April 26, 2013

Q&A for "Earnings Presentation for Fiscal Year Ending March 2013" and "Mid-term Management Plan 2015"

Date/Time: April 26, 2013 18:30-20:10
Location: NEC Headquarters, Tokyo
Presenters: Nobuhiro Endo, President
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Questioner A

Q. You explained NEC is seeking growth overseas, but targeting overseas sales to grow 16% a year in the Mid-term Management Plan 2015 is quite ambitious in my opinion. By contrast, the plan projects domestic sales to continue declining slightly. Could you name the divisions with declining sales projections in Japan and, conversely, rising sales projections overseas? Please provide a breakdown of domestic and overseas sales projections. Also, assuming that most of the profit will come from Japan, I would appreciate it if you could provide a breakdown of domestic and overseas profit projections, as well.

A. While we are currently in the red overseas, our major goal is to see this break even by fiscal 2015. In Japan, net sales will certainly decline in the Carrier Network segment as it currently stands, and we are also forecasting them to decline in the Others segment.

Overseas, we aim to increase net sales from approximately ¥500 billion at present to around ¥750 billion by fiscal 2015, or the year ending March 31, 2016. This also takes into consideration a decline in sales from the deconsolidation of NEC Mobiling, Ltd.. The aim is to reverse the tide and turn our overseas operations profitable once sales hit ¥750 billion.

Q. Monetary easing has tipped the Japanese economy toward recovering, while the yen's weakening is also a blessing for your overseas business. If business is to improve, where do you expect it to improve more, in Japan, or overseas? Also, how realistic is it to seek growth overseas amid economic conditions in Japan recovering?

A. We are also combing for growth areas in Japan within the information and communications technology (ICT) field. To provide you a few basics to work with from a historical perspective, capacity of carrier networks has broadened 1,600 times since the popularization of the Internet, while the processing power of a PC has increased 100 times. There is a surplus capacity in cloud platforms now, which if fully utilized will enable all sorts of services to be transformed by ICT and operate on a real-time basis. Once this happens, services have been increasingly moving into the cloud. This market change in the ICT field is where NEC can contribute most, and we see no boundaries separating domestic from overseas markets in this wide new open market. While this market will give foreign suppliers ready access to Japan, it will also enable NEC to actively set foot abroad and acquire strengths that can ultimately be used in bolstering our position back in Japan. As ICT demand is global, we run the risk of losing our grip of domestic demand unless we stay competitive in Japan while gaining a foothold in the volume zones abroad. Our competitive edge in Japan is something we can lose unless we grow less hung up on domestic demand to pursue business volume overseas at the same time. Our current thinking is that we need a holistic approach to business development, and that this includes the overseas markets.

Questioner B

Q. What was the impact of foreign exchange in the fiscal year ended March 31, 2013, and what are your estimates of foreign exchange rate sensitivity in the upcoming fiscal year?

A. Against an initial assumption of 1 U.S. dollar=75 yen, NEC's exchange rate on net sales averaged 82 yen to the U.S. dollar for the year ended March 31, 2013. Considering that this exchange rate weakening 1 yen was estimated to have had a positive impact of around 0.5 billion yen on profitability, the 7 yen difference in effect bolstered operating income 3 to 4 billion yen. By contrast, our initial exchange rate assumption for the year ending March 2014 is 1 U.S. dollar=90 yen. Given the yen's strong exchange rate during the six months ended September 30, 2012, our response was to eliminate foreign exchange impacts as much as possible. NEC's foreign exchange rate sensitivity this term is estimated at around 0.3 billion yen for each 1 yen differential. We have positioned the Company to be less affected by FOREX, regardless of whether the yen strengthens or weakens.

Q. How much were NEC's underfunded retirement benefit obligations as of March 31, 2013? Also, what would be the impact of accounting for this shortage in retirement benefit reserves on-balance sheet?

