Earnings Presentation Q&A for 3Q (October-December) of Fiscal Year Ending March 2014

Date/Time: January 30, 2014 19:00-20:00
Location: NEC Headquarters, Tokyo
Presenter: Isamu Kawashima, Senior Vice President and CFO

Questioner A

Q. Could you please give details on whether third-quarter results were higher or lower than forecast in each segment? Also, what are your forecasts for the fourth quarter and the full year?

A. Looking at third-quarter operating income against internal forecasts as of October 30, 2013, the Public business outperformed its forecast by just over 5.0 billion yen, while the Enterprise business and Telecom Carrier business performed almost in line with forecasts. The System Platform business posted operating income 5.0 billion yen higher than forecast, while the Others business was almost in line with its forecast. Adding these numbers together, operating income was just over 10.0 billion yen higher than forecast. Considering that operating income was nearly 10.0 billion yen below forecast in the first half of the fiscal year ending March 31, 2014 (fiscal 2014), we have made up for lost ground over the nine months through December 2013.

Our operating income forecast for the fourth quarter is 76.3 billion yen. This represents the difference between our full-year operating income target of 100.0 billion yen and the actual operating income result for the first nine-months of 23.4 billion yen. Operating income deteriorated in the fourth quarter of the previous fiscal year. However, we normally post operating income of more than 70.0 billion yen in the fourth quarter, as in the fourth quarters of fiscal 2012 and fiscal 2013, for example. We will need to increase operating income by 33.4 billion yen year on year to attain our fourth-quarter forecast. Our mobile handset business returned to breakeven in the third quarter, after posting a large loss in the previous fiscal year, and is targeting
a breakeven result for the fourth quarter as well. This alone should boost operating income by 15.0 billion yen. The remaining portion will be covered by the Public, Enterprise, Telecom Carrier, and System Platform businesses, all of which are performing stably.

Questioner B

Q. Today, NEC announced two major group restructuring measures. The total benefit of cost savings from making NEC Fielding, Ltd. a wholly-owned subsidiary will amount to 20.0 billion yen over the next three years. Does this mean that these costs will have been reduced by 20.0 billion yen after three years? Or does it represent the total cost reduction for the three-year period?

A. The cost reductions will be achieved by streamlining overlapping costs between the two companies, unifying management of inventories and taking other initiatives. The 20.0 billion yen represents the total cost reduction over the next three years. In the first fiscal year, the benefit will only begin to appear in the second quarter. Therefore, the benefit will be lower in the first fiscal year than would be the case if the cost reduction were to be split evenly over three years. From the second year onward, we believe that the same benefit will appear every year.

Q. I believe that these group restructuring measures are ideal because NEC is spinning off non-core operations while internalizing core operations. Looking ahead, do you still have the latitude to continuously implement business portfolio restructuring measures? If so, how will you approach these measures?

A. We do not have any further plans at this time. That said, we believe that we must constantly give thought to business portfolio restructuring as the business environment surrounding NEC undergoes changes.
Q. While certain operations should be spun off, I also believe that NEC is engaged in growing fields where there are personnel shortages, for example. How do you plan to bolster fields that you intend to strengthen going forward?

A. We will likely be augmenting such fields as the strong-performing Systems Integration (SI) field; the Software-Defined Networking (SDN) field, which we are nurturing; and the Big Data field. With regard to M&As, we are considering many different opportunities, but we do not have any specific details to announce at this time.

**Questioner C**

Q. You explained that the Others business harbors some downside risk with respect to the full-year forecast, including the buffer of 5.0 billion yen. Is the mobile handset business the main factor?

A. Let me first note that within the Others business, the mobile handset business is underperforming only in terms of net sales. Our outlook for net sales was too high. The actual third-quarter sales volume of 500,000 units was in line with forecast. We have not revised our sales volume forecast of 1,000,000 units for the second half.

This does not mean that operating income will fall short of forecast due to deterioration in the mobile handset business. We did not reflect the upside potential of businesses supported by improving economic conditions into each segment. Instead, we factored in an upside potential of approximately 5.0 billion yen into the Others business. We expect the Public business and the System Platform business to outperform their initial forecasts by 5.0 billion yen, and 2.0 billion yen, respectively. Rather than seeing the Others business as underperforming its forecast, we are expecting upside potential in strong-performing fields, while we are reducing the outlook for the Others business in proportion.

**Q. Has there been any change in the forecast of eliminations/unclassifiable expenses?**

A. We do not expect this forecast to change.
Q. I believe that buildings have increased on the balance sheet due to the purchase of buildings in Kawasaki. The outlook for free cash flow seems to have worsened. Could you please explain?

A. We spent approximately 60.0 billion yen to buy back the Tamagawa business facilities. Because the building rent was high, we executed the transaction in the first half of fiscal 2014 based on our belief that we would reap cost savings benefits every year. In fact, that was the purpose of the purchase. We had anticipated positive free cash flow of 50.0-60.0 billion yen for fiscal 2014. Because we used cash of approximately 60.0 billion yen for this transaction, we expect free cash flow to ultimately break even at close to zero. Furthermore, the transfer of NEC BIGLOBE shares announced today will provide cash of just over 30.0 billion yen, while making NEC Fielding a wholly-owned subsidiary will use cash of 28.0 billion yen. These transactions will largely offset one another, resulting in close to zero net cash flow. Accordingly, we expect to break even in terms of free cash flow in fiscal 2014.

