Earnings Presentation Q&A for Fiscal Year Ending March 2014

Date/Time: April 28, 2014 18:00-19:00
Location: NEC Headquarters, Tokyo
Presenter: Nobuhiro Endo, President
Isamu Kawashima, Senior Vice President and CFO

Questioner A

Q The operating income forecasts by segment for the fiscal year ending March 2015 (fiscal 2015) seem conservative. In the Others business, in particular, I believe that NEC could expect to see growth of around 10.0 billion yen even with the deconsolidation of NEC BIGLOBE, Ltd., based on the improvement of 16.0 billion yen from the mobile phone business. Is the forecast of 1.0 billion yen for the Others business conservative? Furthermore, NEC is forecasting eliminations/unclassifiable expenses of 64.0 billion yen in fiscal 2015 against actual expenses of 48.6 billion yen in fiscal 2014. What are the reasons causing expenses to increase?

A. Others business would see an improvement of 16.0 billion yen in the absence of the loss in the mobile handset business. However, our forecast reflects the following factors: (1) Decrease by around 7.0 billion yen from deconsolidation of NEC Mobiling, Ltd. and NEC BIGLOBE, Ltd. (2) Decrease by several billion yen from the sale of mobile phone patents of several billion yen, which was recorded in fiscal 2014 and will be absent in fiscal 2015. (3) Decrease by around 3.0 billion yen from the transfer of NEC Facilities, Ltd., a subsidiary engaged in office building solutions and other operations, to the Public business. The main reason for the increase in eliminations/unclassifiable expenses is the projected strategic investment of 15.0 billion yen. We also intend to increase the activity budget of NEC’s Central Research Laboratories by around 3.0 billion yen. Eliminations/unclassifiable expenses are projected to increase as a result of these upfront investments.
Q. Under **Mid-term Management Plan 2015**, NEC is targeting net income of 60.0 billion yen for fiscal 2016, which represents a large increase from the fiscal 2015 net income forecast of 35.0 billion yen. What will change significantly from fiscal 2015 to fiscal 2016? Considering the high income tax rates in the past few years, does the projected net income for fiscal 2015 fall in line with Mid-term Management Plan 2015?

A. NEC is forecasting operating income of 120.0 billion yen for fiscal 2015, and estimated it will increase by 30.0 billion yen in fiscal 2016. Therefore 10-15 billion yen will contribute to the increase in net income. Also, in fiscal 2015, we plan to increase investments and expect to see an improvement in extraordinary losses going forward. Based on this, we believe that net income is progressing according to plan.

Q. What is the estimated income tax rate for fiscal 2015? In the past, NEC has been unable to claim tax effects on certain unprofitable subsidiaries. How does NEC see the situation now?

A. With regard to the income taxes for fiscal 2015, we do not expect any subsidiaries to incur large losses nor factored in any special items. In addition, minority interest will improve by making NEC Fielding, Ltd. a wholly owned subsidiary. We will book amortization of goodwill in fiscal 2015. Apart from these items, we expect to record charges on an ordinary basis during the fiscal year.

Q. There appears to be a large difference between ordinary income and net income. Will this difference become smaller in the future?

A. We believe that the current income tax rate will continue for the foreseeable future. Apart from minority interests, there are no special factors except for the amortization of goodwill for which tax effects cannot be recorded.
Questioner B

Q. NEC is forecasting non-operating expenses of 30.0 billion yen for fiscal 2015. However, (1) under non-operating income (loss), NEC incurred interest expenses of 10.0 billion yen in fiscal 2014, mainly due to hybrid financing, but I believe that these expenses will decrease in fiscal 2015. (2) NEC recorded a provision for contingent loss of 11.4 billion yen in fiscal 2014, but I believe that this charge will not be recorded in fiscal 2015. Should non-operating income (loss) improve by around 10.0 billion yen (to about 27 billion yen) from fiscal 2014? What are the assumptions for extraordinary income (loss), minority interests, equity in earnings (loss) of affiliates and the like? In fiscal 2014, NEC posted retirement benefit expenses of 11.3 billion yen. What are projected retirement benefit expenses for fiscal 2015?

A. Under non-operating income (expenses), we expect to see an improvement in the provision for contingent loss. Also, retirement benefit expenses include amortization of around 11.0 billion yen under non-operating expenses in fiscal 2014, and we expect to record roughly the same amount of amortization in fiscal 2015. This will be the final amortization charge. We expect to record some extraordinary income (loss), but we are not expecting any specific items in fiscal 2015. We expect equity in earnings (loss) of affiliates to follow the same track as in fiscal 2014.

Q. In fiscal 2014, NEC incurred income taxes of 42.3 billion yen. Does the Company expect to incur the same amount of income taxes in fiscal 2015? Considering the public debate on lowering the corporate income tax rate, what is the Company outlook for income before income taxes and minority interests with no unprofitable subsidiaries?

A. We anticipate the same level of income taxes in fiscal 2015 as in fiscal 2014. We do not know whether the corporate income tax rate will be reduced in fiscal 2015. However, our current forecasts do not assume a reduction in the corporate income tax rate. In fiscal 2015, we will still be unable to claim certain tax effects on goodwill. This means that we do not expect to account for any special factors in fiscal 2015.

Questioner C

Q. What was net income (loss) of NEC CASIO Mobile Communications in fiscal 2014?

A. NEC CASIO Mobile Communications, Ltd. posted net loss of approximately 40.0 billion yen. The company also recorded an operating loss of 16.0 billion yen and an extraordinary loss of 22.0 billion yen.
Q. I estimate that pension costs will decrease by around 10.0 billion yen in fiscal 2015 compared with fiscal 2014, on an operating income basis. What kinds of assumptions has the Company set with respect to pension costs?

