

July 16, 2019

NEC IR Day 2019 (Public Business) Q&A

Date/Time: July 16, 2019 9:40-10:30 JST

Location: NEC Headquarters, Tokyo

Presenters: Chikara Nakamata, Executive Vice President, head of Public Solutions Business Unit

Noritaka Taguma, Executive Vice President, head of Public Infrastructure Business Unit

Questioner A

Q. In fiscal 2020, is NEC aiming for zero unprofitable projects? At other companies, after they set up a quality-focused organization, they often had unprofitable projects on their order books. What are your thoughts on risk management for profitability?

A. In the public segment, most projects have long-term timelines. For example, defense and space-related projects take three to five years. There are also some projects that finish within one year, from order receipt to sales, but overall, most projects take more than a year. Due to the nature of this business, unprofitable projects can materialize after orders are accepted. There are three key points to improving profitability. The first is to clearly define common processes, like order taking, product delivery and maintenance, within a broad range of domains, and then check them rigorously. The second is to work hard to improve profitability by being more selective at the initial order-taking stage for long-term projects. Finally, we must not forget the spirit of taking on challenges. NEC pursues business while quantifying risk, such as entering into preliminary prototyping contracts with customers while monitoring technological risk. We assume unprofitable projects will be equivalent to roughly 0.5% of revenue, and our earnings targets for fiscal 2020 reflect this assumption.

Q. Is it therefore correct to say that NEC expects unprofitable projects equivalent to 0.5% of revenue in fiscal 2019, and does not expect to improve profitability in fiscal 2020 by reducing unprofitable projects? Will this 0.5% unprofitable project figure change?

A. We assume that unprofitable projects cannot be eliminated based on our past experiences, owing in part to defects in hardware components.

Q. What are the figures for maintenance/support and recurring income businesses? And what are your growth projections for these businesses?

A. Page 11 shows adjusted operating profit trends from fiscal 2018 to fiscal 2019. We expect a ¥1.2 billion improvement in maintenance and operation services. NEC is keen to turn maintenance services into a recurring income stream, and expand sales of services as a new business model. These efforts have only just begun, and therefore do not account for a large percentage of business yet.

Questioner B

Q. How much will gross profit increase in fiscal 2018?

A. As shown on page 8, the improvement in gross profit corresponds to growth in large projects and other revenue.

Q. Can you provide more detail about how gross profit will improve in fiscal 2019?

A. At the order-taking phase, NEC focuses on the gross profit margin when orders come in, and selects orders based on profitability. In the development process, NEC manages risk during each process so that gross profit does not deteriorate and become an unprofitable project.

Q. How much potential is there for gross profit to improve in fiscal 2020?

A. NEC needs to improve its adjusted operating margin by one percentage point, and is working to improve earnings by the same pace as fiscal 2019.

Questioner C

Q. On page 16, NEC estimates the digital government market is worth ¥930 billion for national and local government services, with ¥560 billion in total for digitalization of administrative services and cloud by default. However, I do not see how the market can become this large from the standpoint of investments in ICT by national and local

governments. Does this mean NEC expects existing business domains to decline? What is your outlook for the entire market?

A. We understand that negative and positive factors are both at work in the overall market, with moves to the cloud causing declines in existing systems, and new undertakings by national government entities creating demand. In all, we forecast flat year-on-year growth or a minor uptick in demand. NEC aims to increase market share by taking a leadership role in these trends.

Q. What is NEC's outlook for market share, as shown on page 18?

A. NEC does not anticipate strong growth in the disaster prevention market. We aim to take the lead on providing new added value through AI and IoT to customers advancing digital transformation (DX). We also aim to expand market share in conjunction with sensors and network services, as well as in digital government. Investment in ICT in the railway and roads domain is unlikely to increase considerably, but labor shortages have clearly become a problem in maintenance and other areas, so we expect to see growth supported by ICT in these areas.

Meanwhile, the nature of business has changed in broadcasting and electric power. In electric power, the energy mix is changing while electricity transmission and distribution are separated, and there are limits in how much people can do in managing this, so AI and IoT will provide support in this regard. In broadcasting, media are converging together, while new business opportunities increase. It is necessary to tackle areas where the social and system frameworks are changing, and areas that have always been there.

Questioner D

Q. NEC has set a 5% target for the adjusted operating margin in its current mid-term management plan. The public segment's operating profit margin is higher than this average, leading the entire company. However, if NEC targets an adjusted operating margin of more than 10% in its next mid-term management plan, will the public segment undermine the entire company because the social infrastructure market is unlikely to expand much, given its profitability? Over the longer run, to what degree can profitability improve in the public segment?

A. We believe the government domain has considerable potential in terms of increasing efficiency with AI and IT, given the significant cost of paying for healthcare and other social issues. This is a domain where new value can be created in collaboration with healthcare

providers, not just NEC alone. Apart from healthcare, NEC is working to create a framework where new value can be added onto areas where operations are being advanced in collaboration with the private sector, not just the government as in the past. KMD Holdings, which NEC acquired, has strong momentum with knowledge gained from being in Denmark, an advanced country in digital government, and a track record in breakthrough collaboration between public-private entities. NEC intends to apply KMD's knowledge in business for the Japanese government. When NEC acquired KMD and Northgate Public Services, they became participating members in the public business unit, including PMIs. NEC is keen to generate synergies while conducting due diligence with insights in the domestic market and a strong business sense. NEC aims to increase the adjusted operating profit margin above 10% after fiscal 2021.