Questioner D

Q. You explained that it had attracted a number of highly profitable projects in the third quarter, and saw a decrease in unprofitable projects in the same period. Will this trend continue into the future? Or is it an anomaly?

A. In the Public business, we just happened to see a concentration of highly profitable projects in the third quarter. We do not believe that these conditions will continue into the future.

Q. Industry-wide, there has been a shortage of systems engineers (SEs) in finance and other fields. To what extent can NEC accommodate an increase in project volume?

A. Although I can't give you a quick answer, I can say that the utilization rate for SEs is about 90% at present. That means we do not have that much surplus capacity left. As we take on more and more projects going forward, I believe that we will need to increase the number of SEs.
Q. Some observers say that SEs are likely to be in short supply next fiscal year. What do you think?

A. As of the third quarter, we do not believe that will impact us to that extent.

Q. Could you please share your perspectives on the prospects for introducing IFRS and re-registering NEC ADRs?

A. Our preparations for introducing IFRS are largely on schedule. As soon as management makes the decision, we are ready to introduce IFRS in a timely manner. However, we do not intend to do so in haste. We will introduce IFRS while keeping a close eye on the big picture.

Meanwhile, we have no intention of taking any prompt action to re-register NEC ADRs. IFRS may be one way of doing this, but we are not considering it at this time.

Questioner E

Q. Could you please discuss your thinking behind the fourth-quarter forecast? In the fourth quarter of fiscal 2013, NEC was expecting a concentration of business at the fiscal year-end, but posted operating income of only around 40.0 billion yen. Assuming an deterioration of 15.0 billion yen at NEC CASIO Mobile Communications, along with unprofitable projects of around 5.0 billion yen, did NEC book any other deterioration of about 10.0 billion yen in the fourth quarter of fiscal 2013? Based on these factors, is the operating income forecast of around 70.0 billion yen for the fourth quarter of fiscal 2014 premised only on improvements in each segment? Or do you expect operating income to be a little higher than the forecast?

A. Normally, NEC’s operating income increases in the second half of the fiscal year, particularly in the fourth quarter. In the previous fiscal year, operating income decreased in the fourth quarter in connection with bringing projects forward. In this sense, profit and loss in the fourth quarter of fiscal 2013 was different from that of an ordinary year. Because our customers’ investment plans for fiscal 2014 returned to normal, we believe that operating income for the fourth quarter should return to a normal level, compared to the
same period last year. Additionally, SI-related business performed favorably in the third quarter. If we can maintain this momentum, we can anticipate an additional improvement over and beyond our forecast.

Q. When NEC Fielding went public, the company was able to generate firm profits with mainframes, but its profits have been under pressure lately. I presume that the company’s integration with NEC was partly driven by these factors. Could you please explain in a little more detail the likelihood of achieving the planned cost reductions of 20.0 billion yen?

A. In the past, NEC Fielding and NEC could generate business volume even when working on an arm’s-lengths relationship. With recent advances in cloud computing technology, customers have a mix of IT assets owned on premise (individually owned) and IT services that they utilize without owning the assets. Unless these assets and services are integrated to provide optimal solutions, the companies are now unable to win business orders. Therefore, one major development is that the two companies must work together to provide optimal solutions on a comprehensive basis. By making NEC Fielding a wholly-owned subsidiary, we intend to unify and streamline the overlapping information and inventories held by both companies. Although margins have declined and the price range is tough due to price-based competition, we aim to compensate for this by supplying comprehensive solutions.

Q. I believe that NEC CASIO Mobile Communications has almost completed its structural reforms. With regard to the thinking behind net income, the company faces a particularly unusual situation in terms of its considerably high income tax rate, as well as its tax loss carry forwards. Is it conceivable that around half of the company’s operating income could remain as net income in fiscal 2015?

A. There was a large difference between operating income and net income in fiscal 2014, because tax effects could not be recorded regarding the mobile handset business in the current fiscal year. However, we believe that this picture will start to change from fiscal year 2015 onward. In fiscal 2014, NEC
CASIO Mobile Communications will post a loss before income taxes of 30.0 billion yen. Furthermore, recurring charges include the amortization of goodwill, for which the balance stands at 80.0 billion yen. Tax effects cannot be recorded on this amortization of goodwill, which will remain in place structurally. The situation should become a little clearer provided no unprofitable subsidiaries enter the picture going forward. Meanwhile, if the tax rate changes in the future, this will have a proportional impact on deferred tax assets.

Q. Do we need to consider the tax impacts of making NEC Fielding a wholly-owned subsidiary?

A. We don’t think that the tax impacts need to be considered. Currently, NEC owns a 67% stake in NEC Fielding, including the portion held by the employee retirement benefit trust. However, NEC can only consolidate a 37% shareholder interest, excluding the employee retirement benefit trust, in NEC Fielding’s profit and loss. From the next fiscal year onward, when NEC Fielding becomes a wholly owned subsidiary, NEC will have a positive impact of around 2.0 billion yen a year on net income.

