January 30, 2017

Earnings Presentation Q&A for Q3, the Fiscal Year Ending March 31, 2017

Date/Time:	January 30, 2017 18:00-19:00 JST
Location:	NEC Headquarters, Tokyo
Presenters:	Takashi Niino, President and CEO
	Isamu Kawashima, Executive Vice President and CFO

Questioner A

Q. NEC has reduced its forecasts sharply. Could you please explain the reasons in terms of factors specific to the industry and those specific to NEC?

A. The reasons include both temporary and fundamental factors. We had expected growth in new businesses to cover the downturn in existing businesses, but the new businesses have not grown as expected. Meanwhile, the IT services field has remained relatively firm, and we believe this was largely in line with the industry's performance as a whole. Looking at individual segments, in the telecom carrier business, although capex by telecom carriers in Japan has been decreasing from previous levels, our revised forecast reflects increasing pressure particularly on the international telecom carrier business. We must step up the expansion of SDN/NFV (Software-Defined Networking/Network Functions Virtualization) and TOMS (Telecom Operations Management Systems) solutions. In the public business, the IT services field has remained relatively firm, despite a decline in public services areas. There was a large decrease in the space business. Although some projects were postponed, profitability declined in part because we were unable to properly control our own costs. In the enterprise business, performance was relatively solid because this business involves the IT services field. In the system platform business, we believe that our performance largely reflected industry trends. Revenue from hardware has been declining, so we must further expand software and services fields. In the smart energy business, both revenue and profitability have come under pressure. Notably, the "utility" business providing ICT solutions for electric power companies in Japan, which has been a core earnings driver, has been facing tougher conditions. The situation should improve in the next fiscal year compared to the current fiscal year. In international large energy storage systems, performance was largely in line with expectations. Orders received and preliminarily approved projects have started to emerge gradually. We expect the situation to improve from next fiscal year onward. We are considering all options for domestic small energy storage systems. We are determined to make improvements in this field as well.

Q. I believe NEC faced an even greater crisis three years ago than it does now. I had the impression that NEC was feeling a real sense of urgency at the time. However, the company has gradually returned to normal. Isn't that why NEC has seen loss-making projects arise and why it has been unable to grow revenue? How have NEC's employees changed today compared to three years ago? Could you please share your perspectives on this issue as NEC's president?

A. In the fiscal year ended March 31, 2012, we executed major business structure improvement measures and incurred large losses. In the previous Mid-term Management Plan, we focused on social solutions, and were able to achieve our financial targets in the first two years of the plan. At the time, we felt that our efforts were finally producing results. However, in the previous fiscal year, our performance fell short of our financial targets due to a downturn in domestic demand. Currently, as our business models change, our existing businesses are declining, and our new businesses are not growing. The main reason for this is that we have been unable to keep pace with trends in society and customers. To foster awareness of this crisis, I believe that we must transform the mindset of employees. In this era of upheaval, I believe that we must clearly convey NEC's priorities and direction, thereby paving the way for company-wide efforts to transform our actions.

Questioner B

Q. Could you please explain the events that are taking place in the space business in the public business? What is your outlook for the deterioration in profitability from next fiscal year onward?

A. There are two problems facing the space business: timing differences in revenue recognition and deteriorating profitability. The timing differences in revenue recognition are due to the postponement of a launch. Profitability deteriorated in a project we won several years ago. We had continued design and manufacturing activities on this project, but we started to realize that costs would increase from around one year ago. We closely examined the costs and made adjustments, including those involving the customer, but we were unable to make up for the higher costs.

Q. Did this deterioration in profitability occur in a domestic project?

A. Yes, that is correct.

Q. In the telecom carrier business, I believe the international business had already been on a deteriorating trend, including mobile backhaul (PASOLINK) and projects in Latin America. Will this business remain under pressure going forward? In the domestic business, I understand that NEC faces challenging conditions relative to its competitors. Has NEC lost any market share?

A. Capex by domestic telecom carriers has been gradually declining overall. There are differences in the timing of procurement during the fiscal year, and we believe that these timing differences could have an impact depending on the period. Overseas, conditions in mobile backhaul (PASOLINK) have not changed in the past few years. The earnings structure must be fundamentally improved. Moreover, profitability has deteriorated in TOMS and submarine systems due to temporary factors. In SDN/NFV, as I explained in the 1H earnings presentation, we are now able to use new tools to win projects. Although this field has not yet produced large quantitative results, we intend to expand this field further.

Q. The full-year operating profit forecast in the telecom carrier business was reduced by over ¥30.0 billion. Could you please go over the components of this downward revision?

