January 28, 2016

Earnings Presentation Q&A for Q3, the Fiscal Year Ending March 31, 2016

Date/Time: January 28, 2016 17:30-18:30 JST

Location: NEC Headquarters, Tokyo

Presenter: Isamu Kawashima, Executive Vice President and CFO

Questioner A

Q. NEC said there is a risk of a shortfall in the full-year forecast of the public business. Please comment on the reasons for the concentration of sales and earnings in Q4 in a little more detail. For example, is it because of reasons such as the absence of demand, the postponement of sales, or cutbacks in investments by customers?

A. In the public business, we have been performing steadily in the IT area, but we have encountered project delays in the social infrastructure area. These delays have been caused by rescheduling of projects by customers, delays in defining project specifications and other factors. Each of these projects is large, and they have increasingly been pushed back to Q4. Although we have lost several projects, we still have various projects in the pipeline.

Q. Which areas are problematic in the energy business? I believe this was a focus area for NEC, but performance has deteriorated in this area. Is there any change in the strategic positioning of the energy business?

A. The energy business has not reached its initial forecasts based on its nine-month results. The main reasons have been a decline in business for utilities due to the impact of investment cutbacks by electric power companies, and the fact that we missed our forecasts for small electricity storage systems. In the energy business, we need to examine how we will approach the area of electricity storage systems for the power grid, including the timing for the ramp up of this market. However, it is not the case that the market no longer exists. Rather, the market has been slow to take shape. Therefore, we need to carefully assess our response to this delay in the course of our discussions on formulating our new mid-term management plan.

Q. Demand in the fire prevention digital radio network area of the public business seems to have peaked out. Have sales in this area declined more than expected?

A. Demand in the fire prevention digital radio network area has peaked out largely in line with our expectations.

Questioner B

Q. In the telecom carrier business, do you believe there is a high likelihood of attaining your order and sales forecasts in Japan in Q4? In the public business, to what extent is the sales forecast for Q4 backed by orders? NEC has said that it would implement cost reductions. In which areas will you be able to reduce costs?

A. In the telecom carrier business, we feel that progress on capital investment by telecom carriers in Japan has been slower than usual through Q3. For this reason, we expect some of the slack in investment to be picked up in Q4. We believe there will be a certain amount of investment in LTE base stations. In the public business, we are tracking projects that are progressing slowly on a case-by-case basis. Regarding cost reduction, we have not suddenly realized that we must rush to reduce costs at this time. For projects for which we had expected to see a postponement in sales as of the end of 1H, we have instructed business units to incur expenses when there is a high likelihood of generating sales. If we can generate sales in Q4, we will incur expenses on these projects.

Q. What is your outlook for sales in the public business in the fiscal year ending March 2017?

A. We cannot comment on the outlook because we have yet to form our budget for next fiscal year. However, we recognize that there are projects for which orders are behind schedule because customers' specifications have not been finalized. That said, although it may be difficult to record sales for these projects this fiscal year, we should be able to do so next fiscal year. We will need to watch things a little more closely to determine the outlook for the full fiscal year.

Q. Have any aspects of the business environment changed compared with three months ago? Has NEC taken steps to make those changes known throughout the company?

A. The current IT investment environment is holding firm. Stock prices and foreign exchange rates have been volatile since the start of 2016. This volatility could conceivably have a negative impact on investment sentiment if it hurts the mindset of corporate managers. However, we have not seen any moves consistent with such a pattern at this time. In 1H, we strove to incur upfront costs. However, from the autumn of last year we have shifted to a policy of curtailing upfront costs and incurring expenses only when we expect to win projects, while adopting a heightened risk awareness.

Q. These cost reductions do not seem to be reflected in NEC's actual Q3 results. Will the positive impact begin to appear in Q4?

A. We expect to see cost improvements associated with the costs that were brought forward to 1H from Q4. Additionally, we are being very cautious about how we incur expenses for each project.
Moreover, we are promoting workstyle reforms of back-office divisions such as corporate staff. One initiative in this regard was to gather and station around 1,000 employees of NEC Management Partner, Ltd. at NEC's Tamagawa business facilities from 2H. We taking a range of steps to put emphasis on working more efficiently, including controlling overtime work in back-office divisions. Each division has changed how it incurs expenses in Q4. Specifically, we will incur expenses only within the scope of earnings that can be generated by obtaining additional sales.

