.7	4.0	3.6
2007	8.8	5.8	9.8	1.4	3.1	2.9
2006	9.4	6.6	9.9	1.7	3.2	3.0
2005	10.1	6.9	12.4	1.7	3.5	3.3
2004	19.7	16.9	23.4	2.8	6.5	6.0
2003	19.5	16.8	19.6	3.3	6.3	5.9
2002	24.7	22.1		4.4	9.1	9.1
2001	31.1	26.9		4.4	9.1	9.1

¹² Hashiguchi, Kazuaki, *Nakanishi (7716) Initiating Coverage*, SMBC Nikko Securities, 7/22/11, p.5.

The following charts give some perspective on the company's historical valuation multiples.



The charts show that Nakanishi's valuation peaked in 2006 and has since been compressed. Part of this compression may be explained by Nakanishi's rapid sales and earnings growth which peaked in 2007. If this is the explanation, we are not especially concerned – the market simply overestimated the company's capacity to grow earnings and now is likely underestimating its earnings capacity. A second explanation, which is more worrisome, is that something has fundamentally changed with Nakanishi's business. Here is our list of concerns:

- Inexpensive Chinese handpieces may be depressing pricing and taking share from higher quality handpieces. Mitigating this is the preference, at least historically, by dentists for high-quality handpieces. Also note Nakanishi's large market share (~50%) in

¹³ IBID, p. 3.

¹⁴ Ibid, p.3.

China and their new manufacturing facility in Vietnam (Vietnam is believed to have lower labor costs than China). Nakanishi's focus on manufacturing suggests they are likely to continue to be a low-cost producer.

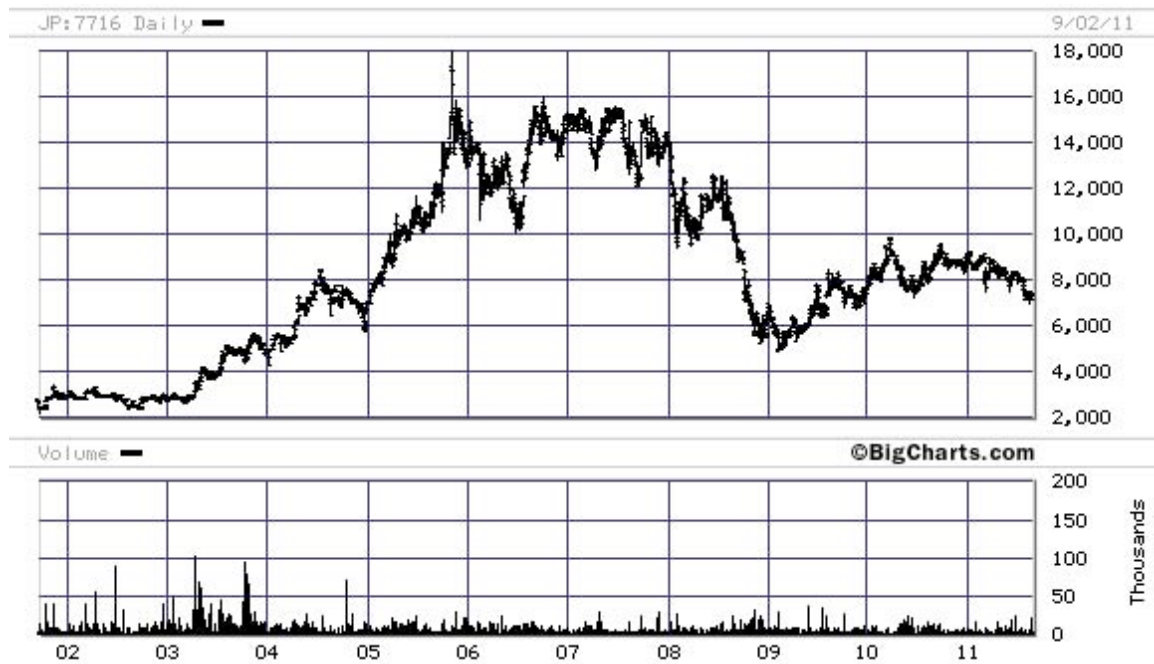
- Increased rivalry among handpiece manufacturers. For example, Danaher's purchase of KaVo and subsequent move down-market, could be damaging the industry. This may be happening, however, it seems to be playing to Nakanishi's strengths: note that Nakanishi has consistently gained market share (and been profitable) since Danaher acquired KaVo.
- Nakanishi's distribution system may not be adequate in some way. While this is certainly possible, Nakanishi management appears to be addressing the issue, i.e., they acknowledged that they need to improve distribution in the U.S. and in China and are taking steps to do this.

Return on capital

The following table summarizes Nakanishi's capital returns; no adjustment has been made to account for the company's very high cash balance (currently 45% of its market capitalization)

Year	EBITDA / assets	EBIT / (tan. assets - CL+ST debt)	Earnings / assets	Earnings / equity
2010	23.2%	23.6%	13.4%	14.8%
2009	22.6%	23.4%	13.1%	15.1%
2008	20.3%	21.5%	12.9%	15.3%
2007	22.4%	24.7%	14.0%	16.0%
2006	24.3%	27.3%	14.9%	17.6%
2005	24.8%	28.1%	14.6%	17.5%
2004	21.4%	23.0%	12.5%	14.3%
2003	24.2%	26.0%	13.7%	16.7%
2002	23.7%	26.3%	12.3%	15.5%
2001	20.3%	22.7%	10.7%	14.2%
mean	22.7%	24.7%	13.2%	15.7%
median	22.9%	24.2%	13.3%	15.4%

Nakanishi's returns are excellent, even with its extremely conservative balance sheet. The company does not publish their annual report in English; however, they do make regular disclosures in English and Shinnihon, an affiliate of Ernst & Young, audits their books. The combination of extremely modest valuation, substantial family ownership, bulletproof balance sheet and high capital returns makes Nakanishi an Absolute Value - we plan to buy Nakanishi shares in the near future.



