Summary Translation of Question & Answer Session at FY 2019 First-Half Financial Results Briefing for Analysts

Date: October 29, 2019
Location: Fujitsu Headquarters, Tokyo
Presenters: Takeshi Isobe, Corporate Executive Officer and CFO

Questioner A

Q1: *I would like you to explain the business model transformation impact for the first half and your forecast for the full year on slide 11. I thought most of the impact would be in the second half, but are we correct in understanding that if will be a 50-50 balance for the first and second halves?*

A1: Yes. Because of the people that left the company by the end of last March, we were able to reduce overhead costs throughout the year through the fixed costs associated with approximately 2,900 employees. It is 10.0 billion yen in the first half and is expected to be 10.0 billion yen in the second half, resulting in 20.0 billion yen for the year.

Q2: *You upwardly revised your forecast for free cash flow for the year by doubling it to 100.0 billion yen. Earlier you explained that cash flows from operating activities would increase, but could you explain in greater detail what it is that lead to the 50.0 billion yen upward revision? Are you not assuming that you will not be able to collect accounts receivable at the end of March, or that the collections will happen after March?*

A2: This time we revised our full-year forecast for operating profit upwards by 30.0 billion yen, and we reflected that in a higher level of cash flow that would roughly correspond to that. In addition, revenue in the first half was fairly strong, and because it is 30.0 billion yen higher than we originally anticipated, we factored in that operating cash inflows would come in earlier. What happens in March of 2020 will, in any case, be reflected in operating cash inflows for the next fiscal year, so we do not think there will be much of an impact on cash flows for fiscal 2019.

Q3: *Your full-year forecast for operating profit has been revised up to 160.0 billion yen, which I think would make your operating profit target for the second half 89.0 billion yen. Compared to the second half of last year, in which over 100.0 billion yen in business model transformation expenses were recorded, that would represent a decline in operating profit on an actual business basis, which seems conservative. Regarding the background to your outlook for the second half, are there areas with the potential to outperform, or what areas are you viewing conservatively?*

A3: We expect an actual decline in operating profit for the second half. There are two main factors. The first is that demand for PC upgrades because of the Windows 7 issue was moved up into the first half, and, in addition, with the ending of support in January, while there may some tail-end demand remaining in the fourth quarter, we expect it to revert to normal. In addition, we expect the price declines for key components in PCs to end soon. Moreover, we have factored in the risk that PC prices may decline because of the decline in price of key components. Another factor has to do with the Technology Solutions segment in Japan. In the fourth quarter of last fiscal year, in particular, we had many major public sector deals, and the increase came at the end of the fiscal year. While the strong trend continued this year, we expect that, compared to last year's fourth quarter, the momentum of higher sales and profits in this fiscal year's fourth quarter will be slightly lower. Accordingly, we are assuming that there will be somewhat of a swing back from the concentration of major public sector deals in last year's fourth quarter. As you mentioned, it is a slightly conservative scenario, but please understand that we consider our figure for the operating profit forecast to be a minimum level on which we will seek to build.

Q4: *If there are specific areas for which your outlook is conservative, please say what they are.*

A4: It was also shown on one of the slides, but the overall trend in orders in the Technology Solutions segment in Japan in the first half was up by 11%, and it was up significantly across all industry segments. The backlog of orders is fairly high, and we expect that will boost our revenue. While that does not account for the entire portion of our forecast for the second half, right now, there are no signs of a slowdown in orders. In a positive scenario in which demand continues at this pace for at least a little while, we think it should be possible to ride that momentum and add to our operating profit.

<u>Questioner B</u>

Q1: *Please talk about the changes in the business environment in Japan. The government has been focusing on the 2025 problem, and has been pushing for IT systems to be transformed, but what is your sense of the changes for customers in Japan in relation to this?*

A1: It is true that the government has issued guidance on the 2025 problem, but it is not as if people act simply because the government has encouraged them to do so. There is extremely strong customer demand for investment spending to transform their businesses. Among the industry segments, in the manufacturing sector there is rising demand to upgrade mission critical systems, mainly for automation and to strengthen their production platforms. In the retailing and distribution sector, too, with rising numbers of foreign visitors to Japan, and to prevail over competitors in an environment with new entrants from other industries, there are strong moves to prepare for the digital transformation of their businesses. In the financial services sector, as well, there is extremely strong demand to modernize mission-critical systems, and when they modernize their systems, they do not just upgrade their hardware and leave their operations alone, so there is extremely strong investment spending demand to transform their operations. Going forward, even if there are some economic fluctuations, there are strong customer needs to transform their businesses. Fujitsu will establish our new digital transformation company in the second half, and with that capability and the expansion of our support organization, if we can support customer needs for transformation, our current solid business conditions should continue.

