Interspace
2122 TSE Mothers

20-Jul.-16

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FISCO Ltd. Analyst
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Strengthening the revenue base from the new native advertising business and the overseas business

Interspace <2122> (hereafter, also “the Company”) operates an Internet Advertising (Affiliate) Business with a focus on affiliate advertising, and a Media Business that is centered on the child-care support site “mamastadium.” In addition, it has launched affiliate service businesses in Southeast Asian countries such as Indonesia, Thailand, and Vietnam, and is currently developing them to become one income pillar in the future.

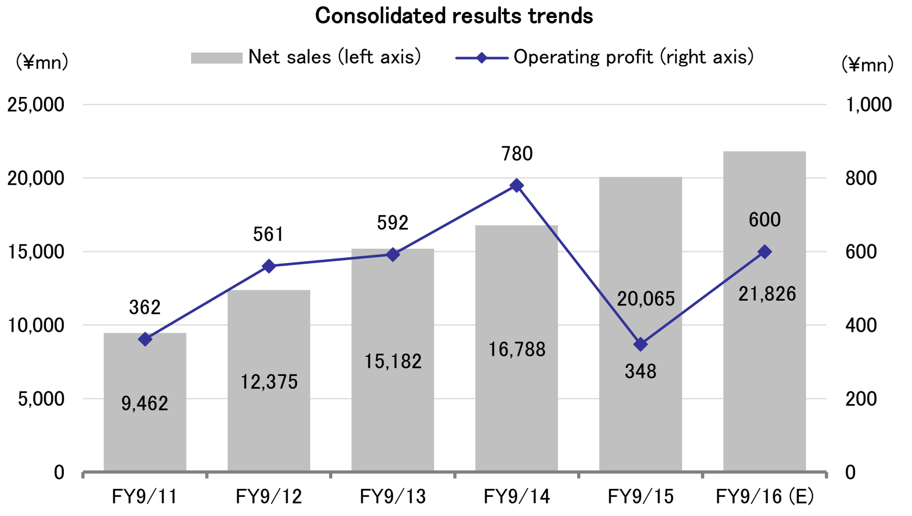
The FY9/16 1H (October 2015 to March 2016) consolidated results were positive and exceeded the initial targets, with net sales increasing 21.6% y-o-y to ¥11,077mn and operating profit rising 264% to ¥404mn. Net sales from the mainstay affiliate services trended strongly and increased by double digits, centered on the e-commerce and services categories. Another factor was the achievement of profitability in the Media Business following the structural reforms implemented in the previous fiscal year.

The forecasts for the FY9/16 results are unchanged from the initial targets, with net sales to increase 8.8% y-o-y to ¥21,826mn and operating profit to rise 72.2% to ¥600mn. Operating profit is set to fall in 2H compared to1H, but this is because of expected factors, including that sales may slump from the effects of the ban on de-facto zero yen sales of mobile phones at storefront affiliates, and also from the higher costs from the newly operational Singapore subsidiary. But up to Q2, the progress rate toward achieving the operating profit target was high, at 67.4%, and the current sales conditions are set to continue to trend favorably, so at FISCO we think it is highly possible that the results will exceed the Company targets.

The Company is strengthening the revenue base in the native advertising business, which it is focusing on as a new business, and in the overseas business. In the native advertising business, the acquisition of media partners for the X-Lift (Cross Lift) delivery platform service released in August 2015 is proceeding smoothly, focused on major curation media, so sales are expected to increase in the future. Also, in the overseas business, we can see that the affiliate services being developed in Thailand, Indonesia, and Vietnam are starting to expand, particularly in the finance and e-commerce categories, while in addition, an ad network service based in Singapore is scheduled to start from this 2H. The outlook in terms of the time periods for these businesses to become profitable is from FY9/17 for native advertising and from FY9/18 for the overseas business, but both of these businesses have major growth potential, so we will be paying attention to how they develop in the future.

