Q&A Regarding Financial Results for the Fiscal Year Ended March 31, 2021 and the Mid-term Management Plan 2025

Date/Time: May 12, 2021 16:30–18:00 JST
Location: Live audio streamed from NEC Headquarters, Tokyo
Presenter: Takayuki Morita, Representative Director, President and CEO
Osamu Fujikawa, Executive Vice President and CFO

Questioner A

Q. Regarding strategic expenses for the fiscal year ending March 31, 2022, along what kind of timeline do you expect to see the ¥32.0 billion return on investment? Will it be next fiscal year, or in the latter half of the Mid-term Management Plan? Also, do you plan to continue the same level of investment (as that ¥32.0 billion) in the next fiscal year and beyond?

A. As indicated in the chart on page 7 of the presentation materials concerning financial forecasts for the fiscal year ending March 31, 2022, strategic expenses of ¥32.0 billion will enter the harvesting phase in the fiscal year ending March 31, 2022. While investments will continue beyond the fiscal year ending March 31, 2023, given that the effects of those investments will also be seen, we will manage them for a net positive result. In terms of our approach to investments for the Company as a whole, in the fiscal year ended March 31, 2021 R&D expenses were about 3.8% of revenue; to achieve high margins in the medium term, we will invest about 4.5% in the fiscal year ending March 31, 2022 and beyond. Our aim is to invest in R&D expenses at the 4.5% level over the medium to long term to achieve high margins. We believe we can return to normal conditions in the fiscal year ending March 31, 2023 and beyond, including returns on our investments in R&D expenses.

Q. You have said that strategic expenses will enter a harvesting phase beginning in the fiscal year ending March 31, 2023. Do you expect those effects to emerge in a somewhat linear fashion?

A. It depends on the project. In terms of development investments in growth businesses and to boost our global structure, that harvesting will start in the fiscal year ending March 31, 2022 based on achievements in 5G and core DX. Investments in business infrastructure and human resources, meanwhile, will be on a somewhat longer timeline, with returns expected to come two to three years later because these include modifications to IT systems. Returns on structural reforms are normally seen within a year, so I think the effects will begin to appear after that.

Q. Assuming R&D expenses continue at high levels in the fiscal year ending March 31, 2023 and beyond, will there be an increase in expenses in the fiscal year ending March 31, 2022?

A. We believe it is management's responsibility to see that costs and benefits do not produce a net negative impact.

Q. The supplementary materials to the Mid-term Management Plan note the average annual growth rate and operating margin for each segment, but call for almost no growth in the Public Infrastructure Business. While I understand special demand due to the GIGA School project boosted the segment in the fiscal year ended March 31, 2021, what are your thoughts on the positioning of Japan Aviation Electronics Industry, Limited (JAE), a consolidated subsidiary?

A. We need to think of NEC Corporation itself and JAE separately. While we recognize that NEC is currently producing considerably high margins, we believe there are issues with ROIC and capital efficiency. Since the fiscal year ending March 31, 2022, the Public Infrastructure Business has led in establishing a budget for ROIC, and we will manage ROIC there as a pilot segment. While it is difficult to see improvement in operating margins, from a medium-term perspective, our goal is to improve ROIC.

With regards to JAE, our objective in raising our equity stake there from 40% to 51% and making JAE a consolidated subsidiary was to strengthen governance. Since then, we have shared our sense of goals for the company with JAE management, and we are at this very moment moving ahead together in an effort to expand value. For example, in the commercialization of compact antennas, NEC transferred its intellectual property to JAE, which then commercialized the product and has begun selling it to Tier 1 companies. We are also considering applications for IoT devices in fields such as these. In automotive optical connector technology, the use and transfer of NEC's optical and network technology is also moving forward. Relatively speaking, we believe that JAE has room to improve value. We will decide what to do in the long term after reviewing the current direction.

Q. I think JAE does have room to improve; what do you think of their progress in the last two or three years? While JAE's medium-term management plan shows a variety of positive benefits, does this mean they have not been effectively incorporated in terms of numbers?

A. In terms of near-term results, while the novel coronavirus (COVID-19) had an enormous impact on JAE's main plants, the third quarter and beyond saw rapid improvement, and we see the situation as having been temporary. At the same time, we believe there have been significant improvements in the relationship from the perspective of governance. While the contribution of JAE incorporated in NEC's Mid-term Management Plan does not represent a large amount overall, it is predicated on sound growth.

Questioner B

Q. In your forecast for the fiscal year ending March 31, 2022, you describe adjusted operating profit of ¥155.0 billion; can you provide a breakdown of the factors behind the increase in profit (¥53.8 billion) from the previous fiscal year?

A. The total improvement of about ¥54.0 billion includes ¥42.0 billion from the recovery from COVID-19 (including JAE); ¥12.0 billion in 5G base stations; an additional ¥9.0 billion from portfolio restructuring, including Avaloq and others; and a negative ¥9.0 billion from the impact of special demand from the GIGA School project and others.

