Transcript of Earnings Call

Results of operations for the third quarter of the fiscal year ending March 31, 2018

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Introduction

Greetings, I am Tetsuya Fukunaga, CFO of SCSK Corporation.

I would like to start by thanking you all for taking time out of your busy schedules to join us for this teleconference, during which we will discuss the performance of SCSK Corporation during the nine-month period ended December 31, 2017.

Let us begin our look at the Company's consolidated performance.

Slide 1

First, I will be offering an overview of our consolidated performance in the nine-month period ended December 31, 2017.

I will start by discussing performance with regard to each item of our usual presentation materials, following the order put forth in the table of contents, and then move on to talk about the revision to our full-year forecasts for consolidated performance and the progress of our business strategies for the fiscal year ending March 31, 2018.

We will end today's teleconference with an overview of the recently announced organizational reforms, which are scheduled to be implemented effective April 1, 2018.

Slide 2

Please look at slide 2, which displays consolidated performance highlights, and slide 3, where you will see a summary of SCSK's consolidated statements of income. I will begin by offering an overview of our consolidated performance in the nine-month period ended December 31, 2017.

On this slide, you will see that sales were up while profit was down, as was the case in the six-month period ended September 30, 2017. During the briefing on six-month performance, it was stated that expenses associated with business investments have been exceeding our initial expectations. Specific reasons behind the higher expenses include expenses related to efforts to advance core strategies, such as the shift toward service-oriented businesses and the development of strategic businesses; depreciation and amortization and R&D expenses for reinforcing existing operations; and marketing expenses. Also, there were delays in the commencement of large-scale projects for customers in the financial industry. As a result, overall operating profit for the six-month period decreased year on year, despite profit increases stemming from the higher sales.

In addition, we had witnessed an increase in deal flow and orders from the manufacturing and distribution industries. At the same time, we had been successful in finalizing certain orders among the delayed large-scale projects for customers in the financial industry. We had also expected to be able to control selling, general and administrative, or SG&A expenses and other business investment expenses to an appropriate degree. As a result, second-half profits were anticipated to exceed our initial forecasts, compensating for the failure to meet forecasts in the six-month period ended September, 2017, and presenting the potential for full-year performance to meet initial forecasts. This situation was explained during the six-month performance briefing.

Comparing performance in the third quarter, from October to December 2017, to our initial performance forecasts, we will see that performance was strong in businesses catering to the distribution industry, which had previously been enjoying an upward trend in earnings, and in IT service businesses serving customers in the manufacturing industry, mainly system development areas.

Meanwhile, business investment-related expenses were more or less in line with our initial forecasts as we sought to appropriately control SG&A and other expenses. The year-on-year increase in expenses was as had been anticipated in these forecasts.

However, earnings were lower than expected in other IT product sales businesses that cater to communications industry customers and in systems development businesses that serve financial industry customers. As a result, overall sales and profit were down year on year in the third quarter. We will look at this matter in a little more detail later on.

Slide 3

Due to these factors, net sales in the nine-month period ended December 31, 2017, were up 2.4% year on year while operating profit declined 7.7%.

As shown on slide 3, profit attributable to owners of parent increased 25.9% year on year. Although operating profit was down, we were able to secure higher profit attributable to owners of parent due to the recording of ¥10.7 billion in extraordinary income resulted from the gain on the transference of shares in QUO CARD Co., Ltd., a fact that was touched on during the six-month performance briefing.

The operating margin was down 1.0 percentage points, at 8.8 %, due to the first-half increase in business investment-related expenses.

Lastly, overall order backlog decreased 0.4 % year on year due to a decline in backlog for maintenance and operation service orders, which counteracted the strong increase in systems development and system sales orders. I will talk about this subject in more detail a little later on.

Slide 4

Moving on to slide 4, I would like to offer a summary of SCSK's consolidated statements of income for the third quarter, from October to December 2017. I will now discuss the third-quarter performance figures mentioned previously in a little more detail.

