April 28, 2016

Earnings Presentation and Management Strategy Meeting Q&A for the Fiscal Year Ended March 31, 2016

Date/Time: April 28, 2016 18:15-19:45 JST
Location: NEC Headquarters, Tokyo
Presenters: Takashi Niino, President and CEO
Isamu Kawashima, Executive Vice President and CFO

Questioner A

Q. How will the balance sheet change under International Financial Reporting Standards (IFRS)? Will there be more capitalized R&D expenses?

A. We are not in a position to clearly disclose details on the balance sheet because our statement of operations for the fiscal year ended March 31, 2016 is still unaudited. Based on our conservative accounting policy on R&D, we expect to record R&D as an expense rather than capitalize it. In terms of our overall direction, we believe that the equity section of our IFRS balance sheet will be smaller than our Japanese GAAP(J-GAAP) balance sheet. Under IFRS and J-GAAP, the discount rate for pensions is viewed differently. Pensions will be calculated using a discount rate of 0.5% under IFRS, compared with 1.3% under J-GAAP. We believe the change in pensions will have the biggest impact, with an estimated change of around 30.0 billion yen. The net D/E ratio will be mostly unchanged under IFRS compared with J-GAAP. We estimate that this ratio will be just under 0.4. Looking ahead, we expect the ratio to improve due to cash inflows. This reflects investment of 200.0 billion yen for inorganic growth measures such as M&A activity.

Q. I have understood the overall direction of the new Mid-term Management Plan. Could you please explain the relationship between your three key businesses and your business segments?

A. The Safety Business is classified under the others segment because it is an independent international business operation. The Global Carrier Networks Business is part of the telecom carrier segment, while the IT Service Business for Retail is part of the enterprise segment. Currently, all three key businesses are breaking even in terms of profitability.

However, in the fiscal year ending March 31, 2019, NEC aims to bring combined international business profitability closer to the Company-wide operating income ratio target of 5%.

Q. I believe the investment environment will be favorable until 2020, but I am concerned about the situation thereafter. At that time, which fields do you believe will pave the way for NEC's growth? Will they remain on the extension line from the fiscal year ending March 31, 2019, or will there be different changes? I don't think NEC's international business profitability is good. How will NEC drive growth in international business from 2020?

A. It is absolutely necessary for NEC to raise the international sales ratio. Although our target for the fiscal year ending March 31, 2019 is under 30%, we really need to build a business structure that is able to attain a ratio of 30% and then 40% as early as possible. To this end, we must build competitive solutions underpinned by our key businesses over the next three years, in conjunction with continuing to expand these businesses globally in 2020 and beyond.

Q. As mentioned earlier, NEC aims to bring international business profitability closer to an operating income ratio of 5%. However, profitability is still low on a segment basis. Is that because of upfront investment?

A. Yes. We are also factoring in the potential for the profitability of existing businesses to decline.

Questioner B

Q. How much year-on-year growth do you anticipate in the telecom carrier business in the fiscal year ending March 31, 2017?

A. We are assuming that the telecom carrier business will contract in Japan but expand internationally.

Q. NEC expects adjustment to increase by nearly 20.0 billion yen on an IFRS basis in the fiscal year ending March 31, 2017. What is the reason for this? Does the decline in profits due to reclassifications suggest that NEC expects to incur charges such as settlement packages and compensation for damage, and provision for contingent loss once again in the fiscal year ending March 31, 2017?

A. First, we are estimating extraordinary loss of around 10.0 billion yen under J-GAAP on items for which the details have yet to be determined. Impairment losses in the energy business that were incurred in the fiscal year ended March 31, 2016 are included in others. Non-operating income/loss will not be the same as in the fiscal year ended March 31, 2016, but we have factored in nearly the same amount to ensure that we are able to cope with the same amount of expenses. The remaining 10.0 billion yen is for increases in research laboratory expenses and corporate expenses. We have made it possible to utilize expenses that were not used in the fiscal year ended March 31, 2016.

Q. Has NEC already decided to use those expenses?

A. We are assuming that the expenses will be used for actual projects that are already in sight.

Q. I believe that most of the reforms of underperforming businesses and unprofitable projects will produce results in the fiscal year ending March 31, 2017. From the standpoint of "One to Many" initiative, doesn't worsening profitability due to deterioration in the business mix contradict the goal you have set? Is NEC provisionally targeting an operating income ratio of 5% because it did not reach its targets for the fiscal year ended March 31, 2016? Or is it because businesses with a high marginal profit will remain at the 5% level?

