July 31, 2017

Earnings Presentation Q&A for Q1, the Fiscal Year Ending March 31, 2018

Date/Time: July 31, 2017 17:30-18:30 JST
Location: NEC Headquarters, Tokyo
Presenters: Isamu Kawashima, Executive Vice President and CFO

Questioner A

Q. Could you please go over the differences between your actual Q1 business results and forecasts? For both the public business and the system platform business combined, NEC initially projected that the nomination suspension would have a negative impact of ¥60.0 on revenue and ¥15.0 billion on operating profit on a full-year basis. What was the extent of the impact in Q1 and what is your outlook for Q2 onward?

A. In Q1, the nomination suspension had an impact of around ¥3.0 billion on revenue and around ¥1.0 billion on operating profit/loss. The local government area of the public business bore the brunt of the impact. This result was largely in line with expectations. We believe that the projected impact of ¥60.0 billion on revenue and ¥15.0 billion on operating profit for the full fiscal year will remain unchanged.

Q. Operating profit/loss has improved by ¥15.5 billion year on year. I would like to confirm the factors behind this result other than the improvement of ¥4.0 billion from the consolidation of Japan Aviation Electronics Industry, Limited. I believe that NEC did not have many unprofitable projects last year. Could you please discuss the details of your improvements in profitability and cost efficiency?

A. In the public business, operating profit/loss improved by ¥5.6 billion year on year. There was an improvement of ¥4.0 billion from the consolidation of Japan Aviation Electronics Industry, Limited. In other areas, profitability improved slightly in the central government area, outweighing the impact of the nomination suspension. In the telecom carrier business, operating profit/loss improved by ¥3.7 billion year on year. We had initially anticipated profits to be mostly unchanged from the same period last year, so the year-on-year improvement outperformed our expectations. This improvement was due to an increase in sales in the domestic business. However, we are not taking an overly optimistic view of this business. Our analysis shows that the improvement reflects a larger-than-usual investment in Q1 by domestic telecom carriers. In Q2, we expect investment to remain mostly flat compared with Q1, and to decline year on year. In the system platform business, operating profit/loss improved by ¥2.9 billion year on year. Although this result was largely in line with expectations, we believe that cost improvements had a large positive impact. Apart from this, the Adjustment account improved by ¥1.7 billion year on year, mainly due to improved back-office expenses. This represents an improvement of around ¥2.0 billion from our initial projection of a mostly flat trend.

Q. Did any one-time costs push down earnings in Q1?

A. There were no such costs in Q1.

Q. Free cash flows have surpassed the full-year forecast, partly owing to one-time factors. Looking at the balance sheet, although the level of cash is normally around ¥200 billion level, cash stood at ¥414.9 billion. Could you please discuss the future uses of cash, particularly your approach to M&As?

A. There has been an accumulation of cash mainly due to the impact of the issuance of bonds in the amount of ¥100 billion. We are considering various M&A possibilities. We are looking at many different options centered on focus areas such as security, safety, TOMS and SDN, and retail. However, nothing has been decided at this time.

Q. You noted that the large amount of cash is attributable to the issuance of bonds. How do you plan to allocate this cash?

A. The main reason for issuing bonds was to procure funds while the financial environment is still favorable for doing so, based on the possibility that interest rates could rise in the near future. We basically plan to allocate these funds to the repayment of liabilities in the current and next year. However, if we decide to execute M&A deals during this period, we could temporarily allocate these funds to those deals. That said, although we are considering various options, we do not have any deals for which these funds will be used at this time.

Questioner B

Q. The nomination suspension had an impact of ¥3.0 billion on revenue and ¥1.0 billion on operating profit/loss. Do you really still believe it will have a full-year impact of ¥60.0 billion on revenue and ¥15.0 billion on operating profit? Hasn't your outlook changed since the beginning of the fiscal year?

A. NEC recognizes that the nomination suspension is the result of a major problem that the company caused. Therefore, we are taking a cautious approach to this problem. In Q2, we are likely to lose a few more orders that we had initially expected to receive. Although it is still hard to size up the conditions until we see how things turn out in Q2, at this time we believe that the impact will fall within the range we had anticipated for the full fiscal year. However, at present, we are not entirely certain about the extent to which any differences from our initial forecast may arise.