Check Point

- The FY9/16 1H results were positive and greatly exceeded the initial targets
- The Company practices debt-free management and its financial position is sound
- The targets in the medium-term business plan are consolidated net sales of ¥25bn and operating profit of ¥1.5bn



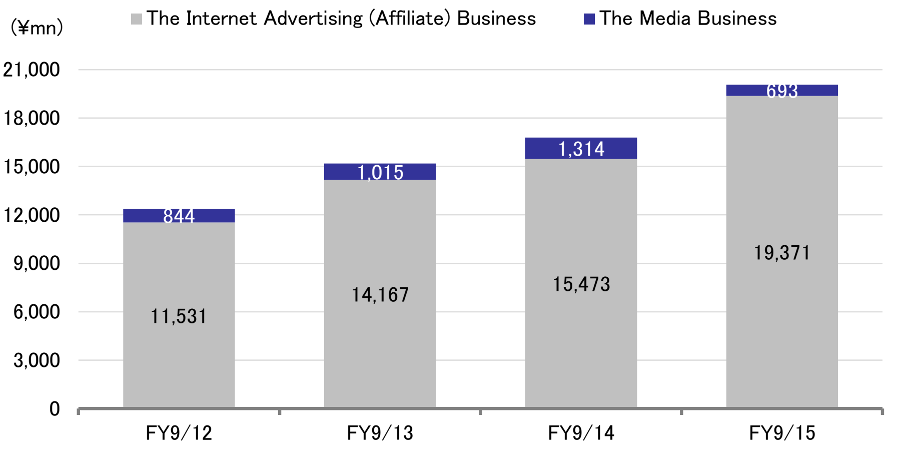
Business overview

The Internet Advertising (Affiliate) Business is the main business pillar

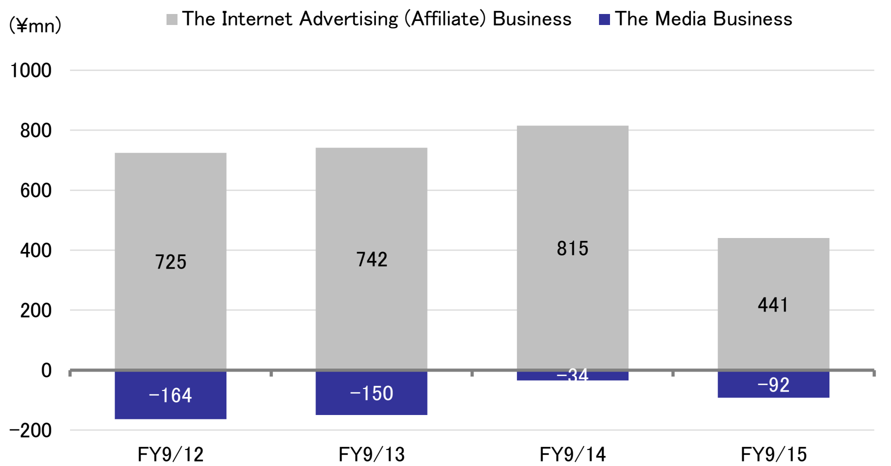
The Company's businesses are divided into the Internet Advertising (Affiliate) Business, focusing on affiliate advertising, and the Media Business. Looking at sales and operating profit by business segment, over 90% of total sales are provided by the Internet Advertising (Affiliate) Business. In addition, the operating profit earned by the Internet Advertising (Affiliate) Business has continuously absorbed the losses in the Media Business, but the Company implemented structural reforms in the previous fiscal year, including the sale of an unprofitable game subsidiary, and from this fiscal year has converted to a profitable business structure.

The Interspace Group consists of six subsidiaries; three are domestic companies–Denno Advertisement Co., Ltd., Ciagram Co., Ltd., and Interspace Global Co., Ltd.–and three are overseas companies (in China, Indonesia, and Thailand). It also newly established a subsidiary in Singapore in November 2015. The Company has partnered with a local company in Vietnam to establish an Internet advertising joint-venture company as an equity-method affiliate (the Company's capital contribution ratio is 49%). In Indonesia, Thailand, and Vietnam, it is developing its affiliate advertising businesses with local finance and e-commerce companies as the clients, while in Singapore, it plans to develop an ad network service business targeting as the clients companies in various Southeast Asian countries.