A. We anticipate worsening business mix in existing businesses such as the telecom carrier and public businesses. Therefore, we would like to focus on driving growth globally. Sales growth has not been very large over the past three years. Therefore, we believe that our aim of increasing the operating income ratio to 5% by expanding growth businesses is an appropriate target for now. We intend to further increase profitability in the period thereafter.

Q. Won't NEC be able to achieve 70-80% of its Mid-term Management Plan target for reforming underperforming businesses and unprofitable projects in the fiscal year ending March 31, 2017?

A. In the fiscal year ending March 31, 2017, we intend to complete a considerable portion of the structural reforms of the energy business to stop losses of 24.0 billion yen and the prevention of new unprofitable projects of 13.0 billion yen. The business process optimization project and the optimization of development and manufacturing functions should deliver improvement benefits evenly over the next three years.

Questioner C

Q. Until now, I believe profit was expected to improve by around 15.0 billion yen upon the transition to IFRS mainly based on pension costs. Goodwill had a positive impact of 11.4 billion yen on profit, but pension costs have had a negative impact. Could you please explain this in more detail?

A. As initially expected, goodwill had a positive impact on profit. Pension costs did not have a positive impact, as a result of changes from our initial assumptions. Upon the transition to IFRS, the discount rate has been reduced from 1.3% to 0.5%. Under J-GAAP, the investment portion of pensions had a long-term expected rate of return on assets of 2.5%. However, under IFRS, this rate of return must be equal to the discount rate. Therefore, it will change from 2.5% to 0.5%. Although there was a positive impact of 4.0 billion yen from the absence of amortization, declining interest rates had a negative impact of 5.0 billion yen eliminating the positive impact.

Q. Looking at your exchange rate assumptions for the fiscal year ending March 31, 2017, why have you set the assumed exchange rate at US$1=115 yen, which represents a weaker yen than the current rate? What is your estimated exchange rate sensitivity?

A. The exchange rate of 115 yen to the U.S. dollar is a conservative figure in terms of the impact on NEC's profitability. For every depreciation of 1 yen against the U.S. dollar, there will be a loss of 0.3 billion yen on a full-year basis. When the exchange rate is stronger than 115 yen to the U.S. dollar, NEC imports large amounts of parts and materials, so every appreciation of 1 yen against the U.S. dollar will result in a net gain of 0.3 billion yen on a full-year basis. This impact breaks down into a gain of 0.7 billion yen against the U.S. dollar and a loss of 0.4 billion yen against the euro.

Q. In terms of underperforming businesses and unprofitable projects, how did NEC perform in the fiscal year ended March 31, 2016, and what is your outlook for the fiscal year ending March 31, 2017?

A. First, the energy business posted a loss of 24.0 billion yen on an IFRS basis in the fiscal year ended March 31, 2016, but the loss was 14.0 billion yen on a J-GAAP basis. Compared with our previous forecast as of February 29, 2016, NEC included an additional valuation loss on inventories of NEC Energy Solutions, Inc. of 2.0 billion yen into its forecast loss of 12.0 billion yen. Apart from this, NEC recognized impairment losses on the full amount of goodwill of just over 7.0 billion yen, as well as on noncurrent assets and other items. Altogether, NEC recognized losses totaling around 10.0 billion yen as an extraordinary loss on J-GAAP basis.

Second, NEC incurred loss-making projects in two areas: IT and networks. NEC recognized costs of around 13.0 billion yen for IT projects, and made provisions of around 4.0 billion for overseas construction delays in network projects. The combined cost was around 17.0 billion yen.

Q. In the fiscal year ending March 31, 2017, smaller losses in the energy business and fewer unprofitable projects will have a positive impact of 37.0 billion yen on operating income. Why then is overall operating income projected to increase to only 100.0 billion yen, compared with 91.4 billion yen in the previous fiscal year?

A. Postponement of large projects in the fiscal year ended March 31, 2016 will have a positive impact of nearly 10.0 billion yen on earnings in the current fiscal year. Meanwhile, there will be a negative impact of nearly 10.0 billion yen as large projects have peaked out. On an IFRS basis, the absence of impairment losses at NEC Energy Solutions will lift operating income by around 10.0 billion yen. We expect unprofitable projects to improve by around 10.0 billion yen in the fiscal year ending March 31, 2017. On the other hand, we anticipate an extraordinary loss of around 10.0 billion yen for items that have not yet been determined. We have also incorporated increases of just under 10.0 billion yen in research laboratory and corporate expenses. In the others segment, we expect a positive impact of nearly 10.0 billion yen. Therefore, we are forecasting overall operating income of 100.0 billion yen for the fiscal year ending March 31, 2017.

