

October 30, 2018

Earnings Presentation Q&A for Q2, the Fiscal Year Ending March 31, 2019

Date/Time: October 30, 2018 17:30-18:30 JST

Location: NEC Headquarters, Tokyo

Presenters: Takashi Niino, President and CEO

Takayuki Morita, Senior Executive Vice President and CFO

Questioner A

Q. In the Global segment, the operating loss was reduced by half in 1H and profitability was restored in Q2 alone. Could you please explain the underlying reasons? In addition, could you please comment on risks for the full year?

A. The operating loss was reduced by half in 1H, and this represents steady progress against our forecast. One main reason for this improvement was a solid performance in the safety business, where profitability was restored as a result of an increase in sales. For the full fiscal year, we expect the safety business to contribute a little bit more to business performance than we had previously expected.

Another reason for the improvement was Pasolink (Wireless Solution). Pasolink's business performance is seasonal, with a tendency for sales to go up in Q2 and Q4. Profits improved almost to the break-even point in Q2. Pasolink remained in the red for 1H, but is making progress as planned. Profits have improved by around ¥2.0 billion compared with the same period of the previous fiscal year.

In energy, while 1H orders were in line with budget, sales have not yet reached the required level. The outlook is starting to turn positive. Meanwhile, with material prices increasing rapidly, we believe that earnings will remain under pressure for some time.

In submarine cable systems, we have won nearly twice the amount of orders than we did in previous fiscal year. Revenue temporarily dropped in 1H, but we expect to recover lost ground on a full year basis.

One unforeseen negative factor has been display solutions. Although displays are still profitable, profits decreased by half in 1H due to a build-up of distribution inventories and slowdown in market conditions. We believe that this trend will persist in 2H.

Service provider solutions can be broadly divided into two fields: the optical-related transmission field and the software field, which includes companies like Netcracker

Technology Corporation. In 1H, we won an order from a telecom carrier in the UK and Germany in the software field, including Software-Defined Networking (SDN) and Network Functions Virtualization (NFV). However, an improvement in earnings may not be forthcoming until next fiscal year at the earliest. Additionally, in the optical-related transmission field, there have been project delays, so some risks remain for the full fiscal year.

Overall, business performance in 1H was in line with expectations, but 2H offers prospects for significant improvement. In terms of the anticipated improvement of ¥22.0 billion in earnings in 2H, around ¥10.0 billion is considered as a challenging target. That being said, we believe that NEC as a whole will be able to adequately cover this risk.

Q. NEC has identified Culture Transformation as a key priority of Mid-term Management Plan 2020. Could you please elaborate on the measures you have implemented in 1H to transform your Culture? Could you please go over the main points for 2H?

A. From March 2018, I (President) have been holding face-to-face meetings with employees. The purpose of these meetings is to encourage every employee to take ownership of the Mid-term Management Plan and to get everybody to work together to see it through. In 1H, I held a total of 30 meetings and communicated with about 10,000 employees. The participants expressed a wide range of thoughts and opinions. Taking this feedback into consideration, we have laid out a concrete vision for NEC's human resources in our "Code of Values." As revising the personnel evaluation system would have a major impact, we arranged for each member of the management team to first prepare a Commitment Sheet, and then declare in the face-to-face meeting what he or she should set out to accomplish. At this time, we have started applying this system to the top management level and general manager level. We have changed the system to look at not only business performance, but also the conduct of employees. We are pushing ahead with initiatives such as appointing Change Agents at each site. The Change Agent is tasked with making improvements at each site from the bottom up. In 1H, we reached the stage of having put a broad framework in place. In 2H, we will breathe life into the framework as we focus intensively on activities to instill the new system throughout the organization.

Q. I believe that NEC is accepting applications for its Early Retirement Program until November 9. At this time, how many employees do you think will apply to the program?

A. We are currently still in the application period, and do not have a forecast for the number of applicants.

Q. Operating profit in the Public segment deteriorated by about ¥5.5 billion in Q2 alone. Could you please go over the main reasons?

A. The main reasons were an increase of approximately ¥3.0 billion in unprofitable projects, as well as the absence of an extraordinary gain of approximately ¥1.5 billion recorded by Nippon Avionics Co., Ltd. in the previous fiscal year.

Questioner B

Q. As shown on page 8 of the presentation materials, Enterprise segment businesses performed very well, with revenue up by around 10%. However, operating profitability was mostly flat, mainly due to upfront investments in IoT platforms. Could you please discuss, in quantitative terms, the amount of intersegment transfers pertaining to this upfront investment and actual performance on an adjusted basis excluding these transfers?

