ITOCHU Techno-Solutions Corporation

1st half of FY2017 Results Briefing - Summary of Questions and Answers

Date and time: October 31, 2017 4:00 PM to 5:00 PM

Attendee: Kikuchi, President & CEO; Matsushima, Executive Vice President; Okubo, Senior Managing Executive Officer

1. Results of first half of FY2017/Outlook for second half

Q: Orders received appear firm. How did they compare to your internal estimate?

A: Orders received appear to be slightly higher than estimated, in part because the environment was general favorable. Orders received in the Telecommunication Business group were particularly strong.

Q: Recently, it appears that large projects are increasing and the business itself is also expanding. Is the strong performance in recent years attributable to an increase in the number of large projects or to an increase in customers?

A: In the Telecommunication Business, revenue per customer is high compared with customers in other sectors and it is difficult to comment on an individual project basis. In other business besides the Telecommunication Business, especially in the Distribution & Enterprise Business, the number of customers used to be extremely high, but we recently changed direction and started developing business relationships with each company. I believe that the effects of this change in direction are starting to emerge.

Q: The balance obtained when actual orders received in the first half are subtracted from the full-year plan suggests that orders received in the second half will be down from the same period a year ago. Is this assumption correct?

A: In the second half of FY2016, there was a surge in orders received from specific customers and it would, therefore, come as no surprise if, this fiscal year, orders received fell accordingly. That said, it is impossible to tell how things will turn out at this stage.

Q: Segment operating income improved, but what about profitability for customers other than major customers? If this improved, please explain why, together with details of the demand environment.

A: Something I have felt over the past few years is that customers have changed their approach. I believe that, whereas customers used to equate IT with cost, they now equate IT with investment. From our perspective as a system integrator, it is not the case that we can increase our resources straight away to meet growth in demand. We, therefore, have to focus our efforts on areas where the structures are in place. I expect that such efforts would also help improve profitability.

Q: The buildup in the order backlog is impressive. How do you plan to convert this order backlog into revenue from next year? Please explain the percentage of the backlog that will be converted into revenue this fiscal year and the percentage that will be converted into revenue next fiscal year.

A: We expect that a little over 50% of the first-half order backlog will be converted into revenue in the second half, and the remaining a little over 40% or so will be converted into revenue from FY2018.

2. Services Business/Cloud Business

Q: Although the top line is strong, growth in services appears weak. I imagine that, given the growth of the cloud business, it would be good if Services grew a little more and the revenue composition ratios by business model improved. What is your view? Also, if the cloud business grows in the future, would this impact positively on profits?

A: Under the current medium-term management plan, we aim to increase the Services ratio to 50% in line with the shift to service-type business. Products have grown, but we think that this will lead to an increase in revenue from maintenance in the future and we are not pessimistic. In the maintenance business, the management of entire systems is now required, not the maintenance of individual products as before, and the structure for meeting these needs is already in place.

As for the cloud business, there are various types of cloud computing and in the case of private clouds, for example, it is not the case that the profit rate improves just because of an increase in volume and growth in revenue. We sell clouds developed in-house and the clouds of other companies, but it is IaaS developed in-house which will impact on the profit margin. In particular, CUVICmc2 will lead to improvement in profitability once accumulated losses are cleared. Accumulated losses will be cleared in FY2019, so you can expect to see growth next year and the year after.

However, in the case of CUVICmc2, replacement demand arises when customers renew their mission critical systems and so, unlike SaaS where we can have both private and corporate customers enter contracts for every business unit, the pace of orders received may appear slow. However, our understanding is that CUVICmc2 business is doing comparatively well.

Q: Regarding CUVICmc2, given that both the number of customers and revenue are increasing steadily, once the business enters the upfront investment return phase, will the gross profit margin improve? And is there still a need to make upfront investment?

A: Since there is no real need for any future upfront investment, the gross profit margin is bound to improve at some point, Also, since these clouds are clouds for mission critical systems, the acquisition of comparatively large customers can also be expected, However, looking three or five years ahead, investment in new services is likely to be necessary to maintain our competitive edge.

Q: You say that you are reviewing the criteria for recognition of cloud revenue. Please give further details of these changes.

A: Currently “cloud revenue” is based on monthly subscription sales of assets in CTC’s possession. We believe that there are slight problems with the current aggregation method, for example, the timing of revenue recognition is not always the same as when proceeds are obtained for some services. We plan to examine in the next medium-term management plan the way in which we disclose information, including the handling of monthly subscription services such as cloud services and management security services.

3. Others

Q: You say that SDN/NFV will be deployed in 5G networks. When will SDN/NFV start to contribute to profit and to what extent? How will you differentiate yourself from your competitors?

A: SDN/NFV started contributing to revenue last fiscal year. Since this is new technology, we are also examining aspects such as which vendor’s technology to use depending on the customer. We are also putting effort into SDN/NFV proposals for other companies besides carriers. This is business which is still small on an individual project basis, but which is expected to increase in scale once volume increases. Among carriers, there are also moves to actively use SDN/NFV not only with 5G but also with 4G and we are also putting effort into this area.

Q: Your revenue target from FY2018 is 500 billion yen. What are your thoughts on the next medium-term management plan?

A: I cannot give any specifics as we are still examining the next plan. However, I do think we need something that will become our next new pillar of earnings in addition to our existing ones. Also, we have previously used revenue as a target as this was easy for employees to understand but next I would like to set several profit-focused targets.

Q: You have accumulated cash reserves. How do you plan to use them?

A: We have no plans for shareholder returns other than the dividends that have been determined at present. As for investment plans, we are making investments, albeit on a small scale, in areas such as data centers, clouds and M&A, and we plan to consider investment based on the same approach as before.

Q: Looking at the revenue of CTC by business model, “Networks” in Products decreased. Why then, in your comments about the results by business model in the presentation materials, did you mention growth in networks as a factor for increase in the revenue of Products?

A: This is attributable to a change in the aggregation method by business model used in the supplementary materials. If we compare with previous materials, revenue related to networks is included in the “Middleware & Applications” column. This does not mean that network revenue decreased.