(October 27, 2022, Tokyo)

Nomura Research Institute, Ltd.

The Second Quarter of FY March 2023 Financial Results

Briefings Q&A Session

First inquirer (analyst)

Q1: For your overseas operating profit, you had an approximate year-on-year increase of 400 million yen to 1.6 billion yen in the first quarter, then an approximate decrease of 1.6 billion yen to 700 million yen in the second quarter. What is your forecast for operating profit during the second half? Have you left your forecast for the second half as-is because you expect to exceed the forecast domestically and fall short of it overseas?

A1: The situation differs by company. Core BTS planned to break even after intangible asset amortization, but their network business was impacted by the semiconductor shortage, and now the sales team has heavier overhead costs. As a result, they are planning to downsize personnel in the third quarter. We expect their costs to lighten and profitability to recover in the fourth quarter.

AUSIEX produced a loss as a result of downsizing its personnel in the second quarter. They will not need to downsize personnel from the third quarter onward, but their systems depreciation expense will remain heavy. While their profitability after intangible asset amortization might not turn positive, measures are being taken.

Planit planned its resources on the assumption of receiving immigrated personnel from the Philippines, but that has been delayed as a result of the COVID-19 pandemic. They pivoted to sourcing the engineers domestically, which caused costs to increase in the first half. However, the harsher times are now behind them, and they expect a return to profitability in the second half.

ASG has maintained its strong performance, and their order backlog is rising. We expect them to contribute to profit in the second half as well.

Q2: Core BTS is planning for layoff costs in the third quarter and AUSIEX had structural reform costs in the first half. It would seem that they will contribute little to profit in the third quarter, but is there a chance for recovery starting in the fourth quarter?

A2: We expect Core BTS to operate at a small loss in the third quarter and then either break even or produce a small loss in the fourth quarter. We expect AUSIEX to turn profitable in the second half.

Q3: Is anything special taking place? Can we expect to see effects from these structural reforms next year?

A3: The impact of the loss produced by AUSIEX in the second quarter was significant. We only recently acquired Core BTS, and it might take two to three years until it settles into a rhythm.

Q4: I want to be optimistic about your increasing order volume in industrial IT (domestic). Is the amount of order backlog to be recorded as sales this year increasing? In addition to large projects that contribute to revenue next year and onward, are orders also increasing for projects that contribute this year?

A4: In the past, we had many contracts for large projects spanning multiple years. However, our contracts now are primarily divided into phases such as upstream processes and development. At NRI, we consider signed contracts to be order volume, so it is safe to assume that a significant portion of order backlog at the end of the first half will contribute to sales during the current year.

Q5: Since your order volume increased by 13% and order backlog increased by 9% in industrial IT (domestic) during the second quarter, can we expect an increase (in revenue) of around 10% in the second half?

A5: In the financial results presentation for the first quarter we explained that large projects would be commencing in industrial IT, and these are proceeding on schedule. While we cannot say anything specific about the rate of increase during the second half, the momentum has changed.

Q6: What is a typical type of project that you receive orders for?

A6: As shown again on page 16 of the financial results presentation, all of the projects in our order pipeline referenced in the first quarter financial results presentation are now in progress.

Second inquirer (analyst)

Q1: Thanks to your in-depth explanation, I was able to understand why your margin is declining overseas. It appears that your domestic profit margin is either declining or stagnant in consulting and financial IT. Could you explain the background behind this? And around when do you expect it to bottom out or recover?

A1: Pease let me make sure I understand what you are asking. As explained on page 12 of the financial results presentation, the cumulative second-quarter profit margin of our domestic business is improving. On a per-segment basis, profit margin is decreasing in consulting as you mentioned, but profit margin in financial IT is increasing year-on-year.

Q2: In financial IT, the increase in profit margin is relatively limited compared to the rate of revenue increase when looking only at the second quarter. Is the fact that profit margin has remained at the same level as last year some sort of precursor (for an economic downturn)?

A2: At NRI, we have disclosed projects producing losses in excess of one billion yen, but this year there are no projects losing a billion yen or more in financial IT. This is a rough estimate, but while profit margin decreased by 0.1 percentage point in the second quarter (domestic), this was due to the effect of an allowance being allocated for some projects producing losses in the hundreds of millions of yen (low single-digit hundred millions).

The domestic portion of the profit margin decline in consulting was just under three percentage points. Also, order backlog at the end of September was a 25% increase, but order volume in the second quarter was a slight decrease. The majority of orders for large projects in the first quarter was for projects in the public sector, and the profit for many such projects is recorded in the fourth quarter. At the same time, the decrease in order volume during the second quarter was attributable to a reversion from large projects the previous year. If we secure enough orders when looking at the full year, we can record solid profit for the year even if our profit margin fluctuates between quarters. However, consulting orders from private companies fluctuate according to business sentiment, so we must pay close attention to these circumstances in the second half.

Q3: I understand that profit margin in consulting declined due to the impact of your mix of projects, but also that margin (for the year overall) will improve if you accumulate orders leading up to the fourth quarter.

