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Nomura Research Institute, Ltd.

Q & A from Small Meeting for sell-side analysts

Part 2

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

(Questioner No.1)

Q: While you are actively acquiring subsidiaries overseas, I get the impression that it has been a struggle. What governance-related problems are you having, and how have you gone about solving them? Please also share how this applies to your offshoring in China.

A: Last year both Australia and North America were impacted significantly by lockdowns, and business was sluggish. In North America we mainly do business in loyalty marketing for B to C, and the businesses of our clients themselves including airlines and car rental companies suffered from the effects of the pandemic. We pushed through a round of layoffs, and now our business there has been breaking even. In Australia where our business is large-scale, lockdowns had a major impact in the first half of last year. We temporarily went into the red, and took measures including personnel cutbacks. COVID-19 was contained starting in the fall and performance rapidly recovered. In the fourth quarter our business there produced profit in excess of goodwill and currently has a double-digit profit margin. I do not think we will have any problems there this year.

Demand has not recovered as we had hoped in North America, so the struggles there may continue. The reason for the slump is more likely due to COVID-19 than governance. Two years ago, the owner/CEO of the company we acquired in Australia at the time of the acquisition retired, and it took time for the new CEO promoted from within to gain a grasp on everything, so there was some confusion. That was our first experience doing business on a large scale overseas, and we consider it an investment in our own education. In Australia we created a controlling company and established a governance system. I think we are in position to do solid business there from this year onward.

As for offshoring in China, we have discussed security-related risks. However, for the services that NRI provides, access from China to the production environment in Japan is prohibited, and no personal information goes offshore. We do not believe that NRI is exposed to China-related risks such as those that have recently emerged.

Q: Would it be safe to say that your business is under control, including Australia?

A: I do not believe there is any cause for concern. Our controlling company NRI Australia is functioning well and exercising effective control over the companies under its lead. Control is also exercised by the boards of directors at each individual company. I think we have good systems in place.

Q: What are the differences between governance in Japan and overseas, and what are the related challenges?

A: The biggest difference is how influential the leadership of the CEO is overseas. We employ locals to handle the role of CEO at our overseas companies. If you make the compensation plan of the CEO too aggressive, they might end up expanding beyond their means. On the other hand, if they are too conservative it might hurt their incentive. First, I think controls pertaining to the CEO are important. There are controls through the board of directors, but those are not enough on their own. We have frameworks for internal audits by the controlling company, but strong trust must also be established between the controlling company and the companies it controls. I think that approach is probably different from Japan.

(Questioner No.2)

Q: Few companies are able to deliver true DX, and it seems not many companies have ventured into what NRI calls DX 2.0 and taken on such projects. Who will your competitors be in delivering true DX?

A: Some international companies have vast resources in upstream consulting. When taking on DX at a large business company, the biggest problem is being understaffed. I think we will see more cases where joint ventures are formed for the purpose of securing resources. These are likely established to conduct temp staffing business. Current DX demand is partially comprised of demand for supply of personnel, but NRI operates under the directive of permanent employment, and we hire large numbers of employees including mid-career hires. We would not be able to flexibly downsize when the upswing in demand dissipates.

In our financial results presentation in April, we spoke about how DX is divided into the first movers and the followers. The followers are much larger in number and business volume. For example, projects for an industrial client in the first mover group were originally for around 1 billion yen two years ago, but rose to a volume of nearly 10 billion yen last year and will probably eclipse 10 billion rather easily this year. At some point, companies that are serious about changing their business models from management all the way down to the worksites will make a big splash. We want to implement DX with precisely that level of investment, going all-in on transforming their business models. I think the beauty of having resources from consulting to solutions is that we can take the approach of working with 10 clients who each spend 10 billion yen rather than accumulating 100 clients who each spend 1 billion yen. This is our concept of the first movers.

