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

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Location: Live audio streamed from NEC Headquarters, Tokyo
Presenters: Takayuki Morita, President and CEO (Representative Director)
Osamu Fujikawa, Executive Vice President and CFO (Representative Director)

Questioner A

Q: I'd like to ask about order trends on page 8 of the presentation materials. Public infrastructure orders were particularly strong in aerospace and defense, yet your full-year earnings forecasts are unchanged from your initial forecasts. Why are there no changes to the earnings forecasts of segments with strong orders? Also, orders in the Global segment increased significantly. What factors helped stronger orders at Netcracker?

A: At the moment, we have put all adjusted operating profit upside from the increase in sales into "Adjustments." Public Infrastructure, Enterprise and Global segment orders are strong, and we anticipate a sales upside of ¥10-15 billion in Public Infrastructure, ¥15-20 billion in Enterprise, and ¥30-40 billion in the Global segment. We expect these higher sales to add ¥14 billion to the operating profit of segments with strong orders. We will continue to assess these figures.

One factor that contributed to stronger orders at Netcracker in the Global segment was two major new orders in the billing operations and management area for telecom operators, each worth tens of billions of yen. I'm not at liberty to disclose the names of the customers due to confidentiality obligations, but these are software orders for major telecom operators.

Questioner B

Q: How did Q1 results compare to your internal targets? And could you tell us about one-off factors such as unprofitable projects and business divestitures?

A: Company-wide adjusted operating profit was approximately ¥10.0 billion below our internal target. One factor for this was postponed orders, but underlying demand is firm, and we have no major concerns about meeting our full-year targets. We believe we have sufficiently factored in areas we need to be conservative about into our financial forecasts for the Public Solutions and Network Services segments. Although I cannot disclose details of real estate and business divestitures, I can say that NEC booked around ¥5.0 billion in the first quarter from gains on sales taken as corporate action.

First quarter adjusted operating profit was ¥4.0 billion yen short of our internal targets for the Public Infrastructure segment due to lower sales, and ¥5.0 billion yen short for the Network Services segment as a result of lower sales and a decline in profitability. It was also ¥2.0 billion short for the Global segment as a result of surging components prices in the wireless business, and ¥4.0 billion yen short for the Other segment due to factors such as currency impact on the System Platforms business unit. By contrast, higher sales saw the Enterprise segment exceed our internal operating profit target by ¥2.0 billion, while the Public Infrastructure segment was in-line with our target.

Q: You were bullish about global 5G business earnings in Japan in your initial plan despite components shortages from the second half of FY3/22. Yet, despite this, you say in the first quarter that demand has been delayed into the next fiscal year. What is the cause of this? Have investment trends of telecom operators abroad also changed due to the macro-economic environment?

A: One factor is the impact of component shortages. For domestic orders, component shortages since last year meant we could not sufficiently meet the required schedules of customers, so had to revise shipping schedules. We think this made customers more cautious with their planning. There were various circumstances of individual customers in the first quarter, but we expect to see a gradual recovery form the second quarter. Internationally, telecom operators' interest in Open RAN remains high, but business progress is slightly behind schedule due to several factors.

Q: NEC is bolstering its 5G engineering resources through the acquisitions of Blue Danube Systems and Aspire Technology. Is the delay in demand resulting in a lower operating ratio?

A: The acquisition of Blue Danube Systems was to acquire 5G base station radio unit development resources. With the need for response to transmission frequencies in line with customer requirements, low-frequency band products that were previously procured through OEM have been replaced with internal development, so there is no question of idle resources. Aspire Technology specializes in on-site system integration services including interoperability. We are already dealing with existing projects, including those of Vodafone's and Telefónica's, so we do not expect any dip in the engineer operating ratio.

Questioner C

Q: Has the one-off ¥5.0 billion gain on sales in first-quarter results been included in the Enterprise segment and the Adjustments? You said that your initial targets for this fiscal year were conservative and were a minimum level, but given that you have included the corporate action gain on sales in your revisions at this stage but have left your annual targets unchanged, isn't this effectively a downward revision? Looking at it that way, is the Network Services segment struggling the most versus your initial forecasts?

A: I can't give you exact figures, but most of the one-off gain on sales were real estate sales. There was little profit from business divestitures, with only a small amount for the Enterprise segment. Looking at the first quarter only, the Public Solutions and Network Services segments fell short of internal targets. Looking at the entire year, we will monitor the extent to which telecoms operators' capital expenditure and our business recovers from the second quarter onwards in the Network Services segment.

Q: You said your medium/long-term outlook for global 5G has not changed, but that progress is slower than expected. Does this mean that the impact of semiconductor and components shortages are within expectations, but that telecom operators' investment is slower than expected?

A: We believe telecom operators' investment appetite will not change in the medium/long-term. For components shortages, we will need to take a cautious outlook for around one year, and this is one reason for our revisions.

Q: For the Network Services annual forecasts on Page 13 of the presentation materials, you initially said you expected high demand for system upgrades for telecom operators in the IT domain, but at the first-quarter stage, you now say you expect earnings to be flat year on year. Is this due to reconsiderations by customers, or have you lost projects?

A: It is not from lost orders. There are existing projects and new projects we expected, but the timing of new projects has slipped back, and the pace for received projects being booked as sales has dropped slightly. The projects will not vanish, so we will aim to secure them in FY03/24.

Questioner D

Q: You said you would aim to achieve the earnings targets including corporate actions you announced initially, but is there an element of you aggressively implementing corporate actions due to the likelihood of you missing your initial targets?