Q. NEC presented specific figures in connection with the sale of shares of Renesas Electronics Corporation. I believe that these numbers only refer to the portion of shares owned by NEC. When considering the portion of shares that will be included in tax-deductible losses, what kind of impact will this have in the current fiscal year? Could you please also discuss how you will treat the portion of shares held in the retirement benefit trust?

A. As you said, we have recorded only the portion of shares owned directly by NEC at this time. The main point is what impact this will have on deferred tax assets. This impact will be considered together with our recovery plans for deferred tax assets. Since we cannot determine the impact at this time, we have not factored it into our forecasts. We will need to revise our recovery plans for deferred tax assets based on various considerations, including the reformulation of Mid-term Management Plan 2018 and our assessment of business results for the current fiscal year. The same applies to the portion of shares held in the retirement benefit trust.

Q. I believe that NEC achieved cost efficiency improvements totaling around ¥3.0-4.0 billion in Q1. What kinds of governance structures or targets have been established to produce this result? Will these improvements be sustainable from Q2 onward? Also, looking only at smart energy alone, it seems as if the numbers have not improved as much as expected by the capital markets. Could you please discuss your approach to cost efficiency improvements, including progress in the smart energy business?

A. In the course of forming our budget for the current fiscal year, we adopted the approach of incorporating cost efficiency improvements to the fullest extent possible given that sales have declined sharply since the previous fiscal year. On the other hand, if we were to pursue only cost reductions, we would be unable to use necessary expenses.. Therefore, we have earmarked expenses of ¥8.0 billion in our budget as strategic investments that can be used at the discretion of the president. That said, this does not mean that we will not use those expenses. Our approach is to use the expenses in conjunction with monitoring the condition of sales. Therefore, a portion of the expenses that were reduced in Q1 might be used in Q2. In the smart energy business, we implemented a shift in resources last year that is now producing results. In addition, we expect to receive orders in the North American business of NEC Energy Solutions, Inc., and we are advancing efforts to win orders. Therefore, we see this business as an area where we should execute strategic investments and grow. We have made clear-cut decisions on the areas where we will use strategic investments and areas where we will not.

Q. How much of the annual budget of ¥8.0 billion in strategic investments did you use in Q1?

A. In Q1, we used only less than ¥1.0 billion of the budget. In H1, we expect to use around ¥1.5 billion for the mobility business and IoT-related areas within the Enterprise business.

Questioner C

Q. The Others segment contains a mix of both promising businesses and underperforming businesses. Could you please go over the Others segment by discussing the future core businesses and the problematic businesses separately? How will you address smart energy and lighting equipment going forward? Also, wouldn’t it be a good idea to transfer the international safety business to one of your core businesses, such as the public business?

A. In the Others segment, we have a mix of back office-led companies and international safety, energy and other businesses. Although it is difficult to explain this segment, we intend to organize the businesses in due time. We will need to discuss which segment to transfer the international safety business when it grows larger than a certain scale.

Q. In this process, NEC would probably downsize the lighting equipment business. Smart energy is also likely to be downsized where it can be downsized. Could you please discuss your approach to balancing and planning these priorities?

A. We do not intend to make lighting equipment a core business at this time. In the energy business, NEC Energy Solutions, Inc. in North America now expects to win orders, so it is still in an investment phase. Meanwhile, in the home energy storage solutions business, subsidies are being phased out. In response, we are considering options for reducing the losses in this business, including reaching a make-or-buy decision to replace certain development activities. Accordingly, we are not considering devoting a large amount of funds to this business.

Q. I believe that all of NEC's business segments are aligned with NEC's future direction, except for the system platform business. The system platform business seems to be following a slightly different course than the direction NEC should ideally follow. Could you please discuss your approach to the system platform business?

A. I believe your question concerns how we plan to address the hardware operations of the system platform business. NEC possesses unique hardware operations in the system platform business, and these operations are essential to advancing our SI business. Therefore, we are not considering divesting the hardware operations at this time. Although the hardware operations are different than our core businesses, we believe that they serve as an essential component for advancing the SI business, an integral part of NEC's unique hardware-based manufacturing activities.

