April 28, 2015

Earnings Presentation Q&A for Fiscal Year Ending March 2015

Date/Time: April 28, 2015 18:00-19:10

Location: NEC Headquarters, Tokyo

Presenter: Nobuhiro Endo, President

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Questioner A

Q. Operating income has been improving. What will be the potential for profits after you have established a ground for global expansion?

A. Until now, the IT business in Japan was a one-to-one business. We provided value to customers by customization. Looking ahead, we seek to build "One to Many" platforms based on our knowledge of "the many" and thereby transform NEC in the IT area as well. In doing so, we intend to boost the profitability of the IT business. That said, NEC has not put these sorts of processes in place until now. Therefore, one of our key priorities will be to build these processes up from scratch.
Looking at the international business, we have held matrix meetings that bring together executives from our regional headquarters. At these meetings, we have discussed the question of where value lies for our overseas customers. To deliver this value to our overseas customers, we plan to provide highly profitable, high-value "One to Many" platforms in such fields as safety.

Q. NEC currently generates most of its sales in Japan. However, by the time that the overseas sales ratio has increased to around one-half, can I expect that the "One to Many" platforms will have penetrated the international market and that profitability of the international business will be higher above than it is in Japan?

A. That's what we are expecting.

Q. Adjustment was -52.4 billion yen for the fiscal year ended March 2015 (hereafter Fiscal 2014) and is projected at -63.0 billion yen for the fiscal year ending March 2016 (hereafter Fiscal 2015.) I believe that adjustment includes the expenses of NEC's Central Research Laboratories. How much improvement can we expect to see from your measures to enhance cost competitiveness?

A. Adjustment includes the expenses of NEC's Central Research Laboratories, in addition to the expenses of corporate staff division. We will now begin standardizing processes through measures to enhance cost competitiveness. However, we can't reduce the back-office workload by 30% overnight, so we will need to make progress at a measured pace. In Fiscal 2015, we expect a temporary increase in cost outlays such as initial investments needed to reach this goal as well as other IT system investments.

Q. Considering NEC's business fields, what do you think is an appropriate term of office for CEO?

A. In my personal opinion, I believe that a term of office of four years would be too short. Because each of our mid-term management plans covers a period of three years, I believe that two consecutive three-year periods would span an appropriate term of office. Beyond that time frame, I believe that the CEO's appointment should be reviewed regularly every three years.

Questioner B

Q. Operating income has steadily improved from the 50.0 billion yen to 70.0 billion yen level, and is now on track to reach 135.0 billion yen. However, operating income target has not been set to reach your mid-term management goal. Changes in the business environment were cited as reasons, but I also believe that NEC's performance was impacted by ordinary business risks in some respects. Were there any changes in the business environment that you did not anticipate when formulating the mid-term plan? Or were there initiatives that you were unable to implement?

A. Net sales were significantly impacted by delays in the adoption of software-defined networking (SDN) by telecom operators and our missed forecast in the energy business. Looking first at SDN, telecom operators have decided to adopt SDN, but are taking a wait-and-see approach to implementation at this time. The telecom operators are watching developments closely to see who will be first to implement SDN, and how much benefit will be derived. NEC must break through this impasse and set a clear direction for the industry. However, given that we do not have a position overseas, we will need to make an uphill struggle. In this sense, the massive trial by Vivo, a subsidiary of Telefonica Brazil, carries tremendous significance. Because this is also an opportunity to demonstrate NEC's true capabilities to other telecom operators, we will provide solid support to this trial even if that means devoting large numbers of personnel to the project. Second, in the energy business, actions in the U.S. to introduce storage batteries using natural energy have fallen behind schedule by around 1 to 1.5 years. Currently, the market in Japan is starting to show more activity, so we are focusing on showcasing NEC's capabilities in this area.
Our operating income forecast of 135.0 billion yen for FY2015 takes into consideration the need for an additional investment of 15.0 billion yen. With the understanding of our stakeholders, we intend to make this investment of 15.0 billion yen to drive NEC's future growth.

Questioner C

Q. Industry consolidation is proceeding among network vendors. What kinds of strategies is NEC able to implement in response?

A. While some of the larger companies may choose to divide up their market share, we must also bear in mind that telecom operators do not want to be dominated by any one vendor. NEC's business domains lie in areas where it is able to fulfill a role or contribute to these telecom operators, and our customers understand that NEC is at least one step ahead in the SDN field. I believe that we will have opportunities in many business areas provided that we are able to properly demonstrate our technical capabilities to our customers. In this sense, it is absolutely imperative that we deliver a solid performance on the Vivo trial.

Q. In the IT services area, public cloud systems are now being implemented in the U.S. I believe that these systems are easy for customers to embrace partly because costs can be reduced by adopting such cloud-based systems. However, this trend is accompanied by the risk of a contraction in the SI market. How do you see this risk?

A. I believe that the Internet of Things (IoT) area will definitely expand. In the IoT business, it is crucial to provide value in both the virtual and real spaces. I believe that SI services in these sorts of business areas will grow. Another increasingly important priority is how to go about protecting secure virtual environments. We expect to see the emergence of more areas that involve systems monitoring and management. Therefore, we intend to contribute to these areas and we expect our business to grow larger as a whole.

Q. Don't you think that the expansion of cloud systems in the U.S. will pose a threat?

A. I certainly agree with you on that point. However, we must bear in mind that providing services at low cost and ensuring security are two completely different things. Providing a secure virtual environment will be a way for us to provide value. For example, Japanese companies will be required to manage and control the use of national ID numbers under Japan's "my number" system. National ID numbers will require a high degree of confidentiality. We believe that these numbers will require an extremely high level of security even when using the same cloud technologies. NEC will provide value by offering these sorts of solutions.