Q2: *Your operating profit margins on your hardware businesses are over 10%, and the profitability of your PC business has also become very high. For next fiscal year and beyond, under normal circumstances, what level of profitability do you expect for your PC business.*

A2: For the full year, we had envisioned our PC business to just break even. We view our PC business as being integral; supporting our overall solutions business and digital transformation business. Right now, with the decline in price for key components and the increase in the volume of sales, it has recorded a significant profit, but we do not envision making a significant profit from our PC business on its own.

Q3: *How is your server business performing?*

A3: In the second quarter, there were substantial sales of mainframes, so the performance was better than usual.

Q4: *I think the operating profit margin on your server business has been around 10%. Is that correct?*

A4: Yes, that is correct.

Q5: *For Other/Elimination and Corporate, the operating loss in the first half was 38.6 billion yen, and, by subtracting from your full-year forecast, you expect a loss of 67.4 billion yen in the second half, which is a big increase. Are there certain risk factors?*

A5: We will be working hard to minimize those losses in the second half.

Q6: *Is there a possibility that you will use additional business model transformation expenses?*

A6: We originally projected 15.0 billion yen in business model transformation expenses for fiscal 2019, and that has not changed. We used 3.0 billion yen in the first half, so we have 12.0 billion yen remaining. Compared to our results in the first half, it is true that the figure for the second half looks large. We want to continue to pursue selection and concentration in our spending.

<u>Questioner C</u>

Q1: *I would like to verify a figure. Excluding PCs, how large was the increase in your orders on an unconsolidated basis in Japan?*

A1: Excluding hardware, there was a 7% increase over the same period in the previous year.

Q2: *Looking at your profit and loss outside of Japan by region, it looks like there has been a deterioration in your performance in the Americas compared to the same period last year. In addition, in EMEIA, it looks like the increase in profits has narrowed in the second quarter compared to the first quarter. Please explain the background to these results in each case.*

A2: We are pursuing structural reforms in EMEIA, closing some locations and changing our sales channels for hardware. It is true that growth of our core business there is not substantial, but the reductions in fixed costs that we have implemented so far have had a positive impact, so even though our revenues have declined slightly, our profits are slightly better compared to last year. Our performance in the Americas in the second quarter fell a notch because there was an unprofitable project. We had been trying to do everything, from hardware to maintenance services to applications, but now we are considering making changes to our business model.

Q3: *Have orders or sales volumes for PCs been declining in October compared to the pace in the first half, or are you simply viewing that as a risk? Also, in your mainframe business, at the beginning of the year you mentioned that there would be a large-scale deal. Did you book that in the first half?*

A3: Orders for enterprise PCs have been coming in at roughly the same pace as orders for system integration. Compared to system integration, for PCs there is a shorter period between orders and revenues, but the trends are similar. There have been no immediate changes in those trends at present, but looking at past trends for the Windows XP upgrades, and taking into consideration the recent increase in the consumption tax, we expect PC orders to fall starting in January, and our assumptions are based on that probability. In mainframes, the large-scale deal materialized as expected in the first half. The reason why we expect performance in the second half to continue to improve following the first half is because of declining prices for key components for x86 servers, and to that extent we upwardly revised our profit forecast.

Questioner D

Q1: *For Services in the first half, could you please tell us how much of the improvement in profit over last year was due to profitability improvements in your business in Japan?*

A1: Including both the reduction in losses from unprofitable projects and the improvements in gross profit margins, about 10.0 billion yen, of the approximately 25.0 billion yen in higher profits is from profitability improvements in our business in Japan.

Q2: *You have increased your full-year operating profit forecast for Services by 10.0 billion yen in Solutions and System Integration, but of that increase in the forecast, about how much is due to increases in revenue and how much is due to improvements in profitability? The reason I ask is that, in light of the status of improvements in profitability in the first half, the forecast for improvements in profitability in the second half looks rather conservative*.

A2: The majority of the 10.0 billion yen increase reflects the impact of higher revenue. We do not envision significant improvements in profitability in the second half. Profitability improvements in the first half were within the range we expected. Having said that, for the second half, I am sure some of you take the view that there might be even more improvements we could make, and I want to work hard to achieve that.