Net sales decreased 0.3 % year on year in the third quarter primarily due to the large decline in the sales of system sales businesses catering to the communications industry. This decline effectively outweighed the strong performance in systems development businesses, denoted by double-digit growth in systems development sales to the manufacturing and distribution industries posted by the Manufacturing Systems Business Group and the Distribution Systems Business Group, as well as the growth in maintenance and operation service sales to the communications industry, among others.

Third-quarter operating profit was also down. Factors behind this decrease included lower sales to the communications industry in the system sales business as well as the lingering impacts of the significant delays in large-scale IT service projects for the financial industry seen during first half of the fiscal year. Although we were able to commence certain projects during the third quarter, the residual effect of these delays resulted in systems development earnings from the financial industry falling below internal forecasts.

Expenses, meanwhile, were more or less in line with our initial forecasts, as mentioned previously. While outflows were seen for business investment-related expenses, mainly cost of sales, as expected, SG&A and other expenses were relatively unchanged from initial forecast.

When we announced results of operations for the six-month period ended September 30, 2017, we had anticipated year-on-year increases of a few hundred million yen in third-quarter operating profit, which were supposed to make up for the lacking first-half performance. However, actual performance fell below this assumption due to the reasons I explained.

Looking at the overall operating environment, meanwhile, we will see that deal flow is currently strong. This trend can be attributed to increases in strategic IT investment by customers for expanding operations amidst the advance of the digital transformation as well as to investments in upgrades to existing systems that had, in effect, been put off for several years. Other contributors to this trend include a rise in IT investments for boosting efficiency and reducing labor requirements in conjunction with customers' working style reforms. Therefore, business conditions have been improving in the fourth quarter.

I will explain recent business trends when discussing incoming orders and order backlog later in this presentation.

Slide 5

Moving on, I would now like to more closely examine earning figures for the period under review through our usual presentation materials.

On slide 5, you will see a comparison of sales by segment. In the systems development segment, overall sales showed a slight increase of 1.1% year on year. The strong trend in systems development demand from distribution industry customers for enhancing digital marketing efforts and adopting an omni-channel retailing approach continued from the first half of the fiscal year along with the solid trend in demand for strategic IT investment among automobile and other manufacturers and among certain major communications carriers and other communications industry customers. In addition, system upgrade demand underwent an upturn during the third quarter as customers mainly from manufacturing industry enjoyed strong earnings. These factors contributed to a substantial increase in systems development demand. Conversely, the commencement of large-scale projects for major financial institutions, such as banks and insurance companies, was delayed to a greater deal than anticipated this year. As a result, growth in systems development sales to the financial industry was sluggish for the third quarter as well, making for only a slight overall increase of 1.1 % in overall system development sales. Looking ahead, we expect to see strong performance due to the benefits of solid strategic IT investment demand and the commencement of development projects for core and other systems aimed at improving efficiency and reducing labor requirements and of large-scale projects, those targeting financial institutions, mainly insurance companies.

Sales were up 2.7% year on year in the system maintenance and operation and services segment. This segment benefited from demand from distribution industry customers for IT services related to enhancing digital marketing efforts as well as strong sales in service-oriented businesses, such as those related to cloud services, and in other system maintenance and operation service businesses. The benefits of these positive developments counteracted the impacts of certain major customers for our conventional business process outsourcing, or BPO, services reducing the scale of their contracts, a trend we touched on when discussing the performance for the six-month period ended September 30, 2017.

The system sales segment suffered from the impacts of the large drop in network and other orders from communications industry customers in the third quarter. Regardless, overall sales in this segment were up 3.5% year on year thanks to an overall increase is system sales during the first half of the fiscal year.

Slide 6

Looking at slide 6, I would like to discuss order backlog and other order trends seen in each sales segment.

