

Strategic Direction in Core Business Segments

The Japanese telecommunications market is undergoing remarkable change amid reorganization and the advent of mobile number portability (MNP). Rather than sticking exclusively with methods that have worked in the past, carriers must develop new business models suited to the increasingly competitive environment.

KDDI has continued to make steady progress in the evolution of its business. It is distinct from its rivals in being the only carrier in Japan with thriving operations in both the mobile and fixed-line sectors. This critical difference offers the company a level of potential for new business development unmatched by other carriers and is thus a significant competitive advantage.

Senior managers from KDDI talk about business trends and prospects in mobile telecommunications, fixed-line telecommunications, and content & media. They do so with respect to the company's keyword, "Strategy and Speed," focusing on the initiatives each business is undertaking for present and future development.



Toru Kawai
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(Note: Mr. Kawai was appointed Associate General Manager of the Consumer Business Sector in July 2006.)

Mobile number portability (MNP) is an opportunity to exploit fully the value of the au brand. We remain focused on raising customer satisfaction while developing innovative value-added services.

Toru Kawai
Vice President
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Note: Mr. Kawai was appointed Associate General Manager of the Consumer Business Sector in July 2006.

Q. In 2005, the au brand secured the highest share of net additions for the third year running. What do you feel are the major strengths of au?

A. I think that au has developed a number of hard-to-define qualities, or “au style,” if you will, that make it the leader in the Japanese market. Essentially, we have infused a spirit of cool, advanced technology — plus an element of surprise — into the handsets, the service content, and the tariff structures. I believe that our customers choose au because it has a strong, all-round offering in each of these areas. For example, au was the first brand to introduce handsets that focus on design. Within the industry, we have also pioneered other advances, including flat-rate data-communication tariffs and such download services as EZ Chaku-uta Full®, which enables mobile users to download entire songs.

Our network infrastructure supports the development of “au-style” service innovations. Most customers may not be aware that our early adoption of high-speed, high-capacity CDMA 3G technology was critical to the technology they hold in their hands today. By constructing our 3G network faster and more efficiently than any other carrier, we have been able to help our subscribers make a smooth transition to 3G technology. And the system is backward compatible, meaning that customers can use 2G technology as needed to overcome gaps in the 3G network. Providing the best content means nothing if customers cannot connect to the network outside certain areas or if they lose connectivity owing to poor reception.

Q. But it seems that rival carriers are putting a lot of effort into building their own infrastructures?

A. That’s right. However, not only are we the clear leader in the proportion of subscribers who have already migrated to 3G — a strength that we plan to exploit — but we also remain one step ahead in network technology.

The launch of HSDPA services by other carriers in mid-2006 will mean that they have caught up with KDDI’s EV-DO technology. But before the end of 2006, we plan an upgrade of our network technology with the EV-DO Revision A. This will enable downlink speeds of up to 3.1 Mbps and uplink speeds of up to 1.8 Mbps, increasing the speed and the capacity of data communications over the au network. That Revision A facilitates high-speed upstream as well as downstream connections will prove particularly significant. This advance makes possible two-way, high-speed, large-capacity communications, which will allow us to offer new and innovative services that were previously simply not feasible. We are in the detailed planning phase for these new services.



au by **KDDI**

Q. How do you view the planned introduction of MNP later this year?

A. In our view, MNP is a huge opportunity to expand the customer base for au, which in total subscribers is the second-ranked brand in the Japanese market. We have already announced a number of moves for the run-up period, including various handset development collaboration projects with new manufacturers and the introduction of an “endless carryover” option that will allow customers to keep any unused call minutes forever up to the pre-determined amount. That service is due to start in August 2006. We are also preparing a number of other initiatives targeted specifically at MNP.

On a side note, we began offering same-number migration to au for TU-KA subscribers in the second half of the fiscal year ended March 2006. This was an extremely useful experience for working out how we could best offer a smooth handover to migrating customers once MNP starts.

