

October 22, 2008

## **Fiscal 2008 Forecast Revision Presentation Q&A**

Key:

- : Question
- : NEC's answer

### **Questioner A**

•NEC has raised its net sales and operating income forecasts in IT-related businesses. How do these projected increases break down in terms of IT Services/SI and IT Products?

→We have yet to determine the breakdown for these two areas. At this point, however, we expect IT Services/SI and IT Products to each account for nearly half of the projected ¥20.0 billion increase in the full-year net sales forecast.

→ We expect IT Products to account for around ¥5 billion of the projected operating income growth for the first half and just under ¥10 billion for the full year in IT-related businesses.

•NEC has lowered its operating income forecast for Network Systems by ¥10 billion in the first half and ¥30 billion for the full year. Could you please explain the reasons in more detail?

→The biggest reason was a downturn in the domestic mobile communications network business.

→PASOLINK was one factor behind the weaker performance in the first quarter, mainly because of an inspection delay caused by an abrupt change in systems by a customer. However, PASOLINK returned to form in the second quarter, as highlighted by record sales volume. However, this improved performance was unable to fully compensate for the downturn in the domestic mobile communications network business. Consequently, Network Systems operating income for the first half should be around ¥10

billion below forecast. This performance also reflects weak overall investment by mobile communications carriers as well as the fact that severe contract terms and other conditions prompted NEC not to accept some orders.

→We basically expect conditions similar to the first half to persist for the rest of the fiscal year. We revised our earnings forecasts taking into account cutbacks in investment by domestic mobile communications carriers, the impact of order screening, and the fact that WiMAX and other new markets have not developed as rapidly as we expected.

•Could you please elaborate on the increase in upfront development costs?  
→WiMAX was an example of a product where we incurred higher costs. Investment was higher in the first half for development of LTE, which is expected to come to the fore from 2010, and MSAN, an access system product.

→In the second half, we expect WiMAX to have a lower impact on development costs as development has progressed markedly so far. However, LTE investment will continue for some time, as we begin investing in earnest going forward.

•NEC has lowered its mobile handset sales volume forecasts by around 0.2 million units for the first half and 1 million units for the second half. What percentage of projected sales volume does ODM account for? Despite the projected second-half drop of 1 million units, there will be only a small impact on earnings. Is this because lower ODM sales volume will have little impact on earnings?

→The ODM sales volume forecast accounts for only a tiny share of the projected overall sales volume, at around several percent of the total. Earnings are impacted primarily by changes in sales volumes to major communications carriers, rather than by changes in ODM sales volume.

## **Questioner B**

• NEC has lowered its Network Systems operating income forecast by ¥10 billion for the first half and ¥30 billion for the full fiscal year. Can I assume that the downturn in the domestic mobile communications network business was the main reason? I was concerned to hear at the first-quarter earnings presentation that PASOLINK was facing fiercer competition from Chinese companies. Can I assume this stiffer competition had no major impact on earnings?

→ Yes on both counts. First-quarter PASOLINK sales fell further than expected because of product inspection delays due to a systems change by a major customer. Second-quarter PASOLINK sales were higher than initially forecast, but were unable to fully compensate for the lower first-quarter sales.

• Do you expect the improvement in second-quarter PASOLINK sales to continue into the second half?

→ Yes. Second-quarter PASOLINK sales volume hit a new record. There was a 20% or so year-on-year increase in sales volume, even though some opportunity losses arose from component procurement issues.

→ We expect to continue growing PASOLINK sales volume in the second half in year-on-year terms, supported by projected double-digit annual market growth. Some measures for increasing sales volume include:

- 1) Strengthening NEC's presence in the Middle East, Africa and Eastern Europe;
- 2) Developing IP capable and larger-capacity PASOLINK models; and,
- 3) Bolstering price competitiveness through cost cutting driven by economies of scale.

Through these and other measures, we are forecasting second-half volume growth, despite some risk of exchange rate volatility.

•Will the downturn in the domestic mobile communications network business, rather than PASOLINK, be mostly responsible for NEC underperforming its forecasts in the second half?

→Yes, the downturn in the domestic mobile communications network business is the major reason. Another reason for the underperformance is a slight projected downturn in the optical fixed-line communications network business.

•Can NEC sustain and improve on a profit margin 5% in the Mobile Terminals business into fiscal 2009, the year ending March 31, 2010? What is your outlook for the market and earnings from fiscal 2009 onward? Some companies may withdraw from the business. How is NEC positioned in the industry as a result of this and other developments?

→Profitability has worsened in fiscal 2008 because of measures taken to raise development efficiency. However, we expect these measures to begin yielding benefits sometime from the second half or next fiscal year onward.

→NEC expects to be affected by a longer replacement demand cycle. However, this year's weak market reflects strong demand last year, so we expect some possibility of demand to improve slightly from this year's level going forward.

### **Questioner C**

•How will NEC be affected by foreign exchange movements, particularly by the U.S. dollar and euro? What impact will this have on each NEC business?

→The average exchange rate for NEC's first-half sales was around ¥106 to US\$1 and roughly ¥163 to €1. Our exchange rate assumptions for the second half are ¥105 to US\$1 and ¥140 to €1. For every ¥1 rise against the U.S. dollar, earnings will be reduced by approximately ¥0.8 billion annually (¥0.4 billion on a semi-annual basis). For every ¥1 rise against the euro, earnings will be reduced by around ¥0.2 billion on a semi-annual basis.

→By business area, products that will be negatively affected by the yen's appreciation include PASOLINK, which is a product line for overseas markets; semiconductors, for which around half of sales are denominated in foreign currencies; and display subsidiaries with a high percentage of overseas display sales. The PC business would benefit the most from a stronger yen.

