July 30, 2021

Q&A Regarding Financial Results for the First Quarter of the Fiscal Year Ending March 31, 2022

Date/Time: July 30, 2021 16:30–17:30 JST
Location: Live audio streamed from NEC Headquarters, Tokyo
Presenters: Takayuki Morita, Representative Director, President and CEO
Osamu Fujikawa, Executive Vice President and CFO

Questioner A

Q. Earnings in the first quarter made favorable progress toward internal targets. How much was the overshoot?

A. In the first quarter, sales exceeded our internal target by ¥33.0 billion and adjusted operating profit exceeded it by ¥13.0 billion.

Q. NEC has already secured two 5G projects outside of Japan. What does the pipeline look like now?

A. We are currently trying to win several projects in the U.S., Europe and Asia.

Q. How much was the new consolidation of Avaloq?

A. The new consolidation of Avaloq boosted sales by around ¥15 billion and adjusted operating profit by around ¥1 billion in the first quarter.

Questioner B

Q. NEC said that earnings in the first quarter were higher than internal targets. Is the ¥8 billion in gains on the sale of real estate included in the full-year forecast? NEC said that strategic expenses of ¥6 billion was in line with plans. In the remaining quarters, what will strategic expenses amount to?

A. Our full-year forecasts do not include gains on the sale of real estate. The overall overshoot in profit was ¥13 billion, broken down as ¥5 billion on a business basis and ¥8 billion for gains on real estate divestures and other factors.
After ¥6 billion in the first quarter, we estimate strategic expenses will be ¥8 billion in the second quarter, ¥8 billion in the third quarter and ¥10 billion in the fourth quarter, for a total of ¥32 billion for the year.

Q. Are there any plans to sell assets during this fiscal year?

A. NEC continues to convert assets, including investment securities, into cash. The timing for stock divestures partly depends on circumstances with customers and business partners.

Q. In the 5G business, NEC will focus more on providing software, but has not yet won orders from two international operators that led to contracts. Does NEC plan to roll out software in the future, including for these new projects?

A. We are negotiating some projects involving virtualization software for 5G core networks. Some of these negotiations entail automation and orchestration projects within RAN. However, automation and orchestration projects begin to show an impact after a number of Open RAN base stations have been installed. NEC does not expect much business in this regard this year or next year. The 5G core network business could grow substantially in scale if orders are won.

Q. Please provide an update on 5G core networks in international markets.

A. NEC has just begun to develop 5G business in international markets. Throughput had been an issue in 5G core networks, but at the Mobile World Congress, one of the world's largest mobile phone events, held this year, NEC, together with Intel and Rakuten Mobile announced we had achieved the industry's highest throughputs in performance tests. In light of this announcement, we believe there is enough potential in this business, and NEC has received high marks from customers for its technologies on this front. The commercialization of virtual 5G core networks comes with many challenges, but we expect to win orders for this software.

Questioner C

Q. I have heard about semiconductor shortages affecting production of base stations. What is the impact? Does the forecast take this impact into account?

A. Shortages appear to have caused tight supply-demand conditions for not only specialty devices and advanced components, which is not surprising, but also commodity parts and electronics components more recently. While these shortages are a concern for base stations and all products made by NEC, the Company has procured almost all of what it needs for the first half. We are now working diligently to procure parts for the second half, and asking parts vendors for their cooperation on various fronts. The shortages pose a risk to achieving our earnings estimates, but we believe this risk can be managed.

Q. Has the COIVD-19 pandemic had an impact on IT spending by customers?

A. Customers have resumed the evaluation process for IT investments, but we think the pandemic has had a significant impact on business conditions. COVID-19 has hit the transportation sector, some consumer fields, SMEs and regional economies hard, and orders from these fields are weak. On the other hand, orders are brisk from leaders in the financial and distribution sectors, central government agencies, and telecom carriers. Consulting services are also doing well, including ABeam Consulting.

