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Nomura Research Institute, Ltd.

Q＆A from Small Meeting for Institutional Investors

Part 1

- In order to make it easier to understand, the contents of the question and answer are partially revised and modified.

(Questioner No.1)

Q: In your financial results briefings you mentioned that willingness to invest may be declining in travel, tourism, and in some sectors of global manufacturing. Has this changed at all over the past three weeks?

A: Around April of every year there are new large consulting projects in the public sector, so orders themselves do not significantly fluctuate between March and April. We mostly see private sector projects from May onward, so I think the big question is how things look at the end of May. As far as we can tell right now, clients are heading in two opposite directions. The business climate is quite harsh for travel and transport-related clients, so we currently have no systems or consulting inquiries from them.

At the same time, some industries are experiencing special demand due to the coronavirus, such as logistics in which we are seeing more projects than expected. While the negative effects that you would expect from the coronavirus are certainly strong, the pandemic is also giving rise to new, special demand, so there are both positive and negative factors. If we limit the discussion to consulting, the negatives appear to outweigh the positives overall. Negative impact is particularly strong in the private sector, so we are trying to compensate for it as much as possible in the public sector. The impact on our first half performance will likely be as forecast.

Q: What kind of changes will occur and what demand there will be if a paradigm shift occurs and business models shift to digital.

A: In both B to C and B to B, the movement toward non face-to-face business models was already there but suddenly gained even more momentum in many cases. For example, many B to C manufacturers had also been considerate of physical channels such as mass retail outlets and did not put much energy into launching their own manufacturer websites and conducting e-commerce. However, now physical markets have shut down and no longer require considerations, so these manufacturers are putting all their energy into launching their own manufacturer websites and shifting operations to them. In terms of business expenses, companies can reduce costs by at least a full digit by switching to direct channels, so this offers an advantage in selling, general and administrative expenses. We are receiving inquiries for NRI to support companies that are taking this opportunity to move forward with e-commerce and recalibrate their business models accordingly, and to support the systems that make this happen.

There is also a trend to reform work itself. Results of polls that NRI has conducted over these past five months show that around 60% of respondents at companies with at least 1,000 employees are telecommuting. Also around 60% of respondents reported problems such as reduced productivity and poorer decision making due to telecommuting. Going forward, actions must be taken to address these issues when switching to work that will be done to a certain degree via telecommuting, and this will generate demand for both consulting and systems.

According to respondents who are telecommuting, roughly 90% of them said that they would like to switch to a workstyle that incorporates telecommuting to some degree even after the coronavirus is contained. Thus, we believe that nearly all employees would like to establish telecommuting as a new workstyle. Management at companies is also likely thinking that once the pandemic is over, they will have to create work processes based on telecommuting rather than returning to the way things were normally done.

Q: If there is robust demand after the coronavirus is contained, will you have the capacity to handle it?

A: For the IT industry, the 2008 financial crisis had a larger impact than the coronavirus. Back then there was no big new trend like DX is now. Existing core systems comprised nearly all the IT demand. When the crisis hit, system renewals were postponed when business performance faltered. Under these harsh circumstances NRI suffered three consecutive years in the red starting in FY 2008, but we rebounded in the three years after that starting in FY 2011. Projects that had been stalled presented themselves all at once and we made a V-shaped recovery but that was probably the case throughout the entire IT industry, not just for NRI.

Back then the market was cyclical relative to the economy, so there were regular peaks and valleys in demand. At certain intervals orders would stop coming in, and later come pouring in again all at once, so we were structured for growth in the areas where we had available capacity. Although we still have that structure now, we also have DX demand, so cyclical changes are not as apparent as they were in the days of the financial crisis. Over the next year or two I think we are going to see more companies halting and postponing reforms to their core business systems. These reforms might then reappear all at once sometime in 2021 or 2022.

We will be doing more rather than less hiring this fiscal year. Efforts toward new hiring for next fiscal year are currently under way, and we are not thinking about decreasing the number of hires. We think it is extremely important to build up production capacity to take advantage of the rebound demand that will arise in the future.

Q: How do you think the coronavirus pandemic might impact the nature of Japan's 2025 Digital Cliff problem?

A: The 2025 Digital Cliff is the warning raised by Japan's Ministry of Economy, Trade and Industry (METI) that if Japan does not act quickly to modernize its legacy core systems, IT will drag down Japan's industry in competition against North American and European businesses which are already ahead of the game in modernization. It costs quite a bit to use various cloud-based components to properly migrate legacy core systems to the cloud and redesign them as microservices using Open API. The costs for some companies could be as much as ten billion yen at a time.

Currently I think that if performance forecasts become unclear and concerns arise about cash flow over the next year or two, companies will be hitting the brakes on major investments in modernization. During this time, employees who have experience with large-scale core systems overhauls will begin retiring. Then after investments have been postponed for a few years and the companies eventually overhaul to new systems, they might not have enough people with experience, and the overhauls might also become even more difficult to implement. While there is a general mood to overhaul core systems leading up to the year 2025, the coronavirus may have snuffed it out. From an IT vendor's perspective we can expect greater demand, so this should lead to business opportunities.