Questioner D

Q. NEC and NetCracker have strengthened the global sales expansion framework for SDN. Which company will be taking the lead in this effort?

A. NetCracker is led by the NEC's Telecom Carrier Business Unit. However, NetCracker has been spearheading activities in the area of Telecom Operations & Management Solutions (TOMS). NEC has taken the lead in setting the course for SDN, including through the development of Management and Network Orchestration (MANO).

Q. Wouldn't it be risky for NEC to take the lead?

A. No. I don't feel it is risky at all.

Q. The SDN market for telecom operators is expanding after a two-year delay. Does this delay mean that NEC's strengths will no longer provide it with a competitive edge?

A. Left alone, NEC's strengths will have certainly diminished. However, if we are able to harness current technology to rapidly trial SDN, this could become our new competitive edge. Delivering results here will enable us to demonstrate our true strength and value.

Q. If you are unable to produce results this year, won't your competitors catch up with you?

A. We believe that this will be a decisive year for competing successfully in the market.

Q. Why aren't you sticking to the operating income target of 150.0 billion yen set out in Mid-term Management Plan 2015? Is the additional strategic investment of 15.0 billion yen an investment eyeing NEC's future growth?

A. The arrival of SDN is absolutely inevitable. That much is clear. To prepare for the arrival of SDN, we need to fortify our technologies. Another crucial priority is to build up a solid track record. In spending additional strategic investments, we will do our utmost to ensure that our customers understand the value of everything we plan to develop in FY2015, including MANO.

Questioner E

Q. Generally, NEC considers a consolidated dividend payout ratio of 30% as one guideline. The dividend forecast of 6 yen per share for Fiscal 2015 represents a lower payout ratio than this level. Why haven't you set the dividend forecast at 8 yen per share?

A. Management has discussed whether we should reinvest profits in NEC's next stage of growth or pay out dividends. We have decided that we must work to accelerate growth at this time. Accordingly, we have decided to set a dividend forecast of 6 yen per share for Fiscal 2015.

Q. If net income is higher than planned, will you consider increasing the dividend forecast?

A. If net income is much higher than planned, we may take into consideration.

Q. NEC has withdrawn its operating income forecast of 150 billion yen set out under Mid-term Management Plan 2015. I can understand that this reflects changes in the business environment. However, in comparison with FY2014, what kinds of impacts are incorporated in the revised forecast?

A. Pension-related factors will improve by around 10.0 billion yen, but strategic investments will increase by 15.0 billion yen. In addition, we expect a negative impact of around 10.0 billion yen from foreign exchange movements. Until now, we had not recorded any negative foreign exchange impacts. However, this was because both the U.S. dollar and euro were moving in the same direction, with the yen weakening against both currencies. In FY2015, the euro is expected to depreciate against the yen by 10 yen from 140 yen to 130 yen while the U.S. dollar is expected to appreciate against the yen. Consequently, because the foreign exchange impact cannot be offset between the U.S. dollar and euro, we have incorporated a negative foreign exchange impact of 10.0 billion yen into the operating income forecast.

Q. The operating income forecast has been reduced to 135.0 billion yen from the 150.0 billion yen targeted in Mid-term Management Plan 2015. Meanwhile, net income is forecast to increase. Why? Does the forecast include the realization of tax benefits from loss carryforwards?

A. We believe that the reduction of 15.0 billion yen in the operating income forecast will have an impact of around 9.0 billion yen on net income. Against this backdrop, net income is projected to improve by 5.0 billion yen from Fiscal 2014. Therefore, we anticipate a total improvement of 14.0 billion yen in net income. The reasons are: first, the corporate income tax rate projected in Mid-term Management Plan 2015 has improved by 5 percentage points from 38%. The lower corporate income tax rate represents around half of the projected improvement in net income. The remaining half should be derived from tax benefits that can be realized now that our unprofitable businesses have been turned around. Please note that the net income forecast for Fiscal 2015 does not incorporate any special factors, the realization of tax benefits from loss carry forwards and other such items.

Questioner F

Q. What impact will the expected sales decrease in firefighting and disaster prevention systems have on the Public business segment? Will "My Number" project cover the decline in these systems, and thereby ensure steady growth for the Public business as a whole?

A. Orders for firefighting and disaster prevention systems have already peaked out. We are projecting strong net sales from these systems in the FY2015, but they will start to decline the following fiscal year. Net sales of around 30.0 billion yen are projected from "My Number" projects in FY2015. We expect these sales to continue in the following fiscal year.

Q. What is your estimate of the impact of the reduction in the corporate income tax rate in FY2014?

A. The reversal of deferred tax assets had an impact of 10.7 billion yen. This impact was mostly offset against the capture of approximately 8.0 billion yen in minority interests of NEC Fielding.

Q. What impact will the adoption of IFRS have on NEC?

A. Looking only at amortization of unrecognized pension obligations and amortization of goodwill, we have said before that the adoption of IFRS would have an impact of 37.0 billion yen on net income for FY2014. Amortization of unrecognized pension obligations in the non-operating income (expenses) of 10.4 billion yen recorded in FY2014 would be reduced to zero in FY2015. In addition, pension fund would improve by around 10.0 billion yen owing to an increase in unrealized gains on marketable securities, reducing amortization of unrecognized pension obligations in income before income taxes and minority interests to 4.0 billion yen, and 3.0 billion yen on net income. Amortization of goodwill will contribute to 12.0 billion yen in net income owing to progress with amortization. We believe that the combined impact on net income from these two factors alone will be around 15.0 billion yen. Other impacts will also have an impact on earnings, so we will need to watch the situation closely.