October 26, 2012

Earnings Presentation Q&A for 1H (April-September) of Fiscal Year Ending March 2013

Date/Time: October 26, 2012 18:00-19:15
Location: NEC Headquarters, Tokyo
Presenters: Nobuhiro Endo, President
Isamu Kawashima, Associate Senior Vice President and CFO

Questioner A

Q. Could you please explain any differences between actual first-half segment sales and operating income, and your initial forecast?

A. In the IT Solutions segment, sales exceeded our forecast by 8 billion yen, mainly in IT Services. Operating income also exceeded our forecast, mainly reflecting the higher IT Services sales and platform cost reductions.

In the Carrier Network segment, sales were 3 billion yen lower than forecast. Sales in Japan outperformed our forecast owing to growth in data traffic. Overseas, sales increased in the second quarter compared with the first quarter, but did not reach our initial target due to the impact of investment cutbacks in the mobile backhaul ("PASOLINK") area. In submarine cable systems, sales were pushed back to the second half of the fiscal year because of delays in issuing agreements. As a result of lower overseas sales, the Carrier Network segment as a whole saw sales fall under the initial forecast. Although operating income was 10 billion yen above target, this mostly reflected the positive impacts of the higher sales in Japan, along with lower costs and cost reductions.

In the Social Infrastructure segment, sales were about 3 billion yen under the forecast. Certain projects were pushed back to the second half. Operating income was 2 billion yen above target, largely reflecting cost savings.

In the Personal Solutions segment, sales were 37 billion yen above the forecast. This was mostly a reflection of our strongly conservative budget for PCs and Others. Sales of mobile terminals topped our forecast by 5 billion yen. Operating income was 3 billion yen higher than target. As regards PCs and Others, we had taken a conservative view of economic trends in Europe, but performance was better than we anticipated.

In the Others segment, sales and operating income both finished higher than the target because of the sale of LCD related patents.

Eliminations/unclassifiable expenses improved by 13 billion yen from our budget. We had budgeted for 10 billion yen in strategic investments, but we actually used 4 billion yen, so 6 billion yen was pushed back to the second half. There were other expenses that were also pushed back to the second half without being used in the first half, as a result of reductions in sales-related expenses and overhead costs.

Q. Could you please go over your second-half outlook for operating income, giving comparisons with the same period of previous fiscal year? Also, please provide a segment breakdown of the projected restructuring benefits of 27 billion yen.

A. Because we have not changed our full-year forecasts, our forecasts for the second half is skewed in some respects due to our higher-than-budget performance in the first half. Looking at the projected restructuring benefits of 27 billion yen for the second half by segment, we are projecting benefits of 9 billion yen in the IT Solutions, 3 billion yen in the Carrier Network, 2 billion yen in the Social Infrastructure, 9 billion yen in the Personal Solutions and 4 billion yen in the Others.

In the IT Solutions, we expect market conditions to become increasingly uncertainty, although the segment will reap restructuring benefits. In the Carrier Network, second-half operating income is projected to decline by 9 billion yen year on year. This projection reflects upfront investment for future business, along with integration costs related to the Convergys Business Support Systems business. However, since our forecast is conservative, we do not expect operating income to decline this much. In the Social Infrastructure, there are projected restructuring benefits of 2 billion yen but operating income is projected to increase 0.8 billion yen, based on plans to make upfront investments in global businesses such as safety. In the Personal Solutions, operating income is projected to improve by 11 billion yen. We want to stay on track to achieving this projection by incorporating restructuring benefits. In the Others, we are also projecting restructuring benefits, but our numbers are conservative. In terms of eliminations/unclassifiable expenses, of the total annual budget of 20 billion yen for strategic investments, we expect to use 16 billion yen in the second half. Accordingly, we are projecting a deterioration of 17 billion yen year-on-year.

Q. Which sectors in the IT Solutions do you think will face worsening market conditions in the second half?

A. In the first half, we saw buoyant private-sector demand in manufacturing and certain other sectors. Demand was solid in the June-August period, but softened slightly in September. We had expected demand to continue weakening, but it has instead increased year on year through to the current point in October. Market swings have been unpredictable lately, so we cannot say confidently that market conditions are firm at this time. We think that the market is on a recovery track compared with the previous fiscal year. However, given the problems in China and Europe, as well as the resulting issues in Asia and elsewhere, we don't know whether we will see the same market conditions continue from the first to the second half.