(Questioner No.2)

Q: Will NRI have to change its strategy or business policies as a result of the coronavirus pandemic?

A: NRI utilizes offshoring in China for production, but from the outset this has involved development work performed while communicating back and forth from a remote environment. We will not have to change the way this work is done due to the coronavirus. Business operations at partners in China slowed down around January but recovered quickly soon after, so they are currently operating with hardly any impact at all. We have as many as 7,000 business partners in Japan, and some of them did not have an environment set up for telecommuting. Before and after Japan's Golden Week holiday we set up a system that allows around 8,000 people to connect to a platform where they can develop in a telecommuting environment called Aslead Remote, and now all our partners in Japan can work via telecommuting. Some of them do not own laptops so we supply them with what we have at NRI.

Another issue is that clients such as financial institutions perform inspections before doing a system release, but in some cases our clients are unable to perform the inspections because they are telecommuting. Releases that were scheduled for April and May have been postponed a bit due to circumstances at some clients. I think this problem will be alleviated once the state of emergency declaration is lifted at the end of May and they can physically return to the office from June onward.

Most of our clients who must actively change their business models in response to the coronavirus are holding review meetings and discussing things in a top-down manner, mainly involving project teams headed by the company president or top managers of comparable rank to the president. One characteristic of measures taken in response to coronavirus is that these meetings are held in top-down fashion rather than the conventional approach of bottom-up involvement. For reviews such as these, it is key to establish relationships at the conceptual stage before plans can be made, or at a stage as far upstream as possible.

Q: In digital marketing there are areas where the IT and advertising industries overlap, but do you plan to build up your advertising business or do you see any problems that need to be addressed?

A: One example in the field of digital marketing is a single-source data service that we operate called Insight Signal. It acquires data such as receipts from consumers and quantitatively analyzes it to calculate marketing ROI (how much return was generated by money spent on advertising) to determine the impact advertisements have on actual purchasing behavior. I believe that NRI is the only company in Japan operating such a business. This service is merely an extension of our consulting, and it is not a foray into the actual business of advertising.

Brierley+Partners which we acquired in North America is a company that owns a loyalty marketing program. In Japan we are operating a service that quantitatively analyzes how loyal customers are, and measures how much improvement was achieved in each loyalty level segment when implementing marketing strategies. Utilizing NRI's strengths, we are providing services in the border zone between advertising and IT, while utilizing our consulting expertise to deliver added value. Based on suggestions from NRI, clients take tangible actions such as changing the way they utilize advertising agencies and release advertisements, as well as adjusting their media mix. As such, we have not considered operating in the advertising business itself. Digital marketing will be increasingly important as the paradigm shift brings non face-to-face into the mainstream, so we might consider taking another step forward and expanding this field of business.

(Questioner No.3)

Q: Is it correct to assume that Industrial IT Solutions has different strengths than Financial IT Solutions? And will you continuously be able to achieve a profit margin over 10%?

A: Our profit margin in Industrial IT Solutions is 10.9% but excluding overseas business it's around 12%. Currently our profit margin there is higher than in

Financial. The characteristics of the business we do in Financial and in Industrial are different. Our revenue driver in Financial IT is ASP services for back office functions. Back office functions in the finance industry are determined by business regulations, so multiple financial institutions have similar back office operations. For example, we can make these operations more efficient by offering a common function that combines NRI's IT with DSB's business process outsourcing (BPO).

In particular, I would point out the trend toward actively utilizing third party services in non-competitive areas. We have expanded business in line with this trend and have been able to maintain a high profit margin for ASP services. On the other hand, in Industrial IT companies that are all in the automotive industry each handle their design and sales operations in different ways as they compete against each other, so we cannot offer the same type of shared online services as in Financial IT. Therefore, rather than determining which industry to target, in Industrial IT the important thing is to determine which individual companies will pay more for the added value that NRI provides. Our concept is to identify individual companies and develop long-term relationships with those clients from upstream through downstream.

One typical example of this is Seven-Eleven's system. NRI invested in building the system, and it is operated from NRI's center. Seven-Eleven does business with us by using the system NRI provides as a service, without owning any IT assets. The client trusts us and consistently uses our systems and services long-term, which is our ideal business pattern. We look at whether each client appears likely to do business with us long-term, whether we can provide services to them from upstream to downstream, and whether they are likely to accept our asking price. This is how our client strategy has been built up over the years, and it is our current business model throughout the segment.

In the past, the IT of our clients in Industrial IT consisted only of business systems and other companies were able to approach them. If other companies had lower costs, we had to get our costs closer to theirs. This meant that profit margin was low. Our profit margin in Industrial IT began rising over the past two to three years when business IT investments began for the purpose of shifting from business in physical stores to business online. In addition to launching an e-commerce website, online business also requires companies to accept orders around the clock, 365 days per year. As a result, the system requirements including inventory management, order and delivery management, and more, can be completely different from those of conventional physical systems. Companies then end up with both physical and online business, and inventory for both must be centrally managed.