Q. Haven't you factored in the impact of improvements on an operations basis?

A. We see this improvement as the positive impact of 10.0 billion yen from the others segment. However, this is not viewed as an improvement in key businesses.

Questioner D

Q. What is your motivation for executing the Mid-term Management Plan? I don't believe NEC will feel any sense of financial urgency unless it conducts M&As. Do you have any objectives in this regard? In hindsight, NEC said it was unable to accomplish all of its goals. How then will you foster a sense of urgency among employees?

A. During Mid-term Management Plan 2015, we sought to create signs of growth, but were unable to do so. We have barely undertaken any M&As in the past three years. We tried to speed up business globally, but our international business did not grow fast enough to build a new pillar. Meanwhile, our financial base has been improving and one of our major initiatives will be to get our key businesses up and running, through such means as investment of 200.0 billion yen. That is why we have appointed a Chief Global Officer (CGO) who is responsible for promoting global business. Previously, it was not clear who was responsible for this business, and we could not hold anyone accountable. Under our new structure, the CEO and CGO are responsible for providing leadership for global business. NEC has also formed a specialized team for investments. Our sense of urgency is reflected in the figures for our Mid-term Management Plan. We are cognizant of whether our targets for the fiscal year ending March 31, 2017 and our numerical Mid-term Management Plan targets are sufficiently ambitious. However, we will send out a clear message to employees that NEC will lay a solid foundation for growth. The same management team has undertaken both existing businesses and growth businesses, but these businesses are clearly different from one another. We have tried to foster a culture that embraces ambitious challenges while tolerating setbacks in the process. However, we have more work to do in this area.

Q. NEC is targeting improvements through internal cost reduction efforts of 35.0 billion yen. In comparison with competitors, I believe that NEC's ratio of operating expenses to net sales is high. Even if it were to grow its businesses globally, NEC would have to sacrifice profitability. I believe that internal cost reduction efforts can be achieved if the management team puts its mind to it. However, do you really think cost reductions of just 35.0 billion yen will ensure adequate competitiveness?

A. NEC's cost structure has a high ratio of SG&A expenses, so I believe we must improve this ratio. In the fiscal year ended March 31, 2016, the SG&A expense ratio was over 20%. Unless we reduce this ratio to under 20% as soon as possible, we will be unable to compete globally. Even if we attain our SG&A expense ratio target for the fiscal year ending March 31, 2019, this would only mark an improvement of 1 percentage point, so it is not sufficient. We intend to consider our options, including new initiatives.

Q. During the term of office of Mr. Endo, NEC's previous president, NEC embraced SDN (Software-Defined Networking), and focused spending on this area. What is your view on strategic costs under the new Mid-term Management Plan?

A. Development costs for SDN in the telecom carrier business are peaking out now, and will be reduced going forward. In terms of development costs, we are strategically focusing spending on the development of 5G technology. Going forward, we don't expect to sharply reduce development costs as a whole.

Questioner E

Q. NEC is targeting cost reductions of 25.0 billion yen through staff operation efficiency and 10.0 billion yen through operating expense / IT cost efficiency. However, even if these targets are achieved, I don't think these cost reductions will have a visible impact on the profits of business units. How will NEC control these KPIs that are directly linked to profits?

A. We will monitor and control the progress of the business process optimization project in conjunction with tracking the SG&A expense ratio.

Q. If the SG&A expense ratio improves by 1 percentage point over three years, it will improve by around 0.3% every year. Does this mean we will see hardly any improvement in the SG&A expense ratio?

A. We will improve the SG&A expense ratio in the course of improving business efficiency incrementally every year.

Q. The earnings outlook for the energy business in the fiscal year ending March 31, 2017 calls for reducing losses of 14.0 billion yen on operations basis to losses of 2.0-3.0 billion yen. What kinds of measures do you have in mind? If progress is slow, will there be a risk of recognizing further impairment losses on noncurrent assets?

A. Losses of 10.0 billion yen are for two parts of the energy business: NEC Energy Solutions in North America and small electricity storage systems in Japan. Until now, we have intensively allocated costs to expand business, but we will now shift to a minimal operation going forward. Overseas, NEC will take steps including those focused on personnel. In Japan, we will address personnel through such means as internal reassignments. We will narrow down development items, and cut costs. In the North American business, NEC has also recognized a valuation loss on inventory. In both businesses, we have factored in improvements of around several billion yen each.