Transcript of results briefing

Consolidated Results of Operations for Three-Month Period Ended June 30, 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 three-month period ended June 30, 2018.

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

■ Contents

First, I will be offering an overview of our consolidated performance in the three-month period ended June 30, 2018.

I would like to provide details on each item of this summary of the consolidated statements of income for the three-month period based on the framework provided by our usual presentation materials.

My presentation will take about 25 minutes.

■ Consolidated Performance Highlights（Slide2）

Please look at slide 2, which displays consolidated performance highlights.

I will begin by offering an overview of our performance in the three-month period ended June 30, 2018. As you can see on this slide, net sales were up 3.8% year on year and operating profit increased 62.8%. In this manner, new three-month records were set for both of these items.

As has been explained previously, SCSK's business environment took a favorable turn in the fourth quarter of the fiscal year ended March 31, 2018. The impressive three-month performance was a primarily result of the conducive business environment and favorable trends that emerged during the fourth quarter of the previous fiscal year continuing on into this fiscal year.

Specifically, IT investment demand among manufacturing industry customers has recently been on the rise. In addition to strategic investment demand for boosting competitiveness, which included demand for investments to adopt AI, IoT, or other new technologies, we saw the emergence of demand for investing in upgrades to various operational systems. These investments were aimed at reducing labor requirements as well as transforming certain legacy systems into open systems, among other applications. Such demand contributed to growth in the deal flow and in incoming orders. At the same time, IT service businesses catering to the distribution industry continued to enjoy strong performance primarily stimulated by demand for digital marketing-related investment while businesses serving the financial industry witnessed the commencement of certain new projects scheduled for the fiscal year ending March 31, 2019. These developments buoyed the performance of the respective businesses.

In addition to these favorable business trends, while the extraordinary factors that adversely impacted earnings in the three-month period ended June 30, 2017, did not affect performance in the period under review. By extraordinary factors, I refer to the upfront expenses recorded in association with a new systems development order from a specific securities industry customer. This lack of extraordinary factors, coupled with the fact that losses from unprofitable projects were almost nonexistent, resulted in a massive increase in profit.

The global political and economic climate is currently opaque, with prominent factors behind this opaqueness including the trade friction between the United States and China. It is therefore difficult to formulate an accurate outlook for IT services businesses serving the manufacturing industry. As explained at the beginning of the fiscal year, we are anticipating the commencement of several large-scale projects from the financial industry. However, we are unable to accurately determine the degree to which projects will actually be commenced at this point in time. We will therefore have to judge the likelihood of us receiving specific orders as the fiscal year progresses. Accordingly, we cannot clearly project full-year performance trends at this point in time, and we have therefore chosen not to revise the performance forecasts for the six-month period ending September 30, 2018, or for the fiscal year ending March 31, 2019, that were released on April 27, 2018.

Nevertheless, as stated, we got off to a good start in the fiscal year ending March 31, 2019, with favorable performance in the three-month period ended June 30, 2018, as indicated by the 12.4% increase in incoming orders, among other factors.

■ Consolidated Statements of Income（Slide3）

This concludes my overview of consolidated performance highlights in the three-month period ended June 30, 2018.

Turning now to slide 3, here is a summary of SCSK’s consolidated statements of income. Net sale and operating profit were as I just explained. In addition, the increase in operating profit translated more or less directly to ordinary profit and profit attributable to owners of parent, and no extraordinary factors arose that warrant additional explanation.

For reference purposes, selling, general and administrative expenses were relatively unchanged year on year on a consolidated basis. However, this outcome was influenced to some extent by the impact of the sale of QUO CARD Co., Ltd., in the three-month period ended June 30, 2017. When this impact is excluded, selling, general and administrative expenses rose roughly 3.0%, to approximately ¥450 million.

I must touch briefly on income taxes in the fiscal year ending March 31, 2019. For financial accounting purposes, the standard statutory income tax rate is applied, but we continue to incorporate tax savings into cash flows.

■ Sales Comparison by Segment（Slide4）

Moving on, I would now like to more closely examine earning figures for the period under review through our usual presentation materials. On slide 4, you will see a comparison of sales by segment.

The systems development segment benefited from the robust demand in systems development businesses serving manufacturing industry and distribution industry customers, as mentioned at the start of this presentation. This performance compensated for the impacts of the rebound from large-scale projects for financial institutions recorded in the previous fiscal year.

An upward trend was seen for strategic IT investment demand from manufacturing industry customers, such as automobile and electrical machinery manufacturers, as well as for operational system upgrade demand, which was a product of higher earnings among customers. In addition, systems development demand in the omni-channel marketing and digital marketing fields remained brisk among distribution industry customers and certain communications industry customers, a trend that continued from the previous fiscal year. As a result, sales in the systems development segment were up 8.8% year on year.