Questioner C

Q. NEC listed the following two main factors as being responsible for the variance between actual Q3 results and forecasts in the telecom carrier business: demand in Japan pushed forward to Q4 and a decline in mobile backhaul equipment. Which of these factors had the biggest impact?

A. Roughly speaking, the impact on both sales and earnings was split evenly between both factors.

Q. Other companies have reduced their financial forecasts in light of the investment trends of telecom carriers. Why hasn't NEC revised its forecasts for the telecom carrier business?

A. We have high hopes for demand in Japan being pushed forward to Q4. On the other hand, we are pushing ahead with cost improvements as a contingency plan in case we are unable to record orders and sales. We do not believe that the capital investment plans of telecom carriers in Japan have changed significantly on a full year basis.

Questioner D

Q. How did operating income for the nine month period compare with the company's forecasts, particularly in terms of each segment?

A. Nine-month operating income for the company as a whole was around 18.0 billion yen below forecast. By segment, the public business was about 16.0 billion yen below its operating income forecast, while the enterprise business was about 5.0 billion yen above its forecast. The telecom carrier business was about 8.0 billion yen below its operating income forecast, while the platform business was largely in line with its forecast. Others was about 5.0 billion yen below its operating income forecast while adjustment was around 6.0 billion yen better than forecast.

Q. Please explain how the Q4 outlook has changed relative to initial forecasts, including measures to regain lost ground in each segment.

A. I would like to explain our outlook by assuming that the risks of a projected shortfall in operating income have actually materialized.
In the public business, we believe there is a risk of a shortfall in operating income of about 10.0 billion yen on a full-year basis. Therefore, operating income would need to be 6.0 billion yen higher than the initial forecast in Q4 to cover this risk. First, we brought forward and expensed costs of about 3.0 billion yen in 1H, so costs will improve by this amount in Q4. There were also unprofitable projects in 1H, but these projects are being controlled in Q4 so as to mitigate losses. Sales also present risks of a shortfall in operating income. However, we will make up for the impact of these risks by increasing efficiency and improving costs. In the enterprise business, nine-month operating income was about 5.0 billion yen higher than the initial forecast. Assuming that full-year operating income will be around 7.0 billion yen above the initial forecast, an improvement of around 2.0 billion yen will be needed in Q4. We expect sales in the enterprise business to increase by just over 10% year on year. We believe this sales growth will enable us to improve earnings in this business. In the telecom carrier business, nine-month operating income was about 8.0 billion yen below initial forecast.

We expect the sales pushed forward to Q4 to help improve earnings in this business. We are also controlling costs conservatively. In Q4, we are targeting operating income of about 8.0 billion yen above the initial forecast by improving costs to make up for the impact of risks associated with sales. In the system platform business, sales present the risk of a shortfall. However, because these sales at risk are centered on business PCs, we believe there will be no impact on earnings in this business. In others, nine-month operating income was about 5.0 billion yen below forecast. If risks materialize on a full-year basis, operating income will be about 7.0 billion yen below forecast. In Q4, the energy business presents risks of a shortfall in operating income. These risks could lead to an additional shortfall in operating income of around 2.0 billion yen. In adjustment, nine-month operating profitability has improved by 6.0 billion yen. Here the outlook will depend on the extent to which we incur expenses. In this sense, we seek to achieve an improvement of about 4.0 billion yen in Q4 by controlling costs, specifically by not incurring expenses as we have done previously.

Q. NEC's progress toward its forecasts has been noticeably slow. What lies behind this?

A. Our understanding is that in the public business, it is taking more time to get many different things done as projects become increasingly larger. We have high hopes for the telecom carrier business in Q4. We believe the slow progress both in the public business and the telecom carrier business just happened to coincide by chance in the current fiscal year.

Questioner E

Q. At the Public Business Briefing held last year, I remember NEC explaining that we could expect to continue to see higher sales and earnings in the public business next fiscal year. Meanwhile, it now appears that there are several projects for which business is not proceeding to plan. Are there any problems with how NEC is advancing these projects? Also, in the telecom carrier business, I was reassured to see that this business posted higher sales and earnings in Q2, but Q3 results were soft. Was this because projects anticipated in Q3 were postponed to Q4? Were you expecting this to happen?