A. The Company's balance of pretax underfunded retirement benefit obligations grew from approximately 200 billion yen as of March 31, 2012, to around 250 billion yen as of March 31, 2013. Approximately 70 billion yen of this change was the impact of lowering the discount rate from 2.5% to 1.4%, in step with sharply falling interest rates in March 2013. This was partly offset by improved financial performance in the management of retirement benefit assets. The result was a net 50 billion yen deterioration in this unfunded exposure to 250 billion yen.

Q. What countermeasures do you have for accounting for this shortage in retirement benefit reserves on-balance sheet?

A. We don't think the impact is that considerable. As the deterioration in retirement benefit reserves would work out to be 150 billion yen from 120 billion yen, on an after tax basis with the 40% of effective tax ratio, the impact would be around 30 billion yen.

Q. How would this affect shareholders' equity?

A. Total shareholders' equity of 710 billion yen would decline another 150 billion yen if this exposure were to be recognized on-balance sheet. We need to determine the taxation rate first but I would like to mention that 65 billion yen out of 130 billion yen of hybrid financing will be added back to total shareholders' equity for credit rating purposes.

Q. Consolidated forecasts for this fiscal year call for 70 billion yen in ordinary income and 20 billion yen in net income. How much profit before income taxes are you forecasting including the 16 billion yen profit from divesting NEC Mobiling, Ltd.? Also, what is your estimate of the taxation rate?

A. We will have a gain from divesting NEC Mobiling, but we also assume the budgeted extraordinary losses. The 20 billion yen net income forecast for the year ending March, 2014 assumes that tax effects cannot be recorded for some of the amortization of goodwill from acquisitions. Also, the forecast assumes that some of the earnings of profitable subsidiaries will be reduced by minority interests.

Q. Does this mean that the 44% taxation rate in the year ended March 31, 2013 is expected to revert back to more than 50% this fiscal year?

A. For tax reasons, the stocks in Nippon Electric Glass Co., Ltd. that NEC sold in the last fiscal year had been provisioned for deferred tax liabilities. Those reserves were contributed for investment in retirement benefit trusts. Selling the stocks means the tax liabilities come due, however. Although the estimates may lean a little on the conservative side, this was an assumption that also went into our taxation estimates for the year ending March 31, 2014.

Q. How much was the charge on inventory revaluation NEC took in its mobile handset business in the year ended March 31, 2013?

A. There were smaller shipments than the sales plan in the three months ended March 31, 2013. This resulted in the provisioning of almost 10 billion yen in inventory evaluation losses.

Q. Your competitors, for example, have pulled out of manufacturing sales while leaving behind a sales company in the mobile handset business, whereas NEC appears to be doing the opposite. Does this mean further drastic steps in structural reforms are in order? Or, was it only a coincidence that the sales company's exit came first? Please provide us with some more guidance.

A. For the past year, NEC has said that the mobile handset business cannot remain commercially viable without a certain amount of business volume. At present, NEC is seeking out partnerships with vendors who supply overseas market. With regard to the mobile sales business of NEC Mobiling, Ltd, it is currently profitable. However, it is clearly evident that it will become increasingly difficult to ensure business volume going forward. Once favorable conditions are in place, we plan to implement structural reforms step by step.

Questioner C

Q. You said that Renesas Electronics does not have any downside risk from an accounting standpoint. However, I believe that certain unrealized losses and valuation losses have not been treated as deductible expenses for taxation purposes. If NEC were to sell its Renesas Electronics shares, would this provide a source of funding for its tax expenses?

A. The sellout of Renesas Electronics shares is subject to a two-year lock-up provision, and so we are not considering selling these shares at present. Assuming that NEC sells these shares in the future, the share sales would be reflected in taxes and incorporated into tax effect accounting. Currently, we have provided valuation allowances for these shares. For accounting purposes, NEC has not recorded any tax effects because all of the shares have been provided for.

Q. What was the extent of the losses of NEC CASIO Mobile Communications, Ltd. in the fiscal year ended March 31, 2013? And what is your projection for the fiscal year ending March 31, 2014? You alluded to negotiations under way with overseas partners. I don't think spending too much time on this will be good when considering the future. Do you have some options if talks on partnerships fall apart?