Sales by business



Operating profit by business



(1) The Internet Advertising (Affiliate) Business

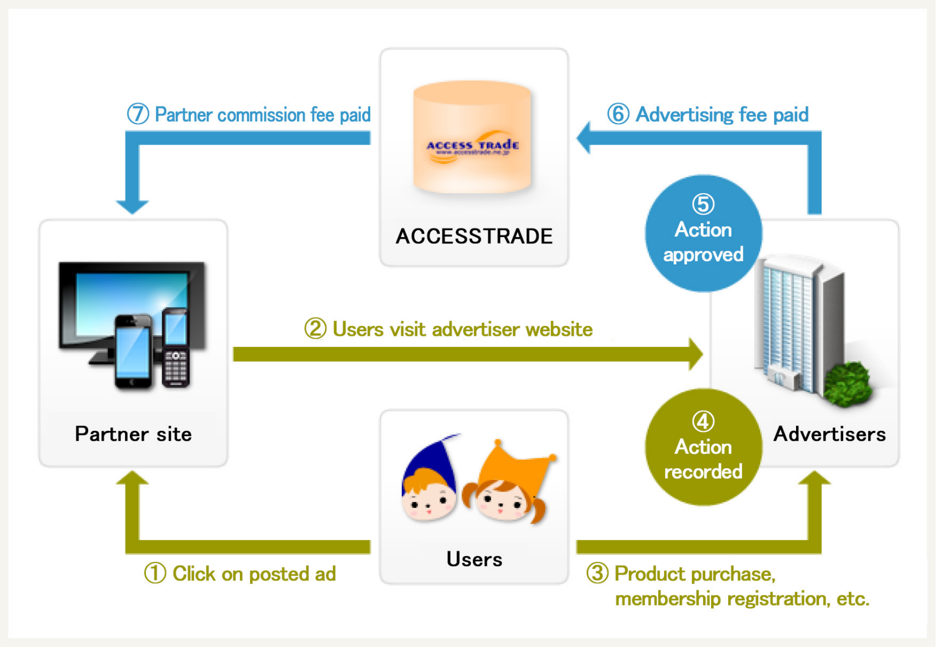
The Company's Internet Advertising (Affiliate) Business is mainly engaged in affiliate advertising, and in addition to offering listing advertising and DSP*1 advertising, it recently started offering native advertising*2. With most of its sales coming from affiliate advertising, the Company has become a major player among the affiliate service providers.

Affiliate advertising uses pay-per-click-based Internet advertising that enables advertisers to compensate operators according to final product purchases, document requests, and other sales from advertisements posted on its websites (partner sites), email magazines, and other electronic media. In affiliate advertising, the Company provides affiliate programs in its role as an intermediary between the advertisers and the website operators, and is paid advertising fees from advertisers, which are recorded as sales. These include commission fees received by the Company's partner sites, which are posted in cost of sales.

*1 DSP advertising: it stands for Demand-Side Platform. In online advertising, it is a tool to help the advertiser maximize the effects of their advertising.

*2 Native advertising: an advertising method to deliver information that readers feel little resistance to by incorporating articles and other information in a natural (native) framework on websites that collect news and other information, such as curation websites and social media websites.

The Affiliate Advertising Framework



Source: Company materials

Affiliate programs are easy-to-use tools provided by companies that enable operators to place advertisements on their own websites. The Company developed "Access Trade" in 2001, and as of the end of March 2016, it was being used on approximately 460,000 partner sites and was handling around 16,000 advertising programs.

Also, one of the characteristics of the Company is that Store Front Affiliates (SFA) account for approximately 20% of net sales in the Internet Advertising (Affiliate) Business. SFA is an affiliate advertising service marketed to brick-and-mortar stores. Provided primarily to mobile phone retail outlets, in SFA services, sales staff recommend advertiser-provided content apps and services to the purchasers of mobile phone, for which commission is paid when these apps are downloaded or services commenced. The ability of sales staff to offer products directly to customers makes SFA a highly cost-effective advertising service for advertisers. The Company has an industry leading network, with about 13,000 contracted stores. It should be noted that SFA sales are closely correlated with the sales trends of mobile phones.

(2) The Media Business

The Media Business is comprised of the media advertising business that sells advertising space on the Company's media, mainly on the "mamastadium" community site for mothers, and the social media / apps business that develops and sells game content. The Company sold its game subsidiary in the social media / apps business and has converted to a business model in which it refrains from developing new content in-house, purchases content for which it judges demand can be expected based on game content in the past, re-releases games as smartphone games, and from them collects advertising revenue as the main source of revenue. On the one hand, the scale of sales has become smaller in this business, but on the other hand it incurs practically no development costs, so it can be said to be a low-risk, low-return business model.