If we were to accumulate 100 clients who each spend 1 billion yen, that would likely mean capturing demand from the followers, but that is not what we do. We strive to have management of the leaders consider NRI their strategic partner and work closely with them over the long term. I would say that the thinking is to steadily increase our numbers of high-volume clients. In terms of industrial, we have built this type of trusting relationship with a major nationwide convenience store chain. Lots of the DX that we currently see takes an approach geared toward the followers, and there are not many clients out there in the first mover group. We do not outright refuse to do work for the followers, but we would prefer to work with clients in the first mover group.

Q: DX delves into the business strategy of the client, but do you limit yourselves to working only with one company in each industry type? Or can you roll out what you have perfected with the first movers to the masses?

A: DX projects are investments in areas of competition, based on the desire of management to achieve differentiation. Rolling out something we have created for one company to another in the same industry may not be illegal, but in terms of business practices it would not be realistic. In non-competing areas such as finance, we can roll out what we create in the form of shared online services. Since we cannot do that in DX, we have to take the approach of delving deeper with one particular client and creating bigger business from there.

Amongst these efforts, over the current two or three-year span we are actively working to make modules out of the components we use in DX, to be rolled out to multiple users. For example, we have made a module to almost entirely automate the building of architecture for e-commerce on AWS, so there is no need to build it from scratch. This is boosting our profit margin in industrial IT. I think the idea is to improve productivity in manufacturing by creating modules, combining them, and providing systems that match our clients. We will probably need to continue creating modules.

Q: Some companies out there in the field of consulting are attaining top-line growth by hiring large numbers of consultants and deploying them into the market. What do you think of such companies?

A: I think the title "consulting" means the business of deploying high-level human resources. It is a service that steps into the chain of command at the client company in place of actual employees. Since there is currently so much demand, there are probably more than a few new businesses starting up with the directive to hire large headcounts and supply them to clients. If we hire large numbers, we would not be able to reduce them once demand falls, so we cannot do this type of business. The demand is there, so this is not really a question of whether it is good or bad. These companies are just seeing the demand for what it is and addressing it.

(Questioner No.3)

Q: Last year you had an unprofitable project, and I realize that DX is not something simple. What is your expectation for the multi-year profitability of the large projects you added last year?

A: Last year we made a proposal and started on a project using a new technology after estimating the expected productivity in light of similar cases from the past. Once we took the lid off, we realized that we could not achieve the productivity anticipated, and we had to devote additional resources to the project. When using a new technology in DX, in some respects you cannot fully understand what level of productivity is possible until you actually try. You can put together a budget with confidence if you have used the same technology at some time in the past, but it is much harder when the technology is completely new.

We had an experience in the past where we produced losses in the billions of yen, but the loss from this unprofitable project is different in substance. DX projects often have quasi-mandate contracts, and the risks can be controlled more closely, so I do not think these will produce any major losses. However, every year there is potential for losses commensurate with the level of challenge. Currently we can produce a profit margin of around 15 to 16% during normal times. We will be creating even more modules going forward and adding more new clients for THE STAR in finance, and we expect these to generate profits. Therefore, we do not think our profit margin will top out at 15.7%. Our outlook is to raise profit margin while exercising proper control over risk of loss.

Q: DX is highly strategic, and quality is more important than price, so would it be correct to understand that you are securing DX orders at premium prices?

A: In cases where both quality and speed are needed, we can secure orders at relatively advantageous prices. When quality is extremely important, or when speed is important due to competition from other companies, cost becomes a lower priority. When both of these elements are there, we are more likely to gain favorable conditions. If client management is strongly committed and driven to transform their business model, they tend to emphasize both quality and speed, thus we generally earn higher profitability from these projects.

Q: You previously said that data quality itself is one of the challenges involved with DX. Have you created anything that can fulfill these requirements?