A. In the public business, our understanding is that projects are taking more time as they get larger, rather than our internal processes being at fault. It is not the case that NEC is dealing with special circumstances. The process leading up to receiving an order is taking more time.

For example, projects have been delayed due to specifications being changed along the way. In the telecom carrier business, some projects anticipated in Q3 were postponed to Q4. We will diligently work to win projects. We are also taking a strict approach as regards incurring expenses as we conduct our business.

Q. Will there be any reversal of deferred tax assets associated with the reduction in the corporate tax rate in the current fiscal year? If so, what will be the amount of the reversal? Also, can I correctly assume that NEC has not factored in the realization of tax benefits from loss carryforwards in its financial forecasts for the current fiscal year? Will NEC be able to use realize these tax benefits if it liquidates NEC Mobile Communications, Ltd. or sells Renesas Electronics Corporation shares?

A. Looking at corporate tax, if the National Diet approves a change in the corporate tax rate, the corporate tax rate will be reduced by about 2 percentage points, as in the previous fiscal year. Although we cannot give you any definitive figures, there was a reversal of around 10.0 billion yen in deferred tax assets last year, so we expect this year's figure to be close to that amount. If this happens, we would like to ensure there will be no impact on our financial forecasts. Therefore, in our initial financial forecasts, we budgeted for a loss of around 10.0 billion yen as an extraordinary loss. Meanwhile, in terms of extraordinary income/loss for the nine month period, we booked extraordinary income of around 5.0 billion yen, including the sale of shares. Although we will continue to carefully assess the situation as current fiscal year-end approaches, we believe NEC will be able to accommodate a change in the corporate tax rate.
We have not factored in any realization of tax benefits from loss carryforwards in our forecasts.

Q. Sales from the four focus areas have increased by more than 1.5 times. By around how much has the profitability of the four focus areas improved as a whole? NEC has been undertaking verification tests of Software-Defined Networking (SDN) in the current fiscal year, and so SDN has yet to produce results. Can we expect SDN to start contributing to higher earnings next fiscal year?

A. In the current fiscal year, NEC is executing upfront investment in SDN, and has not yet reached the stage where SDN is contributing to earnings. We would like to explain our outlook for next fiscal year and beyond in our new mid-term management plan.

Questioner F

Q. NEC reported that operating income for the nine month period was 18.0 billion yen below the company's forecast. Will NEC be able to make up the difference in Q4? Are the businesses that progressed slowly in 1H still continuing to do so?

A. We had seen some signs of slow progress in 1H. However, we have not yet been able to make up for lost ground, primarily in the public business, and the situation has become drawn out.

Q. In the telecom carrier business, NEC must outperform its Q4 operating income forecast by 8.0 billion yen. Will NEC be able to achieve this in the remaining two months of the current fiscal year?

A. We seek to generate earnings by capturing demand from telecom carriers in Japan that was pushed back to Q4. Meanwhile, as of the end of 1H, we have shifted the main thrust of cost control from making upfront investments to incurring expenses in line with sales. We have started to see the positive impact of this shift from Q3, and expect it to continue in Q4. By combining these approaches, we will work to outperform our forecast by 8.0 billion yen as one of our targets. We expect sales on a full-year basis to be mostly flat from the previous fiscal year, particularly given the risks centered on our overseas business. We intend to cover any shortfalls that may arise with sales in Japan.

Q. Has there been any progress on the SDN project in South America?

A. At VIVO in Brazil, we are advancing verification tests using actual networks. These tests are taking time, but it is not the case that problems are occurring. At this time, NEC has not yet won an official order. However, we are moving forward on a daily basis by making progress on the verification tests.

Questioner G

Q. In the public business, NEC has explained that it faces the risk of a shortfall of around 10.0 billion yen from its full-year operating income forecast. Does this mean that if NEC continues on its present course, operating income will be around 10.0 billion yen below forecast?

A. The financial forecasts we have explained are the same as our internal budget. Each business unit is making efforts to meet its targets. Our risk was explained in terms of the possible change that could occur if something were to happen in the process.