Q&A Regarding Financial Results for the Third Quarter of the Fiscal Year Ending March 31, 2023

Date/Time: January 30, 2023, 16:30-17:30 JST
Location: Live audio streamed from NEC Headquarters, Tokyo
Presenter: Osamu Fujikawa, Executive Vice President and CFO (Representative Director)

Questioner A

Q:

Revenue has increased in the global 5G business. How does this revenue break down between Japan and abroad? What are your thoughts on profitability as international revenue increases in the future?

A:

Over the nine-month period, the ratio of revenue from Japan and abroad in global 5G was nearly 90% in Japan and slightly over 10% abroad. International revenue began to rise in Q2 and has continued to increase steadily in Q3.

Telecom operators in international markets have high expectations for Open RAN's cost advantages in comparison to existing single-vendor solutions. First, as it pushes forward with business talks, NEC will do everything possible to prevent unprofitable projects from occurring in the future. Concurrently, we will accelerate technological innovation and bring highly competitive products to market, with the goal of increasing profitability in the coming fiscal year and beyond.

Q:

NEC will need to make fairly substantial improvements in Q4 to achieve its full-year forecast for adjusted operating profit in the Network Services Business. How will you achieve this forecast?

A:

We will regain lost ground primarily through revenue growth in Q4 led by the 5G business for Japan. As promising signs have emerged in business discussions with customers, we have not yet given up hope of meeting our full-year forecast. We also have products with high profit margins, including licenses, so we aim to catch up and achieve our full-year forecast within the remaining time period.

Questioner B

Q:

How does adjusted operating profit for Q3 stand relative to your internal target? Were Intellectual Property (IP) income and expenses for streamlining assets in the global 5G business factored into the forecast?

A:

Adjusted operating profit through Q3 was around ¥8.0 billion higher than our previous October forecast. We recorded ¥14.5 billion in IP income and around ¥5.0 billion in expenses for asset streamlining in the global 5G business. None of these items had previously been included in our internal targets. In addition to these factors, we saw an increase in strategic expenses in the global 5G business, among other items. Meanwhile, the domestic IT business has performed strongly, and overall, we have surpassed our internal target.

Q:

Could you please discuss your outlook for global 5G in the coming fiscal year? It appears that telecom operators are taking steps to curb their capital investments. What impact do you believe this will have on Open RAN investment?

A:

Telecom operators in Japan are currently tending to curb their capital investments. We believe that similar conditions could continue next fiscal year. Meanwhile, in the international markets, particularly Europe, we are not seeing any negative moves with regard to Open RAN investment, and there have been no adjustments to targets for the Open RAN ratio published by telecom operators. However, in North America and certain other regions, we believe there is a risk of delays in Open RAN deployment, so we will continue to monitor the situation closely.

Questioner C

Q:

If the widespread adoption of Open RAN falls behind the schedule that NEC expects, will this affect your ability to achieve the Company's overall targets in Mid-term Management Plan 2025?

A:

The contribution of international business to the profit target of the global 5G business in Mid-Term Management Plan 2025 is not very large. Furthermore, telecom operators in Japan basically plan to maintain a consistent level of capital investment, albeit with some fluctuations. Therefore, the impact on Mid-term Management Plan 2025 will not be very significant. As a contingency plan, we are bolstering the core DX business, which is currently performing well. Given that additional profit growth is anticipated from this business, we are confident in our ability to reach the overall profit targets of Mid-term Management Plan 2025.

Q:

Could you explain the impact of exchange rate movements on Group-wide performance?

A:

The exchange rate sensitivity of NEC is such that theoretically, each depreciation of ¥1 versus the U.S. dollar will have a positive impact of around ¥0.2 billion on the full-year operating profit of NEC itself. Up to Q3, exchange rate movements had a positive impact of ¥11.5 billion on operating profit on a consolidated basis, which includes our subsidiaries. On the sales front, international business had a significant positive influence on our performance due to the weaker yen. On the procurement front, the increased costs of services and components procured from abroad had a negative impact. However, we were able to pass on much of the higher costs to sales prices, allowing us to contain the impact of exchange rate movements from Q2 onward.

Questioner D

Q:

You said that you would consider measures to achieve an optimal cost structure in Network Services. Could you please describe those measures?

A:

We have so far worked to build sales and delivery systems based on the assumption that the international Open RAN market would start up as expected. Going forward, we will reduce costs to an optimal level commensurate with our revenue forecasts. Meanwhile, in terms of development expenses, given that global 5G is expected to experience substantial growth in the future, we will invest in areas where we should invest to establish a competitive edge. From next fiscal year onward, we will control overall costs at an appropriate level in line with the size of our business as we execute business operations.

Q:

IP income in Q3 was ¥14.5 billion. Do you expect to continuously generate IP income in the coming fiscal year and beyond?

A:

We have been putting in a lot of effort to monetize intellectual property. Following on from the previous fiscal year, there was a large IP income project in the current fiscal year. We don’t know if we’ll be able to record the similar amount of IP income from such projects in the coming fiscal year and beyond. However, we will continue to focus on monetizing NEC’s intellectual property in the future.

Questioner E

Q:

Orders in Japan IT services have been favorable. Will this trend continue in the next fiscal year and beyond?