A: Algorithms are becoming more important in many different places. In distribution, we have begun AI ordering over these past two years. We started using algorithms for routing in transport and logistics. The big difference from conventional systems is that these begin when the algorithms start working. Constant tuning is required after release, so our workload is getting heavier. Algorithms are key to business, so clients are making considerable investments in them. Including post-release, the lifetime value is extremely high. Going forward, we need to focus on services with built-in algorithms in order to raise the profitability of our projects, and we are dedicating quite a bit of manpower to this. We have established an in-house certification system for data scientists. We do not have many data scientists at the top tier level, so we are doing everything we can to beef up those numbers.

Q: What is your outlook on differentiation in digital marketing? And what is your current position relative to the competition?

A: Around four to five years ago we were developing algorithms for digital marketing. However, I think this area of business has been commodified. Tools are becoming available one after another, and you can make do with only those. As for battles of resources between large companies, there might be a shortage of manpower but that is being addressed by other companies dispatching large numbers of their staff. I do not feel that we can gain much from digital marketing.

(Questioner No.4)

Q: The Value Co-Creation Committee has been launched and employee mentality is being channeled toward "Dream up the future," but what challenges lie ahead in that regard?

A: In terms of company policy, Creating Shared Value (CSV) and Environmental, Social and Governance (ESG) feature heavily in our Medium-term Plan. We are working on this not only as management but throughout the company. We want every employee to be fully aware of how their business and duties connect to society. Then we will be able to see where new social problems intersect with our business.

We consider this extremely important in exploring where our next growth will come from, and we are engaged in value co-creation that gets our worksites involved. This is currently central in our efforts to be a value co-creation leader. For our third generation this year we will have a few dozen value co-creation leaders who will be able to break down silos and hold discussions interdepartmentally. I think this is also important in that it builds a cross-functional grassroots network throughout our workplaces. The ultimate goal that we are heading toward is for NRI to be a company that the world cannot do without.

From that perspective, we want every employee to think about whether their business and individual duties are generating appropriate value for that goal. Our company takes the bottom-up approach to decision-making, and one of our main tasks as management is to find ways to motivate our employees at high-quality worksites. The CSV and value co-creation we are working on now are an ideal wake-up call for employees at our worksites, and I think the time is right. Hopefully this will motivate each individual employee while elevating their perspectives on their jobs and our business.

Q: Looking at the non-financial side, you will probably need to implement global standard incentive schemes and instill value co-creation overseas, but what are you considering for your next move?

A: I believe we are achieving sufficient returns from our NRI Group-wide activities across company boundaries to grow our presence in Australia to around 3,500 employees. We are considering initiatives to instill value co-creation in Australia. However, face-to-face communication is critical for this, so these efforts are not realistic until overseas travel restrictions are lifted. Concurrently we are thinking about deploying these efforts at group companies in Japan.

Q: As for governance, I believe your issues are that the CEO serves concurrently as the chairman, and diversity. From what angle are you looking to address these going forward?

A: One-third of our Board of Directors is comprised of outside directors, and the board is chaired by a non-executive. We are not officially a company with committees, but we emphasize that we have put substantial controls in place with outside directors playing central roles in our Nomination Committee and Compensation Committee. Regarding diversity, we have indeed received very harsh criticisms from our outside directors. This is not something we can rectify all at once, so we must take a systematic approach. We are reviewing this with the intention of being able to set some type of specific goals in the next Medium-term Plan. In any case, we are aware of these problems.

（Questioner No.5）

Q: What are the current initiatives at joint venture companies you have launched in the past such as Technium and KDDI Digital Design?

A: Technium is directly linking factories to customers through data to conduct sales and services that had previously been handled through a machine tool dealer, while also enabling online downloads of software. They are also making it possible for factory workers to improve their skills online. Traditionally there would be a dealer between the manufacturer and the customer. Technium is directly linking information which could not be communicated in that arrangement. This business is proceeding smoothly according to the plan, and we have no concerns about it. The machine tool industry is not particularly large, so this will likely reach the low tens of billions of yen. We consider this to be an interesting experiment in platform-based business in the field of B to B for manufactured goods. Technium is working on this with the idea that if successful, similar schemes could be rolled out in the field of manufactured goods other than machine tools.

