January 30, 2019

Earnings Presentation Q&A for Q3, the Fiscal Year Ending March 31, 2019

Date/Time: January 30, 2019 18:00-19:00 JST
Location: NEC Headquarters, Tokyo
Presenters: Takayuki Morita, Senior Executive Vice President and CFO

Questioner A

Q. For the nine months ended December 31, 2018, NEC reported that operating profit surpassed its forecast by ¥19.0 billion. To what extent did operating profit surpass your forecast in Q3 alone?

A. Looking at business factors only, operating profit surpassed our forecast by ¥14.0 billion for the nine months ended December 31, 2018. In 1H, operating profit was around ¥4.0 billion above forecast. This means that operating profit was around ¥10.0 billion above forecast in Q3 alone. Apart from this, in Q3, business structure improvement expenses had a positive impact that was about ¥5.0 billion above expectations. Altogether, operating profit surpassed our forecast by about ¥15.0 billion in Q3 alone.

Q. In what main areas did NEC outperform its forecasts? What went well in each area?

A. There was significant improvement in the Public and Enterprise businesses. In the Public business, the positive factors were fewer unprofitable projects than in the same period of the previous fiscal year, in addition to an increase in sales. In the Enterprise business, strong orders led to higher sales and profits.

Questioner B

Q. In the Public business, I recall that NEC had unprofitable projects of ¥5.0 billion in Q3 of the previous fiscal year. How much improvement was made in these projects? Considering that NEC posted business structure improvement expenses of ¥3.0 billion, I believe that the improvement represents strong growth in operating performance. Were there any special factors involved? Will you be able to maintain this level of profits going forward?

A. In the Public business, we reduced unprofitable projects to ¥1.0 billion from what had been ¥5.0 billion in Q3 of the previous fiscal year. One special factor was the recovery in orders from the impact of the suspension from contract bidding processes in firefighting and disaster prevention systems, which has led to improved sales. Looking at the future level of profits, a portion of the results are mixed between Q3 and Q4, but the overall business base has been improving. Given that unprofitable projects are improving and gross profit at order intake is improving slightly, we believe that this level of profits can be maintained going forward.

Q. The Global business seems to be performing steadily when factoring in business structure improvement expenses of ¥1.0 billion. Was safety profitable in Q3? Could you please also comment on the current status of wireless solutions?

A. In Q2, safety was profitable due partly to highly profitable projects, but it posted a small loss in Q3. On a full-year basis, we believe that safety will deliver results in line with our initial forecast. We expect wireless solutions to break even in Q4 atop improving profit. We are also in talks with another company on a business alliance to improve profits further. Combined with the improvement in business, wireless solutions are now expected to contribute to profits next fiscal year.
In contrast to the firm performance in the aforementioned two areas, display solutions, energy, and service providers solutions have so far fallen behind operating profit forecasts by around ¥2.0 billion each. Therefore, we believe that it will be difficult to achieve our forecasts in these areas on a full-year basis.
The main reason for the underperformance in service providers solutions is delay in an ODA-related project in the traditional optical network systems area, despite firm sales in Netcracker's Operation Support System (OSS) and Business Support System (BSS) areas.
In energy, we are targeting orders of ¥30.0 billion for the full year. However, these orders have not yet led to sales. In addition, we are facing cost pressures due to materials shortages. Currently, we are advancing negotiations on long-term contracts for components and diversifying our mix of suppliers. We expect to resolve the cost impacts by next fiscal year.

Q. Will the recent news about Huawei have a positive impact on NEC's wireless solutions?

A. At this time, we cannot foresee whether or not there will be a direct impact. Given that wireless solutions do not involve core fields such as base stations, we don't expect to see very much in the way of suppressed purchasing from Huawei.

Q. NEC had originally planned to use business structure improvement expenses of ¥40.0 billion in the current fiscal year and derive restructuring benefits of ¥30.0 billion next fiscal year. If you execute the measures you are currently considering, how will the plan work out? There are only two more months left in the current fiscal year. Will you be able to execute these measures?