The backlog of systems development orders from financial industry customers declined due to the rebound from large-scale orders recorded in the previous fiscal year as well as delays in the commencement of large-scale orders during the first half of this fiscal year. Meanwhile, systems development order backlog increased more than 10% for such businesses groups as manufacturing systems, distribution systems, and communications systems, and more than 4.0 % on a consolidated basis. The continuation of strong strategic IT system investment demand along with the previously mentioned enterprise resource management system and other IT system upgrade demand mainly from manufacturing industry customers that emerged during the second half of the fiscal year contributed to increases in both incoming orders and order backlog. We have also been recently witnessing an increase in the number of orders received from financial industry customers, and we expect order trends to be even stronger in the fourth quarter and in the fiscal year ending March 31, 2019.

In regard to maintenance and operation services, order backlog decreased 2.6% year on year. Although orders continued to grow in conjunction with our strategies for expanding service-oriented businesses, as mentioned, certain major customers for our conventional BPO services reduced the scale of their contracts, which resulted in an overall backlog decrease.

On September 30, 2017, order backlog for system sales was down substantially from the previous fiscal year due to impacts associated with projects for certain communications industry customers. On December 31, 2017, however, year-on-year change of backlog was turned positive in reflection of the increases in network product sales scheduled for the fourth quarter.

Slide 7

Turning to slide 7, I will now explain trends in sales by customer industry, although I can only touch on the major trends.

Sales to manufacturers were relatively unchanged year on year. Systems development businesses posted strong performance thanks to demand for systems development, including conventional automotive embedded software development, from automobile manufacturers, and to demand for system upgrades aimed at improving efficiency. However, the benefits of this performance were counteracted by a decrease in sales of product verification services to certain electrical machinery manufacturers and reductions in the scale of BPO service orders by certain major customers.

Sales to distributors increased 5.9% year on year. This increase was attributable to an ongoing rise in digital marketing-related development and outsourcing projects for helping customers adopt an omni-channel retailing approach.

Sales to financial institutions decreased 0.4% year on year due to the heavy impacts of the

rebound from orders from banks that were recorded in the previous fiscal year, a factor we have spoken of since the beginning for the fiscal year, as well as to the delays to the start of projects during the current fiscal year in comparison to our initial expectations.
At the moment, large-scale projects for insurance companies and other customers are starting up, and we expect to be able to recover performance going forward.

Sales to the communications and transportation industries were up 7.3% year on year. Although system sales to major communications carriers and cable TV providers were around the same level as in the previous fiscal year, favorable performance in systems development and system maintenance and operation services has continued.

Slide 8

We will now move on to slide 8, which shows a breakdown of the performance I have explained thus far by reportable segment.

In the nine-month period ended December 31, 2017, sales were up in the Manufacturing Systems Business Group due to a continually solid flow of orders from automobile manufacturers, but profit was down as a result of unprofitable projects. Nonetheless, both sales and profit rose in the third quarter, as stated previously, and we anticipate strong performance going forward.

In the Telecommunication Systems Business Group, nine-month sales and profit decreased due to the absence of large-scale orders recorded during the previous fiscal year. However, we look forward to smooth increases in earnings in the future in reflection of favorable trends in systems development projects for major customers.

The Distribution Systems Business Group achieved sales growth thanks to the large appetite seen among customers this fiscal year for digital marketing-related investment for adopting an omni-channel retailing approach. Profit, meanwhile, decreased as a result of higher business reinforcement expenses, including those associated with the shift to service-oriented businesses, as well as the impacts of certain unprofitable projects.

The Financial Systems Business Group was affected by the rebound from previously recorded large-scale orders from the banking industry, a factor that was accounted for in forecasts. Regardless, sales in this segment were up following the start of certain securities industry projects and large-scale projects as well as an increase in system sales orders. Still, as mentioned earlier, this segment falls short of initial forecasts set at the beginning of the fiscal year, due to the delay in commencement of large scale projects. Also, it suffered a decline in profits as a result of increased expenses for establishing new businesses, such as artificial intelligence, or AI, and FinTech businesses, as well as the impacts of unprofitable projects.

The Business Solutions Group posted higher sales due in part to its ability to capture demand for various enterprise resource planning system development projects as well as system upgrade investment demand fueled by high earnings among its customers. The smooth start cut by new service-oriented businesses utilizing SCSK intellectual properties also contributed to higher sales. However, profit decreased due to a rise in strategic business investment expenses as a result of the automotive software systems business being included in this segment beginning in the fiscal year ending March 31, 2018.

