Transcript of results briefing

Consolidated Results of Operations for 3rd Quarter of Fiscal Year Ending March 2020

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■ Greeting

Greetings, my name is Yasuhiko Oka, and I am a senior executive officer 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, 2019.

■ Contents (slide1)

Today, I will be discussing our performance in the nine-month period ended December 31, 2019.

The agenda for today's presentation can be seen in the contents section on slide 1. In accordance with this agenda, I will begin by providing an overview of our performance in the nine-month period ended December 31, 2019, and then move on to discuss specific performance items.

This presentation is scheduled to take around 20 minutes.

■ Consolidated Performance Highlight (slide2)

Please look at slide 2, which displays consolidated performance highlights for the nine-month period ended December 31, 2019.

In the period under review, net sales were up 9.7% year on year, to ¥280.7 billion, and operating profit rose 16.5%, to ¥30.8 billion, making for record breaking nine-month performance.

In addition, the operating margin was up 0.6% year on year, rising above 11% for the first time in a nine-month period.

Conditions in the Japanese economy are currently rather opaque. However, the operating environment and market trends that have remained strong since the beginning of the fiscal year are continuing, and we saw no significant change in IT investment demand in the nine-month period ended December 31, 2019.

Specifically, we witnessed the continuation of firm demand from manufacturing industry customers. Examples included demand for operational system upgrade investments, such as those for converting certain legacy systems to open systems; strategic IT investments for expanding and enhancing operations or boosting competitiveness; and investments for implementing labor-saving measures in response to labor shortfalls.

Furthermore, businesses catering to the financial industry benefited from the continuously strong appetite for system upgrade investments and for IT investments for reinforcing or expanding operations.

The consolidated order backlog was ¥126.7 billion on December 31, 2019, up 5.4% year on year. This figure includes the approximately ¥3.8 billion order backlog of Minori Solutions Co., Ltd., which was converted to a consolidated subsidiary through a tender offer on December 19, 2019.

These conditions led to the performance that I will be discussing next. Please turn to the overview of performance in the nine-month period ended December 31, 2019, on slide 3.

■ Summary of Financial Results from Apr. to Dec. 2019（PL/Incoming Orders/Backlog）(slide3)

Net sales increased 9.7% year on year, to ¥280.7 billion. Factors contributing to this increase included systems development and verification service projects for automobile manufacturers in the manufacturing industry as well as systems development projects and enterprise resource planning system redevelopment projects for the financial industry.

I will explain the factors that influenced operating profit in more detail later on. Gross profit, meanwhile, was up 11.4% year on year, to ¥71.0 billion, and the gross profit margin rose 0.4 percentage points. This outcome can be attributed to higher sales coupled with ongoing improvements in the profitability of systems development and other projects, which offset the sales mix impacts of an increase in relatively low-margin system sales.

Meanwhile, selling, general and administrative (SG&A) expenses rose ¥2.9 billion. This increase includes business investment expenses and was within the scope of our forecasts. In fact, the ratio of SG&A expenses to net sales was down year on year.

As a result, operating profit was up 16.5% year on year, to ¥30.8 billion, making for an operating profit margin of 11.0%.

In addition, extraordinary income of around ¥1.5 billion was recorded to reflect gains on revaluation of equity previously held in Minori Solutions, in which the Company held a 94.26% stake on December 31, 2019, at the tender offer price following the transaction. As a result, net profit attributable to owners of parent increased 29.7% year on year in the nine-month period ended December 31, 2019, to ¥23.0 billion.

Meanwhile, both incoming orders and order backlog increased year on year.

■ Summary of Financial Results from Oct. to Dec. 2019（PL/Incoming Orders/Backlog）(slide4)

Please turn to slide 4. Next, we will take a look at performance in the third quarter of the fiscal year ending March 31, 2020. Third-quarter net sales increased 5.5%, to ¥93.3 billion, and operating profit rose 5.6%, to ¥11.0 billion.

However, year-on-year growth in the third quarter of the fiscal year ending March 31, 2020, was slow in comparison to the six-month period ended September 30, 2019.