Q. Could NEC issue convertible bonds and other securities going forward?

A. We must fulfill scheduled long-term debt repayment obligations of 60 billion yen in this fiscal year and 140 billion yen next fiscal year. The question is how we will raise the 200 billion yen needed to repay these obligations. We have already secured funds of 100 billion yen through a syndicated loan at the end of March 2012. In addition, we obtained long-term debt of 30 billion yen during the first half. We must consider how we will procure the remaining 70 billion yen sometime from the second half to next fiscal year. We will consider using either bank loans or straight bonds to raise these funds.

Q. Do you think NEC needs to increase capital in order to reinforce its business base?

A. We will consider options for increasing capital while giving consideration to the current stock price. At this time, we don't plan to seek funds from the capital markets.

Questioner B

Q. How do earnings break down in the IT Solutions in terms of the IT Services and Platform businesses? Does the high operating income ratio of 8.7% reflect temporary factors? Or does it reflect this segment's true strength in terms of top line growth and cost reductions?

A. In the second quarter, the IT Services business generated operating income in excess of 20 billion yen, while the Platform business generated just over 7 billion yen. In terms of net sales, the IT Solutions segment posted 330 billion yen in the second quarter. This represents a very large volume of business, leading to a high utilization rate. We stemmed cash outflows by cutting spending on external resources, which has led to an improved profitability. Clearly, this performance is not the result of just a temporary project.

Q. When comparing the second-half outlook with the initial forecast, do you think that business conditions have trended better than you expected in Japanese businesses of the IT Solutions and Carrier Network?

A. We saw orders rebound from a slight drop in September to positive year-on-year growth in October. Business conditions are currently firm, but there is increasing uncertainty about the outlook going forward. Accordingly, we will need to keep a close eye on business conditions in the second half. Actually, we don't think that business conditions are particularly unfavorable at the moment. It is just that we don't know for sure how business conditions might change in the coming months.

Q. The key themes of the mid-term plan currently being formulated are "growth strategy" and "reinforcement of our business base." I believe that these key themes follow in the footsteps of the Mid-Term Growth Plan "V2012" announced in 2010. Although NEC certainly cannot afford not to grow over the next three years, wouldn't it be better to focus on just one of these themes, namely strengthening the balance sheet, while giving top priority to improving your financial position? What is your rationale for working to achieve both themes at the same time?

A. Generally speaking, if you focus only on existing businesses, those businesses will inevitably shrink over time. While remaining mindful of driving growth, we intend to hone our global competitiveness. Ultimately, we believe that these efforts will translate into a stronger financial position. We believe that these themes are inseparable. Therefore, we will continue to pursue outward and inward efforts based on each of these themes.

Q. Faced with difficult business conditions, Telefonica, with whom NEC enjoys a strong business relationship overseas, is taking steps such as selling businesses. Won't NEC have to transform its strategy, including the Carrier Cloud business?

A. We plan to achieve overseas business expansion by selecting business domains where NEC excels, and expanding each of these businesses mainly in the Asia-Pacific region. We have already commenced the Carrier Cloud business in Europe, and have been working to expand this business for the past two years or so. However, the reality is that the business has not grown very much because of our reliance on telecommunications operators for access to customers to a certain extent. We aim to expand the Carrier Cloud business to customers other than Telefonica, and will consider our approach to Telefonica separately.

Questioner C

Q. In regard to business related to the Ministry of Defense, NEC faced a compliance issue over 10 years ago. I want to believe that these sorts of issues have been resolved. As NEC's president, could you please explain the current state of affairs?

A. As you point out, NEC acted against the public interest as regards a similar compliance issue 10-15 years ago. Ever since, we have enhanced transparency in all processes. I can clearly say that this sort of problem will not happen again at NEC. I believe that we must constantly foster an awareness of compliance. When I issue internal messages within NEC, I always end with a few words about the topic of compliance. Looking ahead, we will continue to increase our transparency in order to prevent compliance incidents like those in the past.

Q. I appreciate the fact that you have clearly disclosed free cash flow in this presentation. Considering the size of NEC's business, what level of free cash flow would represent the company's true strength? I suspect that you will probably increase your medium-term target for free cash flow further. What level of free cash flow are you projecting for next fiscal year?

A. We are projecting a breakeven for free cash flow for this fiscal year. This target reflects payments related early retirement programs of 40 billion yen in the first half, as well as acquisition costs of 60 billion yen for CSG Limited's Technology Solutions business and the Convergys BSS business. Considering these factors, we will effectively need cash of 100 billion yen to break even in terms of free cash flow in this fiscal year. In the first half, we posted negative free cash flow of 32 billion yen, a deterioration of about 40 billion yen from the positive free cash flow of 9.2 billion yen generated in the previous fiscal year. In the first half, NEC used 100 billion yen in cash but free cash flow deteriorated by only 40 billion yen, meaning that cash flows have effectively improved. I see a breakeven of free cash flow for this fiscal year as equivalent to generating cash of 100 billion yen on a full-year basis.