Q. The fiscal year ending March 31, 2022 forecast does not seem to include any organic profit improvements or growth factors. Have these been included in the recovery from the impact of COVID-19? Given that market conditions are not bad, have you not incorporated the contribution of improvements through growth?

A. While organic growth factors are included in the recovery from COVID-19, I think you are correct in understanding that we are taking a conservative view.

Q. What was the extent of the impact of COVID-19 in the near-term January to March 2021 period? Was it close to zero?

A. Looking at conditions in April compared to the same month in the previous year, our backlog of orders at the beginning of the period was positive, so conditions are better than last year. That said, at the current stage we believe we need to be careful in determining that conditions are good. Additionally, trends differ depending on the sector. For example, solutions for retail and services showed a rise beginning in the third quarter of the fiscal year ended March 31, 2021, and for manufacturing in the fourth quarter, but we are still focused on identifying shifts taking place in the fiscal year ending March 31, 2022.

Questioner C

Q. The supplementary materials to the Mid-term Management Plan include a section on the fiscal year ending March 31, 2026 adjusted operating margins by segment. The plan calls for a significant improvement in the Global Business of 11% versus the near term. What kinds of improvements do you expect in each segment, particularly the Global Business?

A. With regards to the Global Business, we have made significant progress in reorganizing low-earning businesses over the past several years. This process was still underway in the fiscal year ended March 31, 2021, and we expect the effects of these improvements to gradually emerge in the fiscal year ending March 31, 2022. I think the impact of these low-earning businesses will just about disappear beginning in the fiscal year ending March 31, 2023. Furthermore, while we are now simply adding the profits from companies we have acquired, current efforts to achieve cost reductions from offshore utilization and to promote cross-selling will be an additional plus as those initiatives begin to generate results. We think these targets are more than achievable when we consider the synergistic effects that will result as our efforts in business concentration progress and low-earning or money-losing businesses are reorganized.

Q. While you have positioned the digital government field as a pillar of growth, the average annual growth rate for the Public Infrastructure Business is about flat between the fiscal year ending March 31, 2022 and the fiscal year ending March 31, 2026. Why is the outlook for sales from the Public Infrastructure Business flat if you are expecting growth in digital government?

A. While the digital government field is a growth pillar globally, we expect both the Public Infrastructure and Public Solutions Businesses to have a positive impact. Businesses representing an extension of “Smart Cities” and ”My Number systems“ will be an additional plus for the Public Solutions Business. With regards to the Public Infrastructure Business, while at this point we are conducting highly profitable business with government offices, the content will change as it is replaced by business with the Digital Agency.

Questioner D

Q. You are forecasting considerable growth in the digital government field, but are you also expecting the budgets of government offices to expand? Do you plan to get a share of that? Please describe your approach.

A. The numbers for the digital government/digital finance include those for international projects. Those for the Digital Agency, digital government and other central government offices in Japan are under the Public Infrastructure Business, while those for regional and urban governments are included in the Public Solutions Business, but in some areas we do not yet have a view of how those figures will work out. From the perspective of achieving safe, secure digital government operations, we believe this is a role that should be taken by companies with long-term reliability, and we think NEC's role will only expand further. As standardization has progressed, NEC has been involved as a founding member in FIWARE—an open system based on international standards for City OS—since the development stage. As this City OS begins making inroads in Japan as well, progress will be made in the efficient sharing of assets between cities. In that sense, this will further increase our role, which in turn will increase our share. We have particular expectations for a certain level of improvement in our share of the regional market, and have set that as a goal.

Q. Regarding 5G, you are targeting significant global growth and explain that you will capture multiple commercial projects in the fiscal year ending March 31, 2022. Can you provide specific details on regions, etc.?

A. We believe we must be able to announce capturing commercial projects outside of Japan during the fiscal year ending March 31, 2022. While I cannot offer customer names, I can say that our target markets will primarily focus on two regions: Europe and the U.S.

Questioner E

Q. How do you evaluate your results in terms of sales, profits and margins for the fiscal year ended March 31, 2021, the final year of the previous mid-term management plan? Do you think the new Mid-term Management Plan has gotten off to a good start?

A. While we were confident that we would be able to establish a solid base for the next fiscal year and beyond at the start of the fiscal year ended March 31, 2021, the impact of COVID-19 turned out to be extremely opaque. By enacting a variety of policies during that time, we have in fact been able to establish an even sounder, firmer base in financial terms than we had expected. In terms of earnings, we were able to manage unprofitable projects as expected, revealing our fundamental strength. In terms of achieving growth, concrete progress was made in our strategic partnerships with NTT and Rakuten Mobile, Inc. At the end of 2020, we were also able to acquire Avaloq Group AG, a distinctive company in the digital finance SaaS realm that will provide a major weapon in the coming shift to digital, so I think we have gotten off to a very good start.