Sales in the system maintenance and operation and services segment were up 2.4% year on year, regardless of the impacts of certain customers for business process outsourcing, or BPO, services reducing the scale of their large-scale contracts during the fiscal year ended March 31, 2018. As was the case in the previous fiscal year, demand from distribution industry customers for services related to augmenting e-commerce and customer relationship management (CRM) systems to adopt an omni-channel retailing approach remained relatively strong. Meanwhile, recent trends, such as the trend toward implementing more sophisticated user communication measures, contributed to firm sales in the system maintenance and operation and services segment, which includes service-oriented businesses as well as offerings such as cloud services.

System sales increased 3.1% year on year as the solid IT product sales to the automotive and electrical machinery industries outweighed the large decrease in network IT equipment sales from certain communications industry customers.

As all shares of QUO CARD Co., Ltd., were transferred on December 1, 2017, the performance of the prepaid card business is not included in the performance for the three-month period ended June 30, 2018, and will not be included in performance going forward. On a year-on-year basis with QUO CARD being taken completely out of the picture, however, sales increased roughly 5.0%.

■ Incoming Orders and Backlog（Slide5）

Looking at slide 5, I would like to discuss the order trends seen in each sales segment.

Incoming orders and order backlog showed year-on-year increases in all sales segments.

Although the systems development segment was adversely affected by the lingering impact of the rebound from previously recorded orders from major financial institutions, double-digit growth was achieved in both income orders and order backlog, which rose 17.8% and 18.3% respectively, due to smooth increases in orders from manufacturing, distribution, and communications industry customers. The increase in orders from the manufacturing industry was a result of firm overall demand for strategic IT investment along with robust upgrade demand pertaining to operational systems related to enterprise resource planning, production management, and customer relationship management.

In regard to maintenance and operation services, both incoming orders and order backlog increased year on year. Although we felt the impacts of certain manufacturing industry customers for our conventional BPO services reducing the scale of their previously large-scale contracts, overall orders were buoyed by a rise in outsourcing-related orders pertaining to e-commerce and customer relationship management systems for adopting an omni-channel retailing approach as well as the expansion of service-oriented businesses.

Incoming orders and order backlog for systems sales were up year on year. A contributor to this outcome was higher demand for security-related and other IT products amidst the advancement of IoT, which helped us compensate for the reduced network product orders from certain communications industry customers.

■ Sales Comparison by Customer Industry（Slide6）

Turning to slide 6, I will now explain sales and other trends by customer industry, although I can only touch on the major trends.

Overall sales to manufacturers rose by 11.4%. The robust systems demand from automobile manufacturers, which included demand for conventional automotive embedded software development projects, continued from the previous fiscal year. In addition, brisk systems development demand was seen among electrical machinery and electronic component manufacturers. These factors offset the impacts of certain customers reducing the scale of their previously large-scale BPO service contracts, which was a factor we have been speaking of since the previous fiscal year.

Sales to distributors increased 8.2% year on year. This increase was due to e-commerce and customer relationship management development and outsourcing projects aimed at adopting an omni-channel retailing approach.

Sales to financial institutions were up 0.4% year on year. Sales in this category were heavily impacted by the rebound from large-scale orders from banks in the previous equivalent period. Entering into the fiscal year ending March 31, 2019, however, we have seen certain new projects start up while the scale of existing projects has increased, effectively counteracting the impacts of the rebound.

Sales to the communications and transportation industries were down 4.2% year on year. The strong increase in systems development and system maintenance and operation services was not enough to offset the decline in network product sales to certain communications industry customers.

Sales to power and gas providers rose 59.7% due to robust systems development demand.

■ External Sales and Segment Profit by Reportable Segment（Slide7）

We will now move on to slide 7, which shows a breakdown of the performance I just discussed by reportable segment.

Seeking to accomplish the goals of the Medium-Term Management Plan, which is set to conclude with the fiscal year ending March 31, 2020, we are accelerating the shift to service-oriented business. Meanwhile, we are endeavoring to respond to the increasingly sophisticated strategic IT needs of customers in the midst of the advancing digital transformation. To support efforts on these fronts, we undertook a partial reform of our organization during the three-months ended June 30, 2018. The segment information contained on this slide is based on the new organizational structure. Of course, figures for the previous fiscal year have been restated to reflect the new organizational structure.

As has been explained, particularly strong trends were seen in businesses serving the customers in the manufacturing and distribution industries, resulting in higher sales and profit in all segments, with the exception of the Financial Systems Business Group, which was heavily impacted by the rebound from previously recorded large-scale orders.

