January 30, 2018

Management Strategy Meeting Q&A

Date/Time: January 30, 2018 18:30-19:35 JST
Location: NEC Headquarters, Tokyo
Presenters: Takashi Niino, President and CEO
Isamu Kawashima, Executive Vice President and CFO

Questioner A

Q. Revenue is forecast to remain mostly flat in Japan and to expand internationally. Could you please provide a breakdown of revenue for the Japan and international businesses? In the international business, are you focused solely on the growing safety business or are there other business domains that offer prospects for growth as well? Could you please identify which business domains will grow, and which will contract, in Japan?

A. In the international business, revenue is forecast to increase by ¥160.0 billion from ¥730.0 billion to ¥890.0 billion. This growth will be driven by two major factors. The first factor is that we plan to grow revenue in the safety business from around ¥50.0 billion at present to ¥200.0 billion, including additional revenue from M&As. The second factor is the international software and service area. This area encompasses our existing Telecom Operations and Management Solutions (TOMS) and Software-Defined Networking (SDN). We plan to expand revenue in this business from ¥80.0 billion at present to ¥110.0 billion, primarily by reshaping the SDN business strategy centered on NetCracker Technology Corporation, which is a key asset of NEC.
In business in Japan, we expect revenue in existing fields to decline by around 1% per annum. Meanwhile, the growth areas such as public safety for the Tokyo Olympic and Paralympic Games, digital government, and healthcare applications of the Social Security and Tax Number System "My Number." In total, we expect revenue in Japan to remain mostly unchanged.

Q. Could you provide specific details on the service business that NEC is trying to develop?

A. In Japan, particularly in the enterprise area, cloud computing is being adopted at a fairly rapid pace. In the course of advancing the service business, it will be increasingly crucial to adopt platforms. However, rather than compete with the likes of Amazon and Google in general-use platforms, we intend to differentiate NEC by putting its core strengths in technologies such as biometrics, AI and IoT onto those general-use platforms and providing services in fields where NEC has strong domain knowledge. We believe that our success will depend on our ability to embed NEC's core strengths into general-use platforms and convert these strengths into value.

Q. In my view, NEC has not been very eager to cut personnel or downsize assets in the past. Could you please explain the background to your decision to reform the profit structure?

A. I believe that people are the company's most important asset. We had expected personnel shortfalls to arise in step with changes in our business structure. In response, we have addressed personnel requirements by shifting human resources to growth fields over the past few years. In practice, however, we faced problems such as mismatches between skills and job requirements and a lack of speed. While I don't believe that NEC will fall into the red immediately even without structural reform, I have a sense of urgency. In the absence of the necessary investments in growth, NEC will only grow weaker and weaker. Investments in growth are thus vital to ensuring that NEC continues to grow. In the course of drawing up the mid-term management plan, we held internal discussions on various themes. Ultimately, we judged that now is the time for NEC to implement structural reforms in order to drive growth. By ensuring that we get these structural reforms done, we seek to achieve that growth.

Questioner B

Q. Could you please go over the time frame for implementing structural reforms and cutting costs? When will you record the expenses for those measures?

A. We have not yet determined the time frame, as we are just about to start coordinating matters with the labor union and the relevant divisions, including issues such as streamlining factories. Above all, we believe that it is crucial to implement structural reforms at the earliest opportunity. Therefore, we intend to record the necessary expenses in FY2019/3 so as to execute structural reforms at an early stage.

Q. What do you mean by international low-profit businesses in the Telecom Carrier business?

A. Looking at structural reforms in the Telecom Carrier business, the international business, particularly the hardware business, faces enormous pressures. This business also includes PASOLINK. In these businesses, we will first aim to restore profitability, as we rigorously execute structural reforms to ensure that each business can generate adequate profits with a certain amount of sales. If we still do not see any growth potential after achieving this goal, we will need to consider various options. While looking closely at the content of each business, we intend to implement a disciplined decision process. At this time, we are not considering which specific businesses to exit.

Q. You noted that NEC is aiming for NEC Energy Solutions to break even in FY2019/3. Could you please share your forecast for FY2018/3?

A. For FY2018/3, NEC Energy Solutions is projecting an operating loss of approximately ¥4.0 billion. Performance is trending largely in line with the initial forecast.

Q. You noted that maintenance and support will continue for the small-scale storage batteries business. What is your outlook for earnings in this business?

A. In the small-scale storage batteries business, we made a provision of ¥3.0 billion in line with our decision to discontinue development. Looking ahead, we plan to conduct operations within the scope of this provision, but we may incur slightly more expenses. However, we do not anticipate any large expenses.

Q. NEC is forecasting a compound annual growth rate of 0.2% for the Japan business. Depending on your point of view, this could be interpreted as a conservative forecast. There are hardly any other IT-related companies that have set their targets at such a low level. Could you please discuss any specific factors that you expect will reduce sales?

