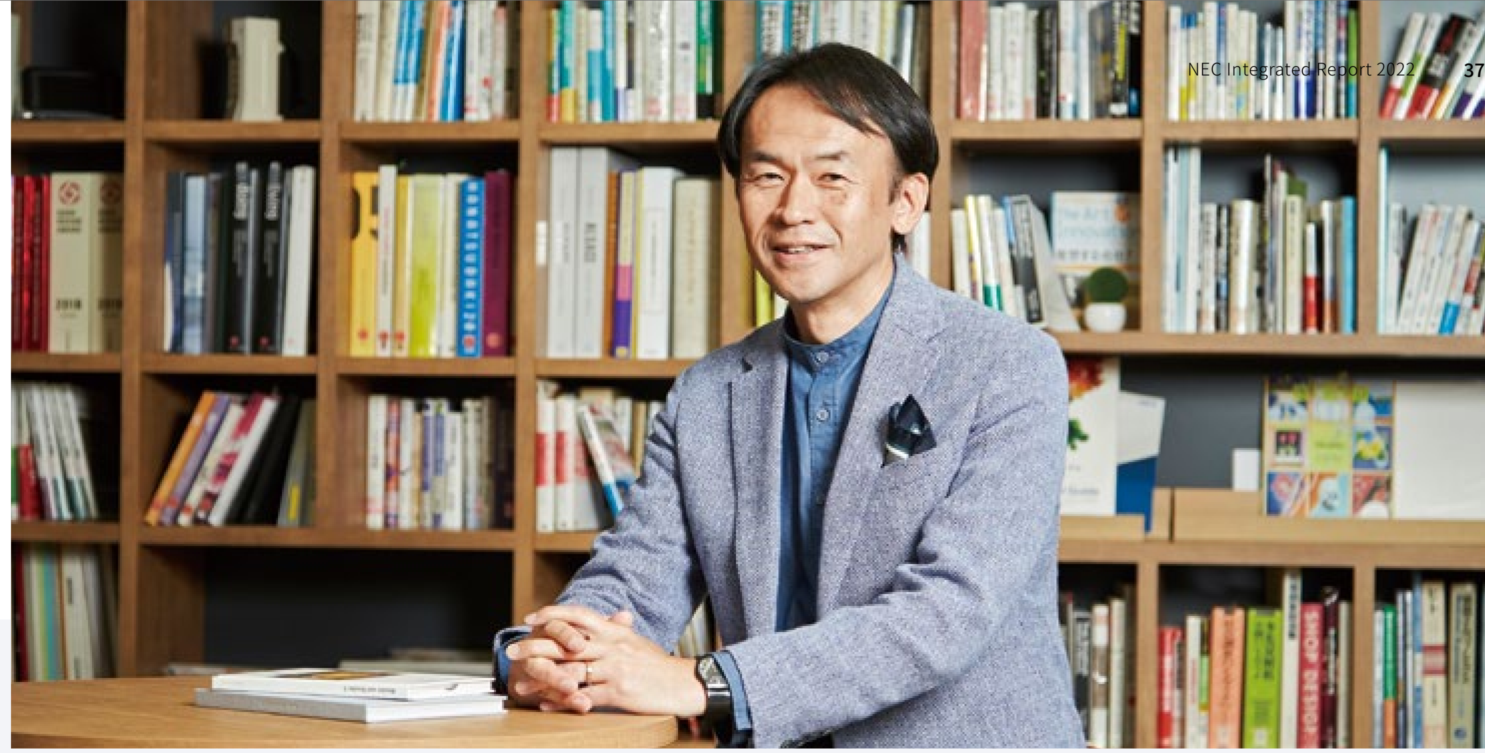
NEC's Business Model

CFO Message

Maximizing Long-term Profit, Optimizing Short-term Profit, and Increasing Corporate Value through Achieving the Mid-term Management Plan 2025



Osamu Fujikawa
Executive Vice President, CFO (Chief Financial Officer) and Member of the Board (Representative Director)

