CFO Message

Maximizing Long-Term Profit, Optimizing Short-Term Profit, and Increasing Corporate Value through Social Contribution

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Despite the impact of the COVID-19 pandemic in fiscal 2021, the final year of the Mid-term Management Plan 2020, we were able to limit the year-on-year drop in revenue to 3.3%, thanks to full-scale shipments of 5G base stations and capturing demand under the "new normal." Turning to operating profit, we were also able to meet the target set in the Mid-term Management Plan 2020 for operating profit ratio, 5.0%. This is a result of reducing unprofitable projects, which improved profitability, and special cost-cutting measures implemented in response to sudden changes in the operating environment. Net profit attributable to owners of the parent amounted to ¥149.6 billion, a record high for the second year in a row, mainly due to an increase in operating profit as well as a decrease in tax expenses. In light of these results, we paid an annual dividend to shareholders totaling ¥90 per share, reflecting a ¥10 increase to the ¥40 per share year-end dividend announced at the beginning of the fiscal year, to ¥50 per share.

Free cash flow decreased ¥25.4 billion, to ¥152.4 billion. However, if we take into account a cash outflow of approximately ¥239.0 billion, corresponding to the acquisition of the Swiss-based Avaloq Group AG at the end of December 2020, this result shows an improved ability to generate cash.

Financial Strategy

The Mid-term Management Plan 2025, announced in May 2021, utilizes a profit cycle that takes advantage of cash generated on a continuous basis through business activities as a resource for growth. With proper allocation, we will maximize long-term profit and optimize short-term profit. These profits are then put toward improving corporate value.

We have also positioned EBITDA and ROIC as indicators to measure achievement. For EBITDA, which measures our ability to generate cash, our target is set at an annual average growth rate of 9%, and for ROIC, which measures capital efficiency, we have set a target of 6.5% for fiscal 2026.

Moreover, if we are to win against the competition on the global stage, we cannot just retain funds needed for investment—we must also reinforce the non-financial measurement methodologies that will ensure the sustainable growth of both Company and society. As a company that creates social value, NEC bears a certain responsibility to contribute to society, so it is highly important that, while we deliver results from our business activities, we must also make contributions to society going forward. In the same vein, we will also invest in ESG and other non-financial areas. The effects of reinforcing non-financial measurement methodologies may not become immediately apparent in numerical form, but I believe that fulfilling this responsibility will lead to greater corporate value for NEC in the long run.

Generating Cash

We are aiming for a cumulative ¥1.3 trillion in cash flow from operating activities from fiscal 2022 to fiscal 2026. To avoid opportunity loss, we believe that we should have an amount of cash available that will allow us to make optimal investments at any time.

Here, I will talk about cash generation in terms of growth businesses, improving profitability of base businesses, improving capital efficiency, and asset monetization, and will save the bulk of my discussion on growth businesses for when I talk about our investment strategy.

Improving Profitability of Base Businesses

Over the course of the previous mid-term management plan, we reviewed our business portfolio and set aside generated cash for NEC's core businesses. However, there is still work to be done regarding low-profit businesses. To determine which businesses should continue, we have set an operating profit ratio target for each business of 7%. When businesses cannot reach this target, our first step will be to try to transform them so that they are able to achieve an operating profit ratio of 7% or higher. If a business cannot reach this hurdle rate by fiscal 2026, we might have to make some pertinent decisions that include reorganizing our business portfolio. But first, we will set goals and timelines in order to raise overall profitability.

Improving Asset Efficiency and Awareness of Capital Efficiency

Since the previous mid-term management plan, we have been engaged in activities to improve our cash conversion cycle (CCC) with a view toward improving asset efficiency. Thanks to these activities, we reduced our CCC by 12 days over a period of two years, from 72 days as of March 31, 2019 to 60 days as of March 31, 2021.