Two things particularly surprised us about the TU-KA shift. The first was that the number of applications to switch was heavily concentrated around the time of our initial announcement. The second surprise was the sheer number of TU-KA customers who wanted to subscribe to au’s WIN service, which allows users to enjoy a variety of content options.

The selling point of TU-KA as far as we were concerned was its simple appeal for those users who only wanted phone and e-mail. So we had expected that the vast majority of migrating customers would select the 1X service option. But this was not the case. What we discovered was that in fact many TU-KA users had not switched to au because changing numbers was a major barrier for them. I suspect that there are many users subscribed to a rival service who would actually like to use au but who have decided against switching carriers because of the inconvenience of changing number. So our plan is to try to entice as many customers as possible to take advantage of MNP and to switch to au by providing the most attractive product and service offering that we can.

We expect user volatility to increase in the first year following the introduction of MNP. Until that introduction actually happens, though, we do not know what proportion of users will switch carriers. But we do expect the numbers of customers who join or leave au to reflect user satisfaction with the service. In a sense,

MNP is a sort of once-in-a-lifetime chance for KDDI, and we are treating it as such. We have been preparing for it for several years, and we plan to focus all of our efforts on making the most out of MNP once it arrives. I am looking forward to it, because I believe that MNP will be the culmination of all that we have achieved and planned to date.

Q. Do you think that KDDI has an inherent significant advantage once MNP arrives?

A. No. My gut feeling is that we will not find out that sort of thing until MNP is finally here. What is important to realize is that MNP is not something short term. Even if we secure an increase in our customer base initially, that base may shrink the year after, or the reverse could happen. Although in many ways it is a great opportunity for us, MNP also levels the playing field with our customers. If a user is even slightly dissatisfied with our service, they could easily migrate to a rival carrier at any time. It will mean that we will have to do our utmost to continue to keep customers satisfied with our offerings. If we fail to do this, we are unlikely to be forgiven in a post-MNP world.

Q. Going forward, what do you believe are the major strategic issues for the au business?

A. Our short-term goal is to secure a 30% share of the market’s subscribers, or roughly 30 million users. The advent of MNP, however, will make the market even tougher, and we will have to continue to do our best to offer customers all that we can. Until now, the au brand has been successful in attracting younger customers. I believe that we have reached a point where to increase our market share we need to offer a more complete lineup of handsets along with additional services to appeal to all kinds of users. This involves a multitude of challenges, since we need to adopt an approach that encompasses different customer segments, including businesspeople, elementary school children, and seniors.

On the other hand, my belief is that amid a challenging business environment we must realize the importance of holding fast to the basic strategy that has always underpinned our business. This is to offer users a high-value-added, all-round package of handsets, content-based services, and tariffs based on the high quality of our network infrastructure. We must, moreover, continue providing innovative and original customer-oriented services that cause people to see au as a cool, advanced brand that also offers an element of surprise. So perhaps our most significant challenge is to ensure that we continue putting on the “au style.”

In the fixed-line business, KDDI's core goal is to become a trusted service provider for customers based on highly reliable platforms.

Toshio Maki
Vice President
General Manager, Broadband & Consumer Business Sector
Consumer Business Sector

Q. The year ended March 2006 was a particularly tough one for KDDI in terms of the profitability of fixed-line operations. How do you evaluate this performance?

A. The loss in the fiscal year ended March 2006 was due principally to the front-loading of sales-related costs for Metal Plus services. In the second half we were able to step up the pace of customer acquisition, and we are now seeing the profitability of these operations come back into line. We project that Metal Plus will become a profitable service on a stand-alone basis in the year to March 2008. We are also working hard to make this happen earlier if at all possible.

