October 29, 2019

Earnings Presentation Q&A for 1st half of the Fiscal Year Ending March 31, 2020

Date/Time: October 29, 2019 18:15-19:15 JST
Location: NEC Headquarters, Tokyo
Presenters: Takashi Niino, President and CEO (Representative Director)
Takayuki Morita, Senior Executive Vice President and CFO and Member of the Board (Representative Director)

Questioner A

Q. Adjusted operating profit was ¥15.0 billion higher than the company's internal plan in 1H. Can you give a breakdown by segment for 1H and Q2?

A. In 1H, the adjusted operating profit was higher than we expected by ¥7.0 billion in the Public segment, ¥3.0 billion in the Network Services segment, and ¥8.0 billion in the System Platform segment, but lower than we had planned by ¥3.0 billion in the Global segment. In Q2 alone, the Public, Network Services and System Platform segments beat our plans by ¥7.0 billion, ¥2.0 billion and ¥6.0 billion, respectively, while the Enterprise and Global segments undershot by ¥2.0 billion and ¥3.0 billion, respectively.

Q. Looking at Q2 figures for the Global segment, the adjusted operating profit fell by ¥2.4 billion year on year. In the previous fiscal year, I understand there was a project with good margins in the U.S., but excluding this project, profitability does not seem to be improving. Is Safer Cities expanding? What other factors are in play?

A. The existing business excluding M&A in Safer Cities was near the breakeven point in Q2. In the previous fiscal year, we had a project for a U.S. government institution that boosted profits, but disappeared this year. In Q2, KMD and NPS contributed to profits. The Service provider was profitable in the ¥1–2 billion range in Q2 alone. The Wireless backhaul returned to profitability, and the Submarine systems were also in the black. On the other hand, the Energy incurred a loss of ¥3.0 billion in total for 1H, with larger losses in Q2. Q1 losses in the Display were offset in Q2, breaking even in 1H.

Q. Did orders weaken for domestic IT services in Q2?

A. Orders slowed down slightly from private-sector demand, such as the manufacturing sector. However, orders remained brisk in the public, retail, and communications sectors.

Questioner B

Q. IT service orders were 90% of the previous year's level in Q2. How does this break down by sector? Do you expect orders to deteriorate in 2H?

A. Orders were robust from government agencies and local governments. Orders declined from the manufacturing and financial sectors, and were basically unchanged from the previous year from the retail and telecommunications sectors. Orders have slowed down somewhat from the manufacturing sector, but overall inquiries from customers have not lost momentum.

Q. Has the ending of support for Windows 7 affected PC orders? Is there any sign of a slowdown?

A. In NEC's case, we only provide business PCs, and we expect orders to remain strong from Q2 into Q3, staying at the same level or declining only a little. Visibility is uncertain for Q4, so by conservative estimate, sales will decrease slightly. Next fiscal year, we forecast a roughly 40% decline in volume compared with this fiscal year.

Q. Even though performance was better than expected in 1H, why hasn't NEC changed its full-year earnings guidance?

A. NEC continues to perform favorably in Japan, and we are moving in a positive direction overall. We identify as a risk the uncertainty of how much deterioration is yet to come in the Energy and Display, but even with this risk, we still anticipate moving in a positive direction. With an eye on hitting our targets under the Mid-term Management Plan 2020, we aim to use this upside buffer in order to implement executable measures for organizations. For example, the Company is accelerating development while moving up work-style reforms and expanding the BASE, co-working space.

Questioner C

Q. Why did the Enterprise segment undershoot your Q2 forecast by ¥2.0 billion?

A. Unprofitable projects occurred for new customers in the Enterprise segment. We have already addressed these projects by thoroughly examining them in detail and provisioning reserves for potential risks in the future.

Q. Can you describe the unprofitable projects in each segment?

A. In 1H, we had a total of ¥7.5 billion in unprofitable projects, including ¥2.5 billion in the Enterprise segment, ¥3.0 billion in the Public segment, ¥1.0 billion in the Network Service segment, and ¥1.0 billion in the Global segment. NEC had ¥15 billion in unprofitable projects in the previous fiscal year, so the pace is about the same this fiscal year. The Company is strengthening project management in 2H.

Q. You explained there are risks in the Global segment, and it seems that the Energy and Display have been on the weak side since 2H of last year. What measures are you taking to address this?

A. Our display business is an asset-light business without any factories, so risks can be properly managed, in my opinion. It posted a minor profit in 1H, but conditions have not improved, especially in Europe, and we see risks in 2H. In the Energy, revenue expanded in the wake of an increase in orders over the past two years, but we need to better manage projects. The Energy recorded a loss of ¥3.0 billion in 1H, and we believe there is a similar risk in 2H. Management is keen to address risks in the Energy and Display this fiscal year so they do not arise again from the next fiscal year onward.

