(Tokyo - 16th May, 2019)

Nomura Research Institute, Ltd.

Q & A from Small Meeting for Institutional Investors Part 2

- In order to make it easier to understand, the contents of the question and answer are partially revised and modified.
- Glossary：
  - ・ DX：An abbreviation meaning Digital Transformation, which refers to initiatives that utilize digital technologies to reform business models and processes
  - ・ D2C：An abbreviation for Direct to Consumer, which refers to a mechanism that bypasses distributors and sells company’s products and services directly to consumers
  - ・ CiT（Corporate IT）：IT that helps enhance the quality and efficiency of clients’ internal operations, including core information systems
  - ・ BiT（Business IT）：IT that contributes directly to the expansion of client businesses

（Questioner No.1）

Q: Please tell us how you define DX-related business and in what areas it appears promising.

A: Within DX-related business, DX 2.0 is the creation of new business models exemplified by groundbreakers such as Uber. Typically, it leads to the establishment of new services in specific fields, and there are not many successful examples of it in the world. The difficulty may be high, but so are the expectations of our customers so we will be doing our best. On the other hand, DX1.0 is transformation that helps to upgrade existing business. There are lots of client needs for this type of transformation, and it is divided into process transformation and infrastructure transformation. Process transformation is further divided into front office (making end user-facing operations digital) and back office (making internal business operations digital). Among these, our clients have greater needs for front office. In what we call “D2C” projects, we obtain data about purchasing behavior from direct contact points with end users, then analyze the data, and find ways to enhance existing business operations. In back office, our typical project involves automating business operations to reduce manpower requirements.

In infrastructure transformation we expect there will be needs to reshape traditional on-premises systems development into structures that utilize the cloud. Core systems transformations like these require large amounts of investment and time, so the more investment capacity a company has, the greater their chances are of being successful. Along with transformations in infrastructure we also expect to see increased demand for various types of security upgrades.

DX-related sales currently comprise about 60% of our overall sales, and through the efforts I have just described we would like to increase this ratio to 75% in four years.

（Questioner No.2）

Q: What kind of consulting will NRI be providing to Japanese companies to help bolster their ESG practices?

A: Page 17 of our Medium-Term Management Plan materials defines our NRI activities and the creation of social value that we can contribute to. For example, expansion of NRI business process reform consulting and shared online services will yield more effective use of resources such as people and things. Our contributions do not necessarily have to come only from consulting either, since we can also contribute through IT services.

Q: This doesn't sound like anything fresh or new. Overall, Japanese companies appear to be lagging at ESG initiatives. Doesn't it seem like NRI should be working more proactively to accelerate the initiatives of corporations?

A: The macro-level issues that Japan faces are also summarized in the "Reiwa Era Economic Growth Strategy" announced May 14 by the Liberal Democratic Party (LDP), and one of the important issues among those is improving labor productivity. One example is the problem of convenience stores such as Seven Eleven being unable to get the workers they need. We can help solve this problem if we can use business process reform to halve the number of workers needed and raise the hourly wages. This does not mean creating new, independent sustainability-related business. Rather, we want to take a firm look at whether we can help solve social problems through each of the business activities that NRI is already engaged in.

Q: As we are starting to see unmanned convenience stores popping up overseas, I wonder whether 50% staff reduction is really enough of a goal.

A: Changing the existing business model of Japan's convenience stores is quite different from deploying completely new business models such as Amazon Go. It is not that easy. You have to fine tune all of the existing operations including the supply chains, while progressing carefully toward achievable goals.

（Questioner No.3）

Q: Why have you set out EBITDA margin as a KPI in the Medium-Term Management Plan?