At the moment, all carriers are struggling in the Japanese fixed-line market. Personally, however, I feel that this is a business that we must and can make profitable for KDDI. But to do this we need to create new business models and develop new services. One of these is FTTH, in my opinion. Connecting up a household to our fiber-optic network allows us to provide customers with not only telephone and Internet services, but also a variety of other services such as video. I believe that FTTH is definitely a business with good profit potential if we look at it, say, over a ten-year horizon. However, to make it profitable we first need to invest. At the moment we are using cash flow from other fixed-line telecoms services to fund our investment in FTTH. Essentially we are sacrificing some short-term profit for long-term gain.

Q. What is KDDI's strategy for developing the FTTH business?

A. Previously we were leasing lines from NTT for the final connection to supply various services. This was a problem for two reasons: first, there were the actual costs involved; second, there were lead-time issues involved before we could actually provide the service to the customer. This was why we had to shift to supplying direct-access services in which the customer gets everything from KDDI, including the access line. Now customers pay the basic monthly charge for a line to us rather than to NTT, which also creates an additional source of revenue for KDDI.

Supplying FTTH services involves upgrading the entire backbone, not just the last-one mile. We have been investing in an IP-based CDN backbone that will be compatible with Metal Plus as well as the FTTH service, which is branded "Hikari one." Construction of this network is almost complete. Since demand for FTTH in Japan is still not mainstream, our plan is to use the CDN initially to connect to the existing copper wire connections, which will allow us to supply the Metal Plus service. After building up this service into a cash generator, our strategy is then to switch focus and to invest more in FTTH.



"Hikari one" FTTH service

In the year ended March 2006, delays in coverage rollout meant that revenue did not cover our sunk costs in the first half. But we should get close to break even this year if we hit our target of expanding the subscriber base to 2.75 million. So we should be able quite soon to start investing cash generated by Metal Plus in the FTTH business.

Q. What is your overall vision for KDDI's fixed-line business?

A. Our ultimate goal at KDDI is to supply customers with a variety of services using communication platforms. One of our key objectives is therefore to create a platform common to wirelines and wireless telecoms. For example, banks could use such a platform to supply a wide range of financial services. You could also imagine many content providers wanting to use such a platform, since it would enable these firms to develop various businesses using web sites tailored either to people on the move or to PC users. There would still be a large variety of access methods — whether FTTH, or ADSL, or mobile phone, or perhaps WiMAX — but if customers could access a single platform for service providers irrespective of the type of connection, then I believe that such a platform would be highly attractive to many users. That is why we have put a fiber-optic network at the center of our plans, and it is also why we are developing an increasingly wide variety of services.

Q. And presumably the alliance with TEPCO (The Tokyo Electric Power Co.) is a major part of this?

A. Correct. Our plan is to merge the FTTH operations of the alliance partners by January 2007, but prior to that happening it is important for us to offer FTTH services to customers as our own network connections. Then the next important question is what level of service penetration we can achieve with FTTH in conjunction with TEPCO. We initiated a joint promotional campaign for FTTH in November 2005, and from June 2006 we changed the name of this service to “Hikari one” and began marketing it as an integrated service alongside KDDI Hikari Plus. Cable television will be the key to future market penetration, and so we also re-branded the Hikari Plus TV service as “MOVIE SPLASH.” Now we are working to improve our video distribution services while putting our full promotional efforts behind “Hikari one.”

Of course, we do face some geographic limitations with the service because TEPCO as a regulated utility can only serve the Kanto region. So our plan is to create a successful business model in the Kanto region in partnership with TEPCO before developing the

business in other parts of Japan. I'm sure that the other regional power utilities will be watching our progress closely.

Q. What is the link between KDDI's investment in a cable TV operator and the FTTH business?

A. For us, the main goal with the investment in JAPAN CABLENET LIMITED (JCN) is to gain access to a customer base. This deal broadens our customer base in one swoop. Plus there should also be synergies from combining their content with the other services that we can supply. Moreover, I think the investment makes a lot of sense for JCN, because they do not have the capability to supply high-speed Internet services over a fiber-optic or similar network. Building such a network from scratch requires a huge capital investment. So I think that it is beneficial for JCN as well to link up with a major telecom company, with both fixed and mobile services as KDDI. This particular arrangement is a capital tie-up, but we also have a number of cooperative partnerships with other cable TV operators. I think we will see more such cooperative ventures in the future.