When you build business IT, it makes the company's business more complicated. Rather than the vendor relationships of the past, we are seeing high-level needs from some clients to have us involved from the upstream stages, start with business discussions, and deliver optimization that incorporates both DX and their existing systems. When this happens, they are entrusting business to us. We can deliver plenty of added value, while our profit margin in Industrial It also rises. We believe that by continuing our current business methods in Industrial IT, we can maintain a proper profit margin while also finding ways to scale up.

Q: Compared to your competitors, what are you focusing on in areas such as hiring and training?

A: Our top priority is to hire high-quality people, so I think the image that young people have of our company is important. Top-tier students are currently applying to work for us, and I think high-quality young people will be heading in our direction. Going forward, we need to pay attention to the increasing rate of turnover for young, talented engineers. In the past it was normal in Japan to keep working at the same company for 10 or 20 years. However, there are more young people now who learn the fundamentals at NRI, then switch jobs at around the age of 30 when they have higher value in the market. Of course salary is important in keeping these people at NRI, but the number of exciting projects we can give them also comes into play. As management, we must provide them the opportunity to create things using the latest technologies and other tools.

For us to keep highly talented people in our ranks, I think it is important that we continue creating environments that make young people think they can grow and learn lots of technologies if they are at NRI, and that they have a better-equipped work environment than they would at other companies.

Q: Do you have a senior management-level relationship with 7-Eleven North

America? And are you getting more work there?

A: Seven-Eleven is currently increasing its stake in 7-Eleven North America, and NRI has created a systems development base in Dallas, Texas where we are developing systems for 7-Eleven North America. We also have a close relationship with senior management of 7-Eleven North America. However, there are a variety of vendors in North America, as well as a strong mentality to do things in-house. 7-Eleven North America also has a desire do their IT in-house. We intend to discuss with the client what they would like to bring in-house and what NRI can do for them, then take on whatever they logically decide should be handled by an outside vendor.

(Questioner No.4)

Q: What is your status and future expectation for improving productivity?

A: The most important thing for productivity is to not produce unprofitable projects. We must make sure not to waste resources. Rather than appearing in the development process, risk of unprofitable projects lies more heavily in the stage of providing estimates. In the past, we had cases where we failed to notice latent risk in the estimate stage and ended up accepting orders without properly calculating man-hours, and other such problems. Three years ago we created a companywide committee to thoroughly pore over how we handle the estimate stage. Now the committee strictly reviews proposals in their entirety, particularly those involving new clients, business operations, and technologies. As a result, we have not had any large unprofitable projects in the last four years.

Second most important is to improve the productivity of our maintenance work. This is the largest overall contributor. Maintenance operations comprise around 30% of our total sales, but if you include maintenance in our ASP services the number is likely closer to 40% or 50%. Rather than having small numbers of staff each handle maintenance for individual projects, we handle maintenance with large groupings as an organization and optimize man-hours overall. We improved the productivity of our maintenance through organizational reform. Every year we convene a production improvement committee internally and review their findings.

Another reason we do this is to leverage our worksite knowledge to see just how efficiently we are utilizing personnel mainly in maintenance work. More than half of the activities that contribute to productivity are efforts made by employees to improve the efficiency at their respective worksites. The degree to which this is instilled and practiced in the company is important. Judging from the per-employee indexes last year, I think that is a contributing factor to productivity improvement. Going forward, our progress will likely be determined by ongoing efforts at worksites, and we will also need to change our business models themselves to businesses that are more productive.

In the finance field in particular, we are in the takeover bid process to make DSB into a wholly owned subsidiary. Creating services that integrate IT with OT (operational technology) we can evolve our current ASP services into an even higher productivity business, which is why we are working on the takeover bid. With the awareness that these business models also must be improved, we want to go the extra mile to further improve productivity.

Q: When did you change your organizational grouping?

A: We have been engaged in maintenance work for some time, but we began working on it as part of our organizational structure about three years ago.

Q: How are you currently blocking out the risk involved in accepting project orders via online meetings rather than face-to-face?

A: I don’t believe we are accepting any orders solely through online meetings. We do reach agreements with clients and accept orders through online meetings only when these are additional orders for new projects arising from existing ones, but looking back on this last month or two I don’t believe there is a single instance in which we have accepted an order for an entirely new project via online meetings only.

There are some cases when we need an elaborate level of communication for defining requirements or in the design process, where we cannot make enough progress through online meetings alone. The cost of communicating with clients is increasing in terms of personnel costs, such as some things that would normally take one hour to resolve which are now requiring multiple online meetings. We are hearing from the worksites that things like this are dragging productivity down, and I think we need to determine the effects quantitatively.

Q: Why are your internal overall labor costs increasing, but not your direct labor costs?

A: Thanks to productivity improvements domestically, we have been able to utilize outsourcing effectively while pushing forward with production activities, and as a result labor costs which impact cost are not increasing much, whereas labor costs for selling, general and administrative expenses are increasing as numbers of employees increase. At the same time, business is not growing much overseas, particularly in Australia. Unlike Japan, their labor practices allow the flexibility to decrease staff numbers, so labor costs there are not increasing. The overall effect comes from the combination of these two factors.