•Why then have you lowered the annual forecast for the PC business, when it stands to benefit from a stronger yen?

→The stronger yen will certainly work in favor of the PC business. However, benefits from a stronger yen are usually cancelled out by price wars with overseas manufacturers and domestic manufacturers who similarly reap foreign exchange benefits.

→We are projecting a year-on-year decrease in full-year operating income in the Personal Solutions area mainly because of a projected decline in earnings from non-PC businesses such as home gateway devices and fax machines, as well as the impact of worsening European market conditions faced by our enterprise PC business in Europe.

•What is your outlook for the Japanese mobile handset market in the first half and second half of fiscal 2008?

→As shown on P16 of the presentation materials, we have lowered our forecasts for overall demand in the Japanese mobile handset market to 20 million units for the first half and 18 million units for the second half.

•When do you expect to see improvement in the market for mobile handset base stations?

→Large-scale investment in the 800 MHz frequency band is ending. In Japan, the mainstream format is HSDPA, which improves downlink (base station to handset) data transmission speed. Next fiscal year, we expect the HSUPA format, which improves uplink data transmission speed, to generate some new demand. LTE is expected to drive demand thereafter.

→We expect a full recovery in 2010, when LTE will begin. In fiscal 2009, the mobile base station market should remain flat. NEC will compensate for the drop-off in base station demand by rolling out NGN, WiMAX, and MSAN (NEC product name for multi-service access equipment) products. NGN-related products are growing steadily, with sales increasing 40% year on year in the first half.

→NEC is also working to expand into new business domains. One example is the OSS area (a service where we strive to more effectively utilize networks that communications carriers have invested in, such as through customer management). Here, NEC has acquired NetCracker Technology Corporation with the view to developing business in this area from next fiscal year onward.

•Macroeconomic conditions are becoming increasingly difficult. How confident are you about achieving your forecasts in this environment? Do you plan to reduce capital expenditures, R&D expenses or other expenses as a means of securing operating income?

→We have no plans to change capital expenditures, depreciation, or other expenses from what we have initially forecast. The semiconductor business (NEC Electronics) accounts for approximately half of capital expenditures. However, we have not heard anything from NEC Electronics about revising its capital expenditure plans at this time.

→With economic conditions deteriorating not only overseas but also in Japan, we have factored all foreseeable factors into our revised forecasts for the second half. We may implement emergency measures such as cost reductions depending on circumstances, as we strive to achieve our full-year operating income forecast of ¥120 billion.

## **Questioner D**

•Sales to domestic mobile communications carriers were below forecast. Which carrier accounted for the largest sales decline?

→I cannot comment on sales to specific clients. I can say, however, that domestic mobile communications carriers actively constructed additional base stations in 2006 ahead of the start of the Mobile Number Portability system. For this reason, network quality remains at a high level, and there is no compelling need to construct that many additional base stations at this time. In addition, NEC withdrew from some negotiations that offered no future prospects for generating suitable earnings.

•Overseas demand remains strong for PASOLINK. However, some overseas clients may present financial risk in terms of their ability to pay. How will NEC handle these sorts of customers?

→Our current policy is not to take on projects where there is financial risk. Because PASOLINK is rated more highly than other companies' products in terms of quality, our major overseas customers understand this policy and contract terms.

•In the Network Systems area, competition seems to be heating up with Huawei Technologies Co., Ltd. and other Chinese companies. Has this affected the PASOLINK business?

→PASOLINK commands the top global market share of approximately 30%. We estimate that Chinese companies together account for no more than a 1% market share. For this reason, these companies currently have no major impact on the PASOLINK business. We believe that PASOLINK is highly competitive relative to overseas competitors. This is the culmination of considerable cost reductions and quality enhancements achieved in many ways over the years. Another advantage is that we are able to reduce costs in terms of component procurement by leveraging economies of scale.

- Why did the Mobile Terminals business post a second-quarter loss? Was there any reason other than the drop in mobile handset sales volume?

→In the second quarter, sales volume decreased by around 0.4 million units from the first quarter. Development expenses also were higher because we brought forward the development of master software for raising product development efficiency.

### **Questioner E**

- Why did earnings in the IT Products area surpass initial forecasts? Will this trend continue into the second half?

→The main reason was higher-than-projected sales of high-margin mainframe and storage devices.

→In the first half, the IT-related business, including IT Services/SI, is expected to outperform initial earnings forecasts by nearly ¥5 billion. We are expecting a similar performance in the second half. We are therefore projecting that earnings will exceed the initial full-year forecast by just under ¥10 billion.

- The domestic mobile communications network business fell short of forecasts. Was this because communications carriers lowered their investment budgets?

→We were unable to achieve our goal of doing what we could to encourage communications carriers to invest a little more. There was no change in communications carriers' investment budgets.

- How do you see the domestic mobile handset market, in terms of sales volume from vendors to communications carriers? How do retail inventories at communications carriers stand?

→Our view of the end-user retail market is shown on P16 of the presentation materials. Although there may be timing differences, there are no large differences between vendor-carrier sales volumes and retail sales.



→ Looking at retail inventories, JEITA (Japan Electronics and Information Technology Industries Association) released data showing that sales volumes were down by half in August. Conditions warrant a sharp reduction in shipments at this time, and we expect these difficult conditions to persist for some time.

### **Questioner F**

• Why did non-operating expenses improve?

→ Non-operating expenses are made up of many different line items, so the improvement does not necessarily mean that one individual line item in particular had a major impact. Of these expenses, however, there was a comparatively large beneficial impact from the large decrease in loss on disposal of noncurrent assets. In foreign exchange-related items, several items that appear under non-operating expenses showed improvement, such as realized gain on deposits and debt and credit valuations at the term-end.