May 12, 2020

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

Date/Time: May 12, 2020 17:00-18:00 JST
Location: NEC Headquarters, Tokyo
Presenters: Takashi Niino, President (Representative Director) and CEO
Takayuki Morita, Senior Executive Vice President, CFO and Member of the Board (Representative Director)

Questioner A

Q. Financial forecasts for the fiscal year ending March 31, 2021 does not factor in the impact from COVID-19, but what risks do you envision? What are your current thoughts from a qualitative and quantitative perspective?

A. There is no way of knowing how widespread the impact from COVID-19 will be. As a company, we estimate sales could decline by around 5% annually, assuming the outbreak fades to some degree in the first half of this fiscal year and then business picks back up from the second half. We are taking steps to address various risks in this scenario, and still aim to achieve our earnings targets.

Our forecasts for the fiscal year ending March 31, 2021, do not reflect COVID-19 as a specific risk, and we believe our forecasts are somewhat resilient to changes in the macro environment. COVID-19 has the potential to damage annual sales by 5% and gross profit by ¥40-50 billion, but we believe this impact can be offset by cutting costs and addressing stronger demand in areas such as telecommuting.

Q. What factors are behind changes in adjusted operating profit in the fiscal year ending March 31, 2021? Gauging by page seven of the results presentation materials, it seems that the disappearance of special demand for business PCs will be a negative factor of ¥10 billion, while the absence of one-

time costs booked in the fiscal year ended March 31, 2020 should provide a boost of ¥27 billion. Are there any other factors in play?

A. As you said, special demand for PCs boosted profits by ¥10 billion in the fiscal year ended March 31, 2020, and the disappearance of this demand will be a drag on earnings in the fiscal year ending March 31, 2021. In addition, we estimate investments centered on 5G will increase by roughly ¥5 billion. On the plus side, ¥27 billion in one-time costs will disappear, leaving a net positive of ¥12 billion. Subtracting this figure from the ¥19 billion in improvements we anticipate for the fiscal year ending March 31, 2021, we are left with ¥7 billion that can be realized by reducing unprofitable projects and improving operations. If we can accomplish this, we believe our adjusted operating profit forecast is achievable in the fiscal year ending March 31, 2021. We do not anticipate any other special factors.

Questioner B

Q. As of the third quarter results announcement, NEC forecasted adjusted operating profit would amount to ¥17 billion in the global business segment in the fiscal year ended March 31, 2020, but ended up incurring a loss of ¥3.8 billion. This has not helped boost confidence in management's ability to achieve its targets for the global business segment. Is there a problem managing the global business, and what does the company plan to do about it?

A. First of all, we missed our target due to three main reasons, namely ¥9 billion in one-time costs being booked in the fourth quarter, sharp deterioration in the energy and display businesses, and slower than initially anticipated growth in the existing Safer Cities business. However, our recent acquisitions, NPS and KMD, performed well, profitability improved in service provider solutions, wireless solutions turned in a profit, and submarine systems saw profit expand, all in line with expectations. NEC decided to deconsolidate the display business, and will make a decision about the energy business soon. We intend to strengthen the structure of the Safer Cities business to spur organic growth.

Q. Please tell us your IT service market assumptions for the fiscal year ending March 31, 2021. Do you see a risk that postponed investments in the manufacturing industry as it deteriorates the earnings?

A. Looking at the projections of a number of market research firms, there is evidently a risk that the IT service market will decrease by about 5% year on year in the fiscal year ending March 31, 2021. While we believe major differences may arise by sector, as you pointed out, investments look likely to be postponed in the manufacturing industry amid severe earnings deterioration, and harsh conditions are likely to continue in the service sector and logistics sector. On the other hand, demand should remain brisk for IT services in the government sector and from telecommunications providers.

Q. I see the potential for adjusted operating profit to fall by ¥10 billion in the system platform business as special business PC demand drops out of the picture in the fiscal year ending March 31, 2021, but NEC only forecasts a ¥5.9 billion decrease for the year. Why?

A. We expect a decline in business PCs, but we also expect convenience store ATM business, which was launched in the fiscal year ended March 31, 2020, to pick up from the fiscal year ending March 31, 2021. Furthermore, we anticipate some contributions to operating profit from the GIGA School project, where the Japanese government aims to provide a PC for every elementary and junior high school student nationwide. Including these factors, we forecast profits will decline ¥5.9 billion.

Questioner C

Q. Please discuss recent conditions and plans for the global business segment. How are current conditions at NPS and KMD, as well as the outlook for these companies, reflected in your forecasts? In the facial recognition field, was the Star Alliance project provided in the fourth quarter of the fiscal year ended March 31, 2020? What is your outlook for IT investment at airline companies *and airports?*

A. NPS and KMD have performed in line with business plans drawn up at the time of their acquisition. They are on track to achieving targets for the fiscal year ending March 31, 2021. In total for both NPS and KMD, adjusted operating profit was roughly ¥7.5 billion in the fiscal year ended March 31, 2020, and we forecast almost ¥10 billion in the fiscal year ending March 31, 2021. In existing business, we secured a profit in the fiscal year ended March 31, 2019, but due in part to the impact from COVID-19 in the fourth quarter, a loss was recorded for the fiscal year ended March 31, 2020, owing to project delays in Asia, especially Hong Kong and Singapore. As existing business improves, profits at NPS and KMD will add to net growth, keeping the Safer Cities domain on track to achieving targets for the fiscal year ending March 31, 2021. NEC plans to recognize sales for the facial recognition project for the Star Alliance in the fiscal year ending March 31, 2021. It should be profitable due in part to licensing agreements, but not contribute much to sales. We anticipate investments in e-gates at airline companies and airports over the medium term, but factor this conservatively into our estimates for the fiscal year ending March 31, 2021. We expect growth from the fiscal year ending March 31, 2022, but will probably have to revisit our forecasts.