A. In the past, we had assumed that the Japan business would follow an overall growth track, taking into account the pace of decline in existing businesses and the pace of expansion in growth businesses. However, one major lesson from our previous mid-term management plan was that the downturn in existing businesses was larger than we had anticipated. In the current plan, we expect growth fields in Japan, such as digital government and the My Number system, to deliver at least double-digit growth. Meanwhile, we are taking a slightly conservative view of fields that are expected to decline. Overall, we are assuming that revenue will remain mostly unchanged. In any case, we intend to set solid targets for the businesses that we need to grow in Japan and to expand those businesses in line with those targets.

Q. The phrase "secure investment funds" has come up several times in this presentation. One of the major themes of the new mid-term management plan is that NEC will lower its breakeven point. However, if you say that you will secure investment funds in this context, I believe that many observers will take this to mean that there will be another large increase in expenses in the near future. What exactly do you mean by "securing investment funds"? Does it mean you will maintain the current level of investment? Please provide some clarification on this matter.

A. The past few years should have been a period of investment in growth for NEC. However, we have remained mired in a situation where we have been continually unable to execute the investments we had projected at the beginning of each fiscal year by the end of each fiscal year. Going forward, while investment will be essential to driving growth in new domains, we basically believe that our first step will be to ensure that we achieve our target of an operating profit ratio of 5%. In the process, rather than substantially increasing investment, we will execute clear-cut investments in areas where necessary. For this, our approach is to reduce fixed expenses to a certain extent in order to free up the funds needed for investments.

Questioner C

Q. I believe that the strategies laid out in the mid-term management plan are logically sound and outstanding. Companies that have tie-ups with external partners and make licenses available to other companies have been generally successful. Therefore, I believe that if its strategies succeed, NEC will be able to replicate the success of those companies in terms of improving earnings. You noted that NEC will encourage innovative action and ambitious initiatives, define management's responsibility and authority more clearly, and bring onboard people who it did not have in the organization previously. However, NEC has a large organization steeped in the company's unique DNA and corporate culture. In such an organization, I believe that it would be very difficult to ask someone who has been working with an inward-oriented mindset to come up with ideas for tie-ups, alliances and so on. I believe that a large company's ability to transform its DNA will depend to a large extent on how it designs its personnel systems and other frameworks. How will NEC go about encouraging innovation among people who have been working with such a mindset? Could you please explain how you will design your frameworks to accomplish this goal?

A. As you point out, we believe that the most important priority in our new mid-term management plan is to transform our corporate culture. NEC currently has good corporate DNA, but we must remove elements that could inhibit our future growth. I believe NEC must transition to a new corporate DNA. We will boldly implement a major transformation of our personnel system and reshape our organization. In the course of promoting diversity, the recruitment of talent from outside the NEC Group will be stepped up even more than before. By doing so, we seek to foster even greater professionalism within NEC as we ensure that we recognize and reward people who work hard and produce results. Previously, our personnel system did not really allow for employee performance to be reflected in remuneration. Going forward, we would like to set appropriate KPIs as we shift to a more clear-cut merit-based system where people who deliver major accomplishments are rewarded significantly.

Q. What is your schedule for reshaping the personnel system?

A. We would like to start phasing in a new personnel system in April. We are currently in the final stages of reviewing the personnel system. We are considering themes such as how we will go about setting specific KPIs for the next three years. For example, we are looking at setting percentage targets for external recruitment and streamlining senior management. We will diligently set three-year KPIs for various metrics and implement measures to achieve them.

Questioner D

Q. You noted that NEC will strengthen the service business in Japan. How large is this business at present and how do you envision the business in three years' time? Could you please explain how profitability will be affected as the service business field accounts for a larger share of business?

A. Service business includes outsourcing, SaaS and maintenance. At present, the service business accounts for around 25% of company-wide revenue. We do not have numerical targets for three years from now. However, profitability is higher in the service business than in non-recurring revenue businesses such as SI.

Q. NEC plans to increase operating profit by ¥90.0 billion in FY2021/3 compared with FY2018/3. How will operating profit trend over the three-year period of the mid-term management plan? Do you expect earnings to temporarily decline in FY2019/3 based on *structural reform expenses and other factors?*

A. In terms of reaping the benefits of structural reforms at the earliest opportunity, I believe that we will probably record structural reform expenses in FY2019/3. In this sense, earnings could decrease in FY2019/3 compared with the current fiscal year. Meanwhile, we can expect to reap the benefits of structural reforms in FY2020/3.

Questioner E

Q. NEC plans to increase revenue from the safety business from ¥50.0 billion to ¥200.0 billion. Could you please explain what percentages of this increase will come from organic growth and M&A activity?

