

January 8, 2019

Q&A Session at IR Meeting for the Acquisition of Shares of KMD Holding ApS

Date/Time: January 8, 2019, 16:00-17:00 JST

Location: Ruby Room, Fifth floor, Keidanren Kaikan

Presenters: Takashi Niino, President and CEO
Takayuki Morita, Senior Executive Vice President and CFO
Masakazu Yamashina, Executive Vice President

Questioner A

Q. KMD has posted an operating loss for two consecutive years and a net loss. Why is KMD struggling in terms of profitability? From the fiscal year ending March 31, 2020, one-time expenses will end. Will KMD then start to post operating profit close to its ordinary level of EBITDA?

A. The one-time expenses consist of the costs of restructuring measures undertaken by the current KMD CEO since her appointment in 2014. Additionally, two major lawsuits with respect to pension and tax software have been brought against KMD in connection with the underachievement of specification requirements, late delivery and other factors. The one-time expenses also include provisions for those lawsuits. Most of the one-time expenses are expected to end in the fiscal year ending March 31, 2020 and profitability is expected to improve from the fiscal year ending March 31, 2021 onward.

Looking at net profitability, KMD has borrowed around ¥80.0 billion and the interest expenses on this debt amount to nearly ¥5.0 billion per annum. Because the debt will be repaid using the proceeds from the acquisition, the interest expenses will no longer have an impact on net profitability.

Q. I believe that NEC possesses highly advanced technologies in the safety business. Would it be too difficult for NEC to increase sales based on the competitiveness of its products alone? Does it really need to acquire companies such as KMD and Northgate Public Services Limited (NPS) to gain access to their sales channels? Will NEC continue to conduct M&As to develop sales channels, in order to expand the safety business?

A. NEC has globally competitive technologies in areas such as AI, biometrics and security, and possesses a strong customer base in Japan. However, we believe that it would be difficult for NEC to compete globally on a standalone basis with its technologies alone. In the safety business, there are differences in applications depending on the country and region. We believe that we can capture synergies by bolting NEC's technologies to companies that possess applications and customer bases in certain regions. Going forward, we believe that a certain amount of M&A activity will be necessary to expand our business globally.

Questioner B

Q. What level of operating profit can KMD expect to generate next fiscal year? When NEC acquired NPS, NEC recorded expenses in the first year, so the acquisition had a negative impact. Could you please confirm whether there are any other factors related to this acquisition that could hinder the earnings of the Global Business Segment in the short term?

A. Looking at KMD on a standalone basis, the impact of one-time factors will end starting from the fiscal year ending December 31, 2020. From the fiscal year ending March 31, 2021, the operating profit ratio of KMD alone is projected at around 10%. On a consolidated basis, NEC is forecasting an operating profit ratio of about 5% at KMD. The difference in the operating profit ratios is due to the amortization of intangible assets that will be recorded by NEC on a consolidated basis. Assuming that KMD has revenue of ¥90.0 billion, we expect KMD to make a positive contribution of ¥4.0 billion to ¥5.0 billion in operating profit to NEC. However, in the fiscal year ending March 31, 2020, NEC expects the contribution to operating profit from KMD to be break-even based on factors such as the recording of the reversal of revenue in accordance with a change in accounting policies, expenses related to this acquisition and other items. These items will depend partly on the timing of accounting procedures.

Q. KMD is closely involved in the systems of the Danish government. Is there any possibility that KMD will find it difficult to win orders after its ownership changes to a Japanese company?

A. First, it is important to note that KMD had already been foreign-owned by Advent International Corporation of the United States prior the acquisition. We closely examined whether there would be any impact on orders as a result of the acquisition of KMD. We

believe there will be no such impact.

Q. NEC had originally budgeted ¥200.0 billion for M&As under the current Mid-term Management Plan. NEC spent just over ¥70.0 billion on the acquisition of NPS and just over ¥130.0 billion on the acquisition of KMD. Does this mean that NEC has used almost all of its M&A budget? Can I correctly assume that NEC will not conduct any more M&As during the current Mid-term Management Plan?

A. Our original budget of ¥200.0 billion was for the previous Mid-term Management Plan from 2016 to 2018. We will have fully used the entire budget of ¥200.0 billion at the close of the fiscal year ending March 31, 2019. As M&As from the fiscal year ending March 31, 2020 onward are now being considered as part of our next rolling Mid-term Management Plan, we do not intend to stop here. Going forward, we will continue to consider M&As while looking into the details of future initiatives, including the size of acquisitions.

Questioner C

Q. Fields that handle the personal information of private citizens are sensitive areas. This is especially true in Europe, where I believe it is difficult to remove personal information obtained in a country outside of its national borders. Will this present any problems? If you have taken any measures to address such issues, could you please go over them?

A. In May, the General Data Protection Regulation (GDPR) entered force in the EU. Being directly affected by GDPR, KMD has responded very diligently to the new regulation. For example, GDPR imposes various restrictions, such as prohibiting personal information from being sent via email. In response, KMD has taken measures such as transitioning to fully Web-based systems. Looking ahead, we believe that the expertise developed by KMD in addressing GDPR will be a strong asset for NEC. For instance, when expanding business overseas, particularly in Europe, we will build data centers in each country.

Q. With this acquisition, I believe that NEC is now mostly on track to achieving its target of ¥200.0 billion for revenue outside Japan in the safety business. Will there be any changes to this forecast as we head into the new fiscal year?

