April 27, 2017

Earnings Presentation Q&A for the Fiscal Year Ended March 31, 2017

Date/Time: April 27, 2017 17:30-18:35 JST
Location: NEC Headquarters, Tokyo
Presenters: Takashi Niino, President and CEO
Isamu Kawashima, Executive Vice President and CFO

Questioner A

Q. Revenue has been contracting, but NEC has not changed the scale of Company-wide assets or personnel. In these circumstances, NEC should have to fundamentally transform its business structure. However, I don't see any action on this front. How do you view this situation? Could you please share your perspectives on your businesses, particularly the smart energy business and the telecom carrier business, as well as your non-core businesses?

A. It is true that our cost structure has increased relative to the current size of revenue. I believe that we must continue shifting resources to growth fields. Our target of a 5% operating profit ratio is not high. That said, to attain more disciplined and clear-cut management than ever before, I would like the priorities of our business units to be monitored extensively at the corporate level, with the aim of fully executing portfolio optimization.

Q. There was talk about strengthening corporate controls, along with increasing the responsibilities assigned to Chief Officers (CxO). How specifically will the responsibilities of the Chief Officers change? How will NEC provide additional incentive to the Chief Officers?

A. Basically, the Chief Officers will have a Company-wide role, and will fulfill their duties integrally with the corporate functions. For example, the Chief Global Officer (CGO) will be delegated with substantial authority for international M&As. Until now, it was unclear who held the overall responsibility for profitability in the international business, because the Global Business Unit and various other business units each assumed part of the responsibility. Some aspects of problems were also unclear. With this in mind, we clearly defined the CGO's role as having overall responsibility for the profitability of the entire international business. We also clarified responsibilities in other areas. To ensure that the Chief Officers have the authority to fulfill those responsibilities, we defined the reporting requirements of each business unit and other related duties. Through these measures, we intend to shift to a firmer business execution structure.

Q. Could you please discuss the major components of the actual free cash flows of ¥99.0 billion for the fiscal year ended March 31, 2017? Why do you expect the free cash flow forecast for the fiscal year ending March 31, 2018 to decrease to ¥80.0 billion?

A. The free cash flows for the fiscal year ended March 31, 2017 include special factors amounting to about ¥50.0 billion. This includes about ¥20.0 billion from the gain on partial transfer of shares in the joint venture with Lenovo, and the net impact of about ¥20.0 billion from Japan Aviation Electronics Industry, Limited (JAE) becoming a consolidated subsidiary. NEC used cash of ¥19.0 billion for the tender offer for shares of JAE, while the cash held by JAE was consolidated as well as positive Q4 cash flows. NEC received repayment of borrowings of nearly ¥15.0 billion from Renesas Electronics Corporation. The free cash flow forecast of ¥80.0 billion for the fiscal year ending March 31, 2018 includes a cash inflow of ¥40.0 billion related to NEC TOKIN Corporation transaction. There will be an improvement of ¥40.0 billion against the ¥50.0 billion reduction in cash due to special factors in the fiscal year ended March 31, 2017. As a result, special factors will reduce cash by a net total of ¥10.0 billion. Apart from this, we are forecasting upfront costs of around ¥10.0 billion in connection with a major construction project at a subsidiary. Consequently, there will be no major changes in our base cash flows.

Questioner B

Q. You noted that NEC's operating profit estimation for the fiscal year ending March 31, 2019 under Mid-term Management Plan 2018 has now been reduced from ¥150.0 billion to ¥100.0 billion. NEC is forecasting operating profit of ¥50.0 billion for the fiscal year ending March 31, 2018. However, this figure includes negative special items of ¥33.0 billion. With this in mind, the revised operating profit estimation of ¥100.0 billion for the fiscal year ending March 31, 2019 now seems conservative. First, could you please go over the factors behind the reduction in the estimation from ¥150.0 to ¥100.0 billion? Also, why do you expect operating profit to effectively improve by only ¥17.0 billion from the fiscal year ending March 31, 2018 to the fiscal year ending March 31, 2019?

A. We have adopted a conservative outlook for the fiscal year ending March 31, 2019, partly based on our reflections on the lessons learned from the fiscal year ended March 31, 2017. We should be able to generate operating profit of around ¥100.0 billion if we simply maintain our present course. However, within the year, we will consider what we must accomplish as we formulate our new mid-term plan, and work to bring operating profit closer to ¥150.0 billion. In the process, we will look closely at generating additional earnings.