A. In the telecom carrier business, the shortfall in revenue had a large impact on the operating profit forecast. Revenue was ¥87.0 billion below the previous forecast. Roughly speaking, international business accounted for about 80% of the shortfall, while domestic business accounted for the remaining 20%. The downturn in domestic business was largely in line with expectations. However, we have also factored in the impact of projects in Q4 that we will be unable to record as expected. Special factors include an increase in costs of around ¥2.0 billion due to the extension of the construction period for submarine systems, in addition to the impact of the stronger yen. We continue to invest in focus areas.

Q. Have you factored in the surcharge related to the digitalization of fire-fighting emergency radio systems into your forecasts?

A. We have factored in around ¥8.0 billion, the amount projected at this time, as provision for contingent loss, including firefighting emergency-related losses. We have already made a provision for part of these losses in Q3. We received a written draft of order to pay surcharges for transactions related to the digitalization of fire-fighting emergency radio systems as well as electric power maintenance communication equipment. Therefore, we have factored in appropriate losses into our forecasts.

Q. Is the provision for contingent loss included in operating profit?

A. Under IFRS, the provision for contingent loss is included in operating profit. The provision of ¥8.0 billion is not entirely for the digitalization of fire-fighting emergency radio systems. In terms of segments, the public segment does not account for the entire provision. Provisions are recorded in or projected for the appropriate segment.

Questioner C

Q. Will any additional business structure improvement measures be factored into your forecasts for the current fiscal year? There has been no announcement of business structure improvement plans for the smart energy business. Why hasn't NEC been able to make a decision on this front?

A. In the smart energy business, we are examining business structure improvement measures, considering all possible options, including shifting personnel. Although business performance has deteriorated in the public business and telecom carrier business, we currently have a personnel shortage in specific fields. A case in point is the collaboration with DENSO Corporation announced at the end of last year. We will accelerate the shift of resources to fields where they are needed, including integrating software subsidiaries. We recognize that we must still do much more to shift resources from an overall Group-wide perspective.

Q. Is there any discussion within NEC on whether or not the current management system and business structure are adequate? You discussed shifting resources within the Group. Is this the optimal solution?

A. Our business models are changing significantly. Until now, we have benefited from surging demand for high-margin products, but those surges do not continue forever. Demand is cyclical, and we are currently in the trough of the demand cycle. The next peak will arrive eventually, but we did not do enough to tide ourselves over. It is imperative that we develop business models that leverage our strengths by collaborating with customers in fields such as AI and IoT. In addition, as part of our alliance with GE, we are working to transplant our image recognition technology to their platform. We believe that our initiatives with various partners are still very weak. Therefore, we aim to accelerate these initiatives.

Q. I believe that NEC has the ability to generate operating profit of around ¥50.0 billion and net profit of around ¥20.0 billion. Meanwhile, if the optimization of resources leads to surplus personnel, NEC may struggle to generate profit for the current fiscal year. What is your outlook for next fiscal year?

A. Operating profit is now forecast at ¥30.0 billion following the downward revision of our forecast. If the one-time issues are resolved, we expect operating profit to improve by ¥20.0 to ¥30.0 billion. Meanwhile, another key point will be to what extent we are able to accumulate revenue after reducing the revenue forecast by ¥200.0 billion. We have not yet started formulating our budget for next fiscal year, so I must refrain from commenting on specific figures at this time.

Q. In terms of your outlook for net profit for next fiscal year, will you do your utmost to achieve net profit of ¥20.0 billion, the level needed to attain a dividend of ¥6 per share?

A. At this time, we would like to consider it as a provisional target to work towards.

Questioner D

Q. Could you please discuss the one-time factors that will be resolved in the next fiscal year in each segment?

A. We expect business structure improvement expenses of around ¥6.0 billion, primarily in the international business of the others business. This portion of costs will decrease if there are improvements, and improvements in business profitability can also be expected. Loss-making projects will amount to around ¥10.0 billion in the public business and around ¥2.0 billion in the international business of the others business. These amounts should improve if we are able to take effective measures. I cannot discuss specific items with respect to the provision for contingent loss. However, the provision for contingent loss for the current fiscal year includes the portion for the digitalization of fire-fighting emergency radio systems. Under the business process innovation project, we are advancing work style reforms. As in the current fiscal year, we expect an improvement of over ¥10.0 billion next fiscal year through those reforms. In the smart energy business, we anticipate a loss of

¥13.0 billion for the current fiscal year. Efforts will be made to reduce the size of this loss, including current initiatives to capture new orders. We have not yet started closely examining the extent of business structure improvement expenses for next fiscal year. On the cost front, we believe that market development costs will be needed, rather than increased R&D costs.

