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

Date/Time: October 30, 2023, 16:00-17:00
Location: Live online streaming
Presenter: Osamu Fujikawa, Corporate Executive Vice President and CFO (Chief Financial Officer)

Questioner A

Q:
What was the year-on-year order growth rate in Q2 for IT Services excluding NEC Facilities, whose orders fluctuate widely on a quarterly basis? Has there been a change in the order environment?

A:
Orders for IT services excluding NEC Facilities grew 3% year on year in Q2. Orders remain brisk in the Enterprise Business. We won a large project for the finance sector and are maintaining a high level of orders for the retail and services sectors. Orders declined for the manufacturing sector, because we intentionally turned down projects with low profit margins, but are unchanged year on year excluding this factor. Public Business orders were also down due to the reversal impact of a large project in the previous fiscal year, but the order environment remains strong.

Q:
Although profit was up year on year for domestic IT Services excluding the impact of a ¥6.0 billion gain on a stock transfer in Q2 of the previous fiscal year, the profit margin improvement contracted. What is the reason for this? Please also tell us about your outlook for profit margin improvement.

A:
The main reason that the profit margin of IT Services improved sharply year on year in Q1 is the large number of low-margin license-related projects in Q1 of the previous fiscal year. We think profitability is at a fair level in Q2. We expect profit margins in the current fiscal year to be higher than in the previous fiscal year and target further improvement in profitability in the fiscal year ending March 31, 2026, the final year of the Mid-term Management Plan.

Questioner B

Q:

You said that profit margins were improving as a result of standardizing development by using NEC Digital Platform (NDP) from around Q4 of the previous fiscal year. Please tell us more about this initiative. What is your view on the scope to improve your profit margins further?

A.

With regard to standardizing development, we are modeling various solutions to improve the efficiency of system integration and raise profitability. The number of NDP applications is steadily increasing, although it varies between projects, and we expect this to help improve profit margins going forward. A positive result of internal digital transformation (DX) in which we have been investing, is the startup of a core system in May that makes the business negotiation process more sophisticated, allowing us to monitor profit margins for each project in considerable detail. We work on improving profit margins of low-margin projects by management of fine details. We see considerable scope to improve profit margins further, because the positive effects of these measures will be more visible from now on.

Q:

What are the positive and negative factors affecting 1H results of Telecom Services from the previous year?

A:

Adjusted operating profit in 1H increased year on year because of the effects of structural reforms implemented in the previous fiscal year, reversal effect from one-off loss recorded in the previous fiscal year, and sales growth of Submarine Systems. Telecom Services will also make investments required for the future while reaping the benefits of structural reforms to achieve full-year targets. The performance of Global 5G, which recorded a heavy loss in the previous fiscal year, has been managed as expected by controlling expenses. In addition to Submarine Systems, consolidated subsidiary NEC Networks & System Integration (NESIC) also contributed to earnings recovery by posting higher sales and profits. For core networks, we are growing sales with the goal of attaining the high level of Q4 of the previous fiscal year, despite telecom operators maintaining a conservative stance on investment.

Q:

What is your approach to Global 5G given the current delay in the start of the Open-RAN market?

A:

In Global 5G, we will first revise the cost structure. In light of the delayed start of the Open-RAN market, we will focus on business areas with high profit margins centered on software, in which we are highly competitive. We are taking a medium- to long-term approach to the establishment of the domestic market, mainly in collaboration with NTT DOCOMO, including OREX. Abroad, we are reviewing our expense structure to create a roadmap for doing business, providing a lineup of products so that we can achieve solid results when the market takes off.

Questioner C

Q:

I believe that defense-related business offers great potential for NEC. What is your outlook for the business?

A:

In 1H, we received project orders of significant value, which will contribute to earnings in the medium to long term. At the beginning of the current fiscal year, we made a large-scale resource shift to redeploy skilled Telecom Services personnel, including Global 5G, from Social Infrastructure to Defense, which we plan to continue. The purpose of the resource shift is to ensure we solidly execute the large project orders we received and to win more projects. We will discuss specific initiatives in Defense at our IR Day in November.

Q:

You mentioned that you are being selective in accepting orders for the manufacturing sector in IT Services. Is this because of a shortage of engineer resources? How will you absorb increases in employees and personnel expenses?

A:

We have been selective about accepting orders for the manufacturing sector relating to other companies' licensed products. We are not taking orders with large sales and small profit. This has nothing to do with a shortage of engineer resources.