A:

Orders for IT services have followed a strong trend, increasing from an upper-single-digit to a double-digit growth rate from the same period of the previous fiscal year. Since the previous fiscal year, the Enterprise Business has performed strongly. Moreover, starting in the current fiscal year, orders have been performing well in a growing range of sectors, from those for the public and healthcare sectors to those for SMEs within the Public Solutions Business. Orders for central ministries have also been firm. Since the previous fiscal year, our order backlog had been increasing as a result of our inability to make adequate shipments due to hardware component shortages. However, component shortages are beginning to be resolved, which has resulted in sales. For these and other reasons, Japan IT services have been performing well overall. For the following fiscal year and beyond, there are currently no signs of a slowdown in orders. The situation varies depending on the industry. For example, the Public Solutions Business is entering a period that will show a trend toward the intake of large orders. In the Enterprise Business, orders for the finance sector have been steady and large projects for the retail/services sectors have been initiated. In the DX area, ABeam Consulting has maintained its strong performance. The SAP area, where ABeam Consulting excels, accounts for around one-third of its overall net sales, with DX-related sales representing 20% to 30% of overall sales. In the future, demand for core DX will continue to increase. We have strengthened alliances with hyperscalers and readied an extensive range of products that will steadily pave the way for improved business performance. Due to these factors, we expect that the Japan IT services will continue to operate strongly in the next fiscal year.

Questioner F

Q:

NEC recorded expenses of ¥5.0 billion for streamlining assets, including inventory valuations, in the global 5G business. Why were those expenses recorded?

A:

We have strategically stockpiled inventory amid shortages of network product components since around the summer of last year. However, certain products had become long-term slow-moving inventory, so we provided an allowance for them. In addition, we applied asset streamlining to the treatment of certain former models of products that would have been difficult to ship in the future, in order to reduce the risk that they might have on future business performance.

Questioner G

Q:

What are your thoughts on pay raises?

A:

To recruit and retain talented human resources, we must compete with consulting firms, foreign-owned companies and other businesses. For this reason, we believe that it is crucial to respond competitively to market remuneration levels, and to ensure that both employees and those joining the Company from outside receive attractive remuneration. That said, we are not considering uniform pay raises. Beginning in April, we introduced a job-focused personnel system for chief officers and higher positions, and in the fiscal year after the next, we will start expanding this system to the whole Company. In this context, our basic approach is to allocate remuneration in a clear-cut manner to employees who have achieved results or possess skills that are valued by the market.

Q:

Could you please explain the purpose of your organizational reforms? Why are you implementing these reforms at this time?

A:

In the previous fiscal year, we also advanced reforms that would allow us to move more quickly, such as de-fragmenting and de-stratifying our organization. Our current reforms are the culmination of efforts undertaken over the past two years to optimize how we will achieve Mid-term Management Plan 2025. As we enter the third year of Mid-term Management Plan 2025, we have decided that now is the time to make major changes. Specifically, we will establish a business unit (BU) for the Digital Government / Digital Finance business, which is a growth area, and unify our business for domestic and international telecom operators, including global 5G. In addition, we will step up activities in the healthcare/life science area, which we expect to become a major growth area in the future, by establishing a business division for the healthcare/life science business, as a measure to prepare for our next phase of growth. In the core DX business, although this business spans several BUs, we will unify the organization and investment with a view to strengthening the NEC Digital Platform's growth and delivery capabilities. Furthermore, we will establish BUs in government digitalization and aerospace and national security areas, where markets are active, in order to move more speedily and produce major accomplishments.

Questioner H

Q:

Could you please discuss conditions in each business in the Global segment, excluding the impacts of exchange rate fluctuations? What is the likelihood of meeting the full-year earnings forecast?

A:

The strongest performer in the Global segment was Netcracker, which is included in the Service Provider Solutions business. Netcracker has been bolstering its workforce since the second half of the previous fiscal year, and the results reflect this. Netcracker has won several large projects and its revenue and profits have both grown significantly. In fact, it is driving the business results of the whole Global segment. Submarine systems are also performing strongly, and this business is expected to achieve its earnings forecast for the current fiscal year. Despite the fact that several risks remain for the Global segment as a whole, we expect to meet our full-year forecast for this segment, which will be aided in part by the impacts of exchange rate fluctuations.

Q:

Could you explain why cash flow from operating activities for Q3 was negative? Was IP income of ¥14.5 billion included in cash flow from operating activities for Q3? Also, could you please discuss your outlook for free cash flows for the current fiscal year?

A:

The main negative factor was the continued strategic stockpiling of inventory in the current fiscal year in connection with component shortages. Accounts receivable also increased in Q3 due to higher-than-expected revenue growth. These are normal accounts receivable, so we believe that there will be no problems on a full-year basis as long as the accounts receivable are collected in Q4. In addition, the IP income in Q3 was recorded in a lump sum in profit, but the cash flows will be received in installment payments over the long term. In terms of the outlook for free cash flows for the full year, cash flows are extremely volatile and are difficult to predict. However, we aim to achieve our full-year forecast by carefully controlling accounts receivable and inventories, as we manage the overall cash flow situation.