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Nomura Research Institute, Ltd.

Q＆A from Small Meeting for sell-side analysts (2nd)

Speaker :

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- In order to make it easier to understand, the contents of the question and answer are partially revised and modified.
- Glossary :
  - DX : An abbreviation meaning Digital Transformation, which refers to initiatives that utilize digital technologies to reform business models and processes
  - CiT（Corporate IT） : IT that helps enhance the quality and efficiency of clients' internal operations, including core information systems
  - BiT（Business IT） : IT that contributes directly to the expansion of client businesses

（Questioner No.1）

Q : What is management currently spending the most time on?

A : Discussions in the Board of Directors have focused on the next Medium-Term Management Plan which will span four years starting next year.

Amongst business strategy issues we are currently discussing what role DX strategy should have, in addition to the definitions and numerical targets for DX within NRI.

Our human resources strategy includes expanding new graduate hires in conjunction with our business growth, as well as doubling our mid-career hires. We are also proceeding with policies to shift NRI employees toward more upstream processes and strategic fields such as DX. The roles of our business partners are being redefined to have them handle a broader scope than before.

Q : How much do you expect labor cost to increase in line with increased hiring? Also, would redefining the roles of partners cause subcontracting costs to rise and decrease marginal rate of return?

A : I think the increased labor cost from more hiring will be canceled out by increased earning effects from higher sales.

In terms of higher per-person labor costs at business partners, we have seen this trend with some partners in China, but it will not cause marginal rate of return to decrease as measures are being pursued such as shifting away from coastal areas in China and toward inland areas where per-person costs are lower.

(Questioner No.2)

Q : Added value per employee is trending downward, but will this continue until we see improved productivity effects after expanded hiring of human resources?

A : The decrease in added value per employee is due to the consolidated effects of overseas subsidiaries from M&A.

We are expanding hiring to be more prepared for strong performance in terms of orders, but this increased labor cost from more hiring will be canceled out by increased earning effects from higher sales, so this will not cause added value per employee to decrease. On the other hand, this could turn into fixed costs that strain profits if orders take a turn for the worse. However, the way orders look now, that does not seem likely. Concurrently, we will also improve productivity, and are currently discussing our human resources strategy to achieve the targets in the next Medium-Term Management Plan.

Q : Are employees putting more efforts into getting orders, and are business partners working harder on development operations?

A : It does not work that way. If employees do not handle development work, there is greater risk of things happening such as mistaken monetary estimates proposed to clients, which would lead to large-scale unprofitable projects. There is still enough leeway to be able to contract part of the development process to partners, and we will rethink the breakdown of responsibilities for this. Moreover, personnel will be shifted toward strategic fields such as DX in each division.

(Questioner No.3)

Q : Can 100 billion yen in operating profit be achieved by the DX strategy and by bolstering human resources?

A : Reflecting on the three years of the current Medium-Term Management Plan, growth in financial IT solutions did not proceed as planned, so I would like to thoroughly ensure that we achieve this growth in the next plan. Additionally, we are actively considering other growth measures such as DX in fields other than financial IT solutions. In addition to our existing business models for systems integration and shared online services, we are looking at diversifying our earnings structure through means such as establishing joint ventures with clients, and pay-per-action revenue models.

Q : Is there anything you are starting on this year without waiting to announce the next Medium-Term Management Plan?

A : We are already moving forward with a variety of initiatives, some of which will also be incorporated into the next Medium-Term Management Plan. The next plan can also be seen as an advancement on the basic framework of the current plan. I think the three years since formulating the long-term vision have been the time for planting seeds such as DX and global, and the four years of the next plan will be the time to harvest their fruits.

Q : Please tell us the financial strategy of NRI.

A : To maintain financial health and high profit margins as a company that provides social infrastructure, while also quietly doing what we can to give back. We have also been improving operational efficiency in order to achieve our target ROE. Additionally, we have already obtained ratings, and would like to maintain our current EBITDA margin of more than 20%.To sustainably grow our enterprise value, we also wish to push forward as the standard setter in the industry not only in financial terms but non-financial terms as well.

Q : Since being an IT services company is a business model that involves not owning assets, ROIC (return on invested capital) does not seem to be an appropriate KPI for operational effectiveness, but is it?