Q. While profits improved in the Network Services and Global Businesses in the fiscal year ended March 31, 2021, what segments have issues to address as you work toward achieving your next targets? Can you tell us why and what improvements are needed?

A. Global Business made significant improvements in the past two years, but is still a work in progress. While M&A and structural reforms have allowed us to come up with a direction, this effort needs to be accelerated further. The fiscal year ending March 31, 2022 is an extremely important year for the Global Business, where under the Mid-term Management Plan we are targeting an adjusted operating margin of 10%. The second point is the Public Infrastructure and Public Solutions Businesses related to the Digital Agency. In the case of the Public Solutions Business in particular, this is a relatively low-margin area, one that we think has room for structural and other improvements. From an overall perspective, putting in place a common technology platform will also be important. The Digital Business Platform Unit is currently working to offer multi-cloud services by strengthening its alliances with hyperscalers. Another important point in establishing an outlook for improved profits in the Public Solutions, Public Infrastructure and Enterprise Businesses will be our progress in developing a common platform for technology, including AI, with its distinctive features unique to NEC, as well as security and biometrics. It will also be an important year for the Network Services Business to prove whether or not NEC can become a global player in the 5G market.

Questioner F

Q. Page 14 of the Mid-term Management Plan presentation materials show your target figure for ROIC, and state that ROIC will go from 4.7% to 6.5% if you reach adjusted operating profit of ¥300.0 billion. Won't this result in a considerable increase in invested capital? I believe it would involve an increase of abut ¥500 billion; can you provide a breakdown? Are there also variations in plans and results for ROIC by segment?

A. We are considering a certain level of investment to drive growth going forward. While this is not limited to specific target areas, it is incorporated into the Mid-term Management Plan. We will be taking action based on EBITDA growth, so this is not a phase in which we should be tightening investment.

Regarding the differences in ROIC between businesses, we have just begun management of ROIC by business unit. At this point, we have not yet been able to break down the IC (invested capital) portion of ROIC (return on invested capital) by individual segment. The Public Infrastructure Business is one area that delivers relatively high profits but has not necessarily maximized capital efficiency. Our first step will be to create a solid system for managing ROIC in the Public Infrastructure Business in the fiscal year ending March 31, 2022, then roll that out company-wide. Currently, that is managed through adjusted operating profits and control of spending in each business unit.

Q. To reinforce your base business and overseas business, etc., you are proposing improvements to the cash conversion cycle (CCC). Are there any business areas in which you will be reducing invested capital?

A. I don't know if "reduce" is an appropriate term, but we believe that in the Public Infrastructure Business, even existing areas of business have relatively high profit levels in comparison to competitors. That said, they were not able to manage with a focus on capital efficiency. As we began establishing a culture emphasizing CCC over the past two years, awareness of capital efficiency has grown, and I think we have established a foundation that will enable ROIC-based management. We look forward to seeing fundamental improvements in invested capital in the Public Infrastructure field, and if that proves effective, we can establish a method for extending that to other businesses.

Questioner G

Q. Regarding the results in the fourth quarter of the fiscal year ended March 31, 2021, although the Public Infrastructure and Global Businesses both posted structural reform and other one-time costs in the fourth quarter of the fiscal year ended March 31, 2020, the range of improvements seems small. Did this involve use of unplanned spending? Also, can you explain what was behind the large increase in adjustment amounts?

A. This is something we have always done, but to avoid carrying risk over to the next fiscal year, we take a conservative approach to reevaluating assets. In the Global Business, we posted reserves as a result of reevaluating software assets and fixed assets; the total amounted to about ¥6.0 billion. In the Public Infrastructure Business, as we work to harvest profits going forward, capturing relatively low-profit projects in new fields has had an impact. We have positioned this as an investment in developing future business, and the amount is about the same as for the Global Business. Adjustment amounts have increased due to Avaloq PPA amortization costs that were generated beginning in the fourth quarter.

Q. Under the previous mid-term management plan, you achieved your target for improving profitability, but under the new Mid-term Management Plan, it seems to me that growing the top line is a major issue. Even under the previous plan, the Global Business did not see much organic growth, and based on your explanations today, I still question the possibility of real growth in your growth businesses under the new Mid-term Management Plan. Core DX in particular shows the greatest improvement in profit; can you tell us how you expect to grow that business?

A. I think there are many ways to define "growth," but we believe we should stay away from policies under which business plans are dependent on the top line, since these can result in optimistic estimates of costs and investments. This is why our growth is established based on a target for growth in the actual amount of EBITDA. Regarding growth in Core DX, one part involves business conducted by ABeam Consulting Ltd., while the other involves the common platform being developed by the Digital Business Platform Unit, including, for example, a facial recognition engine, security and AI products. Digital ID—including facial recognition—and, in the medium term, the field of infrastructure-collaborative mobility also linked to 5G, are included in Core DX. While there are risks, I think the current plan is conservative when all these factors are taken together.