A. Looking at the measures shown on page 19 of the presentation materials, measures worth ¥10.0 billion scheduled for Q4 have already been determined. Currently, we are considering how many additional measures we can implement. We will explain the results when we announce our full-year earnings. Eyeing next fiscal year, we are examining measures that will reduce fixed costs as effectively as possible, as well as trim operating expenses. We believe this is a crucial task for management.

Questioner C

Q. Can I correctly assume that NEC recorded business structure improvement expenses of ¥25.0 billion in Q3 and currently plans to record an additional ¥10.0 billion in Q4? I believe that NEC had factored in growth investments of ¥10.0 billion into its full-year plan. Could you please go over your actual growth investments in Q3 and your forecast for Q4?

A. Your understanding of business structure improvement expenses is correct. We executed growth investments of ¥6.0 billion primarily in the Public Safety area and certain other areas. We plan to use the remaining ¥4.0 billion in Q4.

Q. NEC reported that it will derive benefits from business structure improvements of ¥24.0 billion by streamlining the workforce by 3,000 employees through the implementation of voluntary early retirement and the transfer of the lighting business. However, initial plans called for benefits of ¥30.0 billion, so there is a shortfall of ¥6.0 billion. How will you cover the shortfall? Also, what benefits do you expect to derive from ending the operation of Tsukuba Research Laboratories?

A. We believe that we can generate the remaining ¥6.0 billion in business structure improvement benefits by optimizing the plants of NEC Platforms, Ltd., improving the business structure at NEC Lighting, Ltd. and fine-tuning offices and overseas sites to reduce fixed costs. Ending the operation of Tsukuba Research Laboratories is expected to generate benefits of several ¥100 million on a full-year basis.

Q. In the Global business, could you please go over the actual amount of improvement in the operating profit (loss) of wireless solutions? Also, the organic growth rate in safety in 1H, excluding Northgate Public Services Limited (NPS), was 20%. Has safety grown at the same pace in Q3?

A. Operating profit (loss) of wireless solutions in Q3 of the fiscal year ended March 31, 2018 was an operating loss of ¥2.5 billion. In Q3 of the fiscal year ending March 31, 2019, operating profit (loss) was a single-digit loss. In Q4, we expect to improve profitability almost to the break-even point. Safety showed significant organic growth in Q2, but did not grow in Q3.

Questioner D

Q. NEC seems to have many areas where business performance has been "in line with forecasts" or "exceeding forecasts." In normal years, NEC has often revised its full-year guidance when announcing its Q3 earnings. Given that there are calls for upward revisions to forecasts, is there any particular reason for your cautious outlook?

A. Heading toward the end of Q4, we would like to work until the very end of the fiscal year to examine and execute measures that will contribute to improved profitability from next fiscal year onward. That is, we would like to exhaustively pursue these measures until the end of the fiscal year. We will promptly disclose any changes to our forecasts should such changes become warranted.

Q. I believe that orders have been strong so far, and positive revenue growth can be expected in the new fiscal year. At this time, how confident are you in the prospects for revenue growth next fiscal year?

A. The market as a whole is generally believed to be facing increasing uncertainty. In this environment, NEC's orders have held firm so far with no signs of letting up. However, as we consider our plans for next fiscal year, we will need to closely monitor factors such as the macroeconomic environment and the impact of trade tensions.

Questioner E

Q. You noted that revenue and operating profit exceeded your internal budget for the nine-month period. Could you please provide a breakdown of revenue and operating profit *by segment?*

A. Revenue and operating profit surpassed our internal budget by ¥12.0 billion and ¥8.0 billion, respectively, in the Public business, ¥28.0 billion and ¥6.0 billion, respectively, in the Enterprise business, and ¥10.0 billion and ¥2.0 billion, respectively, in the Network Services business. In the System Platform business, revenue was ¥10.0 billion above budget, while operating profit was in line with budget. In the Global business, revenue and operating profit (loss) were ¥23.0 billion and ¥5.0 billion below budget, respectively. In Others, revenue and operating profit were ¥30.0 billion and ¥3.0 billion above budget, respectively. Adjustment improved by ¥5.0 billion at the operating profit (loss) level.

Q. In the previous fiscal year, NEC was impacted by the suspension from contract bidding processes. Orders are now strong. In your analysis, how much of this rebound is attributable to the recovery from that suspension?