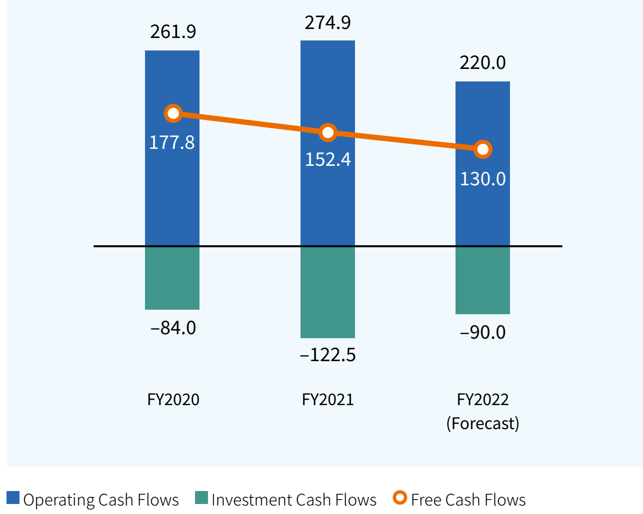
Although ROIC has been set as a Companywide indicator in the current mid-term management plan, we believe that ROIC is an indicator well suited to some individual businesses while not very well suited to others. Take growth businesses, for example. If we place too much emphasis on ROIC, we lose our ability to invest and miss out on business opportunities as a result. We will therefore apply ROIC to businesses that emphasize capital efficiency in their operations, starting with those with stable profits, and gradually expand its application as an indicator throughout the Company from there.

Monetizing Assets

In April 2019, we set guidelines for eliminating cross-shareholdings, and in fiscal 2021 we sold shares in 45 stock listings worth ¥96.3 billion. Shares are only held when the Board of Directors accepts the rationale for holding the shares, having clarified their strategic value and considered the returns from a capital cost perspective. In addition to cross-shareholdings, we are also actively monetizing available-for-sale non-assets.

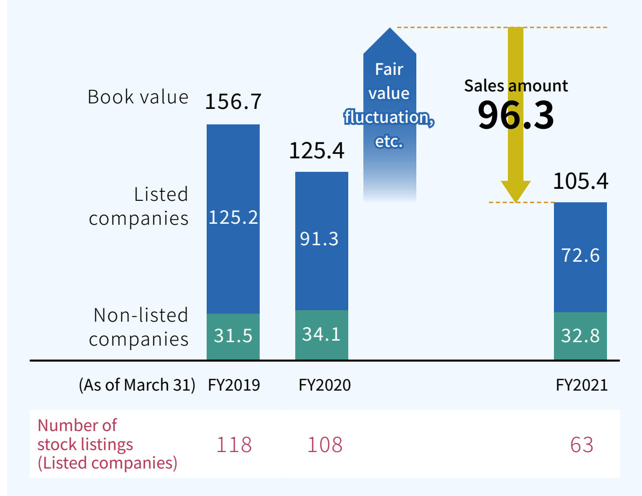
Free Cash Flows

(Billions of yen)



Sales of Investment Securities

(Billions of yen)



Capital Allocation

Ensuring a Sound Financial Structure

We will invest strategic expenses under the Mid-term Management Plan 2025 to enhance corporate value. In order to keep investing strategic funds we need financial discipline. Thanks to efforts made to date, our financial structure is fairly sound, and we have improved both our ratio of equity attributable to owners of the parent (owner's equity ratio) and our net debt-to-equity ratio. We will continue to invest in growth areas while ensuring financial soundness, using our financial structure as of the end of March 2021, which received a one-notch upgrade by credit rating agencies, as a guideline for maintaining our financial structure over the medium term.

Shareholder Returns

We have a policy of providing stable dividends and have had a target payout ratio of about 30% for the past five years. We believe that making investments to achieve growth and increasing profitability will increase corporate value and lead to greater returns to shareholders.

Investing Strategic Expenses for Realizing Growth

Over the course of the Mid-term Management Plan 2025, we intend to make growth investments within cash flows from operating activities and thereby expand corporate value. In addition to investing in growth businesses and improving the profitability of existing businesses, we will also actively invest in business infrastructure and human resources to support them. This is akin to investing within the scope of financial soundness.

With digital government and digital finance, we will combine the software and SaaS platforms of three European companies acquired during the previous mid-term management plan—the UK-based NEC Software Solutions UK (formerly Northgate Public Services), the Denmark-based KMD, and the Swiss-based Avaloq—with NEC's technology, which includes biometrics and AI, its engineering capabilities, and its customer base, and pursue synergies.

As for Global 5G, our goal is to achieve a top position, with a 20% market share in the Open RAN market in 2030. This goal includes expanding our scope in the Japanese market from a base station hardware provider to a software solutions provider. By 2025, we will shift our profit focus from hardware licensing to software licensing and provide service-based solutions to achieve a high level of profitability. To increase our global market share, we will invest strategic expenses into enhancing our development and sales structure.

For Core DX, we will utilize ABeam Consulting's resources to capture more upstream customer demand, and expand the value we can provide by taking a consistent approach from consulting to delivery. We also plan to improve profitability by developing platforms that draw from NEC's technological strengths to act as common infrastructures that offer value-providing services. Furthermore, we will bolster strategic collaborations with hyperscalers and offer a hybrid environment via our own high-security cloud. We will also invest strategic expenses toward the transition of this business model and for developing ICT common infrastructures.