First of all, the Manufacturing & Telecommunication Systems Business Group continued to enjoy robust orders for automobile manufacturers, and the trend in orders from electrical machinery and electronic component manufacturers was also strong. Orders from power and gas providers, which are included in this segment, grew as well. As a result, both sales and profit were up in this segment.

The Distribution & Media Systems Business Group benefited from higher overall orders from customers in various industries engaged in consumer businesses. In addition, impressive performance was achieved in system development businesses serving certain media companies, which are grouped in the communications industry for accounting purposes. These factors lead to higher sales and profit for this segment.

Sales were down in the Financial Systems Business Group, which was heavily impacted by the rebound from previously recorded large-scale orders from banks. However, profit was up due to the absence of the upfront expenses recorded in association with a new systems development order from a specific securities industry customer in the previous equivalent period as well as the fact that we did not incur as many losses from unprofitable projects.

The Global System Solutions & Innovation Systems Business Group posted higher sales and profit thanks to the steady flow of orders from our parent company and the solid performance of overseas consolidated subsidiaries.

The Business Solutions Group witnessed firm demand for enterprise resource planning-related system upgrade investments coupled with a solid level of orders in service-oriented businesses and outsourcing service businesses, leading to higher sales and profit.

The IT Platform Solutions Group achieved growth in sales and profit due to increased sales of IT products to the manufacturing industry.

Lastly, the IT Management Group was able to achieve increases in both sales and profit thanks to firm demand for an array of cloud IT services.

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

■ Operating Profit Analysis（Slide8）

Up until now, I have focused on net sales in our discussion of performance in the three-months ended June 30, 2018.

Looking now at slide 8, you will see a graph detailing the factors that influenced operating profit.

I mentioned some of the factors contributing to increased profit in the period under review at the beginning of this presentation. To reiterate, we owe our profit growth to higher sales on the back of favorable business trends together with the benefits of profitability improvements realized through increased productivity and other means. I would now like to take this opportunity to elaborate on some of the extraordinary factors and other specific factors that led to the increase in operating profit during the three-month period ended June 30, 2018.

I will now explain some of the specific factors increasing profit. First of all, let me talk about losses from unprofitable projects. As usual, we have budgeted for losses from unprofitable projects of around ¥1.0 billion on a full-year basis, of which ¥250 million is expected to be incurred in each quarter. However, the actual amount losses from unprofitable projects recorded during three-month period ended June 30, 2018, was less than ¥10 million. In the previous equivalent period, losses from unprofitable projects amounted to roughly ¥400 million, roughly ¥400 million more than in the period under review. This difference had the effect of buoying operating income. Next, as an extraordinary factor, the upfront expenses recorded in the three-month period ended June 30, 2017, in relation to a development project for a specific securities industry customer, of course, did not recur in the period under review. These two factors effectively boosted operating profit by around ¥1.0 billion.

Conversely, the change in the period for calculating bonuses explained when announcing financial results for the fiscal year ended March 31, 2018, resulted in certain expenses that would have previously been incurred in the fourth quarter of the previous fiscal year being delayed until the period under review. We also recorded higher business investment-related expenses in association with automotive software system and other investments budgeted for the fiscal year ending March 31, 2019, while the earnings of QUO CARD that were included in performance for the previous equivalent period were gone in the period under review. These factors had the combined effect of decreasing profit by ¥600 million year on year.

The net impact of all of the specific factors I just explained had the effect of boosting operating profit by more than ¥600 million, which contributed to the overall increase in operating profit of ¥2.4 billion. Accordingly, the remaining ¥1.8 billion of the overall increase in operating profit was the product of higher sales and improvements to overall business profitability stemming from a rise in productivity and other factors aside from the specific factors influencing profit. Of this amount, ¥800 million can be attributed to higher sales while ¥1.0 billion was a result of the profitability improvements.

The operating margin was influenced by higher profitability resulted from increased productivity as well as the specific factors I have explained. As a result, the operating margin rose 2.9 percentage points from 5.0% in the previous equivalent period to 7.9% in the period under review. We will continue to pursue improved productivity and profitability going forward.

This ends my supplementary explanation of the factors that influenced operating profit.

■ Consolidated Balance Sheets（Slide9）

Moving on from the consolidated statements of income, we will now discuss our consolidated balance sheet. Please turn to slide 9.

There were no extraordinary factors that influenced the consolidated balance sheet in the three-month period ended June 30, 2018.

Cash and cash deposits increased from March 31, 2018, due to the plentiful operating cash flows while the equity ratio rose 1.4 percentage points in comparison to the previous fiscal year-end, to 63.7%.
Going forward, we will conduct proactive business investments in line with our core strategies while enhancing our balance sheet and financial position. At the same time, funds will be allocated to increasing shareholder returns centered on dividends. All of these activities will be funded by boosting earnings and operating cash flows.