At the end of March 2016 on a consolidated basis, the Company had 347 employees, which is a decrease of 12 people y-o-y. Among them, the Company's employees decreased by 9 to 316 people, while at the consolidated subsidiaries they decreased by 3 to 31 people, both of which were natural decreases. The Company actively recruited employees in FY9/15, and the recruitment plan for FY9/16 is to recruit 12 new graduates, and it expects to recruit 20 to 30 people, including mid-career hires, which will be a return to the previous pace of recruiting.

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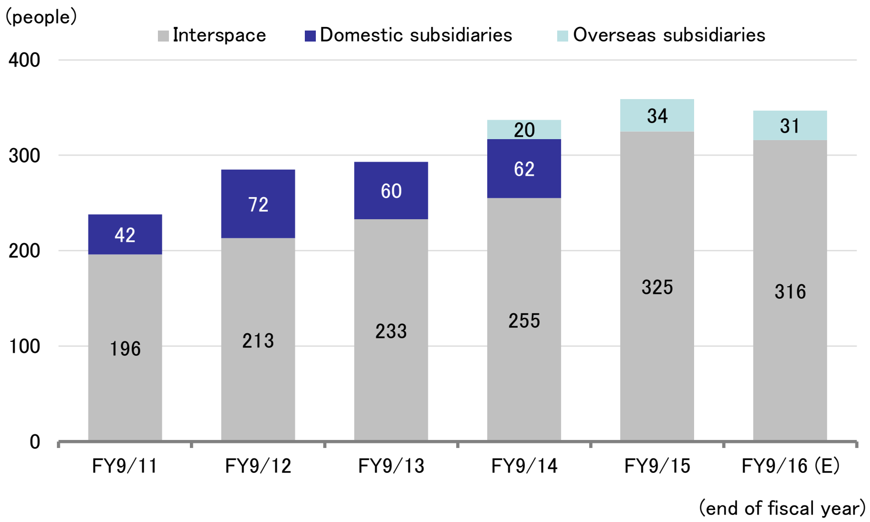
Trends in employee numbers



Results trends

The FY9/16 1H results greatly exceeded the initial targets

(1) Overview of the FY9/16 1H results

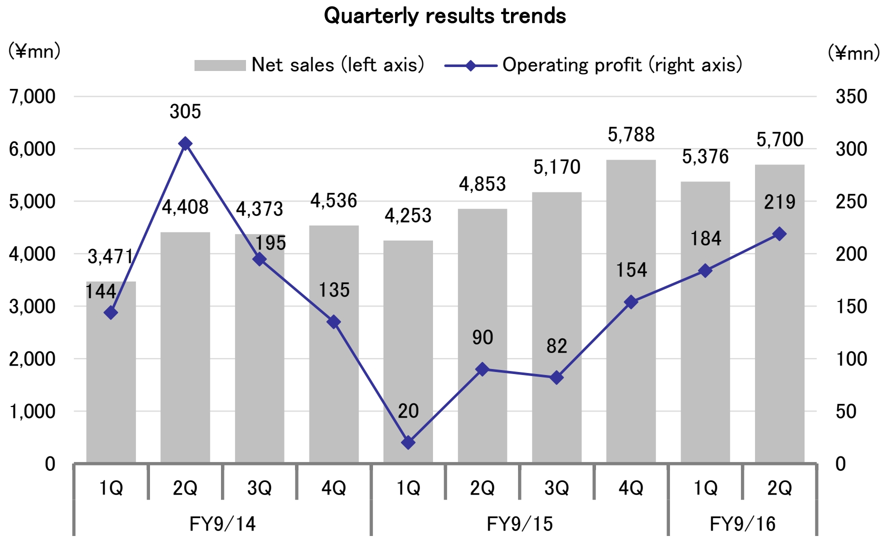
In the FY9/16 1H consolidated results announced on May 10, net sales increased 21.6% y-o-y to ¥11,077mn, operating profit rose 264% to ¥404mn, recurring profit grew 242.7% to ¥401mn, and net profit attributable to the owners of the parent company increased from ¥1mn to ¥234mn, for major increases in profits. On a fiscal half-year basis, net sales reached a new record high from the strong performance of affiliate advertising, while in terms of profits also, in addition to the improved profitability of the advertising business, the achievement of profitability in the Media Business following the structural reforms implemented in the previous fiscal year contributed to the higher results. Compared to the initial Company targets, the affiliate service trended favorably, while the Media Business also trended strongly, mainly due to advertising revenue from “mamastadium,” and as a result both net sales and profits exceeded the targets. Looking at the trends on a quarterly basis also, we see that results are trending upwards after bottoming-out in Q1 of FY9/15. The trends by business segment are shown below.

