

Q&A Regarding Financial Results for the First Quarter of the Fiscal Year
Ending March 31, 2024

Date/Time: July 28, 2023, 15:30-16:30
Location: Live online streaming from NEC Headquarters
Presenter: Osamu Fujikawa, Corporate Executive Vice President and CFO
(Chief Financial Officer)

Questioner A

Q:

You explained that first quarter results were in line with expectations. Full year adjusted operating profit in IT Services is forecasted to increase by ¥9 billion year on year, but in the first quarter it already increased by ¥17.1 billion. Please tell us about your outlook for the second quarter onward.

A:

IT Services had strong orders and a large order backlog, so our assessment is that the first quarter was a good start. Some projects had a higher profit margin than the previous year, which was also a factor for higher profit margin. There are no extraordinary expenses to expect from the second quarter onward, and no projects were brought forward into the first quarter either. We maintained a strong performance and results are in line with our expectations.

Q:

Do you think the forecast is conservative?

A:

We had a sale of assets, etc. in the previous fiscal year. In FY24/3, we do not plan any such action, and we need to produce results at a higher level than FY23/3. In that regard, first quarter results have progressed as expected, and we believe the full-year forecast is reasonable.

Q:

Digital Government/Digital Finance (DGDF) has been named as a growth business in the Mid-term Management Plan 2025. Please tell us the reason why revenue decreased in the first quarter from the previous fiscal year.

A:

We sold the unprofitable businesses belonging to KMD Holding A/S, so the first quarter revenue was down year on year.

Questioner B

Q:

Please tell us the reason why the adjusted operating profit in Adjustments is down ¥10.3 billion year on year in the first quarter. The full-year forecast is down ¥18.9 billion, and approximately half of that has been recorded in the first quarter. Do you need to revise the full-year forecast?

A:

One of the factors behind the downturn in the first quarter is the absence of a ¥4 billion gain on the sale of real estate in FY23/3. Expenses also increased by ¥2 billion from the initial forecast due to in-house DX and other reasons. Everything else was adjustment items, such as unrealized gains or losses on inventories, and these will all be eliminated eventually. Consequently, there will be no change in our forecast of an ¥18.9 billion decrease over the full year.

Questioner C

Q:

Today, the yen started to gain strength following a change in the Bank of Japan's monetary policy. How much of an impact do currency fluctuations have on NEC's results?

A:

Our sensitivity to exchange rates means that we lose about ¥0.3 billion in annual profits for each ¥1 appreciation against the dollar. We have planned for a rate of ¥130 to the dollar for FY24/3, so we don't believe the currency fluctuation impact will be particularly significant.

Q:

Telecom Services are expected to see a significant increase in profit in this fiscal year, partly due to the elimination of one-time factors in the previous fiscal year. How do you see the current progress, and do you think the full-year forecast is likely to be achieved?

A:

In what had been the Network Services Business Unit, which is now included in Telecom Services, one-time factors that occurred in 5G business abroad in FY23/3 were eliminated, and we will control expenses appropriately to improve profitability. In the first quarter, we have already seen the effects of reductions of development investment and SG&A, etc. Structural reform we carried out in FY23/3 is also progressing according to plan. Moreover, we will conduct the global 5G business appropriately while developing it with an eye to the future. For example, advancing development in the

area of software, where profit margins are high, is under way. We are executing projects for which we had received orders from abroad in FY23/3, but fundamentally we expect to gain profits in the domestic market. Telecom Services overall progressed as planned in the first quarter.

Questioner D

Q:

First quarter revenue for IT Services was up about ¥30 billion year on year, but the adjusted operating profit increase was ¥17 billion. Could you please tell us what factors contributed to high profitability of roughly 50% out of the revenue increase.

A:

The improvements in first quarter performance were higher due to increased sales and the effect of steady profitability improvement activities in the system integration area. Positive impacts came from projects for the corporate and public sectors, where there is strong demand, and we expect these to continue going forward.

In addition, following the organizational change in April this year, the IT Services segment has both vertical and horizontal organizations, meaning the segment is managed both by product lineup and by markets. Now that the new system has started operation, we can look at all business negotiations in detail to see which products are selling in which deals. It is also possible to see the deviation from the set appropriate gross profit margin, which enables the implementation of measures to improve profitability. With the foundation now in place to carry out these activities, we expect to see steady improvement in profitability from the second quarter onward, which will lead to a boost in overall profitability.

Q:

What do you think was the main factor in Telecom Services increasing profits year on year in the first quarter?

A:

In the first quarter, Telecom Services increased profit by ¥2.2 billion year on year. Because of the impact of the component shortages since FY23/3, we increased inventories with a long-term view, and conducted an asset cleanup during the first quarter, which resulted in expenses of the low billions of yen. Consequently, excluding these factors, regular operations resulted in an improvement of about ¥4 billion year on year. In the global 5G business, we are taking measures to be more efficient, including structural reform, aiming for improvements in the low billions of yen.

Q:

How do you see the domestic 5G base stations market outlook?

A:

For the domestic 5G market, our view is that demand will arise in the second half, as it did in the previous fiscal year, and now there are no negative factors compared to last year. We will work to achieve better results in the second and third quarters compared to the previous fiscal year. We see no change in the market environment from the previous fiscal year.

Questioner E

Q:

Could you please explain the factors behind the first quarter results in FY24/3 being in line with expectations? In addition, how will adjusted operating profit achieve the full-year forecast?

