CFO Message

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

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Completion of the Second Year of the Mid-term Management Plan 2025

The Mid-term Management Plan 2025, which covers the period from fiscal 2022 to fiscal 2026, is driven by a fundamental policy in which we continuously improve our ability to generate cash from our business activities by maximizing long-term profit and optimizing short-term profit, and enhance corporate value through active investment. 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%.

We have completed two years of the Mid-term Management Plan 2025 and are currently at the halfway point, the third year. Although we faced changes in the external economic environment, such as component shortages that emerged in the second quarter of fiscal 2022, and volatile exchange rates and price increases in fiscal 2023, we were able to minimize the impact of such issues by promptly formulating and implementing Company-wide policies and measures. In the global 5G business, one of our growth businesses, we incurred temporary cost increases due to delayed market rise of Open RAN when compared to our initial expectations. Despite these issues, we were able to deliver results over the past two years that exceeded the revenue and adjusted operating profit forecasts set at the beginning of each year. This was accomplished by achieving a Company-wide balance through efforts such as turning strong domestic DX demand into business opportunities and steadily improving the profitability of low-profit businesses.

In parallel with these business activities, we implemented two initiatives to strengthen the management systems that support our efforts to achieve the Mid-term Management Plan 2025. The first initiative was the building of logic trees aimed at improving Company-wide corporate value. Through this process, we established optimal indicators not only for revenue and adjusted operating profit but also for capital efficiency in line with the characteristics and stages of individual businesses, and began applying these indicators in fiscal 2024. The second initiative was organizational reforms. In fiscal 2023, we introduced a flatter organizational structure by reducing hierarchy and transferring authority to facilitate dynamic and flexible resource allocation and faster decision-making. In fiscal 2024, we have established a business structure based on the strategic elements of the Mid-term Management Plan 2025, including the integration of related divisions to accelerate the core DX business and the ramping up of our efforts toward the digitalization of government and in the national security domain.

Through these measures, I believe that the Company has produced solid results in the first two years of the Mid-term Management Plan 2025 while steadily establishing a management foundation for achieving the goals set forth in the plan. We will continue to work toward achieving these goals while promptly and flexibly responding to changes in the business environment.

Generating Cash

In fiscal 2023, free cash flow was ¥102.5 billion, a year-on-year increase of ¥18.4 billion. While we are still feeling the impact of the component shortages, inventories have been reduced to appropriate levels following the strategic buildup of stock in response to said shortages in fiscal 2023. Meanwhile, the improvement in operating cash flow was modest due to a temporary increase in working capital as sales were more heavily weighted toward the end of the fourth quarter than previously due to an imbalance in the timing of 5G investments made by domestic telecommunications carriers and other factors.

In fiscal 2024, we plan to generate ¥150.0 billion in free cash flow by leveling out our strategic inventories and temporary increases in accounts receivable and returning working capital to normal operating levels.

Over the past two years, the expansion of free cash flow has stagnated slightly due to the decision to respond to the macroeconomic environment as a priority. However, in accordance with the basic policy set forth in the Mid-term Management Plan 2025, we will continue to promote cash generation by increasing profits through boosting business profitability as well as improving asset efficiency and converting assets held to cash.

Generating Cash by Improving Business Profitability

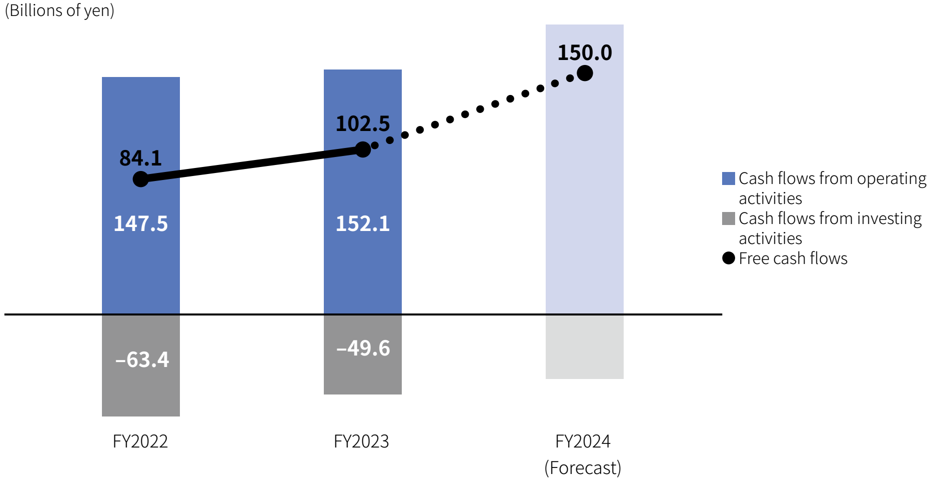
In order to expand Company-wide business profits, I believe that it is important to expand growth businesses outlined in our business strategy and to increase the profit margins of low-profit businesses. As CFO, I am hands-on in monitoring the improvement of our low-profit businesses. We have set an operating profit ratio of 7% as a hurdle rate to determine whether a business should continue operating. For businesses that do not meet the hurdle rate, I will sit down with the relevant business unit and hammer out a plan to increase the operating profit ratio to 7% or higher and implement measures for improvement. Thanks to the work we have completed to date, we have steadily raised the profitability of those businesses as a whole; and in fiscal 2023, we improved the adjusted operating profit ratio of low-profit businesses by 2.4%, to just over 6%. In addition, four of the 16 businesses that we have been monitoring since fiscal 2022 have transformed their business structures, enabling them to generate stable profits, while four other businesses are also making steady improvements. Meanwhile, for those businesses that are deemed unlikely to achieve the hurdle rate by fiscal 2026, we will consider significant structural reforms, including partnering and carve-outs, as options to remove them from the portfolio.

