October 31, 2016

Earnings Presentation Q&A for the Six Months of the Fiscal Year Ending March 2017

Date/Time: October 31, 2016 17:30-18:30 JST
Location: NEC Headquarters, Tokyo
Presenters: Takashi Niino, President and CEO
Isamu Kawashima, Executive Vice President and CFO

Questioner A

Q. I believe restructuring is needed in the smart energy business. Please let me confirm your sense of urgency toward this business. Did today's talk fully cover your restructuring initiatives for smart energy?

A. The smart energy business requires immediate improvement because it posted a large loss in the previous fiscal year. On the other hand, I believe this business offers significant growth prospects going forward. The smart energy business can be broadly divided into three areas: "utility", ICT solutions for electric power companies, small energy storage and large energy storage. In 1H, revenue from utility decreased, due in part to stagnant capex by customers. In response, we transferred utility to the public business effective on October 1, with a view to increasing profitability by capturing synergies with SI departments targeting Japanese utility companies. In small energy storage, competition is intensifying, and overseas players have been entering the market by offering low prices. We will examine this business from many different angles, instead of merely pursuing expansive in-house development. In large energy storage, we have narrowed down the workforce to the bare essential minimum, positioning ourselves to successively capture global business opportunities. Overall, we plan to shift resources from product to service businesses. I intend to transform the business structure, rather than following previous approaches.

Q. Could you please confirm whether you have factored in the impacts of the tender offer for shares of Japan Aviation Electronics Industry, Limited and the transfer of a portion of shares in Lenovo NEC Holdings B.V. into your full-year forecasts?

A. In 1H, NEC recorded a gain of approximately 20.0 billion yen on the transfer of a portion of shares in Lenovo NEC Holdings B.V. However, this gain has not been included in NEC's full-year forecasts. Nor have we included the impact of Japan Aviation Electronics Industry, Limited into forecasts, as the consolidation process has not yet been confirmed. Under current conditions, we should know whether or not the company will be consolidated within the third quarter. NEC recorded tax expenses reduction of about 6.0 billion yen in 1H, but has not included this reduction in its full-year forecasts either. These items realized in our 1H results have not been factored into our full-year forecasts.

Q. Is there any quantitative information you could provide about NEC Management Partner, Ltd. (NMP), internal improvement initiatives and so forth? How about your forecasts for the headcount and asset reductions?

A. We plan to reduce our back-office staff headcount of more than 10,000 by 30% during the Mid-term Management Plan period. Efforts will also be made to streamline operations by transferring IT assets to NMP and unifying Group-wide IT investment.

Questioner B

Q. In Q2, orders for IT services in Japan rose 11% year on year. Which areas were strong? Could you please share your forecast for 2H onward?

A. Orders for IT services in the municipality and medical areas decreased, but all other areas posted year-on-year increases. We believe orders for IT services will remain firm in 2H as well.

Q. In the system platform business, there was a large year-on-year improvement in operating profit in Q2. Could you please comment on the factors behind this improvement and whether it is sustainable in 2H?

A. The factors behind the improvement were the foreign exchange impact and an improved hardware product mix. We will need to look a little more closely at trends to see whether the improvement will be sustainable in 2H.

Questioner C

Q. Company-wide operating profit in 1H was largely in line with the forecast. When was the forecast subject to this comparison issued? How did operating profit differ for each segment?

A. The result is a comparison with the forecast issued when Q1 earnings were announced in July. By segment, operating profit in the public business underperformed forecast by around 2.0 billion yen, primarily in the social infrastructure area. In the enterprise business, operating profit outperformed the forecast by around 3.0 billion yen, primarily in the retail and services area. In the telecom carrier business, operating profit underperformed the forecast by 6.0 billion yen, mainly reflecting sluggish CAPEX primarily in South America in the international business, although the business in Japan was largely in line with the forecast. In the system platform business, operating profit outperformed the forecast by around 6.0 billion yen, mainly reflecting improved server profitability due to a better product mix and mitigation of deteriorating maintenance revenue. In the others business, operating profit underperformed the forecast by around 5.0 billion, mainly as the international business struggled to grow. Adjustment exceeded the forecast by about 2.0 billion yen mainly due to streamlining and timing differences.

