Transcript of results briefing

Consolidated Results of Operations for Six-Month Period Ended September 30, 2018

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■ Introduction

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

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I would like to begin today’s presentation with an explanation of our performance in the six-month period ended September 30, 2018. This explanation will follow the materials that have been distributed to you.

■ Consolidated Performance Highlights（Slide2）

Please turn to slide 2. Here you will see highlights of our consolidated performance in the six-month period. As mentioned by President Tanihara, sales and profit grew year on year in the six-month period, and we were able to reach new record highs for six-month net sales and operating profit.

As explained at the results briefing for the three-month period ended June 30, 2018, strong business trends have continued since the start of the fiscal year. Specifically, the upward trend in IT investment demand among manufacturing industry customers that emerged in the second half of the previous fiscal year has been ongoing, and demand levels are exceeding our initial forecasts.

As explained by President Tanihara, 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.

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. Businesses serving the financial industry, meanwhile, witnessed the commencement of a certain, albeit limit, assortment of new projects scheduled for the fiscal year ending March 31, 2019. Overall, these developments contributed to a year-on-year increase in net sales of 2.4%. If the impact of the transference of QUO CARD Co., Ltd., which was conducted in the second half of the previous fiscal year, is excluded, net sales rose by 3.6% in the six-month period ended September 30, 2018.

Current business trends are strong. As shown on this slide, consolidated order backlog was up 13.3%.

Operating income increased 20.6% year on year. Factors behind this increase included the higher sales stemming from the strong business trends I just explained as well as the benefits of fewer unprofitable projects and of higher productivity, which arose from efforts to boost work quality and streamline operations. These factors enabled us to absorb the impacts of the slight rise in business investment-related expenses that had been initially expected.
As a result, the operating margin increased 1.4 percentage points, to 9.6%.

■ Consolidated Statements of Income（Slide3）
Turning now to slide 3, here is a summary of SCSK's consolidated statements of income.

Net sales and operating profit were as I just explained. We will therefore be looking primarily at profit attributable to owners of parent.

Profit attributable to owners of parent decreased 10% year on year. This decrease was largely a result of the transference of QUO Card, which operated the prepaid card business, conducted in the previous fiscal year. Specifically, the decrease can be attributed to a total reduction of ¥3.4 billion from the absence of QUO Card's profit of ¥0.6 billion and of tax benefits of ¥2.8 billion associated with the transference that were recorded in the fiscal year ended March 31, 2018. For reference purposes, profit attributable to owners of parent rose approximately 25% if these impacts are excluded.

This concludes my summary of our consolidated statements of income.

■ Sales Comparison by Sales 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.

Sales in the systems development segment grew 6.2% year on year. This outcome was a result of the robust demand in systems development businesses serving manufacturing industry and distribution industry customers, a trend continuing from the first quarter. The benefits of this demand compensated for the impacts of the rebound from large-scale projects for financial institutions recorded in the previous fiscal year. As explained by President Tanihara, 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.

Sales in the system maintenance and operation and services segment were up 2.6% year on year, regardless of the heavy impact of certain customers for business process outsourcing (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 IT services related to augmenting e-commerce and customer relationship management systems to adopt an omni-channel retailing approach remained relatively strong. These factors 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.

Packaged software / hardware sales increased 0.9% year on year because of strong sales of hardware accompanying large-scale development projects for distribution industry customers and of IT products for automobile and other manufacturers. These factors outweighed the massive decreases in network IT equipment sales to certain communications industry customers and in projects for the academic sector.

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 six-month period ended September 30, 2018, and will not be included in performance going forward.

■ 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 increased by 12.8% and 13.3%, respectively, on the back of higher incoming orders and backlog for systems development, for system maintenance and operation and services, and for Packaged software / hardware sales.

Although incoming orders in the systems development segment were heavily impacted by the rebound from previously recorded orders from major financial institutions following the conclusion of development projects, double-digit growth was achieved in both income orders and order backlog 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, as has been explained previously.

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 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 grew year on year. Contributors to this outcome included increases in security-related demand as well as in high-performance computing demand from academic sector. Another factor was growth in demand for IT products among automobile and other manufacturers. These demand trends have manifested in orders scheduled for the second half of the fiscal year being recorded during the six-month period ended September 30, 2018. These factors counteracted the large decrease in 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.

Sales to manufacturers rose by 7.7% in reflection of the aforementioned rise in strategic investment demand and in labor-saving and other facility upgrade demand.

Sales to distributors increased 12.5% year on year. This increase was due to the previously mentioned e-commerce and customer relationship management development and outsourcing projects aimed at enhancing digital marketing measures and adopting an omni-channel retailing approach.

Sales to financial institutions were down 1.2% year on year. Sales in this category were heavily impacted by the conclusion of large-scale orders from banks and securities firms that had previously contributed to sales. This factor outweighed benefits of the commencement of certain new projects and the increased scale of existing development projects for insurance industry customers.