Q. What are the major issues for the future?

A. Our priority is to get the Metal Plus service established and making money, in line with our plan. As we roll out the integrated FTTH service in partnership with TEPCO, I think the future prospects for that business will become clearer. In both these cases, I think that owning the final mile will prove a crucial success factor.

Next, we need to show customers a world that they cannot resist. Simply competing on price does not mean all that much. Ultimately I believe our strength at KDDI is in owning a network that can provide a comprehensive linkage between landline phones, PCs, televisions and mobile handsets. What we need to do is to play to our advantage as a single company that spans both fixed-line and mobile communications. If we can provide a highly attractive package of services using fixed-line connections, I believe that customers will want to choose KDDI because of this essential strength.

We aim to tailor varied content-based services to consumer needs to make lifestyles more attractive via “Keitai (mobile phones)”.

Makoto Takahashi
Vice President
General Manager, Content & Media Business Sector

Q. What do you think are the greatest strengths of au mobile content?

A. The au brand is particularly strong in entertainment-related content, most notably in music. Our services in this area have evolved and become steadily more advanced, going from ringtone downloads with EZ Chaku-Uta® and download capabilities for complete tracks with EZ Chaku-uta Full® to our most recent innovation, au LISTEN MOBILE SERVICE (LISMO).

The reason why we have been able to introduce this kind of content ahead of other carriers is that we have a superior network infrastructure, in terms of both transmission capability and cost competitiveness. Successive upgrades have enabled us to provide users with download services that involve more data-intensive content. During 2006, we plan to upgrade once again, this time to EV-DO Revision A. This will realize another major advance in terms of connection speeds and data transmission capacity, in turn enabling us to supply even more attractive content.

Q. What is the difference between the au LISMO service and portable music players such as the iPod?

A. I think that the main difference is in the user age demographic, both actual and targeted. The main users for LISMO and the other au music download services are teenagers and young adults (aged 15-25), whereas the products of other companies tend to have a slightly older user base. In the case of au, most downloads are to mobile handsets, but many people using the portable music players first download the files to a PC before transferring the music to the device. I think the difference in pattern of usage arises because younger consumers tend to be more comfortable with using a mobile phone handset as the primary download tool than they are with using a PC this way.

In fact, in the sense that it connects mobile phones with PCs, I view LISMO as a type of fixed-mobile convergence (FMC) service. With LISMO, you can back up the track originally downloaded to the phone using EZ Chaku-uta Full® onto your PC, with playback possible as well. Similarly, it also allows you to transfer to your phone any tracks burned from a favorite CD or music purchased online from the LISMO Music Store.

Q. FMC is a much-discussed concept these days. How do you envisage it benefiting KDDI's content business?

A. I think that FMC holds a variety of possibilities for our content business. For instance, you could hit a button on your mobile phone to retrieve a video file stored on your hard disk at home. You could then watch this content either on the phone while you are on the move, or else enjoy it on the plasma display back at home. Or you could use your mobile handset to share some video content that you particularly like with



a friend. I think that FMC would provide a variety of new and enjoyable ways of experiencing content. But data-intensive content like video demands a high-speed, large-capacity network infrastructure. I believe that KDDI is the only carrier in Japan that is developing the network capabilities to facilitate these kinds of services.

Q. Aside from music download services, mobile Internet banking is another field with great potential. What is KDDI doing in this area?

A. In April 2006, we announced that we had formed a strategic alliance with The Bank of Tokyo-Mitsubishi UFJ for mobile online banking. The plan calls for differentiating our service from existing online banking operations by using the mobile phone number as an integral part of the security functions so that we can enable simple but secure settlement procedures. With many online banking services today, the actual procedures involved require many steps. We hope to design a service that takes advantage of the highly personalized characteristics of a mobile phone to make the verification and settlement systems as convenient as possible. We are currently working on systems to facilitate simple and secure financial functions using a mobile phone, such as settlement and money transfers.