FY9/15 1H consolidated results

(¥mn)

	FY9/15 1H total		FY9/16 1H total				
	Result	% of sales	Initial target	Result	% of sales	y-o-y	vs. target
Net sales	9,106	-	10,609	11,077	-	21.6%	4.4%
Cost of sales	7,567	83.1%	-	9,070	81.9%	19.9%	-
SG&A expenses	1,427	15.7%	-	1,602	14.5%	12.2%	-
Operating profit	111	1.2%	266	404	3.7%	264%	52.0%
Recurring profit	117	1.3%	266	401	3.6%	242.7%	51.1%
Net profit attributable to the owners of the parent company	1	0.0%	143	234	2.1%	-	64.0%

Note: Company targets are as of August 2015

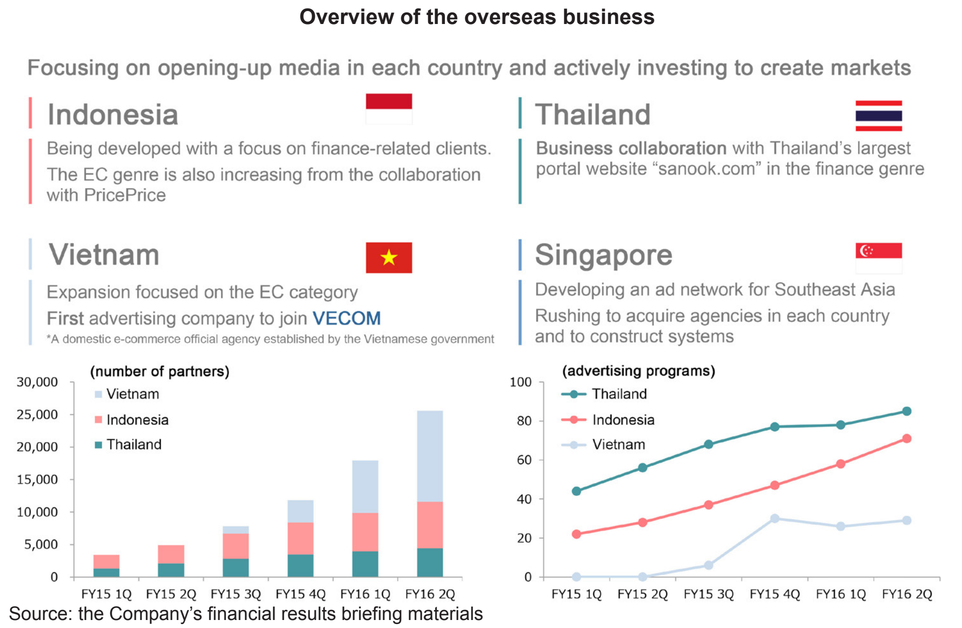


○Internet Advertising (Affiliate) Business

In this business, net sales increased 23.0% y-o-y to ¥10,741mn and operating profit rose 123.8% to ¥384mn. In the same period in the previous fiscal year, profits fell from the effects of the reduction in the gross profit margin following the raising of the partner commission by some partners, including in the finance category, and also due to higher personnel expenses. But in this fiscal period, these effects had run their course, and so the higher sales translated directly into higher profits.