The sluggish net sales growth rate seen in the third quarter was due in part to the timing of upgrades to certain next-generation models in sales of network equipment to the communications industry. In comparison, systems development sales showed substantial growth in the third quarter of the fiscal year ended March 31, 2019, as this period coincided with the timing at which the development volume increased in certain systems development projects for the financial and distribution industries. As a result, the year-on-year growth rate in the third quarter of the fiscal year ending March 31, 2020, was lower than that of the six-month period ended September 30, 2019.

The rate of operating profit growth was also down during the third quarter. In addition to the stated factors affecting net sales, operating profit was impacted by an increase in SG&A expenses, which was due in part to business investments executed during the third quarter as part of the Company's plans to conduct business investments totaling around ¥2.5 billion in the fiscal year ending March 31, 2020.

Incoming orders were down 4.1% year on year, to ¥85.8 billion, in the third quarter.

A major reason behind this decline was a ¥3.0 billion decrease in sales of network equipment to the communications industry in regard to system sales, as we discussed when explaining the factors behind the decrease in net sales.

Systems development sales were impacted by the absence of previously recorded integration project orders from the credit and leasing industry. In addition, we only record the amount of systems development orders for which contracts are concluded. For this reason, only a portion of the actual order amount will be recorded for projects for which contracts are concluded for each project phase. Accordingly, there are currently several large-scale projects for which the order amounts for later project phases, such as implementations and testing, have yet to be included in incoming orders. Another consideration is the fact that order amounts for the condition definition and proof of concept phases tend to be less than contract amounts for other phases.

In this manner, the timing at which orders are recorded had an influence on the amount of order backlog. When Minori Solutions' order backlog of ¥3.8 billion is accounted for, order backlog was up 5.4% in the third quarter.

■ Comparison by Sales Segment（Sales/Incoming Orders/Backlog）(slide5)

Moving on, please look at slide 5, which displays a sales comparison by sales segment.

Year-on-year increases in net sales, incoming orders, and order backlog were seen in all segments.

On the following slides, I would like to explain the performance in each sales segment in a little more detail.

■ Systems Development（Sales/Incoming Orders/Backlog）(slide6)

Please turn to slide 6.

Systems development sales were up 11.6% year on year, to ¥114.1 billion. Sales in this segment were brisk as a result of strong demand for IT investments to reinforce strategic businesses or secure a competitive edge, redevelopment of enterprise resource planning systems, and productivity improvement and streamlining amid the continuation of robust IT investment demand among customers in the manufacturing, communications, and distribution industries. Other factors included a rise in system upgrade demand from the financial industry as well as investment demand for enhancing customer services from the power and gas industry.

Incoming orders were up 2.0% year on year, to ¥112.0 billion, thanks to the firm IT investment demand directed at enterprise resource planning system redevelopment and other applications. However, this figure was dampened slightly by the previously mentioned fact that the recording of orders is dependent on the conclusion of contracts. Another detractor was the absence of previously recorded large-scale orders from the communications and distribution industries and integration project orders from the credit and leasing industry.

Order backlog increased 5.6% year on year, to ¥35.7 billion, when incorporating approximately ¥2.7 billion from the backlog of newly consolidated subsidiary Minori Solutions.

■ System Maintenance and Operation/Services（Sales/Incoming Orders/Backlog）(slide7)
Next, please take a look at slide 7.

Sales in the system maintenance and operation / services segment were up 7.0%, to ¥105.9 billon.

Businesses catering to the distribution industry felt certain impacts from decreased sales of fulfillment services in regard to total e-commerce outsourcing-related systems during the first half of the fiscal year. Conversely, growth was seen in systems maintenance operations, in reflection of the overall favorable systems development trends, and in verification services for pre-market products. These businesses also witnessed robust performance for cloud-based core system services and business process outsourcing (BPO) services related to products and services.

Year-on-year growth was posted in incoming orders and order backlog, the former rising due to the accumulation of data center business and BPO project orders and the latter benefiting from the fact that the order backlog on March 31, 2019, buoyed order backlog on December 31, 2019. Approximately ¥1.0 billion of Minori Solutions' order backlog is included in this sales segment.