In the Business Services Group, sales grew on the back of continually robust demand for the full spectrum of BPO services. Conversely, profit declined due in part to an increase in business investment expenses associated with the opening of a service center aimed at reinforcing business operations through the development of new e-commerce services and the provision of BPO services. Another detractor was higher marketing-related expenses.

Finally, although the IT Platform Solutions Group suffered from a substantial decline in sales and profit in the third quarter, nine-month sales and profit in this segment were up due to an increase in IT product sales to communications industry customers and educational institutions recorded in the six-month period ended September 30, 2017.

With this, I would like to wrap up my explanation of performance by reportable segment.

Slide 9

Up until now, I have focused on net sales in our discussion of performance in the nine-month period ended December 31, 2017.

Looking now at slide 9, I would next like to elaborate on the factors that influenced operating profit. I will primarily be focusing on the expenses incurred during the period.

As you can see on this slide, operating profit was down by more than ¥1.8 billion year on year in the nine-month period ended December 31, 2017. This decrease was the product of a more than ¥3.2 billion increase in expenses, largely a result of higher cost of sales and SG&A expenses, which offset the ¥1.4 billion profit hike stemming from sales growth.

Now, let me touch upon expenses.
The factors that impacted profit were essentially the same as those mentioned during the performance briefing for the six-month period ended September 30, 2017. Factors heightening expenses that were accounted for in our initial forecasts included an increase in depreciation and amortization and other expenses of approximately ¥0.8 billion related to strategic investments in the automotive software systems business, primarily for the increase of amortization of basic software. For reference purposes, these expenses totaled ¥0.9 billion in the nine-month period ended December 31, 2016, and ¥1.7 billion in the period under review. In addition, expenses for starting up new service-oriented businesses increased by approximately ¥0.5 billion and were primarily comprised of personnel expenses, R&D expenses, and depreciation and amortization. The expenses did not rise significantly from the level seen on September 30, 2017. In addition, organizational reform, business reinforcement, and marketing expenses were up ¥0.4 billion, following from the rise seen in the first half of the fiscal year. Losses from unprofitable projects amounted to ¥0.8 billion in the nine-month period, up ¥0.1 billion from ¥0.7 billion in the previous equivalent period. These losses were contained within the scope of the ¥1.0 billion we budget for such losses each year. Furthermore, the rebound from the high-profit orders recorded in the three-month period ended June 30, 2016, lowered profit by a few hundred million yen, as was initially anticipated.

These factors resulted in an increase in expenses of more than ¥3.2 billion, of which ¥2.3-2.4billion was accounted for in initial forecasts.

Expense heightening factors that were not incorporated into our initial forecasts only accounted for ¥0.8 of the total ¥3.2 billion increase. These expenses can be wholly attributed to the rise in bonus payments and in expenses for reinforcing operations and conducting marketing in distribution industry serving businesses and in BPO service businesses in the six-month period ended September 30, 2017.

In the third quarter, we moved ahead with the plans expressed during the six-month performance briefing, namely continuing to carry out the necessary business investments initially budgeted. We also proceeded to manage SG&A expenses and other costs, and the increase in third-quarter expenses was limited to several hundred million yen as a result.

These expense trends are projected to continue on through the fourth quarter, and we currently anticipate that fourth-quarter business investment-related expenses will be a few hundred million yen higher than in the previous fiscal year.

With this, I conclude my explanation of how expenses influenced operating profit.

Slide 10

Moving on from the consolidated statements of income, we will now discuss our consolidated balance sheet. Please turn to slide 10.

During the nine-month period, all assets and liabilities which amounted to ¥100 billion, including ¥43.0 billion in cash and deposits, as well as deposit paid, associated with former subsidiary QUO CARD was excluded from the scope of consolidation following the transference of this company's stock on December 1, 2017.