Q3: *Your shareholder equity ratio as of the end of the second quarter was about 38%, but I think you had previously set a medium-term goal of over 40%. What sort of shareholder equity ratio do you now consider ideal at the moment?*

A3: With regard to cash allocation overall, I am planning to indicate our policy on this subject at a future date, so for now I will hold off on announcing details, but as President Tokita said at the Management Direction briefing in September, we are no longer giving specific guidance with regard to the shareholder equity ratio. We believe that Fujitsu is supporting the infrastructure of society, so we would like to have a strong shareholder equity ratio and significant liquidity on hand, but as you point out, we are within range of hitting 40%, so even without prioritizing allocations in this area, we feel we have reached a sufficiently strong position. We are of course aware of 40% as a rough standard, but we hope you will understand that we will not be specifically targeting this figure.

Questioner E

Q1: *Could you please tell us about the positive and negative factors you foresee in the second half, in light of the improvement in your core business in the first half?*

A1: We would like you to keep in mind that our performance in the fourth quarter was quite strong last year, so in the year-on-year comparison, looking at the first half of each year, this year's performance looks much stronger, but comparing the second halves, that difference may be much less significant.

Q2: *What is the status and what have been the results of the internal personnel shift of the 2,150 people remaining out of the 5,000 person resource shift you previously announced?*

A2: We are making steady progress. In the majority of cases, we are not moving teams of personnel from one unit to another, but rather recruiting internally for individuals who want to make a career change. We are also making sporadic changes to units and job descriptions, so there are places where it is difficult to identify the specific amount of effects, and my understanding is that the effects of the resource shift are somewhat subsumed in the improvements to our core business.

Q3: *How far along are you in shifting the remaining 2,150 people?*

A3: I think more than half but less than two thirds have made the shift. We are also proceeding in stages in terms of timing.

Questioner F

Q1: *Your full-year forecast for Other/Elimination and Corporate is an operating loss of 106.0 billion yen. I think that the 15.0 billion yen in business model transformation expenses is incorporated in that, but am I correct in understanding that 3.0 billion of that was already recorded in the second quarter, leaving 12.0 billion yen? When will that 12.0 billion yen be recorded?*

A1: We think that much of it will be recorded in the third quarter.

Q2: *Even excluding business model transformation expenses, you are presupposing an increase in expenses in Other/Elimination and Corporate in the second half, so are you expecting some sort of increase in expenses, such as an increase in development costs? Or is this just a simple buffer?*

A2: We do not think of it as a simple buffer. While there are questions of certainty as to how much we will be able to do, we are considering investments in digital transformation and AI related areas. There are some areas where our forecast is a little unclear with regard to how much we will be able to allocate to those areas, and whether we will truly use that full amount. This being said, if there are ways we can use our money that will generate positive returns in the future, we would like to actively pursue them.

Q3: *I believe that in the Management Direction briefing in September, President Tokita said that you were looking at a dividend payout ratio of 30%. With these upward revisions to your forecasts, EPS has also gone up, so have there been any changes to your dividend plans?*

A3: There have been no particular changes to our policy. As much as possible, we want to provide stable dividends at a high level, and there has been no change to our desire to provide shareholder returns that correspond to profits. While we have increased our profit forecast, even in our initial forecasts we had planned for a higher dividend over the previous year. Our current plan is to actively consider shareholder returns if we see growth in profits in the second half as well.

Questioner G

Q1: *You said that you were considering changing your business model in the Americas, but do you think that will require major expenses?*

A1: While I think there may be some expenses, we expect the scale of the expenses to be less than 10 billion yen. At the moment, as far as we can see, we think we can implement our overall business model transformation within the 15.0 billion yen total for fiscal 2019.

Questioner H

Q1: *For the second quarter, you attributed 3.0 billion yen in increased profit to factors outside Japan. Apparently this was due to the closure of locations in Europe, but is this an effect that will occur continuously going forward as well? Can we expect further benefits as you continue your policy of closing unprofitable locations?*

A1: The 3.0 billion yen increase in profits is due to a portion of the money set aside as a provision last year for expenses related to the closure of locations in Europe not being needed for retirement and severance packages due to the implementation of measures such as management buyouts in several cases. Our plan is still to close twenty or so unprofitable or low profit margin locations, as originally planned. We expect to complete the process by next summer, and we have a clear prospect of agreements on closing about half of them.

Q2: *I believe in your current full-year forecasts you are predicting a fall in profits of about 12.0 billion yen in your actual business in infrastructure services outside Japan. In the first half, profits were up compared to the previous year, so what sort of risks do you foresee in the second half?*

A2: The risk is that, as we continue to close locations, the negative impact of lower revenue will come to a head if overhead costs do not decrease.