Q. NEC has shipped 5G base stations to NTT DoCoMo. What are your expectations for similar shipments to Rakuten Mobile next fiscal year? Please share your outlook for the 5G business.

A. The Operation Support System (OSS)/Business Support System (BSS) is currently the main business we have with Rakuten Mobile, and next fiscal year, we will add 5G base station radio units. We expect both to contribute significantly to business. In total, shipments of 5G base stations have commenced this fiscal year in small quantities, and should more than offset the decline in 4G base stations from next fiscal year.

Q. How is NEC involved in local 5G network businesses?

A. NEC is currently conducting a variety of field trials with customers. Depending on the sector and application, LTE and WiFi are also used in conjunction with local 5G. NEC approaches the business by providing optimal network services, instead of only supplying equipment for local 5G networks. The Company has already received multiple orders for this kind of business. From this fiscal year or next fiscal year, we think applications will gradually emerge that take advantage of 5G's high speeds and low latencies. NEC plans to begin selling a variety of related services from 2H of the current fiscal year.

Questioner D

Q. What are the Q2 results and 2H forecast in the Public segment?

A. IT systems did well for central and local governments. Although market conditions may not be as good as they were in Q2, we expect solid conditions to continue in 2H.

Q. Can you talk more about NEC's collaboration with Samsung in the 5G area?

A. NEC has already started collaborating with Samsung for NTT DoCoMo, and both companies have also set their sights on global business development, working on joint proposals for customers in Europe and the APAC region. Going forward, we intend to further accelerate this joint initiative with Samsung.

Q. I heard that NEC has received many inquiries about Safer Cities. When do you expect these inquiries to translate into revenue growth?

A. NEC targets revenue growth of around ¥10 billion for Safer Cities this fiscal year on an organic basis, in addition to the boost received from adding KMD to the scope of consolidation. While this may be a bit of a stretch, we anticipate the bulk of revenue will come in 2H. We hope airport projects will grow.

Questioner E

Q. How long do you think favorable performance will continue in domestic IT services? Looking at statistics from the Bank of Japan's "Tankan" survey, corporate earnings do not look that good, and the survey indicates a minor downturn in the outlook. If profits decline across the board, IT services is a lagging indicator so the outlook does not seem that great.

What is your take on this?

A. Overall, we look for favorable conditions to continue this fiscal year and next fiscal year. Even if demand for existing IT services decreases, we anticipate strong demand for digital transformation and expect growth in this field. A key point will be how well we can tap into this demand for digital transformation. Additionally, contrary to the past, IT-related projects are unlikely to be discontinued today simply because earnings have deteriorated for our customers. We believe our customers are increasingly aware of the need for digital transformation as a means of enhancing the competitiveness of their businesses.

Q. Regarding networks, fixed-line networks are being reinforced to handle 5G traffic, but what areas of demand are strong? There should be significant demand from the rollout of 5G services, but how much demand does NEC anticipate?

A. We think that backbone networks will continue to be expanded for quite a while, with a focus on optical fiber as a core field. Core networks are being upgraded ahead of the rollout of 5G services, and we look for demand to gradually shift toward the wireless network domain, including base stations.

Questioner F

Q. In the Public segment, NEC appears to forecast considerably lower revenue in 2H if actual results in 1H are deducted from its full-year targets. Does this sit well with the CEO and CFO? Or should this be interpreted as NEC simply not changing its full-year forecast?

A. We have simply not changed our forecast. In 1H, revenue was ¥80 billion higher than we had anticipated, and our internal full-year target was set based on this performance in 1H. We believe it is important to closely examine operating profit when revising earnings guidance, and we will keep a close eye on progress on this front through Q3.

Q. In terms of the System Platform segment, please give us your thoughts on the reasons for an increase in earnings in 1H by domain.

A. Adjusted operating profits in this segment increased by ¥15.8 billion in 1H, and about ¥5 billion of this figure was attributable to structural reforms in the previous fiscal year. The remaining ¥11 billion is due to the improvement in profit on hardware.

Q. What can you share with us about major projects anticipated in 2H? For example, can we expect any contributions to revenue in 2H from projects related to ATMs for Seven Bank, *systems for unmanned convenience stores, or facial recognition systems for airports?*

A. NEC has already started shipments for Seven Bank, and these shipments will pick up next fiscal year. With regard to unmanned convenience stores, it will be necessary to work closely with our customers to make them a reality, so we have positioned these as future projects, after next fiscal year. Airport-related projects could increase more than we expect this fiscal year, though it depends on how much progress is made, and these projects could slip into next fiscal year. In facial recognition systems for airports, NEC targets 600 medium- and large-sized airports for business development out of the 4,000 airports around the world. The Company aims to reach revenue in the tens of billions of yen in the next three years.