Q. Some forecasts show that capex by telecom carriers will not increase going forward. Have you considered measures to address this risk?

A. We believe it is necessary to transform business models from network equipment and hardware to services including SI. At present, investment by telecom carriers is increasing in the IT services field. We would like to increase revenues in the service businesses of our customers.

Questioner E

Q. Could you please provide specific figures for the changes behind the operating profit forecast?

A. Loss-making projects were around ¥5.0 billion, business structure improvement expenses were around ¥6.0 billion, and provision for contingent loss was around ¥8.0 billion. Improvement in the others business was large enough to cover these negative impacts. The remainder was the shortfall in revenue from existing businesses and new businesses, which amounted to around ¥70.0 billion in total. The loss-making projects were recorded in Q3. We recorded a portion of the business structure improvement expenses and provision for contingent loss in Q3, and expect to record the remaining portion in Q4.

Q. What level of operating profit do you think the smart energy business should attain in the next fiscal year? Could you please discuss measures to reach this level of operating profit?

A. The smart energy business can be broadly divided into three businesses. First, in “utility,” which provides ICT solutions for electric power companies, revenue and profitability drastically deteriorated. We consider this to be a temporary deterioration. From next fiscal year onward, we believe “utility” will return to a normal steady state. Second, in international large energy storage systems, we posted a loss of several billion yen. Projects have been emerging, but it will take time to break even. Meanwhile, the third business, domestic small energy storage systems, presents a major issue. Until now, we have done everything in this business in-house. We are now considering all possible options, including a make-or-buy decision. Overall, we seek to make improvements in order to reduce the loss to several billion yen.

Q. Revenue from new businesses was below forecast. However, I believe that projects are in fact gradually emerging. In my view, the reason for the deterioration in profitability is that NEC has been unable to effectively manage costs. Will NEC increase costs in order to increase revenue in the next fiscal year? In the 1H earnings presentation, NEC noted that it has received orders from five telecom carriers for SDN/NFV. Do you expect marginal profit to improve for SDN/NFV?

A. Investment is still needed in new businesses. Although orders have been increasing, we will continue investing to a certain extent. We have competitive technologies in the safety business. However, investment is needed to establish business models. We expect the investment phase to continue next fiscal year.

Q. Do you expect profitability to improve in new businesses?

A. Under Mid-term Management Plan 2018, we aim to make new businesses profitable from the fiscal year ending March 31, 2019 onward.

Questioner F

Q. When is the delivery period for the loss-making project in the space business? In the IT services field, NEC initially projected loss-making projects of ¥7.0 billion. Following the recent review, loss-making projects were reduced by ¥6.0 billion to ¥1.0 billion. What lies behind this change?

A. We believe the delivery of this space project will take much longer, rather than several months from now. We factored in all of the currently foreseeable loss-making projects into the forecast. We do not expect any loss-making projects to arise in Q4. In the previous fiscal year, we recorded a large amount of loss-making projects in Q4. In the current fiscal year, we have a clearer outlook at this time, because we have now begun the process to agree on projects with customers.

Questioner G

Q. When did you become aware of such a large downward revision? I believe that now that operating profit is below ¥100.0 billion, NEC's earning power has weakened. This tremendous change happened in only three months. Could you please explain the background and reasons?

A. In the current fiscal year, NEC started out with a large shortfall relative to its budget in Q1. In 1H, NEC was largely in line with forecasts when looking only at Q2, relative to its forecasts as of July. Ultimately, revenue fell nearly ¥100.0 billion below the initial forecast. When 2H started, we were looking closely at the extent to which we could make up for this shortfall. Performance progressed as planned in October and November. In December, we realized it to be difficult to achieve our full-year forecasts while we closely examined the achievement level against those forecasts. Figures for the loss-making projects were finalized, and we comprehensively reexamined our revenue forecast for Q4 onward, which is heavily impacted by product acceptance in March. As a result, we had no choice but to accept the shortfall in revenue we have announced. Profitability also deteriorated in line with the revenue shortfall. It is clear that demand for items such as wireless communication products, where NEC has strength, is declining. Our priority is to figure out how to reshape new business models and to build new earnings models. We need to work harder to convert this priority into earnings power. We understand that NEC must develop platforms by working together with partners in fields such as IoT and AI, and accelerate the pace of this transformation.