Questioner D

Q. Page 8 of the presentation materials shows orders are growing strongly in the Enterprise segment, but are weak in other areas. Consolidated orders would have increased 9% year on year if submarine systems and displays were excluded. What is the figure if hardware is excluded?

A.: The Enterprise segment includes subsidiary NEC Facilities, Ltd., but excluding this subsidiary, orders were up 9% year on year. Orders were brisk in the financial sector and are recovering in the distribution sector, centered on convenience stores. Orders are also rebounding in the manufacturing sector, but do not seem fully back to normal yet. Companywide, orders in IT services were up 6% year on year, marking a recovery. At NEC, this figure represents the IT services domain, including hardware.

Q. What is NEC's outlook for orders from the second quarter?

A. We believe major trends have not changed, and that orders from central government agencies and major financial, distribution and telecom companies will stay strong. We expect orders to hold steady year on year from the manufacturing sector, without worsening. Our concerns regard orders from SMEs and local businesses in the Public Solutions segment. Orders have not yet normalized, and if the pandemic worsens, a steady recovery might be difficult. The impact on overall earnings, however, should be manageable because these orders have a limited bearing on total orders.

Q. NEC has a number of global 5G projects in its pipelines for Europe, the U.S. and Asia. What is the possibility of winning more projects, other than the two projects mentioned, in the near term? Or must this be considered over a longer time frame?

A. Some parts of the projects we have already won should have an impact this fiscal year. However, details are to be decided. For example, the project we acquired in Germany is a field test for commercialization in small and medium-sized cities. We think final decisions will be made during this year on projects that will start rolling out commercially with several hundred sites. If no problems are encountered during the rollout, these projects could be scaled up and developed in other countries. We accordingly view these projects on a limited scale this fiscal year and next fiscal year, but if all goes according to plan, we envision a full-fledged rollout from the fiscal year ending March 31, 2024. When the projects ramp up in earnest, orchestration, automation and other software will become necessary. We also anticipate new projects for greenfield launches in the mobile phone market, and these projects are likely to span multiple years.

Q. NEC was selected by two leading global telecom carriers for 5G projects. Why do you think NEC was selected over rivals?

A. We believe the biggest reasons are the reliability of our products, their low power consumption and compact size. Moreover, in open systems, integration is a primary focus, and we believe our ability to work closely with multiple vendors was also highly regarded by the customers.

Questioner E

Q. What is your take on results for the first quarter? Sales were ¥33 billion higher than the internal plan, but first quarters can see major fluctuations year to year. Last fiscal year, special demand for PCs and large projects dropped out of the picture, but this fiscal year, it looks like there was a strong rebound. Can we consider sales figures for this fiscal year as an accurate reflection of NEC's capabilities? What projects made a major contribution?

A. NEC was profitable in the fiscal year ending March 31, 2020, and we thought that our underlying business structure would turn a profit in the first quarter. In the fiscal year ending March 31, 2021, the pandemic and lower operating rates led to a sharp decline, but in the fiscal year ending March 31, 2022, this impact will disappear. Sales have not fully recovered in some areas, such as SMEs, but NEC is reforming its global business portfolio. On an accounting basis that included amortization of intangible assets, adjusted operating profit declined at Avaloq, but adjusted operating profit is important here. Acquired companies have positively contributed to EBITDA and cash flow. These positives have compensated for unprofitable businesses such as energy and displays. NEC will do its utmost to maintain profitability from the first quarter by steadily advancing business.

Q. I understand that NEC is more closely monitoring low profit businesses from the second half to ensure profitability in core businesses during the mid-term management plan. Can you give an update on this? Core businesses generate a large percentage of sales, and they have a major impact on margin improvement, right? Looking past the second half of the fiscal year ended March 31, 2021, what is the time line for this coming to fruition?

A. We started evaluating businesses in June, and put each of them into one of three categories. For the bottom half of the businesses, we are perusing them in more detail, tracking progress toward targets, defining milestones for the current fiscal year, and assessing their ability to step up and start growing from the next fiscal year. We are monitoring trends in other businesses, and will set milestones during the current fiscal year and decide how to divvy them up going forward.