Looking at the breakdown of net sales, sales trended favorably in both the mainstay affiliate advertising and in SFA, increasing 26.1% and 32.3% y-o-y, respectively. Further, looking at affiliate advertising sales by category, e-commerce rose 42%, primarily from health foods and supplements related, while services also grew greatly, by 52%, mainly from HR services and beauty related. The mainstay finance category also trended strongly, up 5%. In SFA, while the sales conditions for mobile phones remain severe, thanks to the Company's efforts to promote operations at non-operational stores and to strengthen sales in local areas, sales increased by double digits. In addition, X-lift, which is a native advertising delivery platform that was released as a new service in August 2015, is being developed with 30 cooperation partners, mainly major curation media, and from January 2016, native advertising sales are being launched sequentially.

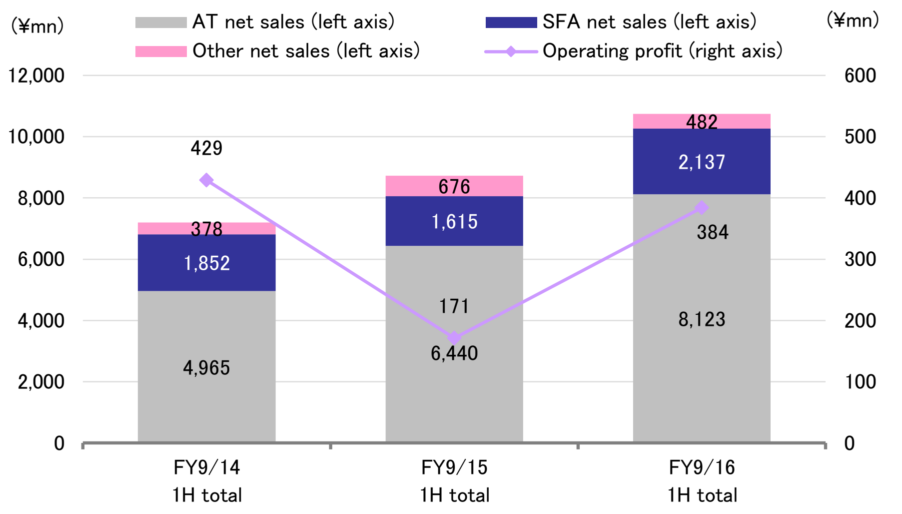
In the overseas business, affiliate services are being provided by the consolidated subsidiaries in Indonesia and Thailand and by the joint venture company in Vietnam. These companies are developing advertising programs and acquiring partner websites, with a focus on the finance category in Indonesia and Thailand and on the e-commerce category in Vietnam. As of the end of March 2016, the total number of advertising programs for the 3 companies was approximately 180 programs, and their number of partner websites had also steadily increased to around 25,000 websites. Further, while the scale is still small, it would seem that the affiliate services have now reached the stage immediately prior to their expansion period.



Source: the Company's financial results briefing materials

In the results of the overseas subsidiaries, net sales were on a scale of several thousand yen, as was the operating loss, but it is considered that compared to the previous fiscal year, the operating loss was reduced to in the region of ¥10mn. Revenue from the joint venture company in Vietnam is reflected in equity in net profits of equity-method affiliates and is not included in operating profits, and this item was ¥6mn in this fiscal 1H, the majority of which was from the Vietnamese joint venture.