Sales to the communications and transportation industries were up 0.9% year on year. The strong sales of systems development and system maintenance and operation services to communications and transportation industry customers effectively offset the large decrease in network product sales to certain communications industry customers.

Sales to power and gas providers rose 49.6% due to robust customer relationship management and other systems development demand in relation to facility upgrades, an area where demand has been limited since the Great East Japan Earthquake.

■ Business Performance 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.

As was explained in the results briefing for the three-month period ended June 30, 2018, we are accelerating the shift to service-oriented business with the aim of accomplishing the goals of the Medium-Term Management Plan, which is set to conclude with the fiscal year ending March 31, 2020. 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. Figures for the previous fiscal year have been restated to reflect the new organizational structure.

First of all, the Manufacturing & Telecommunication Systems Business Group continued to enjoy robust orders from 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 posted an increase in sales following brisk orders from customers in various industries engaged in consumer businesses. However, profit was down due to the rebound from certain media Packaged software / hardware sales to communications industry customers recorded in the previous fiscal year as well as due to higher business investment expenses.

Sales were down in the Financial Systems Business Group, which was heavily impacted by the conclusion of large-scale projects that had previously contributed to sales. However, profit was up due to the commencement of certain new projects as well as a year-on-year decrease in business investment expenses.

The Global System Solutions & Innovation 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, which were centered on our proprietary ProActive enterprise resource planning package, 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 platform system development and cloud IT services, a trend that was also seen in the first quarter.

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 six-month period ended September 30, 2018.

Looking now at slide 8, I would like to explain 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 specific factors that influenced operating profit.

I will start by explaining some of the specific factors increasing profit. First of all, let me talk about unprofitable projects. In the previous equivalent period, losses from unprofitable projects amounted to roughly ¥0.5 billion. The amount of losses from unprofitable projects recorded during six-month period ended September 30, 2018, was around ¥0.3 billion, making for a year-on-year decrease of ¥0.2 billion. This difference had the effect of buoying operating income.

Detractors from operating profit were the same as those discussed at the results briefing for the three-month period ended June 30, 2018. These included the change in the period for calculating bonuses explained when announcing financial results for the fiscal year ended March 31, 2018, which 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 ¥0.7 billion year on year.

The net impact of all of the specific factors I just explained had the effect of decreasing operating profit by approximately ¥0.5 billion.

Adding this amount to the increase of ¥2.7 billion in operating income, we will arrive at the figure of roughly ¥3.2 billion, which represents the boost to operating profit from higher sales and improvements to overall business profitability.

Of the ¥3.2 billion increase in operating income, ¥1.4 billion can be attributed to higher sales while ¥1.8 billion was a result of the profitability improvements aside from the specific factors influencing profit I just explained.

The operating margin was influenced by the specific factors I have explained as well as the higher profitability that was a product of our various efforts. As a result, the operating margin rose 1.5 percentage points from 8.1% in the previous equivalent period to 9.6% in the period under review, as mentioned at the start of this presentation. 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.

In September 2018, the Company issued ¥10.0 billion worth of straight bonds with a maturity period of five years.
Meanwhile, operating cash flows showed a smooth increase, contributing to higher cash and deposits.

The equity ratio was 62.1%, relatively unchanged from the previous fiscal year-end.

Going forward, we will conduct proactive business investments in line with our core strategies while enhancing our balance sheet, financial position, and shareholders' equity. 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.

■ Consolidated Performance Forecasts / Interim Dividend（Slide10）

With this, I conclude our look at consolidated performance.

As the final topics of my portion of today's presentation, I would like to touch on our consolidated performance forecasts and on interim dividends. Please look at slide 10.

As stated, performance in the six-month period ended September 30, 2018, exceeded our initial forecasts. The deal flow remains strong, and, overall, we do not expect any interruptions to the upward trend in strategic IT investment demand from corporate clients.

However, as President Tanihara mentioned, we have chosen not to revise our initial performance forecasts. This decision was based on the instability of the stock market; the opaque operating environment, in part a product of global political and economic uncertainty; the unclear outlook for the businesses serving the financial industry; and our intention to carry out the business investments initially budgeted for the second half of fiscal year as originally planned.

As there has been no change to our full-year performance forecasts, we have also chosen not to change our initial plan for the interim dividend, which calls for a year-on-year increase of ¥2.5 per share, making for an interim dividend of ¥50.0 per share.

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 continue implementing wide-ranging improvements to our management and earnings bases, which will include diligently enacting management measures, such as the *Smart Work Challenge* program and health and productivity management, and enhancing corporate governance systems with the aim of becoming a company offering a pleasant and rewarding workplace to all officers and employees. I hope we can look forward to the ongoing support of investors as we undertake these transformations.

This concludes my portion of today’s presentation.

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