Q. Has progress been made on the SDN/Network Functions Virtualization (NFV) project for Telefónica Brasil (Vivo) in Brazil? Could you please comment on the size of sales and timing of recognition, as well as the project features and other aspects of the five commercial projects NEC was awarded?

A. Final agreements have not yet been reached for the project for Vivo—the details are being finalized. In other areas, negotiations on projects utilizing Agile Virtualization Platform and Practice (AVP) are gathering momentum, and we expect to recognize sales gradually from the second half onward.

Q. Will NEC use the 1H improvement in Adjustment in 2H?

A. Based on our management policy, we will not use the expenses if revenue declines. Given that our revenue forecast is unchanged, we will examine the appropriate amount of cost to use.

Questioner D

Q. Operating income in the system platform business in Q2 improved around 6.0 billion yen compared with the forecast in July, and also increased in year-on-year terms. Could you please provide additional details on what improved?

A. In our July forecast, we had put a conservative estimate on server profitability, but we have also seen the product mix improve. In addition, we had expected profitability in maintenance to decline in 1H because it declined in our Q1 earnings, which turned out to be conservative partly helped by improving costs. In 2H, we will continue to carefully assess projects from Q3 onward.

Q. I believe NEC had around 40 SDN/NFV projects in the pipeline. Will progress be made toward the commercial implementation of these projects?

A. These projects are expected to increase going forward. We believe there is an emerging trend toward the adoption of SDN/NFV by telecom carriers.

Questioner E

Q. Could you please tell us your outlook for operating profit in each segment in 2H?

A. We maintained our full-year operating profit forecasts, so we will be carefully assessing the situation going forward. By segment, we see risks as well as potential. We believe the public business has downside risks centered on social infrastructure fields. Revenue is concentrated in Q4, so we will watch conditions closely. In the enterprise business, we believe the current forecast is slightly conservative, even after considering_strategic investments. In the telecom carrier business, we believe sales growth is crucial, with performance depending on trends surrounding international telecom carriers. Incidentally, the unprofitable project of around 4.0 billion yen that occurred in Q4 of the previous fiscal year has now been brought under control. In the system platform business, foreign exchange is the variable factor. We will also watch for project lineup changes. In the others business, we had initially forecast a full-year loss of around 3.0 billion yen in smart energy, but the actual loss could surpass this forecast by around 5.0 to 6.0 billion yen. Meanwhile, we also see certain parts of the others business as a buffer. We anticipate that this buffer portion should offset the anticipated underperformance in smart energy.

Questioner F

Q. Looking at the profitability of SDN/NFV, when do you expect it to become profitable? How many projects will be needed at that time?

A. At present, we still do not have a sufficient number of projects. SDN/NFV will not become profitable by merely winning five projects. We would like to see SDN/NFV contribute to earnings by the fiscal year ending March 31, 2019, the final year of the Mid-term Management Plan.

Q. To what extent did 1H revenue underperform your forecast in July?

A. Revenue underperformed forecast by around 40.0 billion yen.

Q. Considering this shortfall in revenue against forecast, don't you think that further cost cutting is needed relative to the Mid-term Management Plan? You noted that profitability is improving at NMP as anticipated. Do you think profitability can be improved further than your target?

A. Revenue in 1H decreased by nearly 100.0 billion yen year on year. However, in terms of the components, the foreign exchange impact accounted for just over 30.0 billion yen of this decline. The main factor behind the decline in the base portion other than foreign exchange was the slow launch of key businesses. It is crucial to determine whether profitability will improve based on a close assessment of progress on this front. Meanwhile, cost-related components improved by around 30.0 billion yen in 1H. We will continue pushing ahead with improving SG&A expenses and launching key businesses.

Questioner G

Q. Does this mean that SDN/NFV projects will not be profitable even if they are commercially implemented?

A. It means that SDN/NFV is still in an investment phase, and sales are not yet big enough to cover the investments.