Maximizing Long-term Profit, Optimizing Short-term Profit

The Mid-term Management Plan 2025, which covers the period from fiscal 2022 to fiscal 2026, is driven by fundamental policy in which we gear our business activities toward generating cash, our source of growth, and then allocate capital to maximize long-term profit while optimizing short-term profit. This will create a profit cycle that will increase corporate value. We have also set indicators to measure achievement. For one of these indicators, EBITDA, we have set a target annual growth rate of 9%. To raise capital efficiency, we have adopted ROIC as an indicator and set our fiscal 2026 target at 6.5%. Beyond the financial aspect, we have established a policy for enhancing our non-financial measurement methodologies and will therefore invest in non-financial areas as part of our commitment to increase corporate value, and to do so in a sustainable way.

In fiscal 2022, the first year of the plan, we were hit by component shortages, but even so, we managed to increase revenue thanks in part to the expansion of our growth businesses as a result of increased shipments of 5G base stations, our collaborative work with ABeam Consulting in core DX, and other factors. While we made vast improvements to our operations, the impact from component shortages, higher strategic expenses, and a drop-off in one-time profits from fiscal 2021, among other negative factors, led to a decrease in adjusted operating profit of ¥7.2 billion from the previous fiscal year. On the other hand, we broke our record for adjusted net profit attributable to owners of the parent for the third consecutive year due to a decrease in tax expenses. In light of these results, and based on forecasts made at the beginning of the fiscal year, we paid an annual dividend to shareholders totaling ¥100 per share, reflecting a ¥10 increase.

In fiscal 2022, we reached our initial target for adjusted operating profit under the plan. In addition to reaping the benefits of investments made over the three years of the previous mid-term management plan, we aim to maximize long-term profit and optimize short-term profit through investments, with a view to long-term and meticulous business management. I believe this two-pronged approach has set a virtuous cycle in motion. By keeping this cycle moving, we can show that we have moved away from a company whose plans end unfulfilled to one that does what it says it will do. I for one want this to happen, and for us to win back the trust of the market.

Generating Cash for Strategic Investment

Over the course of fiscal 2022 to fiscal 2026, we intend to generate cash flows from operating activities amounting to ¥1.3 trillion. Our policy is to secure a certain amount of surplus in order to avoid missing out on investment opportunities, and to pounce on the right opportunities when they arise.

The shortage of parts and materials, which manifested around the summer of fiscal 2022, had a negative impact on business results, but thanks to Companywide efforts, we were able to limit the negative impact on operating profit to ¥8.0 billion. On the other hand, the strategic increase of our inventories conducted in response to these shortages resulted in a year-on-year drop in free cash flow of ¥68.3 billion, to ¥84.1 billion. In fiscal 2023, we plan to generate revenue amounting to ¥18.0 billion by bringing our inventory back to normal levels on the assumption that the shortage of parts will subside.

We will maintain appropriate control over temporary factors such as this shift in inventory as we continue to expand growth businesses, improve the profitability of base businesses, increase asset efficiency, and convert our assets to cash in line with our fundamental policy. This will generate the cash we need.

➤ Generating Cash by Improving Base Business Profitability

As CFO, I keep a close eye on low-profit businesses in an effort to improve the accuracy of our annual plans for base businesses. We have set an operating profit ratio of 7% or higher as a hurdle rate to determine which of these businesses should continue. As a first step to helping these businesses over this hurdle, I will sit down with the relevant business unit and hammer out a plan, and then implement measures for improvement. If a business cannot reach this hurdle rate by fiscal 2026, we will explore other options, such as reorganizing our business portfolio. Thanks to the work we have put in to date, we have steadily raised the profitability of NEC as a whole; and in fiscal 2022, we improved the adjusted operating profit ratio of low-profit businesses by 2.6%. In fiscal 2023, we plan to improve this ratio by a further 1% by stepping up these measures and optimizing our business structure, which will include downsizing some businesses and shifting resources.