Internet Advertising (Affiliate) Business results trends



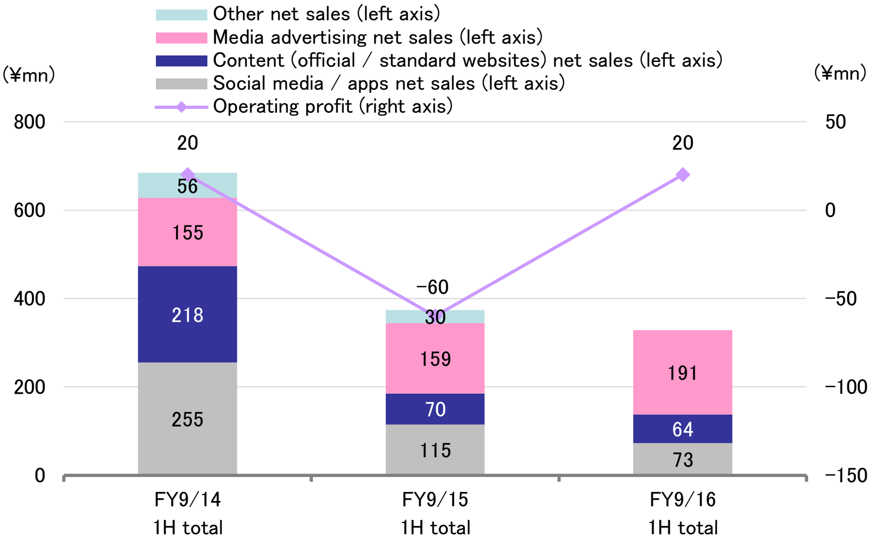
○**The Media Business**

In this business, net sales decreased 10.6% y-o-y to ¥335mn and the operating profit was ¥20mn (compared to a loss of ¥60mn in the previous fiscal year). Looking at the breakdown of net sales, while media advertising trended strongly, up 20.1%, social media / apps declined 36.5% due to the reduction in size of the game business, while content also fell 8.6%.

Within media advertising, the number of monthly unique users for the mainstay "mamastadium" website exceeded 5 million for the first time in February 2016, and its media value continues to rise, including through it establishing its position as the leading child raising support site for mothers. However, advertising sales are still being affected from the fall in sales due to the changes to the regulations on advertising delivery established in Q3 of the previous fiscal year, and they declined slightly y-o-y. But the fact that sales grew by double digits despite this was due to the increase in advertising revenue from other media websites, including listing advertising to support media advertising and native apps.

Conversely, in the social media / apps and content businesses, while net sales declined due to the reduction in size of the game business, the extent of the loss still shrunk because of the major reduction in development expenses. Also, the Company is at the stage of focusing on acquiring users and is working to enhance articles and content, including from the new releases in the previous fiscal year of MOFMO, which is a curation app targeting dog and cat lovers, and KOIMEMO, which is a romance-based curation app. It is aiming for synergies with native advertising by raising the media value of these Company websites.

The Media Business results trends



Practices debt-free management and its financial position is sound

(2) Financial position and management indicators

The Company's financial position at the end of March 2016 was that the balance of total assets had risen ¥411mn compared to the end of the previous fiscal year to ¥6,754mn. This was because the increases in cash and deposits and sales receivables of ¥527mn and ¥72mn respectively exceeded the decrease in income tax receivable of ¥156mn.

Total liabilities rose ¥243mn compared to the end of the previous fiscal year to ¥3,565mn, mainly due to the fact that while accounts payable declined ¥134mn, corporate tax payable and interest-bearing debt increased ¥200mn and ¥ 100mn respectively. Additionally, net assets rose ¥167mn to ¥3,189mn, as while the Company paid dividends of ¥54mn, it recorded net income of ¥234mn.

Looking at the management indicators, the equity ratio fell slightly, from 47.6% in the previous fiscal period to 47.2%, but the Company practices debt-free management and the current ratio is also trending stably at above 160%, so it is judged that it is continuing to maintain a sound financial position.

Balance sheet (consolidated)

(¥mn)

	FY9/13	FY9/14	FY9/15	FY9/16 Q2	Change
Current assets	4,098	4,670	5,227	5,701	473
(cash and deposits)	2,387	2,471	2,335	2,863	527
Fixed assets	810	924	1,115	1,053	-62
Total assets	4,908	5,595	6,343	6,754	411
Current liabilities	2,371	2,759	3,263	3,495	232
Fixed liabilities	104	88	58	69	11
(interest-bearing debt)	86	58	-	100	100
Total liabilities	2,476	2,847	3,321	3,565	243
Net assets	2,431	2,747	3,021	3,189	167
The main management indicators					
(stability)					
Current ratio	172.8%	169.2%	160.2%	163.1%	
Equity ratio	49.5%	49.1%	47.6%	47.2%	
Interest-bearing debt ratio	3.5%	2.1%	-	3.2%	

Future outlook

The FY9/16 outlook is for increases in sales and in each profit item

(1) FY9/16 results outlook

For the outlook for the FY9/16 consolidated results, the Company has left its initial targets unchanged, which are for net sales to increase 8.8% y-o-y to ¥21,826mn, operating profit to rise 72.2% to ¥600mn, recurring profit to climb 73.1% to ¥600mn, and net profit attributable to the owners of the parent company to grow 8.3% to ¥328mn. The progress rates for the full fiscal year targets up to the end of Q2 was 50.8% of the net sales target and 67.4% of the operating profit target, so the progress rate for profits was particularly high. The fact that the 1H results exceeded the initial targets was a result of the continuation of the recent favorable sales trend, and as long as there are no major changes to the market environment going forward, at FISCO we think it is highly likely that the results will exceed the Company targets.