A. Under current conditions, our target of ¥200.0 billion for the fiscal year ending March 31, 2021 is mostly within reach. We would like to make this field a core driver of growth. Accordingly, we will seek to make every effort to deliver revenue above our target.

Q. In the conventional field of security, NEC's business for police forces has been fairly easy to understand. In the field of digital government, the business has a broader range, covering national and local governments, and it seems unclear which areas NEC will address. Could you please discuss the direction for this business?

A. The "NEC Safer Cities" program covers an extremely broad range of fields. We believe that we will be able to expand our business from the safety business centered on police force-related areas to digital government through this acquisition. From here, we will be able to further expand business to various other fields, including smart transportation. Rather than seeking to narrow down our fields to particular businesses, we would like to carefully determine the fields where we will be able to expand business globally, including growth through future M&As.

Questioner D

Q. What kinds of companies will you compete with in business for the Danish government?

A. Our largest competitors will be companies like IBM, Accenture, and Fujitsu. KMD has captured a dominant share of the market in Denmark. Relative to an order intake of approximately ¥60.0 billion in the previous fiscal year, KMD has captured a market share that is around 5 times greater than the local company with the second largest share.

Q. Could you please go over the amounts of goodwill and intangible assets?

A. The total amount of goodwill and intangible assets is about ¥140.0 billion on a basis excluding software assets linked to projects. Half of this amount is goodwill, while the other half is intangible assets subject to amortization.

Q. What is the time frame for realizing the synergies expected from this acquisition?

A. Cost synergies, which typically appear in the short term, are expected to emerge from the fiscal year ending March 31, 2020. We will work to capture other synergies, which will have a larger benefit than the cost synergies, through 2022.

Q. What amount of cost synergies do you expect to capture?

A. We expect to capture synergies of several billion yen by replacing the software, services

and other items purchased by KMD with items currently purchased by NEC.

Questioner E

Q. You noted that the provisions for lawsuits have been mostly completed. Has NEC assumed any litigation risk through this acquisition?

A. We will consider a certain amount of provisions in the fiscal year ending March 31, 2020, and those portions corresponding to risk related to the litigation are to be deducted from the purchase price and paid.

Q. You noted that KMD holds data. How does this arrangement work?

A. In the field of healthcare, for instance, KMD will use medical histories, including information on the types of treatment individuals have received, to provide an analysis of future treatment plans and drug administration plans. In addition, KMD will use data held by the central bank of Denmark to provide an analysis of economic conditions and predictions. It's important to keep in mind that the owner of the data is the national government. KMD is granted the right to use the data to provide services.

Q. You noted that NPS has performed favorably. Could you please discuss NPS' performance in terms of orders and revenue?

A. NPS has an EBITDA ratio of around 28%. In May 2018, NPS won an order for a project worth several ten million pounds from the Metropolitan Police Service. As a result, NPS' share of business for police forces has surpassed 50% at this time, up from 28% at the time of the acquisition. We believe NPS has upside revenue potential, over and beyond our initial estimate of around ¥22.0 billion in revenue at the time of the acquisition. Last year, NPS acquired i2N Ltd, a company that provides software to the criminal justice sector, for approximately ¥1.0 billion. In addition, NPS acquired APD Communications, a company that supplies software to the emergency services sector. These acquisitions will also add to the upside revenue potential of NPS.

Q. You said that NEC will continue to actively consider M&As. How much risk is NEC willing to tolerate?

A. Our basic approach is to maintain our current credit rating. Conservatively speaking, the

surplus cash flow we will generate next fiscal year will serve as funding for additional M&As, providing a potential source of funds for acquisitions. We will control risk at this level. We also have another benchmark. We will control risk by ensuring that the sum of goodwill and intangible assets stays at or below our limit of 40% of equity. If held to this level, we believe that we will be able to maintain a sound financial position, even in an emergency.

Q. In regard to the surplus funds, what level of shareholder returns are you assuming for that time?

A. Assuming that the dividend is restored to the level of annual dividends for the fiscal year ended March 31, 2018, we expect to see potential surplus funds of nearly ¥100.0 billion in the fiscal year ending March 31, 2020.

Questioner F

Q. What is the amortization period for the intangible assets?

A. The amortization period is about 10 years on average. Given that this period can vary depending on the composition of the intangible assets, we would like to disclose the details within the permissible extent when they are finalized.

Q. In regard to the talk about lawsuits, my understanding is that when cost overruns occur in government-related business, the vendor usually must assume the extra costs. I believe that the lawsuits brought against KMD involve such cases, and that KMD needs to control the situation so that other similar cases do not occur in the future. Could you please discuss your approach to project management?

A. KMD appointed its current CEO in 2014 and has successfully reformed operations that it had previously been unable to reform. As a result, KMD has been able to manage projects very effectively over the past year and a half. One-and-a-half years ago, KMD had more than 10 problem projects. Today, it has reduced that number to two projects, and those two projects will soon end. NEC intends to strengthen project management further by dispatching personnel to KMD. Why did these problems happen? The main reasons were that KMD took orders that were beyond its ability to fulfill, or that KMD was either unable to implement projects effectively after winning orders or was unable to foresee the requirements of projects. The same things have also happened in Japan. We would like to make thorough improvements in these areas as part of our post-merger integration (PMI)

activities going forward. This will also involve applying NEC's project management expertise to solving various issues.

Q. In terms of future project management, will you create a mechanism where, for example, the green light for projects is given after the final project decisions are made in Japan?

A. We already have such a mechanism in place at NPS. A Project Agreement Board is always convened for projects of a certain size. We would also like to implement such a mechanism at KMD.