Q. I don’t think that NEC has recorded tax effects on Renesas Electronics related business. Is this the case?

A. We have booked an allowance for Renesas Electronics-related business. We have taken a cautious approach to tax treatment, and have not recorded tax effects. This is because NEC was previously the largest shareholder of Renesas Electronics, and has invested a large amount of capital into the company.
Questioner F

Q. I believe that NEC will be able to record tax effects on NEC CASIO Mobile Communications by making the company a wholly-owned subsidiary. Aggregate tax losses over past years had reached 90.0 billion yen as of March 2013. Can NEC record a portion of the tax effects against those losses? If so, from when can the tax effects be recorded? Also, are there any constraints and suchlike as regards recording the tax effects?

A. We have not recorded tax effects. NEC intends to maintain NEC CASIO Mobile Communications in its current state. Currently, we are not at a stage where we can record tax effects.

Q. In the Telecom Carrier business, I understand that the Telecom Operations & Management Solutions (TOMS) business, which is growing overseas, offers stable profitability. Is it correct to assume that the situation has changed from the past, when profitability was low overseas? In the past, given that profitability was strong in Japan, profits would decline when business in Japan would contract. Is this relationship between profits and business proportion changing? I expect that the overseas business will continue growing next year. As a result, what kinds of changes will occur with the product mix?

A. In essence, I believe you are asking how the profits of NetCracker Technology Corp. will impact if its sales increase. Because NetCracker has a double-digit operating income ratio, any sales increase at the company will be a positive factor that contributes to higher profits. Therefore, we believe that there will be a change in the situation in which the profitability of a business was low simply because the business was based overseas. However, NetCracker’s business is not yet large enough to drive the growth of NEC’s overall overseas business. First, the key point will be to see how much growth the company can achieve next fiscal year.
Q. Third-quarter operating income in the System Platform business was 5.0 billion yen higher than forecast. It is hard to believe that this profit was generated solely through the sale of business PCs. Was your forecast too conservative? Please explain in a little more detail.

A. Business PCs were not the main source of profit growth. Although business PCs had a slight impact on profit, profitability improved due to a tighter supply-demand relationship in an improving IT investment environment. Business conditions improved overall, including software and servers. The end result was that operating income surpassed the forecast by 5.0 billion yen.

Q. You explained that you are targeting fourth-quarter operating income of about 2.0 billion yen higher than forecast in the System Platform business. Why is this smaller than the 5.0 billion yen above forecast recorded in the third quarter?

A. Our outlook also reflects the fact that we were 2.0 billion yen below forecast in the first half of fiscal 2014. We would like to watch a little more closely whether the current tight supply-demand conditions will continue.

Questioner G

Q. Against the backdrop of the weakening yen, how is the PASOLINK business performing in terms of profitability? Emerging countries are facing problems related to currency fluctuations. In this context, how should we view the PASOLINK business?

A. The profitability of the PASOLINK business was close to the breakeven level in the third quarter. In the fourth quarter, we expect this business to move into the black. In emerging countries, our third-quarter performance was strong in Russia, Asia and certain other markets. The currency fluctuation problems have begun only very recently in Argentina, Turkey, South Africa and elsewhere, so we will need to watch how things play out for a little longer. That said, our goal is to expand the PASOLINK business.
Q. As regards goodwill, it seems you do not need to apply Japanese GAAP when IFRS is introduced. Accordingly, what will the impact be when the balance of goodwill is gone? I imagine that it will be easier to conduct M&As. Could you please share your perspectives on this matter?

A. We are amortizing 15.0-20.0 billion yen of goodwill a year. If we no longer have to amortize this goodwill, there will be a commensurate increase in operating income. That said, the collectability of investment is crucial to M&As. Even if we transition to IFRS, we will still need to remain aware of the impairment of goodwill to a significant extent. Therefore, we do not believe that a large number of M&As will be undertaken. Although we believe that M&As are necessary to our growth strategy, we will not conduct more M&As simply because of a change in accounting standards.

Questioner H

Q. What was the balance of unrecognized pension liabilities as of December 31, 2013?

A. As of March 31, 2013, NEC had unrecognized pension liabilities of approximately 250.0 billion yen. Although I cannot say anything definite about the tax effects, if we assume a tax rate of 40%, net assets will be reduced by the remaining 60%, or approximately 150.0 billion yen. However, the situation has improved thanks to the recent increase in stock prices. Therefore, we believe that unrecognized pension liabilities have fallen below 200.0 billion yen at the current time. While we will need to look a little more closely at whether we can apply a tax rate of 40%, we are roughly estimating a reduction in net assets of around 100.0-120.0 billion yen. Our equity ratio as of December 31, 2013 was 28%. If we record unrecognized pension liabilities on the balance sheet, we believe that the equity ratio will decrease to around 22-23%. However, this projection assumes that the current stock price levels will persist through to the end of the fiscal year.