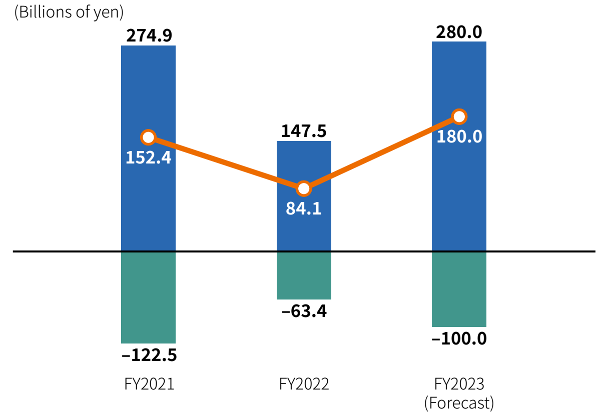
➤ Generating Cash by Improving Capital Efficiency

Since the previous mid-term management plan, we have engaged in activities to shorten our cash conversion cycle (CCC), which is ultimately an effort to improve capital efficiency. As a result, we reduced our CCC by 12 days over the course of two years, from 72 days as of March 31, 2019 to 60 days as of March 31, 2021. As of March 31, 2022, this number has rebounded to 66 days, but this is due to our decision to strategically increase inventories that I alluded to earlier. If we exclude this extenuating circumstance, we actually shortened our CCC even further, to 58 days. Until fiscal 2021, corporate headquarters had a hand in efforts to improve NEC's CCC, but in fiscal 2022, the leaders of each business unit proceeded with their efforts and achieved improvements with autonomy. I believe the heightened awareness of capital efficiency coupled with cultural reforms is steadily building up our execution capabilities.

This is important because, under the Mid-term Management Plan 2025, we are transitioning from profit and loss-centered management to management that emphasizes capital efficiency. ROIC is generally the go-to indicator for measuring capital efficiency, but in addition to ROIC, we will emphasize various other efficiencies relevant to business activities such as the efficiency of human capital and production. However, if we place too much emphasis on efficiency, we will restrain top-line growth in growth businesses and new businesses. Therefore, instead of monitoring efficiency throughout NEC with a one-size-fits-all approach, we will adopt a long-term perspective and expand the range of indicators we can apply to each business in order to match its specific nature. As an example, for fiscal 2023, we will set management indicators such as free cash flow or EBITDA, which are best-suited to each business, and then build logic trees for these businesses to determine key performance indicators (KPIs) that will play an integral role in formulating plans and steering operations for fiscal 2024.

Free Cash Flows

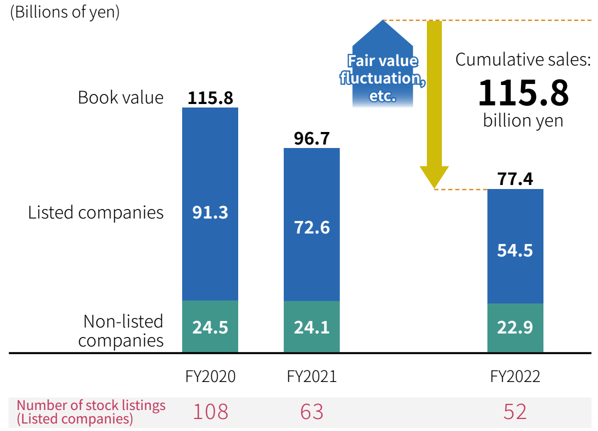
(Billions of yen)



■ Cash flows from operating activities ■ Cash flows from investing activities
○ Free cash flows

Sales of Investment Securities

(Billions of yen)



We will maintain an appropriate surplus for strategic expenses and investments, and invest when the right opportunity arises.

We are working to build an understanding of capital costs among division general managers to ensure this strategy works effectively. Profit is undoubtedly important. The idea here is to have a shared understanding throughout NEC that, as a company, we have an obligation to the capital market and financial institutions to generate profit that exceeds capital costs—in fact, this duty is how NEC is able to exist—while also using the targets set for fiscal 2024 as a means to further improve capital efficiency throughout the Company.