A. NEC CASIO Mobile Communications recorded losses of 40 billion yen in total, including over 20 billion yen in operating losses and more than 15 billion yen in impairment losses, in the last fiscal year. We do not expect extraordinary losses in this fiscal year, but neither do we see this company turning profitable.

Q. But isn't the improving business performance of this company a factor behind NEC projecting an increase of around 30 billion yen in net income for the fiscal year ending March 31, 2014?

A. The outlook here is for NEC CASIO Mobile Communications to post a loss in the first half, and then break even in the second half of the upcoming fiscal year. The operating loss we are assuming is just over 15 billion yen in the first half, and we don't expect this loss to be recovered by the end of the fiscal year.

Q. I don't get the impression business environment improvements have been factored into NEC's net sales and operating income projections. By this I am referring to Prime Minister Shinzo Abe's so-called "Abe-nomics" economic stimulus policies, and business conditions picking up in the social systems field. Is NEC implying that this has been factored into the projections but that the upside is limited? Or, is NEC looking to a slow start for the fiscal year, despite appreciating the uplifting turn of events in qualitative terms?

A. As the fiscal year ending March, 2014 is the first year of the Mid-term Management Plan 2015, there was a considerable amount of upfront investments factored into the projections. This is why there is a slight dislink between sales increase and profits growth. There was some priority in solidifying the groundwork.

Q. How much was the subtotal for loss-making contracts in the IT services business? Will any of this be carried over into this fiscal year?

A. The loss-making contracts in the last fiscal year were around 14 billion yen. We are operating under the assumption that there's a certain constant in project cost overruns each fiscal year, but even taking that into account, I don't think the deficit in the upcoming fiscal year will be as much as in the last.

Questioner D

Q. NEC has forecasted a decline in eliminations to 52 billion yen in the fiscal year ending March, 2014, from 61 billion yen in the previous fiscal year. This doesn't match with the comment on increased investments you just made. What items under this expense account are you forecasting to decline?

A. The strategic investments are for NEC as a whole, and for each business units. Eliminations include corporate-wide investments for new and other selected fields that can't be classified yet under any of our business units. In contrast to a 20 billion yen budget, our corporate-wide strategic investments in the last fiscal year were actually 14 billion yen. This budget was lowered to around 10 billion for this fiscal year. Meanwhile, a growing number of investments in new and other select fields were reclassified for development under the existing business units.

Q. That explanation accounts for a 4 billion yen decline in this expense. Apart from that, what else is NEC doing?

A. We have company-wide initiatives for reducing expenses.

Q. How much will fixed costs in the mobile handset business decline as a result of recognizing 15 billion yen in asset impairment losses?

A. This 15 billion yen loss was mainly on software assets. While normally there is a two-year depreciation applied on software assets, we depreciated in lump sum. It will reduce fixed costs from 5 to 10 billion yen for the year.

Questioner E

Q. Once again, please explain the process of reaching 10% ROE, the recognition of pension reserve shortfalls on-balance sheet, hybrid finance, and net income, among other factors reducing shareholders' equity from 710 billion yen as of March 31, 2013, to a projected 600 billion yen on March 31, 2016.

A. NEC is primarily attempting to quantify the impact of accounting for unrecognized liabilities on-balance sheet, as well as dividend payouts, on the 710 billion shareholders' equity balance as of March, 2013. Around 600 billion yen is what we estimate would be left in the balance after subtracting these.

Q. Would that imply trying to hold the current level of dividends and consolidated net income constant in the fiscal year ending March, 2015, as well?

A. We would like to increase dividends a little more, provided a plan in which they are increased after securing a certain level of profit. This is to say that we plan to secure a net income in the fiscal year ending March, 2015 that is not far off from the ¥30.4 billion we posted in the last fiscal year.

