January 29, 2020

Earnings Presentation Q&A for Q3, the Fiscal Year Ending March 31, 2020

Date/Time: January 29, 2020 17:30–18:20
Location: NEC Headquarters, Tokyo
Presenter: Takayuki Morita, Senior Executive Vice President, CFO (Chief Financial Officer) and Member of the Board (Representative Director)

Questioner A

Q. For the nine-month period, adjusted operating profit was ¥15.0 billion higher than the company's internal plan, the same overshoot (¥15.0 billion) as in 1H. Does this mean Q3 was in line with the company's expectations? Also, were there any one-off expenses in Q3, such as for unprofitable projects or business structure improvement costs?

A. Q3 was broadly in line with our internal plan. Earnings were steady, and definitely not lower than projected. One-off expenses included unprofitable solar power projects at NEC Networks & System Integration Corporation (NESIC), but earnings basically bottomed out as a strong growth in the Network Services Business absorbed these expenses. We expect growth from next fiscal year in this domain.

Q. Were the unprofitable projects in Q3 only at NESIC?

A. In addition to NESIC, there are unprofitable projects, as we anticipated, in the Public Business, so we recorded around ¥3.0 billion.

Q. Reverse-calculating from full-year forecasts, it seems NEC expects profits to decrease ¥11.5 billion year on year in Q4. Why? It seems profits should increase in Q4 with a year-on-year improvement of ¥28.0 billion related to the absence of business structure improvement expenses posted in the previous fiscal year and their effects this year. Is NEC planning other spending? Or is management just staying on the conservative side?

A. Our basic approach entails not taking any special measures to generate profits in Q4. Rather, we intend to implement feasible measures that will lead to better earnings and business expansion in fiscal 2020 ending March 2021 and from fiscal 2021 ending March 2022. Profits for the first nine-month period were ¥15.0 billion higher than internal company plans, but we do not expect momentum to slow down in Q4. Furthermore, we initially allocate a ¥10.0 billion risk buffer overall. We plan to spend ¥10.0 billion on additional measures in Q4, and potentially more if possible. As long as something unexpected does not arise, we believe these measures will contribute to future profit growth.

Q. Please explain conditions for Safer Cities in the Global Business. Did sales increase in organic areas, excluding KMD Holding (KMD) and Northgate Public Services (NPS)?

A. KMD and NPS have shown greater-than-expected progress, owing in part to post-acquisition roll-up M&As. In organic areas, we saw steady progress on individual projects, but their contribution to sales and profits will probably come in March or next fiscal year and beyond. Growth was basically flat in organic areas over the nine-month period, and our outlook for the year is on the weak side due in part to the situation in Hong Kong, foreign exchange rates, and delays in some projects in Asia.

Questioner B

Q. How much do you expect business PCs and servers to contribute to revenue and profit growth in the System Platform Business?

A. Over the nine-month period, they, mostly business PCs have contributed roughly ¥50.0 billion to revenue growth. We estimate they will boost revenue by about ¥60.0 billion the entire year.
We estimate business PCs will contribute almost ¥10.0 billion to annual adjusted operating profit. We assume this nearly ¥10.0 billion boost will disappear next fiscal year.

Q. In the Global Business, you expect that adjusted operating profit to come in around ¥10.0 billion below the annual forecast, so could you please provide that breakdown?

A. We see downside risks of about ¥4.0 billion in energy, ¥3.0 billion in displays, and ¥3.0 billion in other areas.

Questioner C

Q. In Q3, the Public Business saw a year-on-year increase in unprofitable projects, and revenue and profits declined at Japan Aviation Electronics Industry, Ltd., implying that other key domains saw sharp improvement. What factors are in play here?

A. Our controls on unprofitable projects have been effective. Although the situation worsened in Q3 alone, we expect the business to contribute to earnings improvement for the entire year. Orders, including for IT services, increased briskly, and this order backlog should contribute to earnings this fiscal year and next. Earnings improved strongly alongside growth in sales in Q3, and we expect this level of profitability to persist.

Q. What were conditions for orders in Q3? Fiscal 2018 ended March 2019 saw an increase in reaction to NEC being prohibited from participating in bids in fiscal 2017 ended March 2018. In this context, was public solutions growth negative in fiscal 2019 ending March 2020?

A. It is difficult to answer this question based on quarterly figures since we caused a misunderstanding with our explanation of Q2 figures only when we released 1H results. but in fiscal 2018, orders grew strongly for local government in the Public Business. Therefore, although the order environment for the public business was steady, a comparison to Q3 only shows negative growth.

Q. What impact will additional measures have from next fiscal year onward? Will NEC focus more on Displays and Energy?

A. Our measures to improve earnings are likely to have a measurable impact of accelerating software development in Japan, accelerating the depreciation of legacy products as a result, and business structure improvement costs for unprofitable operations outside of Japan. From every angle, we are examining measures to drastically improve earnings in Energy and Displays, and we intend to draw up plans for the future during this fiscal year. We are now searching for ways to avoid negatively impacting earnings next fiscal year and beyond.