Generating Cash by Converting Our Assets

In April 2020, we set guidelines for eliminating cross-shareholdings. This, coupled with our transition to the Prime Market segment of the Tokyo Stock Exchange, means that we have an even greater obligation to justify whatever cross-shareholdings we have in our possession. These shares are subject to comprehensive annual review by the Board of Directors, in which the Board clarifies the strategic value of each holding and considers the returns in terms of capital costs and other perspectives. If the Board accepts the rationale for a holding, it is kept; if not, it is sold. In fiscal 2022, we sold shares in nine stock listings worth ¥19.5 billion. Compared with fiscal 2020, or over the course of two years, we have reduced our cross-shareholdings in listed companies from 108 to 52.

In addition to cross-shareholdings, we are actively monetizing available-for-sale non-core assets so that we can allocate these funds to growth areas and areas that can generate synergies.

Capital Allocation

We plan to allocate cash generated by the measures I have mentioned toward strategic expenses, which will increase corporate value and help maintain a surplus for future investments. We will then seize opportunities to actively invest in growth drivers and fields when they appear. As for our financial structure, we improved both our owners' equity ratio and net D/E ratio, and over the medium term, we aim to maintain the financial structure applied as of March 31, 2021, a structure that afforded us an upgrade by credit rating agencies. Regarding dividends, our basic policy is to maintain stable dividends with a target payout ratio of roughly 30% on average over a five-year period.

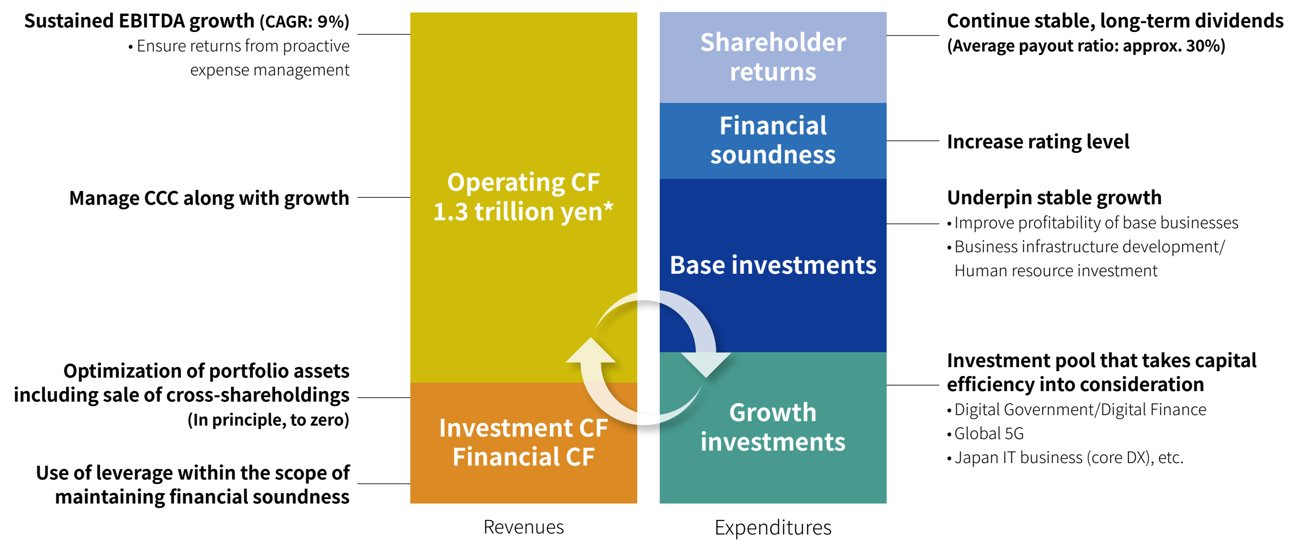
In addition, we have made the decision to acquire treasury shares amounting to ¥30.0 billion over the course of August 30, 2022 to March 31, 2023. This decision was made to send a clear message to the market after a comprehensive assessment of stock prices relative to our improved financial structure and outlook. Altogether, we will adhere to our basic policy for capital allocation in which we prioritize investment opportunities for growth and provide returns to shareholders under the aforementioned dividend policy and via capital gains achieved by higher earnings and the corresponding increase in corporate value.