Meanwhile, we recorded an increase of ¥22.5billion in cash and deposits associated with the transference, which included a ¥10.7 billion gain on share transference.

Together with performance in the period under review, the transference of QUO CARD's stock led to a substantial improvement in various indicators. Notably, the equity ratio rose from 42.8% on March 31, 2017, to 62.6% on December 31, 2017.

Slide 11

Looking at slide 11, I will now touch on our full-year forecasts for consolidated performance.

As for operating conditions in the fourth quarter, we are seeing strong demand for strategic IT investment among customers looking to strengthen and expand their operations. Also, demand is strong for system investment for boosting efficiency and reducing labor in conjunction with customers' working style reforms, investments in upgrades to various operational systems funded by the high performance of customers, and other types of IT investment. We therefore anticipate that all business fields will benefit from robust IT services demand during the fourth quarter.

Moreover, we expect that IT services businesses catering to certain customer industries, such as the manufacturing industry, where order and deal flow growth is currently exceptionally large, will post earnings exceeding our initial forecasts in the fourth quarter.

Meanwhile, in system sales businesses serving the communication industry, which were a major cause of the sales and profit declines seen in the third quarter, we are currently unsure of the extent to which performance will rise above initial forecasts. This uncertainty remains despite the fact that we anticipate strong full-year performance stemming from the increase in order backlog posted on December 31, 2017.

Further, , it was systems development businesses targeting the financial industry that were originally expected to drive performance in the fiscal year ending March 31, 2018. In these businesses, we finally have been able to commence several large-scale projects, and some new large-scale projects are also in the pipeline for the fiscal year ending March 31, 2019. We therefore anticipate earnings growth in these businesses going forward.
Unfortunately, however, although fourth-quarter earnings are on course to meet our initial forecasts, we do not expect earnings to exceed forecasts to any great extent. The reason for this outlook is the impacts of the delays in large-scale projects that occurred during the first half of the fiscal year.

Based on these factors, we judged that it will be difficult to consider that our consolidated fourth-quarter earnings will increase to a degree that greatly exceeds our initial forecasts and fully compensates for the rises in business investment and reinforcement expenses and the delays in earnings that occurred during the first half of the fiscal year, which lead us to judge that achieving our initial full-year forecasts for consolidated performance will be difficult.

Although we expect that 20% of year-on-year increase of operating profit for the 4th quarter will be likely, we think it will be difficult to make up for all the amount of year on year decrease recorded for the nine-month period ended September 30, 2017. Therefore, we decided to revise our forecast of operating profit for fiscal year ending March 31, 2018 downward by ¥2.0 billion to ¥34.0 billion, which results in 0.8% year-on-year increase. Along with the change, we also revised ordinary profit by the same amount as operating profit. Profit attributable to the owners of parent, however, remain unchanged, as we are likely to record tax benefit resulting from transfer of shares of QUO CARD. LTD., more than we had estimated.

This concludes my explanation of our full-year forecasts for consolidated performance.

Slide 12

With this, I end my explanation of SCSK's consolidated performance in the nine-month period ended December 31, 2017.

I would now like to touch briefly upon the progress of our strategies for the fiscal year ending March 31, 2018. Please turn to slide 12.

With regard to the shift to service-oriented businesses, a core strategy, the various organizations within the Company are working together to combine their operational expertise and cutting-edge IT technologies with the aim of creating unique system service businesses that offer system services matched to shared customer needs and operational standardization needs. These initiatives are as has been explained.

As part of these initiatives, we have been engaging in various proof of concept projects related to cutting-edge technologies, such as FinTech, AI, and the Internet of Things, during the second half of the fiscal year. As these projects are still at the proof of concept phase, only a few are at the stage in which they will begin being developed into concrete service-oriented or strategic businesses. We look to shape several of these projects into actual businesses over the fiscal year ending March 31, 2019. In addition, in the AI-related initiatives that are part of our efforts to promote strategic businesses, we view our mission to be providing customers with truly beneficial proposals for the practical utilization and application of AI and making these proposals a reality. To help us fulfill this mission, we are currently advancing business development initiatives via collaboration with various AI developers. Through such collaboration, we hope to make it possible for SCSK to select the optimal AI technology for any task from among a diverse range of technologies, including proprietary SCSK technologies in areas of strength, such as voice recognition, language analysis, and image recognition and analysis. We are moving ahead with these initiatives while envisioning a wide range of fields for the practical application of AI.