A. The Enterprise segment's expense burden will increase by ¥2.0 billion in 1H and ¥4.0 billion for the full year. Therefore, Enterprise businesses effectively posted a ¥2.0 billion increase in earnings in 1H.

Q. Will these expenses fade away from next fiscal year onward?

A. We have not yet made plans for next fiscal year. However, given that the IoT platforms we have developed so far have transitioned to a commercial stage, we believe that the expense burden should gradually decrease.

Just to clarify, the allocated amount of the upfront investment is about ¥8.0 billion for the full fiscal year, with ¥4.0 billion allocated to the Enterprise segment, ¥2.0 billion to the System Platform segment and the remaining ¥2.0 billion mainly to the Public and Network Services segments.

Q. Is the customer for the SDN/NFV projects you discussed earlier a telecom carrier or a service provider? Which segment was the project recorded under – the Global segment or the Network Services segment? Also, are the project's sales proceeds spread out over the long term?

A. The customer for this project is a telecom carrier. In 1H, the order for the project was recorded under the Global segment. The project is spread out over several years.

Q. I had heard that the adoption of SDN/NFV is not progressing because major telecom carriers do not want to take the risk of introducing new technologies. Was the project adopted ahead of other vendors around the world?

A. As you can tell from the research reports of market research companies, NEC is the frontrunner in this field. Major telecom carriers have invested considerably in existing systems and employ large numbers of personnel involved with those systems. Therefore, these carriers are generally believed to be cautious about adopting SDN/NFV. However, the customer for this project is a so-called mega carrier. In the past, NEC had won an order for a small project from this customer in another country. We believe that our track record with the project in that country has paved the way for NEC to win this order in Europe.

Q. Will NEC be able to apply this project to other telecom carriers?

A. Although it will take some time, we believe that other telecom carriers will proceed to introduce SDN/NFV over the long term. We believe that newer telecom carriers and telecom carriers moving aggressively in services will adopt SDN/NFV at an early stage. Advances in 5G technology should also drive the trend toward virtualization. NEC has strengths in operation, management and billing systems for communications services that it has realized through conventional IT systems, and orchestration fields that link IT systems and networks. We intend to compete in the areas that fully harness those strengths.

Questioner C

Q. NEC reported that revenue surpassed the 1H forecast by ¥35.0 billion, while operating profit beat the 1H forecast by ¥4.0 billion. How did revenue and operating profit perform against forecasts in each segment?

A. Looking at revenue, the highlights were an improvement of ¥20.0 billion against forecast at NEC Energy Devices, Ltd., which is recorded under Others, and an improvement of approximately ¥18.0 billion against forecast in the Enterprise segment. In addition, operating profit in each of these two fields has improved by ¥2.0 billion against forecasts.

Q. The IT services orders in Japan are shown on page 17 of the presentation materials. What is your outlook for these orders in 2H?

A. Order performance has remained strong enough to raise concerns about personnel shortages. Our outlook is that this situation will continue for some time. Order performance in 2H of the fiscal year ended March 31, 2018 was mostly flat year on year. Although this raises the bar in terms of the extent of the increase we can anticipate in 2H, we expect positive growth going forward.

For your reference, the overall order performance has been trending positively, with orders increasing by 10% year on year on a Company-wide basis.

Q. What advantages will NEC derive from the partnership with Samsung Electronics Co., Ltd.?

A. When we shift to 5G, systems will be split up into a Central Unit (CU) and Distributed Unit (DU), and standardization will proceed further. In addition, telecom carriers will seek a wide range of services and will need to support many different frequency bands. With this in mind, NEC has partnered with Samsung Electronics to increase development efficiency and speed. NEC excels in wireless technologies such as DU, antennas, and miniaturization. We would like to use this partnership to extend the reach of NEC's outstanding products to overseas markets. In the field of software and services, customers are increasing their investments as a whole. Therefore, we will strive to implement business expansion initiatives in the areas of security and applications.

The shift to 5G is expected to lead to further advances in network virtualization. NEC's SDN/NFV technology offers good prospects for the future.

Q. In the safety business, NEC won a project from a US government agency. Could you please describe this project? When will this project contribute to revenue and profits?

A. It is a licensing project for face recognition software for airport related facilities. The project is only worth around several billion yen, but it is a major project. The project has contributed positively to the Global segment's performance in 1H of the fiscal year ending March 31, 2019.