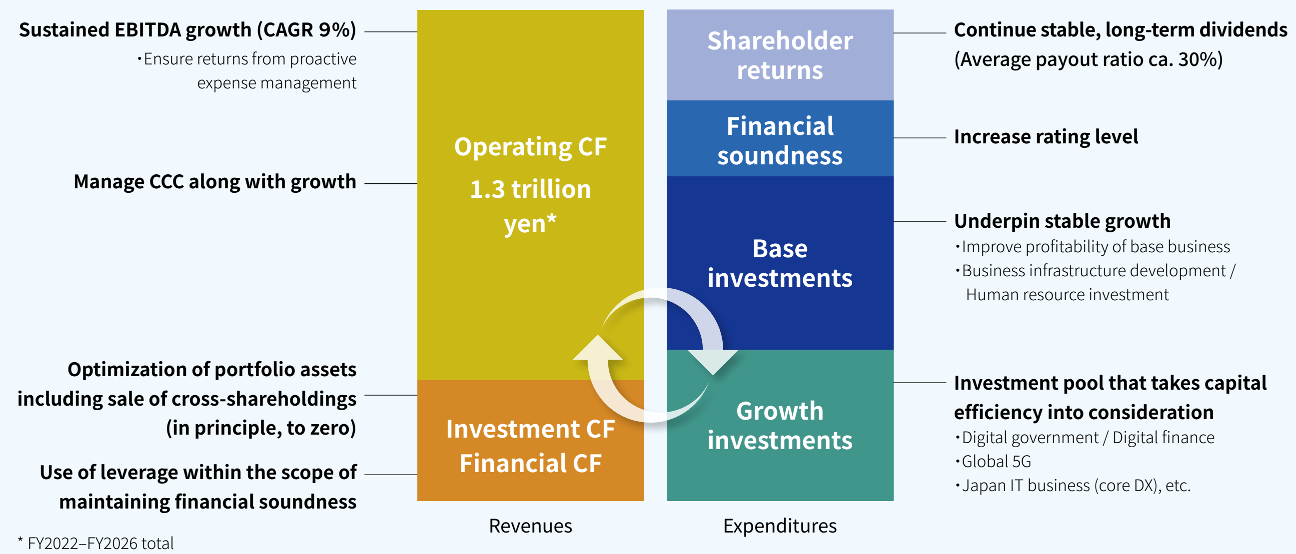
Turning to the Company's business infrastructure development, we will work toward increasing the level of freedom in management not only by establishing an IT base but also by simplifying business processes across the Group and accelerating the shift toward data-driven management.

As for human resources, we will work to ensure diversity, an important source of innovation, and continue making workstyle reforms to improve productivity. We will also invest whatever it takes to foster the next generation of leaders, who will be the ones to drive future growth. These moves will help grow the business going forward and lead us to greater returns.

By reaping the benefits of focused cash investments in areas with higher growth potential, and choosing optimal investments with optimal timing, we will generate even more cash to invest toward our next stage of growth and establish a cycle that will maximize our corporate value.

The basic policy behind capital allocation is to balance growth investments, shareholder returns, and a sound financial structure in order to execute a business strategy that will meet market expectations and an underlying strategy to support the business strategy by maintaining and improving financial soundness.

Profit Cycle and Capital Allocation



* FY2022–FY2026 total

To Our Stakeholders

I have served on the front lines in the business of providing a variety of IT-related services and have helped commercialize and launch NEC's superior technology both in Japan and overseas. I know from this experience that the roles of a CFO are to ascertain the company's business, manage investments aimed at future growth, understand financial indicators—not just the numbers, but also the conditions surrounding them—and provide timely decision-making and operational support. And, in order to maximize the assets of a company and realize greater business growth, it is also important to develop human resources who can understand both the business side and the finance side, and as CFO, I would like to help foster such human resources.

Looking at NEC as a whole, I see the potential for great things, made possible by the abilities of the Company's people. The Company has a great many talented and highly skilled people, and these people work closely with the many people who have recently joined NEC, who are also talented and skilled, to produce outstanding things day after day while being respectful of one another. These people are a true asset to NEC. As a member of management, I will utilize these assets and work with them to create greater value. There are still challenges ahead, but now that we have a sound financial base and the ability to make new investments, we will create a virtuous cycle in which the people who work for NEC do so with confidence and pride, and produce results. Going forward, we will leverage this virtuous cycle to increase corporate value.