KDDI Digital Design is doing double-digit billions of yen in sales and is progressing very nicely. I am not aware of any particular problems there.

Q: What sort of timeline do you anticipate for the potential rollout of this scheme to others in the field of manufactured goods?

A: Each individual market in the field of B to B for manufactured goods is small in scale, and the details in each market are discussed in dialogues between professionals. Many fragmented markets for professional specifications will likely be emerging, and we think the experience that Technium accumulates can be deployed in these. For example, pneumatics and hydraulics are fairly similar fields to machine tools. There are probably many business opportunities that have not been capitalized on, for which similar approaches can be applied. However, I think these are smaller in scale than B to C.

Q: Do you see any angles in DX 3.0 that could lead to business in shared online services?

A: We have various ideas. Japan is highly dependent on fossil fuels, and if that does not change, the spread of EVs will still not necessarily be a direct curb on CO_2 emissions. If this problem can be solved, CO_2 emissions can be curbed even when taking the life cycle assessment (LCA) of EVs into consideration. If the market share of EVs were to rise, it is highly likely that direct sales models would emerge. There could be a variety of new carbon neutral-related business models, as well as potential platforms to support them.

We want to anticipate the future as much as possible and explore business opportunities with our finger on the pulse of changes happening in the world. While it is not beyond the realm of possibility that we would be the ones playing the main role in such business, we would be happy to launch new businesses together with people who are taking on these challenges. We expect various business models to emerge with DX 3.0, and we would like to think during the next year or so about what new businesses to make from them. Around this time a year from now, I would like to be able to tell you about what new efforts we will have started.

Q: In finance, are you working on anything for a Japanese version of a Turnkey Asset Management Platform (TAMP)?

A: As we shared at our financial results briefing in April, we are planning services that can be used in front office as a finance platform. Companies are shifting toward asset management-based sales, and there are a number of services to facilitate this change. For example, advisor platform services are used for sales in retail to explain asset portfolios to individual investors. In the past, various fragmented services like these had existed for front office, but there was nothing that assembled them into a complete lineup. Front office is an area of competition, so systems integrators had generally created these to achieve differentiation. For example, the securities subsidiary of a local bank is partnering with a securities brokerage to pivot toward a financial intermediary business model.

When changing to a dedicated front office asset management-based business model, the full set of tools must be made available. Having a systems integrator design this is not worth the cost, so we provide a standard platform, then load the operations of the local bank onto it in order to offer a solution tailored to the client. Starting this year, we will be incrementally expanding our lineup of products that could serve as bases for new sales platforms in retail. It will probably take about two years to get these to their final form.

（Questioner No.6）

Q: Are there any common qualities, mindsets, ways of thinking, corporate cultures or backgrounds of managers who are capable of exercising leadership in DX?

A: These tend to be managers who are hands-on. Quite a few managers make decisions with an eye for balancing out all the ideas that come up from below, but the common thing about managers of first movers is that they are the type who understand the finer details of the business and exercise leadership by getting hands-on and driving business model transformation themselves. The speed of their decision making is entirely different. There are not many of these managers out there, but I think they are the type that invest all at once and create things that are different from what other companies have.

Q: Is there no way to increase the number of first movers other than to wait for the companies themselves to change, such as a changes in management? Or is there anything you could do to stimulate demand for change?

A: Our consulting business has a long history. As such, we have a variety of member organizations such as regular study forums which we invite managers to join, as well as longstanding relationships with many companies. Therefore, we do have various forms of relationships with companies that are candidates for first movers. As these relationships continue, it is important to seize the right moment, such as a change in management, or when they are faced with the need to transform. Whether or not we can approach them at the right time and make a full proposal largely depends on how close of a relationship we normally maintain with them. We are probably at an advantage having a consulting function as well as clients with whom we maintain close relationships.