A:

In the first quarter of FY23/3 there was a ¥5.0 billion gain on sales of assets, therefore, there is a reversal impact in the first quarter of FY24/3. In addition, the component shortage had an impact in the first quarter of the previous fiscal year. Although we could accelerate shipments of mass-market items such as servers in the second half of the previous fiscal year, shipments in the first half did not go as well as we had wanted. These negative elements did not exist in this first quarter. In addition, measures to improve profit margins resulted in the overall increase in profits in the first quarter as expected.

In a normal year, our adjusted operating profit tends to be weighted toward the second half, towards the fourth quarter in particular. This tendency was particularly evident in the fourth quarter of FY23/3, therefore we must keep in mind that we cannot expect a similar year on year increase in profits in the fourth quarter of FY24/3. That is the reason why we're trying to achieve results ahead of schedule in the first through third quarters this fiscal year.

Q:

What is the reason for holding IR Day in November this year instead of September as in regular years?

A:

It has been two years since we formulated the Mid-term Management Plan and there are various positive and negative elements in our businesses, so we would like to explain after more in-depth discussions, considering changes in the business environment and other factors. We have absolutely no intention of changing the Mid-term Management Plan and believe it is achievable, but for these reasons we will hold IR Day in November this year.

Questioner F

Q:

IT Services and Social Infrastructure increased revenue and profits in the first quarter, so how have the market environment and situations for customers changed compared to the previous fiscal year? Please also tell us if this favorable situation continues toward the end of the fiscal year.

A:

The order trend for IT Services, and the utilization rate at an NEC subsidiary which develops systems remains at a higher level compared to the corresponding time in the previous fiscal year. This trend shows no sign of slowing down at all and, as far as we can see, the market environment for IT Services has not changed since last year. In Social Infrastructure, there has been no significant change in the market environment for Telecom Services. We expect the situation with ANS (Aerospace and National Security) will improve going forward, but it will still take some time for the upside to be seen in light of the government's new policy.

Q:

In IT Services, rather than the market environment getting better, are measures to improve profitability contributing to the increase in profits?

A:

In addition to measures to steadily improve profitability, we are also preparing new solutions that are suitable for customers' needs and products, such as offerings that are attractive for management and people in the workplace, although the impact in terms of numbers is still small. In order to expand sales, for the past two years we have worked to strengthen our common infrastructure, including reinforcing consulting and alliances with partner companies, which has increased our competitiveness and contributed to improved profitability.

Questioner G

Q:

Please tell us about orders for IT Services. Firefighting and disaster prevention systems, which are included in IT services, do not have the same trend of the normal IT services. Please tell us the numbers for orders received for domestic IT, excluding firefighting and disaster prevention systems.

A:

We haven't disclosed the numbers excluding firefighting and disaster prevention systems, but you can get an indication from the Public and Enterprise sectors that

orders received for IT Services continue a strong trend. In the Enterprise sector, excluding large projects, double-digit growth has continued for the past two years, and this has grown strongly by several percent points this year. Order trends from manufacturing is not weak either, as we have maintained the high level of the previous fiscal year, while finance, retail and services have shown an extremely strong trend, with further growth from the previous fiscal year. Moreover, Public is also continuing stable growth and in FY24/3 is expected to grow 2% more than the level of the past two years.

Questioner H

Q:

We have heard that you are receiving quite a few inquiries regarding the NEC Generative AI Service. Where are the greatest needs coming from in terms of types of business?

A:

We have launched projects with about 10 clients, including the finance and transportation fields, and have chosen clients with a particular willingness to work in unity. Generative AI is delayed in Japanese language environments, in particular as other companies are only working in an English-language environment. Our being able to provide a Japanese language environment has been valued and many clients have expressed their interests.

Questioner I

Q:

Society on the whole is using more data, so I imagine data center demand is rising. To what extent are inquiries in the data center business increasing, and how stringent are they?

A:

The reason capital investment increased in the previous fiscal year is because of investments in two data centers. This is a business model that will grow steadily, and we are increasing them as planned. Features of NEC are that the data centers we have created together with SCSK Corporation are engaged in advanced projects and we have been able to provide good services. For example, when a client does not want their data to be public, we prepare closed environments. And we are also commended for being able to provide a variety of options such as hybrid environments, and these points are the backdrop to our steady growth. For investments, we will invest with appropriate timing in terms of lead time while looking at resource plans for the future.

Questioner J

Q:

Please tell us the specific amount of investment and the timeframe it will take for core systems renewals at NEC.

A:

We can't tell you the investment amount, but we will be renewing the core part of the general SAP system. Parts of newly incorporated changes are called O2O (opportunity-to-order) and the most central parts are called R2R (record to report). We are not conducting any significant customization, so please just think in terms of standard costs. The construction period is in its third year, having started with detailed design in 2019. We released the first phase in May and will release the second and third phases at around the same time next year, and the year after that, with an expected completion in May 2025, meaning the total period will be about five years. Going forward, we want to transform to data-driven management through management process improvements.

Q:

What specific initiatives were successful in improving the profitability of IT Services?

A:

Aside from an improvement in the unit price of system engineers (SE) and a shift to value-added models, more straightforward activities are leading to results. We have created a system emphasizing training, standardization, and greater efficiency with the objective of raising the overall quality of SEs. Moreover, we are carrying out various quality improvements in the areas such as the development environment, human resources and processes, and these straightforward efforts are steadily expanding and ultimately leading to improved profitability.