Generating Cash by Improving Capital Efficiency

Since the previous mid-term management plan, we have been engaging 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. However, from fiscal 2022 onward, due to the strategic increase of inventories to cope with component shortages and sales leaning heavily toward year-end, our CCC rebounded to 70 days at the end of March 2023. Even excluding these special factors, the number currently stands somewhat higher than desired at 64 days. In fiscal 2024, we will first ensure that levels of these temporarily accumulated assets are normalized while simultaneously promoting further improvements by once again encouraging the leaders of each business unit to take action autonomously.

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 operation. However, placing too much emphasis on efficiency in new and growth businesses could curtail growth-oriented investments. As such, it is important to set targets for indicators that are in line with the characteristics and stages of each business, rather than aiming for Company-wide uniformity. In the process of constructing the logic trees mentioned at the beginning of this message, appropriate indicators and numerical targets were selected for each business, for which PDCA implementation has begun in earnest in fiscal 2024. To enhance the effectiveness of this approach, we promote a shared understanding throughout the Company that we have an obligation to capital markets to generate profit that exceeds capital cost for our continued existence as a company, and we intend to further improve capital efficiency.

Free Cash Flows
(Billions of yen)



Generating Cash by Converting Our Assets

In April 2020, we set guidelines for eliminating cross-shareholdings. All cross-shareholdings possessed by NEC are subject to comprehensive annual review by the Board of Directors, in which the Board clarifies the strategic value of each holding and considers 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. Compared with the end of March 2020, over the course of three years, we have reduced our cross-shareholdings in listed companies from 108 to 33. We have already agreed upon the sale of many of the remaining 33 cross-shareholdings and are waiting for the right time to sell. As such, we have reached a point where we have, in principle, eliminated cross-shareholdings in listed companies. As for unlisted stocks, there are some that will take time to eliminate due to the circumstances that surrounded them from the time of investment, but we will continue to put forth our utmost efforts to do so.

In addition to cross-shareholdings, the Board also assesses the significance of continuing to hold real estate and other assets and actively promotes the conversion of such holdings into cash.

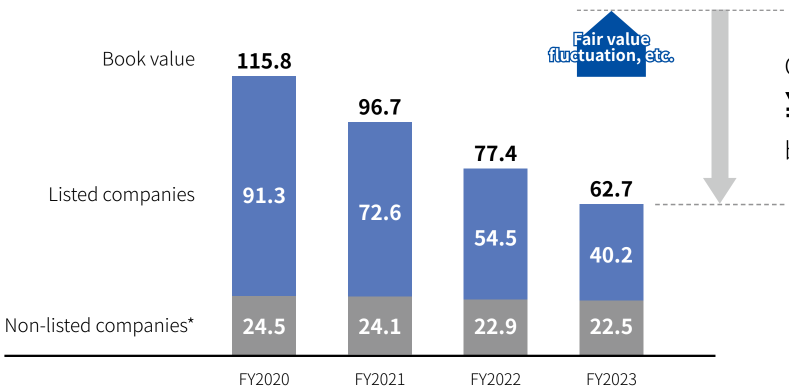
Capital Allocation

Through the measures I have mentioned, we aim to generate ¥1.3 trillion in operating cash flow over the five-year period from fiscal 2022 to fiscal 2026. Our policy is to retain the cash generated as surplus funds for investments in areas that will become growth drivers in the future, as opportunities arise aimed at increasing corporate value while prioritizing stable dividends and maintaining financial soundness. We will use the level of financial soundness currently evaluated by credit rating agencies as a guideline to be maintained over the medium term. Our basic dividend policy is to maintain a stable dividend payout ratio of approximately 30% on average over the five-year period.

In the dynamic ICT market, there is an abundance of investment opportunities for business expansion. Our basic approach to capital allocation is to translate these investment opportunities into the expansion of revenue and the enhancement of corporate value, thereby realizing capital gains and maximizing returns to shareholders while maintaining the stable dividends mentioned above.