Q. As I recall, operating income had outpaced NEC's projections by around 60 billion yen for the first nine months of the fiscal year ended March, 2013. I also understand that the mobile handset business underperforming targets and an outperformance in the IT services business year on year in the fourth quarter significantly impacted NEC's full fiscal year results. Please explain what you have done to address volatility from one quarter to another to re-establish some balance to quarterly earnings? My concern is, If the surge in the first nine months was an anomaly, what assurances do we have that in the upcoming fiscal years, that NEC will return to its perennial cycle of securing profit in the fourth quarter?

A. If we consider those two factors—namely, reduced earnings increase in the fourth quarter compared to previous fiscal year, and slowing momentum in the mobile handset business—it appears that NEC's financial performance was frontloaded in the fiscal year ended March, 2013. In that regard, I admit that our fourth quarter figures were low. At the same time, I don't think that our financial performance will decrease that much in the upcoming fiscal year. We have activities compressing the cash conversion cycle (CCC) that should speed up accounting recognition of sales and collection of receivables. We do not expect that earning in the fourth quarter of this fiscal year will be as depressed as in the fiscal year ended March, 2013, but from our efforts to achieve more balanced earnings recognition, we also do not expect as much of a back-end load to the fourth quarter as we had in the past

Q. Please provide some year-on-year guidance on the first half of the fiscal year ending March, 2014.

A. NEC is headed in the direction of profit on an operating basis in the first half. In the first half of the last fiscal year, there was a frontloading of sales from the second half of the year. So we couldn't compare them under the same conditions, but we are aiming to make an operating profit.

Questioner F

Q. Allow me to reconfirm the variance analysis of operating profit in the Mid-term Management Plan 2015. If I'm not mistaken, the plan calls for securing operating income of between 140 to 150 billion yen. You show this in the analysis as the end result of reversing a 10 billion yen deficit from deconsolidating NEC Mobiling and boosting operating income to around 140 billion yen on cost reduction, and then edging this closer to 150 billion yen by reducing losses overseas. As a framework, is it fair to assume that this plan can be achieved if NEC succeeds in reducing costs?

A. Cost reductions in the period of Mid-term Management Plan 2015 will be 30 billion yen against fiscal year just ended, but some of this was unraveled by sales prices falling, among other factors. NEC will carry on with cost reductions as a matter of course, and build up some downside resistance. But cost reductions are not the main subject of this mid-term plan.

Q. Why wasn't the end result in operating income higher for the fiscal year just ended, given 40 billion yen in fixed cost reductions and the patent income NEC received apart from this? Please elaborate on NEC's internal targets for the last fiscal year.

A. NEC in fact outperformed its internal target for 100 billion yen in operating income. What we didn't see coming was the 20 billion loss in the mobile handset business. Initially we had expected operating income to be higher by that amount.

Q. What are your thoughts regarding NEC's balance sheet projections for March, 2016? With 600 billion yen of shareholders' equity, 600 billion yen of interest-bearing debt, and a 130 billion liability on hybrid finance borrowings, I don't get the impression net income projections for 20 billion yen this upcoming fiscal year, to 40 billion yen the following year and 60 billion in the year ending March, 2016 will give NEC much financial flexibility.

A. The 600 billion yen shareholders' equity estimate in the plan exclude a 65 billion yen add-back from half of the proceeds of hybrid financing. While the standard for recognizing this as equity differs from an accounting and credit rating standpoint, this proportion will be recognized as equity by credit rating agencies.

Questioner G

Q. Please provide us some guidance for the fiscal year ending March, 2015, as a midway point to the Mid-term Management Plan 2015. The plan points to about 40 billion yen in net income that year. Where do you place your free-cash flow estimate at the midway point, given that it's projected to over 42 billion yen and 100 billion yen in the initial and final fiscal year of the plan?

A. We will need to carefully monitor the business environment as the fiscal year ending March, 2015 approaches. At present our financial estimates that year are on the understated side taking the increase in a consumption tax rate into account. Free cash flow estimates will depend on our CAPEX allocation, which I don't think will be all that high, even though we want them allocated mostly in the first two years of our three-year plan.