

October 29, 2015

**Earnings Presentation Q&A for the Six Months of the Fiscal Year Ending March 2016**

Date/Time: October 29, 2015 18:15-19:20 JST

Location: NEC Headquarters, Tokyo

Presenter: Nobuhiro Endo, President

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**Questioner A**

*Q. What factors were behind the public business underperforming its internal forecast of 1H operating income by 9.0 billion yen?*

A. Lower sales, front-loaded business reinforcement costs and an increase in unprofitable projects each accounted for around one-third of the shortfall in 1H operating income.

*Q. The postponement of projects in aerospace and defense business to the 2H and beyond was cited as a reason why the public business underperformed its 1H sales forecast. Does the public business face any risks with respect to its full-year forecasts?*

A. Projects that could not be fully completed in 1H will be undertaken in 2H. However, we cannot rule out that some projects may still be postponed to next fiscal year.

*Q. Why did the telecom carrier business underperform its internal forecast of 1H operating income by 5.0 billion yen? What were Q2 wireless sales like in Japan?*

A. The shortfall in mobile backhaul (PASOLINK) sales accounted for around half of the underperformance in operating income. Other factors included higher development investment outlays for increasing the speed and the data capacity of PASOLINK.

Wireless in Japan performed largely in line with expectations. Although the level of investment by telecom carriers in the domestic wireless business has been declining, we have not actually seen any large drop in investment. We believe that Q1 sales in the wireless business in Japan declined primarily because telecom carriers made large

investments in Q4 of the previous fiscal year, and that the Q1 sales outcome was inevitable. In Q2, sales in the wireless business posted double-digit growth in year-on-year terms. In Q3 and Q4, we believe that sales will return to levels seen in the corresponding periods of the previous fiscal year.

*Q. When announcing your new mid-term management plan, do you plan to unveil specific numerical targets for the business process optimization currently underway, led by NEC Management Partner, Ltd.?*

A. Although we are still uncertain about numerical targets, we have already aggregated approximately 3,000 personnel at NEC Management Partner, Ltd. We have so far shifted around 250 personnel to growth areas. Looking ahead, we plan to reduce corporate staff by simplifying many more business processes, and shift those human resources to focus areas and growth areas.

## **Questioner B**

*Q. There was talk of NEC's outstanding security capabilities. Is there any change in your focus on the cloud, as discussed at the beginning of the year?*

A. We remain as focused as ever on the cloud. Based on our highly secure cloud platform, we are also expanding businesses including My Number related projects. In private cloud services, we are currently building a data center in the Kansai region. From this facility, we will also drive expansion in businesses encompassing security.

Cloud related sales in 1H were not substantial, reaching the mid-10.0 billion yen range. However, these sales have increased by around 70% in year-on-year terms.

*Q. The basic policies of the new mid-term management plan seem abstract. How specifically do you plan to generate earnings?*

A. We have said that we will make two different types of effort to generate earnings. First is our inward effort, specifically the business process optimization led by NEC Management Partner, Ltd. Second is our outward effort, specifically the "One to Many" and "One Platform" strategies we are advancing. For example, NEC previously had a large number of product lineups for its "NeoFace", face recognition solution. By reorganizing those lineups, we have transformed our operations into a more efficient business.

## Questioner C

*Q. NEC explained that PASOLINK was responsible for most of the shortfall in the telecom carrier business' 1H operating income relative to internal forecast. Considering the marginal profit rate relative to net sales, it seems that the shortfall in earnings is large relative to the shortfall in sales. What factors were at play? Can you confirm that the shortfall in sales is due to the postponement of sales to 2H, and that no sales will be pushed back to next fiscal year?*

A. Our profit margins also vary depending on the market and project. Taking all of these factors into account, the shortfall in earnings represents the sum of the 5.0 billion yen shortfall in sales and additional development investment outlays. At present, we expect to make up for this shortfall during 2H.

*Q. The enterprise business seems to have a low profit forecast for 2H, assuming that the 2H forecast consists of the difference between the full-year forecast and the 1H results. Similarly, in the system platform business, the 2H profit forecast would remain mostly flat from the same period last year, despite the impact of foreign exchange movements in the previous fiscal year. Each of these forecasts seems out of place because the full-year forecasts have been maintained. Please clarify your 2H forecasts.*

A. The enterprise business saw healthy growth in IT services orders in 1H. We expect this momentum to continue in Q3. Therefore, the 2H figures derived from subtracting full-year forecasts from 1H results are now conservative, and we are seeking to outperform those figures. In the system platform business, IT investment in Japan is currently expanding for servers, storage and other products. We believe that corporate demand for PCs will also start to recover. We are anticipating a negative impact from foreign exchange rate movements in 2H. However, we still believe our forecast for the system platform business is slightly conservative.

*Q. I don't think NEC realized tax benefits from loss carryforwards in 1H. What is your approach going forward?*

A. I believe that you are referring to the matter of Renesas Electronics Corporation shares and NEC Mobile Communications, Ltd. Because Renesas Electronics is a listed company, NEC would like to refrain from making any comment. There are no clear developments

with respect to NEC Mobile Communications at this time. We need all of the issues, including business channels, to become clear. We remain aware of those issues.

*Q. The phrase "One to Many" came up several times. We are also seeing an increase in the number of verification tests eyeing platform-based businesses. However, while the key feature of these sorts of businesses is that they have high profitability, it also seems as if the upfront investment costs for these businesses are also increasing. What is NEC's take on this issue?*

A. We are already making progress on "One to Many" platforms in the safety/cybersecurity business. Meanwhile, in Software-Defined Networking (SDN), we are investing in verification tests. We cannot yet foresee certain aspects of the timeline for the emergence of actual businesses. However, we believe that we must push ahead with establishing the NEC brand and increasing our market recognition, even if that means incurring some expenses. Accordingly, we are proactively working to make progress in this field.