Q. What will be the main points you will be looking at?

A. There has been no change in our policy of seeking to achieve sales growth internationally. It will be crucial to accelerate the pace with which we get businesses up and running. We aim to accelerate sales expansion in NEC's three key businesses, including through M&A investments of ¥200.0 billion over the next three years. In the fiscal year ended March 31, 2017, we had already started considering these initiatives. In the fiscal year ending March 31, 2018, we intend to expand international businesses by putting our plans into action. Meanwhile, looking at business in Japan, IT investment has been trending firmly but overall sales have remained unchanged. In this environment, we intend to improve profitability in Japan by pushing ahead with the shift to services.

Q. Could you please explain the details of the revision of business segments from the first quarter?

A. The forecasts for the new segments are still estimates, so please see them as rough projections. One major change spanning different segments was that we transferred our business involving financial institutions in the public business, to the new enterprise business, staying aware of the FinTech field. Moreover, we transferred regional sales functions, which had previously been included in the others business, to the new public business (Public Solutions), because the regional sales functions account for a large percentage of business to the public sector.

Q. By the next closing of accounts, I would like NEC to disclose financial results retrospectively for past periods based on the new segment classification.

A. We plan to provide such disclosure by that time.

Questioner C

Q. In your forecast of the Adjustment account for the fiscal year ending March 31, 2018, which kinds of expenses are projected to increase?

A. We are forecasting business structure improvement expenses of ¥10.0 billion and strategic investments of ¥8.0 billion. We are still considering the content of the business structure improvement expenses. We envision expenses that will improve our earnings structure. Strategic investments will be used flexibly at the President's discretion at critical moments to support NEC's growth strategies. Apart from these items, the Adjustment account also includes an increase in expenses for Central Research Laboratories. We plan to increase strategic expenses. Ultimately, we plan to record the strategic investments of ¥8.0 billion under each segment, rather than under the Adjustment account. We also believe that the business structure improvement expenses could also be recorded under each segment, depending on how these expenses are used.

Q. Is there any possibility that these expenses could serve as a buffer?

A. Basically, we assume that these expenses will be used completely.

Q. You mentioned that the next Mid-term Management Plan will be announced in January 2018. I believe that NEC faces uncertainties on various fronts. One of these uncertainties is that NEC has a large Adjustment account in comparison with other companies. Therefore, I am concerned that each business unit may not have a suitable awareness of costs. Wouldn't it be advisable to indicate a lower profitability to customers by allocating the relevant expenses to each segment? Do you have any plans to allocate the funds in the Adjustment account, which appears to lump together many different items, to each segment?

A. Your suggestions have also been discussed within the company. Allocating these funds to each business unit would help to firm up targets in each business unit. Therefore, we will consider this issue closely and make improvements in the future.

Questioner D

Q. I believe the operating losses in both the smart energy business and the PASOLINK (mobile backhaul) business are large. Could you please discuss results in the fiscal year *ended March 31, 2017, forecasts for the fiscal year ending March 31, 2018 and future improvement measures in each business?*

A. In the fiscal year ended March 31, 2017, the smart energy business posted an operating loss of ¥14.0 billion. In the fiscal year ended March 31, 2016, the smart energy business posted an operating loss of ¥24.0 billion, due in part to an impairment loss on goodwill at NEC Energy Solutions, Inc. In the fiscal year ended March 31, 2017, we saw an improvement in expenses due to a shift in personnel resources. However, because we recorded charges of ¥3.0 billion including impairment losses on equipment assets, the improvement from the previous year appears to be limited only to the ¥10.0 billion from the impairment loss on goodwill. In the fiscal year ending March 31, 2018, we expect to record an operating loss of ¥7.0 billion. Basically, we do not anticipate any more valuation losses on assets. Combined with operational improvements of around ¥4.0 billion, we expect an overall improvement of around ¥7.0 billion. With orders for large Energy Storage Systems (ESS) increasing, we should see the benefits from this improvement materialize in the fiscal year ending March 31, 2018. We also expect conditions to improve in the electrode business. PASOLINK will continue to post losses, but profitability improvement is factored into our forecast. We have adopted a conservative outlook for sales in the fiscal year ending March 31, 2018. Rather than seeking to achieve large growth in sales, we will aim to improve our earnings structure, including that of overseas subsidiaries.

Q. Could you please discuss the details of the specific measures you will take in addition to three key businesses? Will you undertake M&As to develop core businesses other than the three key businesses?