A. As you point out, we are expecting an improvement in pension costs of around 10.0 billion yen in fiscal 2015. We have incorporated half of this improvement into the earnings forecasts of each business unit. However, we have left out the remaining half, taking into consideration the factors that could cause changes in the future.

Q. Could you please explain the substance of the provision for contingent loss? How is the provision for contingent loss treated for tax purposes?

A. The provision for contingent loss is set aside to provide for future claims for damages. While we cannot comment on the specific details, the provision means that we have taken necessary actions on this front.

Q. You noted that NEC does not anticipate any special factors with respect to the income tax rate in fiscal 2015. Will NEC consider making use of the tax losses recorded over past years? In fiscal 2014, NEC recorded valuation allowance. Does the forecast for fiscal 2015 include such valuation allowance?

A. We do not intend to make use of tax losses in fiscal 2015. We formulated our budget assuming the ordinary income tax rate.

Questioner D

Q. It was mentioned that in reviewing its policy on the mobile phone business, NEC recorded maintenance costs as an extraordinary loss while continuing to operate the domestic mobile phone business for the time being. Please explain in more detail.

A. Companies shipping mobile phones are responsible for the maintenance of those mobile phones for a period of four to six years thereafter. NEC must maintain the framework needed to fulfill its maintenance responsibilities. Therefore, we have properly estimated the related costs and have provided for those costs that are clearly evident at this time.
Q. The Telecom Carrier business is forecasting a year-on-year increase of 5.7 billion yen in operating income in fiscal 2015 based on a projected sales increase mainly in the international business. Notably, NetCracker Technology Corp. is forecasting net sales of 70.0 billion yen in fiscal 2015. How will NetCracker’s operating income change from fiscal 2014 to fiscal 2015?

A. NetCracker has an operating income ratio of more than 10%. It attained profit even with amortization of goodwill in fiscal 2014. This business is growing steadily.

Q. The Enterprise business is forecasting a 1% year-on-year increase in net sales in fiscal 2015. This level of growth seems low relative to the external environment. Are there any factors specific to NEC that are behind this forecast?

A. The Enterprise business posted a high sales growth rate in fiscal 2014, with sales even higher than forecast. In fiscal 2015, sales are projected to increase, mainly in the manufacturing industries, while sales in the retail and services industries should remain at the same level as in fiscal 2014. We believe that the projected sales growth rate of 1% year on year is conservative. However, we would like you to view these forecasts in comparison to performance in fiscal 2013.

Questioner E

Q. What is the projection for income before income taxes forecast for fiscal 2015? Given that the statutory tax rate for fiscal 2015 is 35%, does NEC estimate an effective tax rate of around 45%, including amortization of goodwill?

A. We do not disclose numerical figures for the income before income taxes forecast. We are factoring a certain amount of extraordinary loss into the ordinary income forecast of 90.0 billion yen. There are no special factors included in the income tax rate. We have incorporated amortization of goodwill, so the scenario you envision is a good approximation.

Q. In fiscal 2016, NEC is targeting sales from Software-Defined Networking (SDN) of around 150.0 billion yen, combining sales of about 100.0 billion yen for the telecom carrier and about 50.0 billion yen for the enterprise segment. Does this mean that sales are expected to grow in earnest in fiscal 2016, with not so much growth in fiscal 2015?
A. We understand that demand exists for SDN as an enterprise systems application. This demand has been greater than anticipated, and has shown through in our results for fiscal 2014. The Telecom Carrier business is currently at the stage of conducting field trials of SDN on a global basis. In fiscal 2015, we will be exploring opportunities for winning SDN orders, but we expect to see actual growth in the business in fiscal 2016. Accordingly, SDN sales should be greater in fiscal 2016 than in fiscal 2015.

In fiscal 2014, the Telecom Carrier segment recorded SDN sales of around 20-30 billion yen in fiscal 2014. We anticipate seeing strong sales growth in the Telecom Carrier segment in fiscal 2015.

(Note: The SDN sales target of 150.0 billion yen for fiscal 2016 is a Company-wide figure, including enterprise systems.)

Q. What kinds of sales and profit assumptions should we apply to NEC’s acquisition of the battery storage system business of A123 Storage Systems, Inc.?

A. The size of the power grid system market is estimated at around 180.0 billion yen in fiscal 2016 and around 300.0 billion yen in fiscal 2018. NEC already has track records, and we aim to capture a share of about 10% of each of these markets.

Q. What is the Company outlook for free cash flow in fiscal 2015?

A. In fiscal 2014, free cash flow was 55.2 billion yen, which was better than we had initially anticipated. We believe that greater awareness of the importance of cash conversion cycle (CCC) activities within the company went a long way toward achieving this result. In fiscal 2015, we are forecasting operating cash flow of 80.0 billion yen as a base level. Adjusting for the acquisition funds of 10.0 billion for the battery storage system business of A123 Storage Systems, operating funds for it, and certain payments in fiscal 2014 that carried over to fiscal 2015, we expect to generate free cash flow of around 50.0 billion yen in fiscal 2015.

Questioner F

Q. What is the estimate of the amortization of goodwill?

A. If NEC had adopted IFRS, the impact on operating income in fiscal 2014 would have been around 50.0 billion yen, the sum of 40.0 billion yen for the amortization of pension costs and goodwill combined and non-operating income (expenses) of 10.0 billion yen. We believe that the around half of operating income would have been goodwill.