Our basic policy for strategic expenses is to make investments from cash flows from operating activities in growth businesses while improving the profitability of existing businesses; this includes active investment in the business infrastructure and human resources that support it. In fiscal 2022, we made a balanced investment of ¥73.0 billion toward these strategic expenses, an increase of ¥26.0 billion from fiscal 2021. The announcement of these planned investments was met with a negative response in the stock market, since the increase caused our performance to fall below our plan for the fiscal year. To avoid this from happening again in fiscal 2023, we will use the strategic expense amounts from fiscal 2022 as our baseline; and if we make increases in an investment for a particular segment, we will only do so within the scope of profit improvements in that segment. This will help us manage these expenses and ensure that we do not dampen our performance.

Non-financial Strategies for Enhancing Corporate Value

Year after year, as social issues become increasingly complex and the demand for disclosure becomes increasingly strong, the importance of management based on integrated thinking is becoming increasingly important. There is a call to go beyond disclosure of non-financial information at the request of external parties, and to also provide non-financial strategies that both show a clear link to the financial aspect of a company and offer a logical explanation of how the strategies will improve corporate value in a sustainable way. In response, we are employing external evaluations and discussions held by the Sustainability Advisory Committee, which was established in 2022, to identify and correct any deficiencies in our disclosure and to make our explanations more logical. We are also working with Group company ABeam Consulting to conduct a causal analysis between indicators of corporate value and non-financial data and initiatives. I would like NEC to analyze and utilize non-financial indicators as part of data-driven management while we continue to accumulate data.

Profit Cycle and Capital Allocation



* FY2022–FY2026 total

Financing as Management for Sustainability

In July 2022, NEC issued Japan's first sustainability-linked bond with three maturities via a public offering in the domestic corporate bond market. The issuance of the bond is an example of NEC using financing to show its strong commitment to one of its material issues (materiality), "environmental action with a particular focus on climate change (decarbonization)." These SDGs-based financing initiatives are the NEC Group's "Purpose" put into practice, and provide a way for us to engage in dialogue and co-creation with a variety of stakeholders related to our management of sustainability initiatives.

Final Remarks

In fiscal 2023, we intend to increase revenue by 3.8%, with this increase centered on growth businesses. Taking into account the additional profit from increased sales, we have also forecast an adjusted operating profit of ¥185.0 billion. Although the business environment remains uncertain due to factors including the restricted supply of components and yen depreciation, we will maintain a steady course by capitalizing on the robust demand for DX and making full use of our ability to respond to situational change. In addition, we have disclosed our earnings forecasts for fiscal 2023 on a non-GAAP basis. This is due to the fact that NEC's senior management emphasizes non-GAAP-based indicators that include Purchase Price Allocation (PPA) amortization to measure underlying profitability.

We are in a time marked with instability and an inability to predict future business conditions. It is becoming less tenable for companies to survive based on what worked in the past. This, however, also upends the competitive environment, making it easier for new opportunities to arise. With the digitalization of processes and other areas and the accumulation of data, NEC is primed to harness its technological assets—its AI, its security technology, and its engineering capabilities—to expand the areas where it can generate social value to a significant degree. Our AI drug development business symbolizes this perfectly, as a field that no one could have imagined in the past, and one that NEC had never been involved in previously.

Looking ahead to the NEC 2030VISION, we will combine NEC's strengths and provide value to society. By doing so, we hope to achieve the goals of the Mid-term Management Plan 2025 and make sustainable improvements to corporate value.