A. It is difficult to estimate the exact amount. Orders in the Public business have been trending favorably, and we believe that around half of these orders is attributable to the recovery.

Q. You noted that the acquisition of KMD is expected to be completed by February. Is there any possibility that KMD could act as a drag on NEC's consolidated financial results next fiscal year?

A. Looking at KMD's contribution to consolidated financial results, we expect it to break even after amortization of intangible assets.

Questioner F

Q. There were 2,170 applicants for voluntary early retirement, compared with 3,000 employees initially sought for the program. The threshold of 3,000 employees was reached through the transfer of all businesses of NEC Lighting, Ltd. Did you anticipate this outcome from the beginning?

A. The retirement program involves voluntary retirement, so the number of participants cannot be planned with certainty. Based on the projected cost savings effect of ¥30.0 billion, we had estimated that 3,000 employees would be needed to participate in the program. Ultimately, the number of participants turned out as we expected, but the cost savings effect fell short, at approximately ¥24.0 billion. The reality is there is a shortfall of around ¥6.0 billion. In response, we are now taking steps to implement measures in Q4 that will lead to an improvement of ¥6.0 billion. Putting aside the question of whether all the measures will produce lasting benefits, we believe that, at the very least, we will be able to cover the shortfall of ¥6.0 billion through the cost savings effect in the next fiscal year.

Q. This would be NEC's fourth round of business structure improvements since 2000. Will this be the last time NEC implements restructuring with respect to personnel? Will NEC be able to achieve President Niino's target of reducing the SG&A expense ratio to 20% or below by growing revenue?

A. We don't plan to conduct any more restructuring with respect to personnel in Japan, considering that we face personnel shortages in some areas. In terms of improving SG&A expenses, we believe it is imperative to step up business process optimization activities already under way at NEC Management Partner, Ltd. Our main focus will be to implement improvements through means other than personnel cuts.

Q. At the presentation on the acquisition of KMD, you noted that you expected to generate free cash flow of nearly ¥100.0 billion in the next fiscal year and that you wanted to use those funds for M&As. How do things stand now?

A. First, we will not stop conducting M&As following the recent KMD acquisition. We are continuously examining M&A opportunities. If we conduct an M&A next fiscal year, we believe that the upper limit for the acquisition value will be the amount of free cash flow in the next fiscal year.

Questioner G

Q. What is your estimate of NPS' contribution to profitability in the fiscal year ending March 31, 2019? Could you please also discuss your outlook for the direction of revenue and profits in the fiscal year ending March 31, 2020?

A. We expect NPS to post revenue of ¥22.0-23.0 billion in the fiscal year ending March 31, 2019. NPS' contribution to operating profit will be held to several ¥100 million due to the impact of the amortization of intangible assets. However, NPS is expected to contribute around ¥4.0-5.0 billion to EBITDA. In the fiscal year ending March 31, 2020, we believe that NPS will achieve growth in sales and make a higher contribution to operating profit as the amount of intangible assets decreases.

Q. In the fiscal year ending March 31, 2019, NEC aims to achieve a break-even result in the Global business. Without becoming complacent with that result, will you consider further optimization measures? For example, will you consider entering into capital alliances in wireless solutions from the fiscal year ending March 31, 2020?

A. Although we don't have any specific plans at this time, we cannot rule out such a possibility. With wireless solutions, profitability has been improving as we have successfully downsized the product line and selectively taken orders. In the fiscal year ending March 31, 2019, we made development investments of ¥2.0 billion to standardize products, and we expect to reduce development costs by 40% from the fiscal year ending March 31, 2020 onward. Going forward, we will continue to develop a common platform for products, thereby transforming wireless solutions into a business that contributes to profits.

Q. Could you please discuss your future shareholder return policy? While continuing to examine M&As, haven't you considered options for reorganizing the business portfolio?

A. In my personal opinion, I would like to first set dividends per share at ¥60. I'd also like to focus on a payout ratio of 30%. In addition, I'd prefer to invest in areas with good returns over conducting share buybacks. I believe that NEC has moved earlier than other companies to implement measures to reshape the business portfolio. Without slowing the pace of these measures, we intend to continuously reshape the business portfolio.