Q. NEC has adopted "Company with a Board of Auditors" as its governance structure. Do you believe this governance structure is adequate? Do you have plans to transition to a "Company with Committees" system in the near future?

A. Our current governance structure is based on the "Company with a Board of Auditors" system. However, we have incorporated the best aspects of the "Company with Committees" system into our structure, including the appointment of Nomination and Compensation Committee members. We have adopted the policy of incorporating various positive initiatives into our current governance structure. Therefore, we have no plans to change this policy.

Questioner D

Q. Looking at the next three to five years, can NEC expect to reduce fixed costs as a result of the retirement of the baby boomer generation and other such factors?

A. I don't have any precise figures in hand. However, we have established NEC Management Partner, Ltd. to centralize the Group's back-office operations. Going forward, we will reduce costs by minimizing the replacement of any retirees. These cost savings have already been realized in each segment.

Questioner E

Q. Could you please share your perspectives on the business environment for the IT services business, as well as the business environment for the telecom carrier business in Japan?

A. We believe that the business environment for the IT services business is largely satisfactory. NEC posted a year-on-year decline in IT services orders in Q1. However, this decline reflects a pull-back from large-scale projects recorded in the previous year, such as projects for the Social Security and Tax Number System ("My Number") and the impact of the nomination suspension. In the telecom carrier business in Japan, in Q1 NEC saw business results surpass expectations as the amount of capital investment in Q1 was larger than in normal years. Meanwhile, capital investment by telecom carriers is ordinarily larger in Q2 than in Q1. However, this year we believe that capital investment will remain largely flat from Q1 to Q2. We expect capital investment in Q2 to decrease year on year. Therefore, we are not taking an overly optimistic view of the telecom carrier business in Japan.

Q. The forecast of the Adjustment account for the current fiscal year has been reduced by ¥5.0 billion from the initial forecast based on segment reclassifications. What are the reasons for this reduction?

A. The decline reflects the transfer of part of the Business Innovation Unit, which had previously been included in the Adjustment account, to each segment.

Q. I believe that the transition to electric vehicles (EVs) is progressing on a global basis. NEC is engaged in electrodes in the smart energy business. How do you see NEC's current position in the market?

A. NEC has so far been shipping electrodes for EVs to Nissan Motor Co., Ltd. Recently, we started shipping new electrode products with a larger capacity to Nissan. NEC's electrode sales are forecast to increase in the current fiscal year, and the technological superiority of our products has been maintained. With no fire accidents since we began shipping electrodes, we believe that our electrodes offer a high degree of safety.

Questioner F

Q. NEC is improving cost efficiency based on a cost containment approach. Could you please discuss the extent to which costs are being contained compared with ordinary cost levels?

A. We are containing costs by having each segment gradually reduce costs. It is not necessarily the case that costs have been reduced drastically in a specific area. Cost containment is being achieved through a collective effort by all segments, not because of any drastic cost reduction measures. In terms of the cost structure, we recognize that the cost ratio has not necessarily deteriorated, despite a decrease in sales.

Q. What is the time frame for the impact of ¥60 billion on revenue from the nomination suspension? I believe that the impact of the nomination suspension will end in H1, and revenue will recover in H2. Could you please comment on this?

A. Looking at the allocation of the ¥60 billion impact over H1 and H2, we believe that the impact is likely to be larger in H2. Although we plan to closely assess the situation in Q2, the impact started out at a low level in Q1 and increased slightly in Q2, so we believe the impact will increase further in Q3. The outlook should become largely clear by the end of H1. We don’t anticipate the situation to deteriorate more than initially expected. At this time, we believe the impact will end mostly within this year.

Q. Does this mean that within H1, you will have a clear outlook for orders?

A. Yes. That is how we see the situation.

Q. I believe that there still remains a surplus of about ¥7.0 billion on a full-year basis, based partly on the impact of the gain on sales of Renesas shares. Are you considering using this ¥7.0 billion to improve your earnings structure a little more?

A. We have budgeted for business structure improvement expenses of ¥10.0 billion and are considering our options for using this budget. We will address each measure individually. At this time, we are capable of addressing measures within our budget of ¥10.0 billion.