Q. Did NEC set a cautious dividend payout ratio in light of COVID-19? How much cash can be made available by unwinding cross shareholdings and liquidating receivables? What is NEC's policy on allocating free cash flow for investments, shareholder returns and retained earnings?

A. Our basic thinking is as follows in these extraordinary conditions during the fiscal year ending March 31, 2021. We have not changed our fundamental approach to dividends. Our basic policy on investments, shareholder returns and retained earnings is to comprehensively return value to shareholders through improvements to enterprise value and steady shareholder returns, including dividends, over the long term. In the surrounding industry, NEC believes it is its mission to pursue growth through investments within the scope of free cash flow while maintaining financial health. Accordingly, we basically believe free cash flow should be used to explore investment opportunities, including M&A. Regarding its financial health, NEC currently has an R&I credit rating of A−, and aims to increase its credit rating by a notch over the next few years. Although we have not had a clear calculating formula for dividends, our basic approach is to pay a steady dividend equivalent to about 30% of net profit over the past five years. In the fiscal year ended March 31, 2020, net profit was higher than normal, partly due to tax effects. As a result, the dividend payout ratio was temporarily lower, but still within the average five-year range of 26% to 28%. We are taking a conservative approach to using cash in the fiscal year ending March 31, 2021, owing in part to COVID-19. NEC took the initiative in raising capital, issuing bonds a little earlier than usual. NEC also has sufficient commitment lines in place. While unlikely, if free cash flow were to fall to zero, and payments from all of our clients is delayed by a month or so, we would still have more than ¥150 billion in cash available. In addition, NEC is ready to take additional measures for generating cash by reprioritizing investments and disposing of assets. We believe NEC is very stable financially. We are prepared to dispose of assets in the unlikeliest of scenarios, at an appropriate timing and proper form. We have the potential to generate more than ¥50 billion in cash.

Questioner D

Q. NEC forecasts adjusted operating profit will improve by ¥23.8 billion year on year in the global business segment in the fiscal year ending March 31, 2021. Can you break down this improvement? I understand that ¥9 billion in one-time costs booked in the fiscal year ended March 31, 2020 will disappear, but it seems the year-on-year change is quite high.

A. In addition to the disappearance of ¥9 billion in one-time costs, we anticipate a ¥2 billion improvement as its effect, for a total boost of ¥11 billion. The remaining ¥12 billion is generated from other business improvements. We plan to improve operations in Safer Cities, service provider and submarine system businesses. I understand this target is more complicated than it seems, but we are prepared to make the necessary changes to achieve this growth.

Q. Among the unprofitable businesses in the global segment, NEC is addressing the display business by forming a joint venture with Sharp Corporation. When will NEC find a partner in the energy business?

A. NEC has been reviewing the energy business since the previous fiscal year, and aims to come up with a new direction for the business during the current fiscal year.

Questioner E

Q. There are two conflicting views that COVID-19 will either accelerate digital transformation or put a freeze on IT spending at corporations. What is your outlook for industrywide orders after COVID-19 ends, and what role will NEC play? What business opportunities do you envision?

A. I think we will see different trends in each sector. From a long-term perspective, digital transformation will probably gain momentum in Japan. Spending might be temporarily shelved in the manufacturing and service sectors, but we expect investment in digital transformation to increase as society evolves. Touchless technology, online and remote work have become even more essential to corporate activities and our daily lives. NEC will provide biometric recognition and solutions utilizing AI and 5G technology to meet these changing needs.

Q. NEC is cleaning up its assets in the energy business as an additional measure taken in the fourth quarter of the fiscal year ended March 31, 2020. Can you be more specific as to what this entails? What is visible on the horizon, such as the possibility of removal from the scope of consolidation?

A. NEC has taken the necessary steps while preparing to find a partner, conservatively reassessing the potential for recouping its investments in fixed assets and inventories, for example.

Questioner F

Q. The government is apparently moving forward plans to upgrade PCs in all elementary and junior high schools this fiscal year. Is this reflected in your earnings estimates for the fiscal year ending March 31, 2021? If they are, what contribution will this make to sales and operating profit?

A. NEC will work hard to secure a 40% share of the PC market for schools in Japan, but it does not expect a major contribution to profits due to the nature of the education market.

Questioner G

Q. How will earnings be affected by the postponed Olympic and Paralympic Games, assuming related demand was expected?

A. We had expected a boost of about ¥200 billion to sales in related businesses over a period of five years. Performance was better than expected until the fiscal year ended March 31, 2020, and combined with the current fiscal year, we estimate an overshoot of 10-20% past this ¥200 billion figure. Our earnings estimates for the current fiscal year do not reflect the postponement of the Olympic Games, but we do not anticipate a major impact on the bottom line.