*Q. Does NEC need to develop each of the 40 verification test systems individually?*

A. We are currently conducting virtualized Customer Premises Equipment (vCPE) tests at Telefónica Brasil S.A. We hope to compile the benefits of vCPE by the end of Q4. Once we complete this process, we don't believe that considerable customization will be needed for other projects, meaning that the basic functions will be embedded. Given that we are confirming the benefits of vCPE for the first time, we are taking our time to conduct those verification tests.

## **Questioner D**

*Q. Do you expect to recover your upfront investments in the smart water related and space related areas in the public business during the current fiscal year? What are your 2H forecasts for each segment?*

A. The enterprise business is expected to outperform its forecasts. In the public business, performance is expected to improve in 2H, as the increased costs incurred in the 1H were brought forward from 2H. In addition, the strong-performing local government related business is also expected to contribute to results. In the social infrastructure area, NEC has businesses in digital terrestrial broadcasting related areas for broadcasting companies, and SDN for companies in the fields of transportation and city infrastructure. We will strive to generate returns from these businesses. In the telecom carrier business, we expect to see Telecom Operations & Management Solutions (TOMS), which performed strongly in 1H, continue to contribute for growth in 2H, along with improvements in PASOLINK. In the telecom carrier business in Japan, we aim to achieve results on a par with the same period last year. In the system platform business, hardware related business held firm and absorbed the foreign exchange impact in 1H. We believe that some aspects of our 2H forecast are conservative. In other businesses, we do not anticipate any sizable increases. We currently expect to spend the budget for Adjustment as planned in 2H, despite some timing differences in the recording of these expenses. We have earmarked those expenses primarily for the activity costs of Central Research Laboratories and strengthening the management system of NEC Management Partner, Ltd. However, we will closely examine how much we will spend based on overall business trends as we strive to minimize those expenses. Considering that we have already used some expenses brought forward to 1H, we will carefully assess spending in 2H. With this in mind, we seek to achieve our full-year forecasts, including sales growth.

*Q. How does NEC foresee the timing for recovering investments and generating returns in each of the four focus areas that it has identified as key international businesses? Can NEC generate returns by fiscal 2019, during the next mid-term management plan? Won't NEC need to find partners in each business area?*

A. We intend to start recovering investments in the next three years. We are starting out in the smart water business area by building a business model. While visiting our customers, we are verifying how far we will be able to expand the value we offer. As you

suggest, NEC will need to find partners. We are also exploring how we can produce value by joining forces with partners. We intend to arrive at a conclusion as soon as possible. If we conclude that things will not work out, we could decide to cancel the initiative. We believe that the safety, retail, and network business areas will definitely grow as businesses. We would also like to search for partners in the retail business area.

*Q. Which of the four business areas does NEC believe to be the most promising?*

A. I would like to focus our greatest efforts on the safety business area.

### **Questioner E**

*Q. Can we expect the Japanese government's supplementary budget to contribute to NEC's performance in the security related business in the current fiscal year? Do we need to anticipate downside risks in the energy business under other businesses?*

A. In security, we hold high hopes for the supplementary budget for the current fiscal year, but we expect the contribution to appear in Q4. In the smart energy business, we missed our 1H forecast. In 2H, we will work to expand sales channels for small energy storage systems, upgrade and expand solutions for utilities, and address the power producer and supplier (PPS) market in conjunction with the separation of power generation and transmission. We will also strive to launch international businesses. In any case, we will need a little more time to carefully identify projects, and this may cause evaluation to take a little longer.

*Q. There are other companies that have incurred losses in smart meter related businesses. Doesn't NEC find these sorts of new fields to be difficult and risky?*

A. NEC is involved in communication modules for smart meters. Therefore, we believe that our situation is different from that of the other companies you mentioned. However, we believe that the pace of growth in the smart energy market is slower than anticipated.

*Q. When does NEC expect to produce results in SDN for telecom carriers?*

A. We don't expect to see results in Q3. We are currently concentrating on verification tests. Telecom operators are sounding out vendors to find a good partner. Unless SDN is actually implemented and proven to deliver value, I don't think that it will be adopted by customers. Therefore, we intend to demonstrate the possibilities of network virtualization through verification tests at Telefónica Brasil S.A., Swisscom AG and others. We believe that telecom operators understand how other telecom operators are placed. In this sense, whether or not SDN is deployed in an actual network is a crucial consideration. For this reason, we believe that the projects at Telefónica Brasil S.A. and Swisscom AG provide a good opportunity to demonstrate NEC's performance features. Accordingly, we will do our utmost to make a success of these projects. In terms of the timeline, we are falling slightly behind schedule, so business may not start expanding until CY2016. Nonetheless, the Internet of Things (IoT) has been making headlines recently, and if IoT comes to fruition, network capacity will come under pressure. According to some sources, data traffic is estimated to increase ten-fold by 2017. To mitigate problematic network delays, there is a need to overhaul the entire network, including edge networks. This will make it vital for telecom operators to deploy SDN at an early stage. That is why I believe that SDN will be mandatory in the near future. Telecom operators will need to decide how intensively they will deploy SDN. I believe that the best way forward is to conduct verification tests on actual networks and to show the results to telecom operators. Based on this belief, we have executed our investments to date.

*Q. How do current conditions stand for SDN deployment by telecom operators in Japan?*

A. Telecom operators in Japan are proactively seeking to deploy SDN, and NEC has been very cooperative in addressing their interest in this technology. We intend to push ahead in this area, where we are well positioned to make a contribution.