■ Packaged Software/Hardware Sales（Sales/Incoming Orders/Backlog）(slide8)
Turning to slide 8, we will see performance in the packaged software/ hardware sales segment.

Packaged software/ hardware sales in the nine-month period ended December 31, 2019, were up 10.9% year on year, to ¥60.6 billion. Although sales were down in the third quarter as a result of the timing of upgrades to certain next-generation models in sales of network equipment to the communications industry, nine-month sales benefited from sales of network equipment to the communications industry and sales of hardware to the manufacturing industry.

Incoming orders were up 4.0% year on year, to ¥65.1 billion, while order backlog rose 12.2%, to ¥19.2 billion, due to higher orders for hardware from the automotive industry and from academic research institutions. Roughly ¥0.2 billion of the order backlog of Minori Solutions has been included in the order backlog of the packaged software/ hardware sales segment.

With this, I conclude this explanation of performance by sales segment.

■ Sales Comparison by Customer Industry (slide9)

We will next look at sales by customer industry.

Sales to all customer industries were up in the nine-month period ended December 31, 2019. I will therefore only be explaining industries for which sales increases were particularly pronounced.

You also might want to refer to page 2 of the supplementary information data book.

Sales to manufacturers rose ¥7.8 billion year on year. This sales growth was a result of increases in strategic IT investment demand from automobile manufacturers aimed at systems development and in analytical server and other sales. The increased sales of verification services for pre-market products and BPO services related to products and services was also a factor. In addition, contributions came from operational system upgrade demand from the construction industry.

Sales to financial institutions were up ¥4.9 billion year on year. Factors behind this increase included the continuation of systems upgrade projects for the banking industry as well as system integration and development projects for the credit and leasing industry.

Sales to the communications and transportation industries were up ¥6.8 billion year on year. Network equipment sales to communications industry customers grew in the six-month period ended September 30, 2019, and we continued to take part in the core system upgrade projects for the transportation industry that began emerging during the previous fiscal year.

Sales to the service industry increased as a result of core systems development projects.

■ Business Performance by Reportable Segment (slide10)

On this slide, you will see this performance reorganized based on the Company’s reportable segments.

I have already explained performance by sales segment and customer industry. This performance reflected the strong business trends that have continued from the first half of the fiscal year. In the nine-month period ended December 31, 2019, as well, higher sales and profit were seen in all of our reportable segments.

As was explained at the financial results presentation for the six-month period ended September 30, 2019, the performance of the Mobility Systems segment includes the performance of automotive application development operations, in which SCSK performs model-based development, and platform field operations, which pertain to SCSK’s QINeS product, as well as the performance of VeriServe, an our consolidated subsidiary

The platform field operations of the Mobility Systems segment, which develops our automotive software systems business, were initially anticipated to post a loss. Performance in the nine-month period ended December 31, 2019, was within the scope of this forecast.

Overall, however, the Mobility Systems segment posted year-on-year growth in both sales and profit, with operating profit in this segment coming to ¥0.8 billion.

I would also like to take a minute to explain the trends seen in the Manufacturing & Telecommunication Systems Business and Global System Solutions & Innovation Business segment, which experienced low profit growth in comparison to sales growth, and in the Financial Systems Business segment, which saw high profit growth in comparison to sales growth.

Although profit in the Manufacturing & Telecommunication Systems Business segment was up thanks in part to the benefits of systems development demand from the automotive industry, profit growth was only around 4% due to the impacts of unprofitable projects.

The Global System Solutions & Innovation Business segment only achieved profit growth of 7% as a result of the costs associated with our expansion into Southeast Asia.

The Financial Systems Business segment achieved a high profit growth rate of 14% due to the absence of the unprofitable projects that impacted profit in the previous equivalent period as well as to the benefits of core system upgrade demand and business augmentation investments.

■ Operating Profit Analysis (slide11)

Looking now at slide 11, I would like to offer an explanation of the factors that influenced operating profit.