■ Business Strategies for FY2018（Slide10）
This ends my explanation of consolidated performance in the three-month period ended June 30, 2018. Lastly, I would like to offer a brief overview of our business strategies for the fiscal year ending March 31, 2019.

First of all, we will move forward with the shift to service-oriented businesses in this, the fourth year of the Medium-Term Management Plan, as we implement measures for further promoting service-oriented businesses. We have already created various service-oriented businesses, and we will continue efforts to this end. In each of our service-oriented businesses, we will go beyond simply expanding sales by developing an understanding of the needs of each customer to provide them with the IT services that most ideally meet their needs by combining solutions from our service-oriented business and other SCSK businesses and from external partners.

Countless companies are examining the possibility of investing in technological fields in response to the digital transformation. In the light of this trend, we strive to accurately address the new business needs of each our target industries, such as those arising from the trend toward IoT and AI in the manufacturing industry, the development of operations to adopt an omni-channel retailing approach in the distribution industry, and the drive to introduce FinTech and AI technologies in the financial industry. At the same time, we are developing a wide variety of service-oriented businesses with the aim of applying new technologies in response to customers' business reorganization needs.

I would like to take some time now to explain two recent examples of our service-oriented businesses. In the IoT field, we have partnered with Murata Manufacturing Co., Ltd., to collaborate and develop a solutions business in the smart factory automation field, as was announced this month. As one facet of these efforts, we have commercialized the facility operation monitoring software that has been at use within Murata for more than a decade to create the m-FLIP™ factory productivity improvement solution. This solution aims to put the power of this software into the hands of other manufacturers. This partnership was realized when Murata, seeking to create new IoT-related IT services, reached out to SCSK. After examining the possibility of developing a joint IT services business, we succeeded in creating and commercializing the aforementioned product through collaboration with Murata

As for AI initiatives, we have developed our proprietary SCSK Neural Network toolkit, otherwise known as SNN. This kit is comprised of several AI base models, made using the distinctive expertise we have been accumulating since the AI boom of the 1980s, into which customer data and insight could be injected to create an AI model that is unique to each customer. In recent years, deep learning technologies have been evolving at breakneck speed. In the midst of this trend, SCSK has received several inquiries regarding the utilization of AI from customers seeking to identify which of their issues can be addressed through the application of AI and to determine what measures will need to be implemented to verify the benefits of those technologies. Whether performing proof of concept level verification or otherwise working to adopt AI, significant time is required to develop the necessary AI model algorithms and to prepare the massive quantities of data. Moreover, a look from the customer's perspective will reveal that massive time and work is required to implement AI-power operational systems. Accordingly, reducing lead times and workloads is one challenge faced in relation to adopting AI. Seeking to use this experience to help customers overcome such challenges, we developed SNN as a tool that will allow for the swift development of unique AI models designed exclusively for specific customers.

SCSK is currently looking to apply SNN to the automobile accident analysis activities of insurance industry customers and to the production management optimization efforts of manufacturing industry customers.

These are just two examples of our efforts to develop service-oriented businesses. With an eye to realizing higher growth potential and increased profitability in the future, we plan to dedicate an adequate amount of business investment expenses to creating new service-oriented businesses while also rapidly boosting the earnings capacity of businesses that have already been launched, such as IT infrastructure-related cloud service businesses. Through these efforts, we hope to achieve growth of more than 10% in sales from service-oriented businesses on a full-year basis, as we stated at the beginning of the fiscal year.

As for the high-interest topics of new strategic businesses, namely the automotive software systems business, as explained at the results briefing for the fiscal year ended March 31, 2018, it currently looks as though profitability will not be achieved in this business until later than originally planned. Nevertheless, we will continue to conduct business development investments in line with our initial plans to secure a position as a forerunner in advanced technology development in this business. Although this business will begin generating profits later than expected, we are dedicated to recovering the upfront investments conducted in this business as quickly as possible, and we will be implementing various business measures to this end. In the three-month period ended June 30, 2018, investment amounts in and earnings from the automotive software systems business were more or less as planned.

This ends my brief explanation of the business strategies we will be implementing during the fiscal year ending March 31, 2019.

SCSK stands committed to becoming a leading company in the IT services industry. During the fiscal year ending March 31, 2019, the fourth year of the Medium-Term Management Plan, we will decisively transition to a business structure promising higher growth potential and profitability. At the same time, we will implement wide-ranging improvements to our management and earnings bases, 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 as we undertake these transformations.

In closing, I would like to thank you all for joining us for this teleconference.