Questioner D

Q. Orders in Q3 alone appear to have declined compared with the previous fiscal year. Even though the business structure improvement measures last fiscal year has had a measurable impact, improvement on the operations front does not seem that significant.

What can you say to this?

A. Over the nine-month period, adjusted operating profit has improved by ¥47.0 billion in terms of reductions in the business structure improvement expenses posted last fiscal year and the benefits from structural reforms. However, adjusted operating profit improved by ¥66.6 billion, for an underlying improvement of around ¥20.0 billion, a sizeable amount. We have not revised our full-year earnings forecasts, even though adjusted operating profit improved ¥15.0 billion more than we expected internally over the nine-month period. This is because we place more importance on earnings growth next fiscal year, the last year of our Mid-term Management plan 2020, and beyond, and will prioritize investment to this end. We believe underlying business conditions have been improving.

Q. What areas are likely to facilitate sales growth next fiscal year?

A. The Public Business is robust. In the Network Services Business, we expect business related to 5G and local 5G to expand. In the Enterprise Business, key customers are on the verge of launching major projects, so we expect to see healthy growth and profits overall.

Questioner E

Q. Among this round of additional measures, NEC plans to spend about ¥5.0 billion on the digital transformation and 5G fields, but can you be more specific? For example, do you plan to hire more personnel? How will this ¥5.0 billion be spent in the less than three months remaining in the current fiscal year?

A. There are three broader areas, one of which is security. NEC will bolster security, such as through redundancy in its own systems. Another area is system modernization, including open-source initiatives at customers, and addressing the so-called “2025 cliff.” The third area is accelerating the development of digital ID solutions, including facial recognition, and cross-sector platforms.

Questioner F

Q. Is NEC thinking about changing the scope of consolidation for Energy and Displays? Additional measures do not seem to include amounts for Energy and Displays. Is this *because estimates cannot be formulated? Or is this because margins should improve next fiscal year even without additional measures this fiscal year?*

A. Some additional measures for Energy and Displays are included in this round of measures for improving earnings. However, these measures aim for linear improvement, not drastic improvement. We are not denying the possibility of changes in how we hold capital in terms of taking drastic measures. We are considering measures along these lines as well.

Questioner G

Q. I have heard talk that NEC is considering alliances with other companies in Displays and Energy. Is NEC making progress as planned to forge such alliances during this fiscal year?

A. We are indeed undertaking such efforts, and can commit to coming down to a final decision on this front eventually, but we cannot comment on when this will happen.

Q. Regarding the ¥10.0 billion in additional measures, will they disappear next fiscal year and help increase profits in year on year comparisons?

A. NEC plans to include in the new fiscal year's budget everything we can envision for the next fiscal year. Since ¥15.0 billion more in adjusted operating profit was generated over the nine-month period that exceeded expectation, we will implement a round of measures to leverage that profit to enhance corporate value and take us one step closer to achieving our Mid-term Management plan. We do not assume there will be something similar to this in the next fiscal year.

Q. I believe investors have not settled on an outlook for demand conditions in the Public Business and Enterprise Business next fiscal year. Will revenue continue to expand? Or, will they decrease? Please tell us your current forecasts.

A. Uncertainties have grown recently, so we cannot say with 100% certainty, but at this juncture, we do not expect sales to decrease. Given the buildup in orders, the Public domain is doing rather well, and contract timeframes are long. We therefore do not anticipate negative growth, despite the uncertainties.

Questioner H

Q. Can you comment on how NEC positions ABeam Consulting?

A. Chief Digital Officer (CDO), Mr. Ishii became chairman at ABeam last fiscal year and has been working to build stronger ties with NEC. For example, he is working on a number of projects, such as integrating a comprehensive approach to specific accounts, from consulting to delivery. Moreover, NEC's resources can be deployed in several areas of the projects taken on by ABeam, and we are creating a framework like this that is able to systematically address customer needs. We believe this will result in stronger synergies between the two companies from next fiscal year onwards.

Q. What is dotData's position from NEC's perspective?

A. Our first goal is to enhance corporate value by leveraging the talents and business ambitions of their excellent researchers. Our second goal is to accelerate the pace of commercialization. Instead of taking 100% of 10, we aim to move from 10 to 100, and take 30% or 40%. We intend to build a model that enhances overall value. Our third goal is to make dotData more independent, and create synergistic benefits by dividing operations in Japan where NEC is strong. dotData plans to receive funding from two companies, underscoring its corporate value despite having losses on their books. I believe they will be able to bring this value front and center.

Q. Profits on business PCs is just under ¥10.0 billion annually. What is your estimate of profit contributions from business PCs in Q3 and Q4?

A. Business PCs have contributed to about 80% of profits through Q3. Since January, the PC business has not shown signs of slowing down.