Sales of Investment Securities

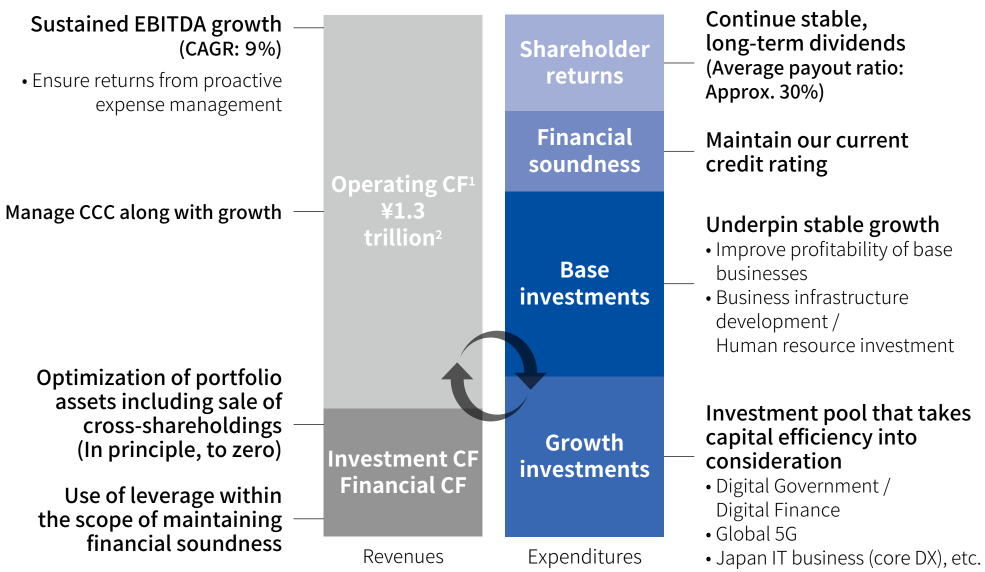
(Billions of yen)



	FY2020	FY2021	FY2022	FY2023
Number of stock listings (Listed companies)	108	63	52	33

* Excluding alliance companies

Profit Cycle and Capital Allocation



1 CF = Cash flow 2 FY2022–FY2026 total

Non-financial Strategies for Enhancing Corporate Value

Year after year, as social issues become increasingly complex and the demand for disclosure becomes increasingly strong, management based on integrated thinking is becoming increasingly important. Positioning non-financial strategies as an important foundation for sustainable growth, we not only disclose non-financial information in response to requests from external parties but also aim to utilize non-financial information for the sustainable enhancement of corporate value by further clarifying the link between non-financial strategies and financial aspects of the Company. In addition to working to reduce capital costs over the medium to long term from a risk management perspective, we will leverage the know-how we have developed through our in-house efforts to address issues such as climate change and information security to propose solutions to our customers, leading to expanded business opportunities and increased free cash flow. We are also conducting a causal analysis between indicators of corporate value and non-financial data and initiatives. I would like to incorporate non-financial indicators into data-driven management while we continue to accumulate data.

In July 2023, NEC issued a Sustainability-Linked Bond via a public offering in the domestic corporate bond market, the second issuance following that of last year's. 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 they 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 2024, we intend to increase revenue by 2.0% and increase adjusted operating profit by approximately ¥15.0 billion, to ¥220.0 billion, through increased sales and efforts to improve profitability. Although the business environment remains uncertain due to concerns over economic recession caused by soaring global prices and geopolitical risks, we will strive to ensure steady business execution by capturing strong DX demand and fully leveraging our ability to respond to situational changes.

Also, from fiscal 2024, we will start to disclose non-GAAP profits and losses in addition to conventional adjusted profits and losses. This is to show more intrinsic profitability by removing one-time gains and losses such as expenses related to restructuring, impairment losses, and gains and losses on sales of real estate and businesses, as well as purchase price allocation amortization and other expenses recorded as a result of M&As, which are accounted for in conventional adjusted profits and losses. The practice of adjusting for these nonrecurring items is common in capital markets worldwide, and by reporting profits and losses in such a way, NEC intends to increase its comparability with global competitors.

We are in a time marked by 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. It could also be said, however, that such dramatic changes in market conditions make it easier for new opportunities to arise. With the digitalization of the world around us and the accumulation of data, NEC is seeing a major expansion in the areas in which it can generate social value by making full use of its AI and security technologies, as well as its engineering capabilities that leverage these technologies. The drug development business, which was once far remote from the world of NEC's businesses, has now emerged because the digitalization of genetic information, starting with the sequencing of the human genome, and the development of immunology have advanced in sync with the evolution of AI technology.

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 generate sustainable growth in corporate value.