Nakanishi Balance Sheets

(000 Yen, Japanese GAAP)	6/30/11	12/31/10	12/31/09
Assets			
Cash	13,284,427	11,934,033	10,397,634
A/R	3,300,691	3,179,444	2,917,269
Marketable securities	932,683	1,590,757	1,485,804
Money held in trust ^a	2,499,293		
Inventories	5,618,832	5,560,418	5,368,595
Deferred tax assets	512,581	467,426	519,636
Other	475,318	399,679	374,675
Allowance for doubtful accounts	(23,812)	(16,233)	(10,247)
total CA	26,600,013	23,115,524	21,053,366
Buildings & structures	3,975,433	3,900,935	3,858,536
Machinery, equipment & vehicles	2,067,332	1,902,706	1,653,466
Land	1,039,178	1,014,050	1,070,096
Construction in progress	646,984	453,247	65,882
Tools, furniture & fixtures	1,981,465	1,871,202	1,798,671
Accumulated depreciation	(5,190,370)	(4,934,477)	(4,532,739)
Intangible assets (primarily software)	492,785	535,542	548,803
Securities	2,987,984	3,506,764	4,105,420
Other assets	2,720,769	3,585,623	3,410,967
total assets	37,321,573	34,951,116	33,032,468
Liabilities			
A/P	597,951	482,607	562,349
Current debt	110,270	109,339	115,087
Taxes payable	1,556,856	1,111,528	1,430,914
Accrued employee bonuses			
Accrued directors bonuses			
Other	863,920	1,133,082	1,445,163
total CL	3,128,997	2,836,556	3,553,513
LT debt	9,698	13,735	28,322
Deferred tax liabilities	726	733	1,105
Retirement benefits, employees	246,139	281,749	291,352
Retirement benefits, directors			316,800
Other	140,978	140,979	51
total liabilities	3,526,538	3,273,752	4,191,143
Stock acquisition right (subscription rights)^b	19,333	9,140	
Minority interests	102,501	74,914	126,191
Shareholders' equity	33,673,201	31,593,310	28,715,134
Tangible BV	33,180,416	31,057,768	28,166,331
Cash & securities, net of debt	19,584,419	16,908,480	15,845,449
Return on capital metrics			
EBITDA / assets		23.2%	22.6%
EBITDA / tangible assets		23.6%	23.0%
EBIT / (tan. assets - CL+ST debt)		23.6%	23.4%
Earnings / assets		13.4%	13.1%
Earnings / tangible assets		13.6%	13.4%
Earnings / equity		14.8%	15.1%
Earnings/ tangible equity		15.1%	15.4%

Nakanishi Income Statement

(000 Yen, Japanese GAAP)	6 ME 6/30/11	6 ME 6/30/10	12 ME 12/31/10	12 ME 12/31/09	12 ME 12/31/08
Revenue	11,272,877	11,062,722	22,213,537	19,982,635	23,020,328
COGS	(4,525,108)	(4,106,905)	(8,792,541)	(7,739,300)	(8,684,260)
Gross profit	6,747,769	6,955,817	13,420,996	12,243,335	14,336,068
SG&A	(3,039,651)	(2,890,930)	(5,820,140)	(5,997,462)	(6,514,965)
Non-operating income	145,181	42,129	92,189	551,734	97,559
Non-operating expenses	(9,733)	(442,128)	(499,510)	(27,673)	(1,646,307)
Interest income, net	36,545	58,277	110,810	88,988	224,648
Extraordinary income (losses), net	436,297	342,224	332,287	61,283	(316,319)
Income taxes	(1,613,455)	(1,542,711)	(2,911,764)	(2,538,679)	(2,290,508)
Minority interests	(24,218)	(24,354)	(36,954)	(43,376)	(4,772)
Earnings, Japanese GAAP	2,678,735	2,498,324	4,687,914	4,338,150	3,885,404
D+A ^b	327,951	271,418	630,152	686,974	682,018
Capex ^b	719,887	478,147	1,238,158	362,064	830,218
FCF	2,286,799	2,291,595	4,079,908	4,663,060	3,737,204
EBIT	4,255,645	3,982,758	7,488,868	6,787,841	5,951,264
EBITDA	4,583,596	4,254,176	8,119,020	7,474,815	6,633,282

Valuation metrics

Market capitalization / earnings	8.0	8.6	9.2	9.9	11.1
Market cap - (90% cash+securities)/ earnings	5.2		6.0	6.7	8.5
Market capitalization / FCF	9.4	9.4	10.5	9.2	11.5
Market capitalization / book value	1.3		1.4	1.5	1.7
Market capitalization / tangible book value	1.3		1.4	1.5	1.7
Market capitalization / (CA-all liabilities)	1.9		2.2	2.6	3.3
EV / EBIT	2.8	3.0	3.2	3.5	4.0
EV / EBITDA	2.6	2.8	2.9	3.2	3.6

Gross margin	60%	63%	60%	61%	62%
Tax rate	37%	38%	38%	37%	37%
Employees (000)			0.606		

^a Nakanishi changed their fiscal year to a calendar year starting in 2006; their previous fiscal year ended on February 20.

^b Depreciation + amortization and capex are taken from the cash flow statements in Nakanishi's "Flash Reports;" Capex is the sum of purchases of tangible fixed assets and intangible assets.