We aim to increase profit by absorbing cost increases, such as personnel expenses and a larger work force, by sales growth and improved efficiency. This applies to our subsidiary ABeam Consulting as well, which substantially increased its work force in the past two and a half years, but has grown its sales and profit as well. Even the strongly performing Enterprise Business has experienced an increase in personnel expenses due to internal resource shifts and mid-career hires, but they have also raised their profits by ensuring the expenditure leads to sales growth. We are shifting to a strategy of increasing efficiency and turnover by optimizing system integration and offering solutions to make more profit with the same resources.

Questioner D

Q:

What was the level of order backlog in IT Services? We assume the sales growth rate for IT Services increased in 1H of the current fiscal year, because brisk orders in the previous fiscal year were converted to sales, but is there a risk that sales will not increase in 2H, because you have cleared your order backlog?

A:

Projects that were not booked as sales in the previous fiscal year accumulated as order backlog at the beginning of this fiscal year. This resulted in brisk sales in 1H for the Public and Enterprise businesses. The estimated order backlog for domestic IT Services in the current fiscal year is up by more than 10% from the previous fiscal year. For the Enterprise Business in particular, the order backlog has increased by more than 20%. The order backlog is also up for the Public and Cross-Industry businesses. The order backlog is managed in accordance with the situation of each business unit in order to achieve our full-year forecast. For example, because the Japanese government's Supplementary Budget is approved in December, the Public and Cross-Industry businesses can expect to win more orders. We also expect strong orders to continue for the Enterprise Business amid a favorable order environment.

Q:

What is your view on the impact of raising the upper limit of defense equipment profit margins on earnings

A:

We think it will be some time before raising the upper limit of defense equipment profit margins makes an impact on earnings. We aim to improve profitability further, with new rules being applied to new projects and by making more efficiency improvements to development and delivery.

Questioner E

Q:

What do you think about the profitability of IT Services in 2H? Please also tell us about measures to pass expense increases, including personnel expenses, onto prices.

A:

We think we can earn a fair profit in proportion to sales growth in 2H as well. The current fiscal year is no exception in that personnel expenses will continue to rise. We are therefore working on reflecting the increase fairly in pricing, and this has produced a good result in 1H. We are also raising maintenance fees and other prices, and expect the effect of these measures to materialize in 2H onward. As for NDP products, visualization of profit margins for individual products has allowed us to make precisely targeted improvements by identifying products with low profit margins. We think we can lift overall profitability through these measures.

Questioner F

Q:

What is your order outlook by segment?

A:

Orders are down year on year for the Public Business, which had large projects in 1H of the previous fiscal year, but we are beginning to see positive factors in 2H, such as the Supplementary Budget, and orders for September are up year on year. We expect strong orders to continue in 2H for the Enterprise Business to build up an order backlog for the next fiscal year. For the Cross-Industry Business, we foresee a peak in firefighting and disaster prevention orders in the next two fiscal years, which offer new business opportunities. Although the severe macroeconomic environment in Europe is a challenge for achieving our full-year forecast for the Digital Government and Digital Finance (DGDF) Business, we will steadily increase orders from the pipeline negotiations stage. Orders are usually concentrated in Q4 for Telecom Services due to customers' investment plans, but we are looking to win some orders earlier in Q3. For Aerospace and National Security (ANS), we will aim to win orders with an eye on resources while maintaining strong performance. In summary, we think that we can maintain strong orders overall in 2H and beyond.

Questioner G

Q:

Your full-year Companywide adjusted operating profit forecast is ¥14.5 billion higher than the previous fiscal year, but your 1H adjusted operating profit was ¥14.6 billion higher. It would make sense to revise your full-year forecast. Are there any causes for concern in 2H?

A:

In the previous fiscal year, earnings were more concentrated in Q4 than in other years. In the current fiscal year, we have taken steps to book earnings earlier in the year from Q1 through Q3, and accordingly, take a more cautious stance on Q4. Another factor is the downward revision of the earnings forecast of Japan Aviation Electronics Industry. In light of these factors, we have not revised our full-year forecast.

Questioner H

Q:

1H orders for ANS have been robust, increasing 40% year on year. What is the timing for orders contributing to earnings?

A:

I can't provide specific figures, but with regard to project orders received in 1H, some will be recorded as sales in the current fiscal year, but most will contribute to earnings toward the fiscal year ending March 31, 2026, the final year of Mid-term Management Plan.

Questioner I

Q:

Have trends changed in Defense? Do you have a sense of upside versus the initial targets of the Mid-term Management Plan?

A:

We discussed the upside for Defense at our IR Day in the previous fiscal year. The timing of starting our proactive sales approach coincided with the Japanese government's policy of increasing its defense budget from an economic security perspective and companies' plans to raise profit margins. Our resource shift has also proved successful. We expect a significant upside to our initial plan formulated as part of the Mid-term Management Plan, and intend to strengthen the defense-related business as a future core business.