A: We are constantly taking corporate actions to optimize our balance sheet. Including those already achieved, we will carry these out as contingencies this fiscal year. Please consider the earnings forecasts we initially announced as a sign of our determination to achieve them.

Q: You revised your earnings forecasts by segment, but can you tell us your intention in including all the adjusted operating profit upside in the Adjustments? Was it included in the Adjustments because you don't have specific forecasts for each segment?

A: We will of course track the figures internally. Our promise as a company to stakeholders is the company-wide financial forecast.

Questioner E

Q: I believe the deterioration in the macro-economic environment could affect IT investment of some customers from the second half of this fiscal year. You said that first quarter orders were strong, but could you tell us about your full-year forecasts, such as whether you are seeing changes by sector?

A: My feeling from meeting with CEOs of customers is that interest and appetite for DX remains extremely strong, particularly from major companies. Based on this, I don't think demand will change based on short-term economic trends.

Overall IT services orders grew 10% year-on-year, and remain strong even excluding large projects. By sector, public and healthcare sectors and SME orders were brisk, as were orders from the finance, retail/services and manufacturing sectors. For consulting, Abeam Consulting orders were also strong. Based on the order backlog, we expect some upside.

Looking at the first quarter only, orders from SMEs were strong, but full-year orders fell in FY3/22. We think orders have almost bottomed out, and will need to closely monitor the situation for future forecasts.

Q: For global 5G, you mentioned that investment by both Japanese and international customers will not vanish but has been pushed back. How much downside do you expect domestically and internationally versus your sales plan of ¥110.0 billion this fiscal year?

A: Our previous sales forecast for global 5G was ¥110.0 billion, but we have now factored in a downside risk of ¥25.0-30.0 billion. We now think the negative impact on sales will be roughly equal for Japan and internationally. Our previous plan had an 80/20 split for Japanese and international sales, but our revised forecast assumes a 90/10 split. We view our revised forecast as the low-end figure.

Questioner F

Q: Delayed demand in the Network Services segment both in Japan and internationally is likely caused by a number of factors such as deteriorating business sentiment and components shortages, but what factors are particularly significant?

A: I can't talk about the circumstances of our Japanese customers, but I feel investment was slightly weak in the first quarter. Having said that, I think customers have no plans to reduce investment over the year and in the medium/long-term, so it is a question of timing. We had envisaged securing international orders in the first half of this fiscal year and booking sales from the second half of this fiscal year, but due partially to the decision-making of customers, this schedule has been pushed back slightly. For new markets such as Open RAN, our view is that we need to manage the business with an understanding that these sorts of changes often occur.

Q: You said that international Open RAN investment appetite was unchanged but delayed, and that you expect domestic Open RAN investment to recover from Q2. With first quarter Network Services orders including international orders down year-on-year, do you expect a recovery from the second quarter, or are you still lacking visibility?

A: There are various circumstances affecting overseas orders. One example is the various changes in the market, such as the delay in frequency licenses in India, but we think interest in Open RAN remains high overall. As the introduction of Open RAN ramps up, we expect commercial projects to proceed through the cutover process, and the shift to practical use to accelerate. UK's Vodafone and Spain's Telefónica have already said they will use it commercially, and that they expect to start between the end of this fiscal year and the start of the next. We think this will open up and invigorate the market in various ways. For this reason, we feel that accomplishing existing orders from the second half of this fiscal year into next year is extremely important.

Q: Orders were strong overall in first quarter results, but please tell us the timing with which sales are recorded. Looking at first quarter adjusted operating profit, it looks like it has been a very challenging start. You say one-off gains on sales will also be booked in the second quarter, but excluding this, can the company boost profits organically? Please tell us how you view the second quarter.

A. We will make the utmost effort to at least stabilize performance in the second quarter, and believe it important that performance returns to the levels we expected. We are currently looking into the timing of booking sales for projects secured in the first quarter. We are acting to achieve upside versus our initial plan in the second quarter, and expect visibility to improve then. At present, we are working towards our revised targets.

Q: Why have your forecasts changed so much in just three months since what you said were relatively conservative forecasts in your briefing on full-year results in April? You have left your full-year forecasts unchanged, but taking out one-off profits, it looks like a downward revision in real terms.

A: What is important is to maximize long-term profits, not necessarily operate the business on a quarterly basis. For the Network Services segment, telecom operators are facing different circumstances, but we expect a gradual recovery barring any major change in equipment planning. For the Public Solutions segment, although orders were strong in the first quarter, a decline of sales having a negative impact on profit was the cause of the downward revision. Given strong orders in other areas, we are confident we can achieve our initial full-year targets including contingency management.

Questioner G

Q: First quarter profits are underwhelming, but does the fact you haven't revised your full-year earnings forecasts mean this is not an unexpected downturn?

A. It is true that first quarter profit was ¥10.0 billion short of the company forecast. However, this was due to slow starts in the Public Solutions and Network Services segments, so we expect to see a corresponding recovery over the full year. Orders are on the rise in the Enterprise, Public Infrastructure and Global segments, and sales will be booked between the second and fourth quarters. With corporate actions added to this, we believe we can more than make up the ¥10.0 billion gap.

Questioner H

Q: You have said you will reduce the negative impact of currency impact by passing the influence onto prices. What areas will be subject to such measures, and to what extent?

A: The sudden change in foreign exchange rates meant we could not pass it onto prices in time. We hiked prices for general hardware, etc. in July. Going forward, we will factor in yen depreciation in project contracts with clients, which should minimize currency impact from the second quarter onwards.