A: We have been disclosing EBITDA margin in our past financial results summaries, but now we are newly expressing it as a KPI in the Medium-Term Management Plan. As NRI becomes more global, it is difficult to get the effects of accounting standards when comparing performance with overseas competitors, and we understand that EBITDA margin is typically used since it can compare the ability to generate cash flow. In “NRI Business Overview” on page 7 of the materials, we measure our EBITDA margin against those of overseas competitors. With an EBITDA margin of over 20% we can see that NRI has more capability to generate cash flow than the others, including business creation effects from investments. I understand that according to global rating agencies, EBITDA margin of 17-18% is the requirement to receive a high rating in the IT industry.

Q: Do you think that even if business in DX 2.0 doesn’t go well, you will still be able to achieve the numerical targets in the Medium-Term Management Plan?

A: In DX 2.0, new “As a Service” businesses have to be launched. There were seven of these over the three years of the previous Medium-Term Management Plan. In this new Medium-Term Management Plan, we want to start up even more new businesses. It would be ideal if a number of these could ultimately do sales in the tens of billions of yen, but they likely will not make any significant contribution to profits until this Medium-Term Management Plan is over in FY2022 or later.

While our efforts in DX 2.0 start with investment and contribute little in terms of immediate profit, we gain a lot of expertise and other knowledge that will be beneficial going forward, so we will continue to engage in a certain ratio of such projects. For example, at Technium—our joint venture with DMG Mori, data on client factory operation status is being collected in real-time. If the shift toward unmanned factories progresses in the future and we can provide processing programs to machine tools online, it could be a big business opportunity. I think this can turn into business in about four to five years.

（Questioner No.4）

Q: With what kind of business balance do you expect to achieve the target of 14% ROE in the Medium-Term Management Plan? For example, it seems that new DX projects typically have low profitability, so will it be possible to achieve the target while expanding DX business at the same time?

A: We envision an overall business breakdown of 20%/60%/20%. The first 20% is business that can achieve a higher-than-standard profit margin. The middle 60% is business at around our standard profit margin (15%). The last 20% is business in which we challenge ourselves at doing new things without fear of making losses, with the goal of contributing to growth in the future. We are always conscious of maintaining a portfolio such as this.

DX projects require agile development, and there are other differentiating factors as well which mean that the expertise needed for project management in DX is not the same as for traditional CiT. Because of that, we were worried three years ago about whether DX business could expand. However, over the last three years we have experienced a large number of projects, through which we have learned techniques for managing them. Now we are sufficiently capable of generating the same profit margins in DX as we traditionally have in CiT. There are no longer any concerns about stepping on the accelerator to expand in DX.

Q: Let’s say you are taking on a challenge in DX with a new customer. Will the profit margin be lower?

A: Generally, projects for new clients and new business operations are in the 20% of our business where we are challenging ourselves and are not afraid to take losses. Even if we take a loss on the first project, we put in the time to accumulate expertise by doing more and more projects, aiming to eventually turn them profitable. We deliberate about projects carefully in the Senior Management Committee and decide whether or not to take them on.

Q: Depending on the company and the industry, there appear to be some cases of sacrificing single-year target profit levels to prioritize advance investments. Does NRI intend to keep its single-year profit levels controlled?

A: In IT services I don’t think it is good to throw your finances off balance in order to make advance investments. It is important to maintain reasonable financial balance on a single-year basis.

（Questioner No.5）

Q: As your ratio of DX business increases, how will you go about hiring human resources with DX skills?

A: Even if they have only previously worked in traditional CiT, employees in their early forties or younger can still acquire the necessary skills by experiencing a certain number of DX projects. This could even apply to employees in their fifties, depending on the person. The important thing is to have them work on more projects. We are also sharing expertise internally through our intranet and doing other things to establish a supportive environment. So far, we have not had any major problems with manpower shortages. In the future, hiring talent will be more important than it has been before. However, we believe we are sufficiently prepared, and we will be increasing our mid-career hiring from 100 to 200 people per year.

Q: Can we assume that the larger DX business with a client is, the larger proportion of business with that client will be comprised of DX?