Q. Which businesses are specifically being targeted?

A. There are businesses targeted for profitability improvement in each business unit, both domestic and international. Businesses with very poor profitability will be restructured. NEC aims to increase margins by restructuring operations and migrating personnel. We will strategically invest resources and reallocate personnel to shift from low-margin to high-margin businesses.

Q. What are the metrics for businesses to be grouped as low, or high-medium margin?

A. The key metric is an operating profit margin of 7%, as outlined in the mid-term management plan.

Questioner F

Q. Profit overshot internal targets by ¥13 billion in the first quarter. Does this indicate upside for the full year's performance, assuming conditions do not change? If the overshoot stays at this level, will NEC boost strategic expenses above the planned ¥32 billion year-on-year increase?

A. We will consider accelerating strategic expenses if conditions warrant it, but at this juncture, we do not anticipate an increase. If all goes according to plan in the second, third and fourth quarters, the current overshoot will carry forward for the entire year. However, it is the responsibility of management to consider any opportunities that arise in the business environment, so we will continue to consider the best actions to take for maximizing corporate value.

Q. Regarding global 5G projects, when the mid-term management plan was released in May, NEC stated that it aims to acquire at least one project from a foreign telecom carrier this fiscal year, and in June, the Company announced it had acquired two projects. What has changed since the initial outlook when the mid-term management plan was released?

A. Basically, our outlook has not changed. Vodafone was our very first commercial project, and speaking from experience, nothing is set in stone until the final contract is signed, so we have made cautious statements. In this sense, we have crossed over one hurdle. We intend to use this momentum to win additional projects in Europe and the U.S.

Questioner G

Q. The Transformation Office was created directly under the CEO. As a major corporation, what issues and areas need improvement at NEC?

A. About 10 years ago, NEC integrated its core systems globally, and moved these systems to the cloud last fiscal year. Looking ahead, we must transition to data-driven management while reforming our business processes and creating frameworks for using data. These issues should be addressed at the core system level, and we must change the way we work and our business processes. That is why the Transformation Office reports directly to the CEO. We began making preparations for this about two years ago. Digital workspaces are another issue to address. NEC is working with Microsoft to deploy cloud-based Microsoft 365 to create remote workspaces for its 110,000 employees around the world. By integrating this with our technologies in AI, security and biometric authentication, we aim to create cutting-edge office environments. NEC will be the testing ground at first, and then this technology will be rolled out to customers. The Company was moving in this direction from before and the pandemic significantly changed everything, and we intend to have three styles for our workspaces; one-third of our employees in traditional office spaces, one-third in co-working spaces, and one-third in remote workspaces.

Q. Vodafone and Deutsche Telekom have adopted 5G base stations. How does NEC envision its position on the Open RAN market? What is the potential for Open RAN in Japan?

A. New entrants into the 4G and 5G mobile phone market, like Rakuten Mobile, are not bound to past service offerings, so they can more easily adopt the latest technologies. However, some major established telecom carriers are taking on the challenge of incorporating new technologies into their 2G and 3G services. Vodafone, a major operator, decided to use Open RAN commercially, and its decision to select NEC as its strategic partner is highly significant. NTT DoCoMo and Rakuten Mobile have also made strong commitments to Open RAN, so we think Japan will take the lead on the Open RAN market.

Questioner H

Q. Has NEC already started to reduce office space?

A. NEC is always assessing the optimal use of its offices. The Transformation Office's and Smart Work 2.0 initiatives are currently underway, and we will make changes based on the results of assessments. In my opinion, I think we can reduce our office space by at least 50% if we want to, but it is also important to increase productivity, so in the end, around 30% of office space might be cut. NEC owns land at the Fuchu and Tamagawa business sites that might be used for new building construction over the medium term, in addition to remodeling standard offices. Our approach is to change offices, not simply reduce them.