As we advance such business development initiatives, we expect that service-oriented businesses will post reasonable sales growth on a full-year basis in the fiscal year ending March 31, 2018.

Moving on, I would like to take this opportunity to mention that, in the automotive software systems business, SCSK's QINeS-BSW and the technologies related to this product have been adopted for use in the development of next-generation products by Sanden Automotive Components Corporation. A news release on this matter was issued on

January 16, 2018. I am limited in the details that I am able to offer, but I can say that we have also concluded agreements regarding similar projects with multiple other partners that have not yet been disclosed. As has been stated previously, projects of this nature do not promise large returns to the Company nor do they boast significant potential for being developed into actual businesses. However, we believe that these projects do represent a necessary step to be taken toward building our track record in the future.

Slide 13

Looking now at slide 13, I would like to provide an overview of the recently announced organizational reforms and discuss the purpose of these reforms. SCSK is currently accelerating the shift toward service-oriented businesses with the aim of accomplishing the goals of its Medium-Term Management Plan, which is slated to conclude with the fiscal year ending March 31, 2020. At the same time, customers' strategic IT investment needs are growing increasingly sophisticated as the digital transformation progresses. We will institute organization reforms effective April 1, 2018, in order to enhance our ability to respond to such needs and advance the aforementioned shift. On the right side of this slide, you will see the organizational structure planned for the Company after the implementation of these reforms.

First of all, we will establish new Companywide sales and relationship management organizations for serving specific customers in order to bolster our ability to swiftly display SCSK's capabilities as a group in response to the IT needs of major customers. The organization will oversee Companywide sales activities pertaining to IT services for which we are targeting strategic deployment throughout the Company.

Our next step will be to integrate solutions business groups responsible for the development of operations based on SCSK intellectual properties with BPO divisions. The goal of this integration will be to establish business solutions divisions that can help enhance service-oriented businesses.

In addition, we will reorganize and consolidate business groups based on specific industries and otherwise take steps to adjust the structure of organizations catering to certain target industries. This move will be aimed at better enabling SCSK to exercise its specialized capabilities while more flexibly allocating human resources, such as by positioning strategic personnel in high-value fields.

As for our IT management businesses, organizations handling security and other aspects of data center operations as well as IT infrastructure platform development and maintenance operations will be integrated into IT management divisions responsible for IT infrastructure. This measure will be taken in response to the spread of cloud computing.

Finally, certain corporate staff organizations will be reorganized and consolidated to enhance corporate governance and promote business process reengineering.

Reportable segments will also be adjusted effective from the fiscal year ending March 31, 2019, to reflect the organizational reforms.

From the fiscal year ending March 31, 2019 forward, all information disclosure will be based on the new organizations. We apologize for any inconvenience this change may cause. Figures from the previous fiscal year will be restated based on the new organizations for the purpose of making year-on-year comparisons.

With this, I conclude my brief explanation of the upcoming organizational reforms.

Yesterday, we announced new management team effective from fiscal year ending March 31, 2019, as well as new board members for fiscal year 2018. As a part of our ongoing effort to improve our corporate governance, the number of board members are to be decreased from sixteen to twelve, keeping percentage of outside directors on the board at more than one-third.
This is aiming at enhancing close communication and discussions among directors regardless of his or her positions.

SCSK stands committed to becoming a leading company in the IT services industry. On this quest, we will decisively make a transition to a business structure promising higher growth potential. At the same time, we will implement wide-ranging improvements to our management base, which will include promoting health and productivity management; making the Company a pleasant, fulfilling place to work; and enhancing corporate governance systems.

I hope we can look forward to the ongoing support of investors.
In closing, I would like to thank you all for joining us for this teleconference.