Domestically, orders are recovering in both financial IT and industrial IT, but I am interested to know about the continuity. In financial IT, you have forecasted an improvement due to new implementation projects for THE STAR. Excluding THE STAR, can we expect an increase in the second half from projects such as modernizations? And what about similar continuity in industrial IT?

A3: For financial IT, we expect new THE STAR implementation projects to continue in securities. In insurance, there could be some ups and downs since systems integration projects are the focus, but we anticipate projects to remain plentiful going forward. In banking, the orders have not yet been recorded, but we are anticipating orders to switch the core systems of online banks to NRI's BANKSTAR. For industrial IT, it is important to properly launch the large projects we received orders for, and to manage them. In our case, we often receive consultations about more sophisticated projects to re-engineer the business logic as opposed to projects such as simple SAP renewals. We believe that we can continue expecting more core system overhaul projects going forward.

Q4: I would like to ask about how you allocate funds. While I understand your policy is to allocate in a well-balanced manner, you expended quite a bit on M&A last year. What are your approaches to how you will utilize funds, your priority level for M&A, and treasury share purchases going forward?

A4: For M&A, our focus is on North America. The pipeline of potential acquisitions is robust, but we also must consider valuation. We want to make assessments that enable us to acquire at the appropriate price.

Regarding shareholder returns, most importantly we are unsatisfied with our current share price. Also, (our shareholder) the JAFCO Group is dealing with a request received from a fund. It is not a matter that is up for decision at this time, but we want to decide on it when the time is right.

Third inquirer (analyst)

Q1: Since the projects you received orders for in industrial IT (domestic) are orders for upstream processes, will you continue receiving these orders over multiple years going forward? My understanding is that you received orders for core systems overhauls as a result of handling front-end DX, but is this a case where NRI was able to newly acquire business in core systems that were previously handled by a competitor?

And while I understand you are bolstering your hiring including mid-career hires, with capacity utilization at such high levels, will you have sufficient allocation of resources to support increased revenues in the second half and next year?

A1: The core system overhaul projects will span multiple years. The upstream processes we received the orders for in the first half are classified under consulting services, and the projects will continue into the development process in the future. Among the multiple core systems projects we have, there are projects in which we are overhauling core systems that NRI had previously been handling, and also projects where other companies had been handling the core systems but we received the order because of work we handle on front-end DX.

Next about hiring, in the past we had primarily been hiring new graduates, but recently we have also been dedicating effort to mid-career hiring. We have brought aboard around 240 mid-career hires so far this year, and we expect around 300 for the full year. We hired around 400 new graduates this year, but it will take some time until they can fully contribute. As for resources capable of contributing immediately, we acquire them either through our partners or through mid-career hiring.

Q2: Are the forecasted 300 mid-career hires for the year in industrial IT? Do you have enough headcount to support increased revenue in industrial IT?

A2: The approximately 300 mid-career hires (including consultants) is an overall figure, but a significant portion is for industrial IT.

Fourth inquirer (analyst)

Q1: Is “Procurement costs due to exchange rate impact” on page 12 of the presentation materials due to dollar-based contracts? Or is it due to price increases with yen-based contracts? In the event of the former, would costs decrease if the yen appreciates? Also, is it correct to assume that the impact of domestic and international inflation will likely continue into the second half?

A1: Since our contracts such as those for AWS and Azure are dollar-based, the weak yen is a factor. If the yen were to appreciate, procurement costs would go down. However, NRI does not shoulder the entire cost burden. The client also bears part of the burden. Taking these things into consideration, the cost increase in practical terms is around 2.0 billion yen. In the first half there were signs of just enough improved profitability to absorb this, but the increased cost situation is likely to continue into the second half, so we will also work on internal cost control.

Q2: Are utilities costs also increasing overseas?

A2: Yes, they are. However, since we do not own data canters overseas, we are less impacted than we are domestically.

Q3: Could you explain about the second half forecast for Core BTS in North America? Also, since the yen is weaker than you had anticipated one year ago, is that impacting the progress of the long-term plan for your North America strategy?

A3: In the network business, we expect the supply shortage of Cisco products to continue for around a half year longer. Depending on the circumstances, supply shortages could continue into sometime around the summer of 2023, and sales could fall short of the initial plan for the year. For that reason, the plan is to adjust their sales personnel in the third quarter.

On the other hand, the circumstances in cloud business are different from those in network. They are struggling to mobilize enough sales personnel to capture the robust demand. They changed their head of sales and are focusing efforts on new hiring for core sales personnel. The plan is to have cloud business make up for the lack of growth in network business.

Regarding acquisitions in North America based on the current exchange rate, this may just be a generalization, but the price of acquisitions will be higher when converted into yen, so it might not be economically logical to make acquisitions at this time. We intend to keep looking out for potential acquisitions and assess them carefully.