As mentioned previously, the continuation of the strong business trends seen in the first half of the fiscal year resulted in net sales growth of 9.7%, boosting operating profit by ¥5.5 billion. At the same time, improved profitability in systems development and maintenance and operation service businesses buoyed operating profit by ¥2.0 billion.

In the nine-month period ended December 31, 2019, losses from unprofitable projects were just below ¥0.8 billion. Losses from such projects in the nine-month period ended December 31, 2018, were above ¥0.6 billion, and losses in the period under review therefore decreased operating profit by nearly ¥0.2 billion year on year.

Furthermore, SG&A expenses were up ¥2.9 billion. Factors behind this increase in expenses included the rise in performance-linked bonuses payments explained at the financial results presentation for the six-month period ended September 30, 2019, and higher expenses associated with events commemorating the 50th anniversary of the Company’s founding. Another factor was higher SG&A expenses associated with the extension of training periods for new employees that began in the fiscal year ending March 31, 2020. In addition, business investment-related expenses, which are projected to amount to between ¥2.0 billion and ¥3.0 billion on a full-year basis, climbed above ¥1.8 billion in the nine-month period ended December 31, 2019, more than ¥1.0 billion of which was recorded as SG&A expenses.

The combined impact of these factors was a year-on-year increase of approximately ¥4.4 billion in operating profit, which came to ¥30.8 billion.

■ **Consolidated Balance Sheets (slide12)**
We will now discuss our consolidated balance sheet. Please turn to slide 12.

The new inclusion of Minori Solutions in the scope of consolidation following a tender offer on December 19, 2019, brought with it assets totaling ¥11.0 billion and liabilities amounting to ¥2.6 billion.

Also, goodwill of ¥14.0 billion was recorded and we expect to post amortization of this goodwill in an amount of nearly ¥0.4 billion in the fourth quarter of the fiscal year ending March 31, 2020.

Also, SCSK has voluntarily opted to adopt International Financial Reporting Standards (IFRS) beginning with the fiscal year ending March 31, 2021. I will discuss this matter in a little more detail later on. Granted that no signs of impairment are seen going forward, we do not anticipate additional amortization of goodwill in the fiscal year ending March 31, 2021, or beyond. We are currently calculating the purchase price allocation, and amortization expenses will be incurred after the amount of assets subject to amortization has been finalized.

■ **Consolidated Financial Forecasts (slide13)**
Next, please turn to slide 13.

There has been no change to our initial forecasts for full-year performance in the fiscal year ending March 31, 2020.

The current operating environment presents a great deal of cause for concern for performance. For example, we cannot be complacent with regard to the influences of the trade friction between the United States and China and the issues surrounding the United Kingdom’s withdrawal from the European Union. In addition, we must worry about the impacts of the recent new coronavirus epidemic on the global economy.

Meanwhile, we intend to revise our human resource and compensation systems at the end of the fiscal year to conform with the new medium-term management plan slated to begin with the fiscal year ending March 31, 2021.

In conjunction with these system reforms, we plan to record expenses that corresponds to the amount of performance-linked bonuses to be paid based on performance in the fiscal year ending March 31, 2020, at the end of the fiscal year. This was another factor behind the decision not to revise forecasts.

■ **Topics (slide14)**
Lastly, please look at slide 14.

The final topic I would like to talk about is the Company’s plan to voluntarily adopt IFRS standards beginning with the fiscal year ending March 31, 2021.

This decision was made with the goal of improving the international comparability of the Company’s financial information. IFRS standards will thus be adopted for SCSK’s consolidated financial statements from the fiscal year ending March 31, 2021, replacing the previously employed JGAAP standards.

Disclosure based on IFRS standards is scheduled to begin with the fiscal year ending March 31, 2021. However, as the forecasts for the fiscal year ending March 31, 2021, to be announced together with financial results for the fiscal year ending March 31, 2020, will adhere to IFRS standards, the Company intends to also voluntarily disclose the relevant profit and loss figures for the fiscal year ending March 31, 2020, based on these standards.

This concludes my presentation. SCSK looks forward to your support and encouragement going forward.

We greatly appreciate you taking the time to join us today.