Q. Do you believe that your current strategy for the mobile handset business is satisfactory? Please share your views at present on the mobile handset business.

A. We would like to retain the human interface technologies of mobile handset which are closely related to cloud-based services. That said, we cannot achieve business viability unless we have a certain amount of business volume. In this sense, we are currently facing extremely difficult conditions. In the mid-term management plan, we will consider the future course of this business, including options such as forming business partnerships.

Q. Don't you think that free cash flow only appears to have increased because of the impact of the earthquake in the previous fiscal year? Isn't your cash flow target of 100 billion yen for this fiscal year, the starting point for the mid-term management plan, too high?

A. Our profitability has changed significantly compared with the previous fiscal year. This is mainly the result of having increased our true strength. We are also engaged in a Company-wide drive to streamline assets, which we believe will generate projected benefits of several ten billion yen. Our 100 billion yen target takes into account various factors, including changes in the business environment.

Q. The letter NEC received from the SEC of the U.S. has remained a stumbling block for a large number of U.S. institutional investors. I believe that you have looked into this issue from many angles. Could you please explain your current approach to this issue?

A. This situation was caused by the timing of our transition from U.S. to Japanese GAAP. Regarding the future, we have not determined a policy on this issue at this time. We will look into this matter again when we transition to International Accounting Standards.

Questioner D

Q. What is your production capacity for electrodes? Could you please give an update on your plans for expanding production capacity?

A. Our current annual production capacity is 2 million kWh. Basically, we will decide on capital expenditures while closely monitoring the supply-demand balance.

Q. Does that mean that capital expenditures is lower than the initial budget?

A. Yes. Although the popularization of electric vehicles will take some more time, there is a great needs for large-scale energy storage systems for power grids from customers other than Enel Distribuzione. There is also buoyant demand for small and small and medium-scale energy storage systems in the Asia-Pacific region, although the capacity of individual systems is smaller. We should also see considerable business volume emerge from energy storage systems for households through our partnership with ORIX and other channels. Taking these factors into consideration, we should ramp up production capacity when the timing is right.

Q. Could NEC form an alliance with heavy electric machinery manufacturers in the energy business?

A. It’s possible. Although alliances will vary significantly depending on the nature of the business model, if there were to be such an alliance, it would be one that takes full advantage of the competitiveness of NEC’s electrodes.

Q. How big do you expect the business opportunity to be for Telecom Operation Management Systems (TOMS) in the Carrier Network?

A. The Convergys Business Support Systems (BSS) business and NetCracker Technology Corp., which conducts an Operations Support Systems (OSS) business, will work together to generate about 30 billion yen sales a year. The two businesses aim to double this figure over the next few years. Traditionally, the two businesses could conduct business separately in the OSS and BSS fields. Going forward, however, both fields must be combined to offer a total TOMS service to maintain commercial viability.

Q. Assuming that base stations and core networks are strong, how much longer will current momentum of demand for network infrastructure last? With the increasing popularization of iPhone 5, isn’t it likely that data traffic will significantly increase when all users start tethering? Some people say that only a few percent of users are currently using 70-80% of network capacity. If other people start using network capacity in the same way, by how much will telecom carriers need to increase capital investment? How big is the opportunity for NEC?

A. Although I don’t have exact figures at hand, I think your view of network capacity is correct. The answer to this problem will be to offload traffic. We should be able to take steps such as providing base stations for small zones and femtocell solutions. Some telecom carriers also package smartphones with WiFi. Because users will start competing with one another for bandwidth, I think the problem will be solved using base stations that cover smaller zones.

Q. Won't this mean that telecom carriers will continue to make huge investments over the next two to three years?

A. I'm not sure how much capital expenditures will be needed. However, I believe that we will see an increase in small base stations.

Q. Operating income in the first half was 46.4 billion yen above budget. As NEC's president, how much of this surplus operating income would you like to maintain on a full-year basis?

A. As president, I'd like to say that I want to maintain all of it, but I know that things won't go that easily. Although I cannot give you a clear answer until we can see through the uncertainty in the second half, I would like to keep around half of the surplus operating income.

Q. What is your operating income target for the mid-term plan you are currently formulating?

A. We will need some more time before we can disclose specific numerical targets. I can say that I would like to target sales growth of around 1% higher than the GDP growth rate, and an operating income ratio of about 5%.