A: That depends on the client. For example, if a client has never previously had anything to do with NRI core systems and we support the launch of e-commerce business for them only in front office systems, it will be 100% DX business even though the scale of the business is small. On the other hand, if we deliver a relatively large DX project for an existing client who has already been working with core systems, the DX portion of our business will be smaller if the size of their existing core systems business is several times greater.

Q: I would like to ask what your forecast is for business with Nomura Holdings this year, and from next year onward.

A: The effect of decreased sales to Nomura Holdings mainly due to implementation of THE STAR at Nomura Securities has already been fully incorporated into past performance results. As to whether or not new systems development projects will be added relative to our 60 billion yen in sales to Nomura Holdings in FY March 2019, I think that will depend on their business strategy. In terms of overseas business, the launch of NVANTAGE—our joint venture with Nomura Holdings in India, is proceeding smoothly, and they are already working on the number of projects they had initially planned.

（Questioner No.6）

Q: Please give us a specific picture of how you see investments expanding in DX. What kind of investments will there be, and how big will they be?

A: First off, we are not thinking about building any new data centers. As for investments in software, we believe there are new investment opportunities in the field of finance. Rather than traditional financial institutions that focus on over-the-counter services, we are particularly attracted to the idea of providing new financial services platforms to Internet-based financial institutions and platform operators that have large numbers of user IDs. Outside of finance, DX is generally a competitive field, so it would not seem likely that we could provide shared online services in DX. However, we believe that we could invest in deriving components from learned models that utilize AI and other such constructions. For example, we could take the results of analytics on car sales data that we are working on at NRI, invest to turn those results into sharable components, then incorporate those components into CRM for other industry types.

As for how much we plan to spend on growth investment, we envision being able to allocate about one-third of future generated cash flow toward normal capital investments such as software, about one-third toward shareholder returns, and then allocating the remainder to growth investments such as overseas M&A and our DX strategy. However, we may have to fine-tune the balance between growth investment and shareholder returns according to changes in the business environment.

Q: Where will your mid-career hires for DX come from?

A: We do not believe that we can get people who are capable of creating new business models in DX 2.0 through general recruitment. Rather, the shortcut will be to find the right people by searching internally. As for finding people to handle manufacturing processes in normal DX 1.0 projects, we have a track record of hiring people from other companies in the IT industry, from software departments at manufacturing companies, and other related businesses, and we believe that we will be able to continue doing so.

（Questioner No.7）

Q: I have doubts about whether DX investments by companies will be sustainable. It seems to me that in the end there will be a few winners, but many others will never recoup results from what they invested.

A: Those doubts are perfectly normal, and some companies are actually struggling. All we can do is shoot for success so that NRI clients do not end up with similar struggles. Unlike countries such as the United States, labor practices are a bottleneck for Japanese companies since they cannot easiy lay off personnel all at once to reorganize their businesses and organizations. Each company needs to plan its own business model transformation and implement it gradually.

Q: How do you select promising DX projects?

A: We consider the three models shown on page 8 of the Medium-Term Management Plan materials to be promising. High-volume retail stores and other such businesses are working on “integrating real and digital,” which involves utilizing data collected through direct channels to boost earnings in real channels. In terms of “new services in ecosystems” we are particularly intrigued by the potential of platform operators entering the finance field. “As a Service” involves sharing risk with clients and launching new business models.

（Questioner No.8）

Q: Electricity costs at data centers increase along with the move to cloud, so have there been any discussions about how hard it might be to set a KPI for reducing CO2 emissions?

A: NRI owns five data centers, each of which has high environmental performance. We have already set environmental objectives specifying target amounts for reducing greenhouse gas emissions through our business activities, while also working to use more renewable energies ahead of joining the RE100, and we have set KPIs accordingly. As for the environmental impact of shifting to the cloud, the key to that lies in technological innovations in hardware. In other words, if processors can achieve even greater density and servers can become drastically smaller, data centers will need less space and electricity costs for data center air conditioning will decline.

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