A : It is true that in providing the high added-value services of NRI, we consider human capital to be most important. Actually M&A expansion is behind our use of ROIC as one of our KPIs.

(Questioner No.4)

Q : Do you think your current capital structure is optimal?

A : Generally I think so, but we are considering the use of additional debt. While we are using 10% debt/equity ratio as a benchmark, we think it would be acceptable for this to be as high as 30% so we are maintaining a corporate bond issuance quota for this purpose.

Q : What is the purpose of obtaining ratings?

A : Currently our goal for obtaining ratings is not to procure debt, but rather to boost the presence of NRI in our overseas business. Having ratings allows investors to see the position of NRI according to global standards, and our relationship with Nomura Holdings. At the same time, there is risk that our rating could drop if our EBITDA margin falls below 18% or if our business does not show any growth. The financial foundation of NRI is our valuation according to both shareholders and credit agencies, and I think the ratings show that we are making good on that.

Q : Please tell us your M&A strategy going forward.

A : In the current Medium-Term Management Plan we have invested around 50 billion yen in M&A. I also think M&A is important from the perspective of buying us time in order to continue expanding our business globally.

In Australia I think we would also like to consider M&A in order to build our presence in the Australian IT services market. Meanwhile I think we also need to strengthen our presence in North America from the standpoint of IP acquisition, greater global expansion, and delivering synergies with our domestic business.

Q : From a valuation standpoint, about when do you anticipate conducting M&A?

A : We are continuously considering M&A in both Australia and North America. Valuation is one decision factor, but our basic policy remains to acquire companies that own good IP.

Q : ROE is better than it was in the past, but ROIC is trending downwards. On the other hand, M&A is necessary for business expansion, so how do you see this balance?

A : We believe that M&A is necessary for overseas business expansion, and therefore a short-term decline in ROIC is inevitable. At the same time, we are also moving ahead with profitability improvements domestically by improving productivity, and we would like to raise ROIC over the medium- to long-term.

(Questioner No.5)

Q : Please tell us your forecast for the macroenvironment of domestic IT services from 2020 onward.

A : We believe the growth rate of the domestic IT services market will be between 1 and 2%. However, we are also making a forecast that business confidence worsens, and we are working out a business plan that anticipates such a situation. Even so, curbing investment due to worsening business confidence would simultaneously cost us growth opportunities. As such, we are making this plan on the assumption that we will continue investing in stable, long-term growth.

Q : If IT investment slows down, how do you think you can keep subcontracting costs down?

A : Subcontracting costs are variable costs, and they fluctuate along with sales. We therefore employ measures such as avoiding risk by dividing our orders among multiple companies rather than leaning more heavily on only particular business partners.

Q : As you pursue your DX strategy over the next three to five years you will likely be competing with foreign-owned consulting firms. What do you think that competition will be like?

A : We will differentiate ourselves as a strategic partner that builds long-term, deep relationships of trust from the perspectives of our clients through integrated consulting, IT solutions and systems management as well as the establishment of joint ventures, and more.

(Questioner No.6)

Q : How are you managing human resources in Australia?

A : We are implementing retention measures to ensure that we have the core management personnel in place. Additionally, we will shift human resources toward managed services business focused on large-scale government projects which offer stable profitability. Since the project cycle is short compared to Japan, it is also easy to shift resources. Furthermore, we are maintaining around 1,000 engineers in the engineer dispatch department that had belonged to SMS, and they are also available for shifting of resources.

(Questioner No.7)

Q : Please tell us what impact there was on NRI, such as damage claims, from the connection failure at the Tokyo Stock Exchange in October.

A : This connection failure was caused by a massive data transfer from Merrill Lynch Japan Securities, and NRI was not directly involved. The Tokyo Stock Exchange is currently working on cause analysis and recurrence prevention measures, and we support the formulation of these measures. This incident has had no impact on the performance of NRI.

(Questioner No.8)

Q : Have you concluded the unprofitable projects in North America? The US stock market is also very volatile, so how much of an impact does that have on NRI?

A : We are concluding the unprofitable projects at Brierley+Partners. Since the scale of our business in North America is not large, these have only a limited impact on NRI overall.