Q4: Since Core BTS's clientele is primarily comprised of midsized companies, they would likely be quick to tighten their purse strings in an economic slowdown. Are there any changes in demand?

A4: There are discussions about the pipeline at every monthly meeting of Core BTS's Board of Directors, but they have never brought up any decrease in demand for cloud. Demand for DX remains strong, and we believe that clients' investments will not diminish even in an economic slowdown. However, the situation could change over time, so we must remain vigilant.

Fifth inquirer (analyst)

Q1: For your order volume in consulting (domestically) during the second quarter, I understand there was a reversion from the 33% increase last year, but are there any warning signals that inquiries from clients could be trending downward?

A1: Orders are progressing on track to achieve our plan for the year, and there are no signs that demand might be dwindling. Our manufacturing clients are particularly impacted by overseas demand, which will require attention, but there are not currently any project cancellations due to uncertainty about the future.

Q2: What was the scale of the personnel downsizing cost incurred at AUSIEX during the second quarter? And will the downsizing cost planned for the third quarter at Core BTS be in the range of 1.0 billion yen?

A2: Downsizing cost at AUSIEX is in the low hundreds of millions of yen. In the case of Core BTS, this has yet to be implemented and I cannot provide any figures, but we do not expect the cost to reach 1.0 billion yen.

Sixth inquirer (analyst)

Q1: What was the impact of exchange rates and how much sales did Core BTS have in the second quarter?

A1: Regarding exchange rate impact, our consolidation of Core BTS in the US began at the end of December 2021, so there are major changes in our North American business between this year and last. This makes it difficult to factor out and explain how much impact was attributable to exchange rates. As for revenue, Core BTS recorded around 8.0 billion yen in the second quarter.

In Australia, the exchange rate impact included in order volume was around 1.0 billion yen. As for the impact of exchange rates in terms of revenue, it was about the same as in the first quarter.

Q2: Around how much of your organic growth was overseas in the second quarter?

A2: Our revenue increase in North America was almost entirely attributable to inorganic growth. While our revenue increase in Australia does include exchange rate effects, it was largely attributable to organic growth.

Q3: Did you have unprofitable projects domestically?

A3: There were no unprofitable projects as large as 1.0 billion yen subject to disclosure. We are working on a large number of projects, and unprofitable projects in the range of 100 to 200 million yen occasionally arise.

Q4: What do you think of the overseas and domestic second-quarter results? Are they within your expected range?

A4: Domestically they were mostly within our expected range, as we were able to absorb cost increases and solidly boost profits. However, we cannot let up in the second half. Overseas, it was hit or miss depending on the affiliate. Core BTS and AUSIEX had problems relative to our initial expectations. ASG is performing steadily as planned. Planit has increasing labor costs, but the impact of that on a consolidated basis can be considered small.

Seventh inquirer (analyst)

Q1: At 2.35 billion yen, roughly how far short of the initial plan was the overseas portion of your operating profit in the first half? And about how much increase or decrease in profit are you expecting for the year?

A1: Due to the impact of consolidating Core BTS, we expected our operating margin of 10.7% last year to decrease into the high single digits in the first half. For the year, we believe that we will improve the 3.7% from the first half through measures such as personnel downsizing.

The downsizing at AUSIEX has been settled, and we expect them to turn profitable in the second half. Core BTS will have several hundred million yen in temporary costs during the third quarter in addition to amortization costs for intangible assets. We expect a recovery in the fourth quarter, but they still might not progress according to the initial plan for the year due to the effects of the supply shortage for devices in the network business. It is difficult at this time to anticipate how much of that could be compensated by the strong performance of ASG, but we are aiming for a small improvement in margin during the second half compared to the first.

Q2: Can we assume that the effect of the weak yen on operating profit is small?
A2: The weak yen does have an effect on profit, but the amount of the impact is small relative to revenue

Q3: Your Net Debt-to-EBITDA ratio and outstanding liabilities are gradually increasing. How far can you stretch the balance sheet temporarily or medium- to long-term if you need cash for something like M&A or share buyback? What is your current approach?
A3: We would like to maintain our S&P single-A rating as much as possible, but we also do not completely avoid leveraging our finances. We could possibly pivot toward higher leverage. We would like to indicate our financial strategy when we announce the new Medium-Term Management Plan in April 2023.

Q4: Could you accept a Net Debt-to-EBITDA ratio of two?
A4: We believe that our policy of keeping net debt within EBITDA must be adjusted at some point. Since the specific figures will require careful consideration, there is nothing I can announce at this time.

Q5: In addition to M&A, the current level of your net debt-to-equity ratio also appears to be the result of share buybacks in response to Nomura Holdings selling off shares of NRI. Can we assume that you are also using cash for growth?
A5: We want to use cash for growth. However, when a major shareholder sells off a generally sizeable amount of NRI shares, some situations require us to respond with the profit of our existing shareholders in mind. We did not conduct a share buyback when Nomura Holdings sold off shares of NRI in March 2022, but we are making such decisions according to the circumstances in each case.