A. The revenue forecast of ¥200.0 billion comprises an organic component of around ¥90.0 billion and an M&A component of around ¥110.0 billion, including the acquisition of Northgate Public Services Limited (NPS), which has already been announced. NPS currently has revenue of about ¥25.0 billion, with prospects for gradual revenue growth going forward.

Q. Does this mean that the remaining ¥80.0 billion, excluding the contribution from NPS, will come from new M&As?

A. Roughly speaking, that is correct. However, out of our investment budget of ¥200.0 billion, we have M&A funds of ¥130.0 billion left. After using these funds, we will consider M&A opportunities within the scope of our free cash flow.

Q. NEC said that it is stepping up production based on its latest factory in Thailand, as part of the reorganization of production bases in Japan. Could you please provide additional details on the new factory in Thailand?

A. NEC has long owned a factory in Thailand. On this site, we completed the construction of a new factory fitted with the latest IoT and AI technologies. The new factory mainly manufactures PBXs, projectors and automotive products.

Q. Going forward, will NEC shift production from bases in Japan to the factory in Thailand?

A. We are shifting our factories to a global "One Factory" model to create a production system that enables every factory to produce any kind of NEC product. We already have a system in place for shifting production when it is cheaper to manufacture something overseas rather than in Japan. Mindful of the ongoing aging of production bases in Japan, we will consider how to best go about streamlining our production bases and the timing for doing so, from the perspective of overall optimization.

Q. NEC said it will cut personnel by 3,000 through structural reforms. How did you arrive at this number?

A. One of the major problems facing NEC is that it has a high SG&A expense ratio. Currently, the SG&A expense ratio is 22%, excluding R&D expenses. We recognize the need to reduce this ratio to 20% or less at an early stage in order to achieve an operating profit ratio of 5%. We must ensure that we successfully implement these structural reform measures, including cutting personnel expenses as well as other costs, because it will enable us to achieve an SG&A expense ratio of 20% or less and an operating profit ratio of 5%. Based on this belief, we decided to cut personnel by 3,000 through structural reforms. Another factor behind this decision was the need to address the decline in the hardware business area, which has been experiencing commoditization.

Q. How many employees will the entire NEC Group have after the structural reforms? Could you please provide the number of employees in Japan and overseas as a percentage of the total workforce?

A. The total number of employees was 108,000 as of the end of December. After personnel are cut by 3,000, the number of employees will be 105,000. We believe that the headcount could increase due to M&As and related activities. Although it will depend on future trends, M&As are more likely to be undertaken internationally than in Japan. Therefore, we believe that the number of international employees will increase, whereas the number of employees in Japan will decrease.

Questioner F

Q. Could you please go over the components of the ¥13.0 billion in cost cutting and business process optimization in connection with reforms of the profit structure and the time frame for their contribution to earnings?

A. Components of the ¥13.0 billion in cost cutting include the streamlining of fixed property costs, marketing costs and IT costs. Through this cost cutting, we expect to generate cost savings of ¥13.0 billion over the next three years.

Q. Can I correctly assume that the improvement in underperforming businesses of ¥17.0 billion will be realized through the Smart Energy and Telecom Carrier businesses?

A. That is correct.

Q. I feel that NEC's targets of revenue of ¥3,000 billion and operating profit of ¥150.0 billion are ambitious goals, the details of which have probably yet to be fully finalized within NEC. In this context, NEC has set out to transform its corporate DNA. As the CEO, how do you see your role in this process?

A. NEC has targeted revenue of ¥3,000 billion and operating profit of ¥150.0 billion several times before. This time, I believe that the targets are slightly less ambitious, in practice, when taking into account the consolidation of Japan Aviation Electronics Industry, Limited. Against the backdrop of a contraction in NEC's businesses over the years, I believe that my most important role is to put NEC back on a growth track over the next three years. These numbers are not just aspirational goals; they are targets that we must absolutely achieve. As the CEO, I'm fully committed to doing everything necessary to hit those targets.

Questioner G

Q. In the previous mid-term management plan, NEC withdrew its targets in the face of a decline in revenue. Could you please explain the reasons for setting a revenue target for the new mid-term management plan? I thought it might suffice to set targets only for profit margins in each segment. Why did you set the revenue target?

A. I don't believe the revenue target is as ambitious as it was before. I believe our first priority as a company is to attain an operating profit ratio of 5% as early as possible. Unless we are aware of the importance of taking steps to generate growth, our businesses will only continue to shrink. That is why I would like to do my utmost to end this contraction. To this end, we will expand businesses that offer growth prospects by investing in them, while properly managing businesses that will contract. We have set the revenue target because we would like to closely monitor the revenue mix, instead of focusing solely on achieving an operating profit ratio of 5%.