A. We will accelerate our efforts around the three key businesses. In other areas, NEC has an alliance with DENSO Corporation in the automotive field, for example. Here, we will shift human resources within the company to address a shortage of software personnel. We also expect growing needs to emerge in the healthcare field. From among the options considered to date, we would like to start laying the groundwork for new businesses, with a view to achieving commercialization.

Q. NEC has announced that it will work to achieve a net profit target of ¥30.0 billion for the fiscal year ending March 31, 2018, and continue to pay an annual dividend of ¥6 per share. However, in the past, NEC has been unable to take sweeping measures because of the need to maintain its dividend. I believe that NEC should allocate expenses to improving its earnings structure, and that it would be acceptable for the company to revise down its *business forecasts for the fiscal year ending March 31, 2018 for this purpose. I also believe that NEC's efforts to maintain the dividend of ¥6 per share contradict its other priorities. Even if NEC draws up its next Mid-term Management Plan, won't it ultimately have to revise down its forecasts due to a lack of sales growth?*

A. I intend to effectively formulate our next Mid-Term Management Plan. I'd like to achieve a 5% operating profit ratio as early as possible, as targeted under Mid-Term Management Plan 2018. It is our commitment to continue paying out an annual dividend of ¥6 per share.

Questioner E

Q. NEC's profitability has deteriorated significantly. How would you summarize the reasons for this deterioration, and what is your analysis of the situation? Wouldn't it be advisable to go back to basics and explore ways to raise the profitability of your existing businesses? In the telecom carrier business, NEC has no chance of winning overseas if it remains focused on business targeting domestic carriers. I think NEC would benefit from an approach that is more focused on competing with vendors in businesses targeting global carriers. NEC must also compete to enter new fields. Could you please share your perspectives on these issues?

A. There are many reasons for the deterioration in profitability, including one-time factors such as unprofitable projects. We had already expected the decline in hardware business targeting domestic carriers. To make up for the deterioration in profitability in business in Japan, we must, for example, transform our profit structure by shifting from systems integration to services in the IT services field. In international business, we invested in SDN/NFV (Software-Defined Networking/Network Functions Virtualization), and successfully won 10 commercial projects globally in the fiscal year ended March 31, 2017. We intend to improve profitability by increasing volume through the build-up of service-oriented businesses, rather than relying on one-time hardware sales in Japan. The safety business is the field where we expect to achieve growth. Our face recognition technology has earned a strong global reputation. NEC has placed first in evaluations of face recognition technology not just in still images but also in video. Looking ahead to 2020, NEC has been trialing crowd behavior technology, including identifying people from afar in stadiums, and recognizing individuals from among crowds of people walking through airport gates. NEC has an artificial intelligence (AI) engine, but it must do more to enlarge this business through partnerships. We will accelerate these efforts, including M&A activities.

Q. Could you please discuss sales and profitability for SDN/NFV and face recognition, specifically in regard to your results for the fiscal year ended March 31, 2017 and your forecasts for the fiscal year ending March 31, 2018?

A. In SDN/NFV for carriers, sales were ¥40.0 billion in the fiscal year ended March 31, 2017 and the sales target is ¥60.0 billion for the fiscal year ending March 31, 2018. In terms of profitability, we posted a loss of several billion yen, and are working toward the goal of breaking even in the fiscal year ending March 31, 2019. In global safety, sales were between ¥40.0 and ¥50.0 billion in the fiscal year ended March 31, 2017, and we aim to expand sales further in the fiscal year ending March 31, 2018. Profitability is in the red because we are still in an investment phase. However, we have set the fiscal year ending March 31, 2019 as one target for global safety to begin contributing to profits.

Q. A lot of overseas acquisitions do not succeed. Unless risk management is properly implemented, NEC could ultimately book impairment losses. I believe that entrusting authority to the Chief Global Officer (CGO) is a good idea, but it will be difficult to succeed unless the CGO has good judgment. How do you intend to implement risk management?

A. Last year, management decided on the process to follow when undertaking M&As, involving the CGO and CFO. Given the post-merger integration (PMI) issues that have arisen after acquisitions, we must strengthen our personnel even more. We will perform due diligence by bringing together our professionals, including making effective use of personnel from Netcracker Technology Corporation.

Q. Dealing with legal issues is another crucial priority for expanding international business. What kind of cost outlays do you envision in this area? Considering that the international business could be mired in a series of legal battles through lawsuits, what is the current state of development of your legal platform?

A. We have made progress on developing a legal platform to a certain extent. We intend to further strengthen our hand in this area, including our Legal Division.