Q. And what about KDDI's partnership with Google?

A. I think that this is an extremely important development, because equipping mobile phones with a high-powered search engine enormously increases the ability of the user to access content.

Content businesses tend to adopt one of two kinds of business model. The first type is the download model, such as the EZ Chaku-uta Full® service. This type of model gives users access to valuable content for a fee. The other type is the information reference model, which is typified by web portals and news sites. This kind of service addresses rising user demand for free access to information anywhere at any time. Usage of search sites as a means of finding content is also on the increase; it is remarkably common among our au flat-rate subscribers.

In this context, I believe that our partnership with Google is highly significant. Our aim with the agreement is to offer au customers easier and better access to search services. The Google search engine is based on a web crawler*1. Compared with the directory*2 approach, this dramatically increases the amount of searchable information. We also believe that the Google search technology will enable our customers to find more relevant results for the keywords entered for any particular content-related query.

*1: Robot or crawler search engines use programs that automatically crawl the Internet to compile web pages.

*2: Directory-type search engines depend on manual categorization of web sites by people.

Q. In the future, what do you think the key factors will be in the content and media business?

A. Currently our business development efforts are focused on trying to take greater advantage of flat-rate usage tariffs using content tailored to the PC Site Viewer flat phone browser, or other attractive content such as streaming video. We are seeing a significant increase in access by au subscribers to blogs and to SNS*3. In

addition, our users are spending a lot more time at such sites. Due to their extremely high popularity, we are looking to build practical new business models based on the growth of SNS in Japan.

Another area with a lot of potential is in the linkage with broadcasting. In April 2006, we initiated a joint trial with broadcasters of a business based on "One Seg (One segment broadcasting system)"*4. We aim to create a new business model by offering multiple links from broadcasts of highly rated programs to related content in such a way that the responses provide information on what program element triggered viewer interest. Our goal is to unite the ubiquitous nature of mobile phones and "One Seg" broadcasts to expand viewing opportunities and thus maximize opportunities for content usage. We are already seeing increasing numbers of track downloads occurring during music video broadcasts, and we believe that such phenomena could be a new profit opportunity for KDDI and for the broadcasters alike. Examples include viewer-targeted links to content sales within programs, or various ad-linked opportunities that we could offer advertisers.

Our overall aim here is to develop and supply widely the platforms and functions needed to underpin such broadcast-linked business opportunities, because this way we can create more value from content distribution. We also hope to explore new business opportunities in collaboration with program broadcasters, and I think that we can build win-win relationships through such initiatives.

*3: A social networking site (SNS) is a communication-oriented web site designed to allow participants to make friends and develop relationships with others online. While some sites are fee-based, many are free to users. Most free sites have business models that involve collecting revenue from advertisers or levying small intermediary fees on the sales generated by people recommending purchases of books, CDs or other goods to friends via the site using specially designed functions.

*4: It shows digital terrestrial broadcasting for mobile. We separate the 13 segments for digital terrestrial broadcasting as one-channel to broadcast the video, voice and data. HDTV needs 12 segments for broadcasting and other one segment is only for mobile within 13 segments.

Q. How do you see the future development of telecommunications services from a content and media perspective?

A. Extreme as it may seem, my personal view is that we are approaching a time when carriers will no longer be in the telecommunications business alone. Consumer lifestyles will probably develop to the point where people feel happiest using the PC at home and the mobile handset when they are away from home. I believe that those customers using both devices will start to regard them merely as different gateways to gain access to a variety of information and services.

For example, you could purchase insurance or a package holiday on your mobile phone, or, as I mentioned before, you might like to watch the video that you recorded at home outdoors on your mobile. I think we are not that far off these sorts of capability becoming a reality. People have extremely varied needs, and I think the key to future growth will be in working out how to use the network infrastructure most profitably to deliver valuable services and information to users.