The risk factors in 2H include the possibility of a reduction in sales in SFA from the impact of the sales policies of communication carriers. However, this risk was anticipated by the Company when it set its initial targets, so as long as the reduction is not greater than forecast, its effect on results is expected to be limited. Also, factors that will increase costs in 2H are the anticipated higher costs from the start of operations at the Singapore subsidiary and also for sales promotions for new businesses, including for X-lift. But the monthly costs at the Singapore subsidiary will only be in the range of ¥1mn, and it is also possible that the new businesses will actually have a positive effect if their sales proceed steadily. The outlook according to business segment is as follows.

FY9/16 consolidated results forecast

(¥mn)

	FY9/15		FY9/16 forecast			1H progress rate
	Result	% of sales	Company targets	% of sales	y-o-y	
Net sales	20,065	100.0%	21,826	100.0%	8.8%	50.8%
Operating profit	348	1.7%	600	2.7%	72.2%	67.4%
Recurring profit	346	1.7%	600	2.7%	73.1%	67.0%
Net profit attributable to the owners of the parent company	302	1.5%	328	1.5%	8.3%	71.5%

○Internet Advertising (Affiliate) Business

In this business, the Company is targeting net sales of ¥21,200mn, up 9% y-o-y. Within this amount, affiliate advertising will rise 7% to ¥15,700mn from the growth in demand for advertising in the e-commerce, finance, and service categories. But in 1H, the result of ¥8,123mn trended above target and currently the strong sales are continuing, so at FISCO we think it should be able to maintain net sales in 2H on the same level as in 1H.

Conversely, the target for SFA is net sales of around ¥3,600mn, which is basically unchanged from the previous fiscal year. In FY16, the mobile phone sales volume of major communication carriers is expected to decline by a single digit, and compared to 1H, sales are forecast to fall in 2H. But net sales were above target in 1H and depending on the conditions going forward, it is possible that the result will exceed the target for the full fiscal year also.

For other advertising services, the Company is targeting sales in the region of ¥1,700mn, up 45% y-o-y, as it is expecting an increase in native advertising sales to X-lift partner media. By further expanding X-lift partner media in 2H, it intends to accelerate the increase in native advertising sales and is expecting annual net sales of around ¥300mn. The Company has already introduced native advertising on to its own media, including on to the “mamastadium” site. Compared to conventional display-type advertising, with native advertising the matching rate between the media and the advertising is high, and users receive the information from the advertising with the sense that its content has been harmonized with the site. So demand for it is rapidly increasing from advertisers as a method of easily increasing the effects of advertising, and its market is growing. It is thought that the Company wants to develop the native advertising market so that this business becomes its second income pillar after affiliate advertising.

The forecast for the overseas business is for net sales to increase by around 2 times y-o-y, to in the region of ¥50mn. This is slightly down on the initial target of an increase of three times, but this is due to the Company strengthening as a priority the affiliate system in Indonesia (for measures to prevent fraud). In Indonesia, since January 2016, advertising programs in the e-commerce category have also started to increase from linking the Priceprice.com-Indonesia website, which is the largest purchasing support website in Southeast Asia that is operated by Kakaku.com, Inc. <2371>, with the Company's data feed optimization service "SimpleDataFeed," and there has been no change to the expectation that this market will grow in the future.

In Singapore, an ad network service for local companies has been launched, including for companies in neighboring countries. The actual sales activities will be carried out by the Group companies in Indonesia, Thailand, and Vietnam, with Singapore positioned as the hub base. In terms of the profit or loss from the overseas business, while costs will be incurred for the launch of this business in Singapore, the loss is still expected to shrink slightly y-o-y.

○The Media Business
In this business, net sales are forecast to decrease 9% y-o-y to ¥630mn, because while sales from media advertising will increase, they will continue to fall in the social media / apps and content businesses. The Company is targeting operating profit in the region of ¥10mn. Already in 1H, ¥20mn has been achieved and the target exceeded, so it is highly likely that it will also exceed the target for the full fiscal year.

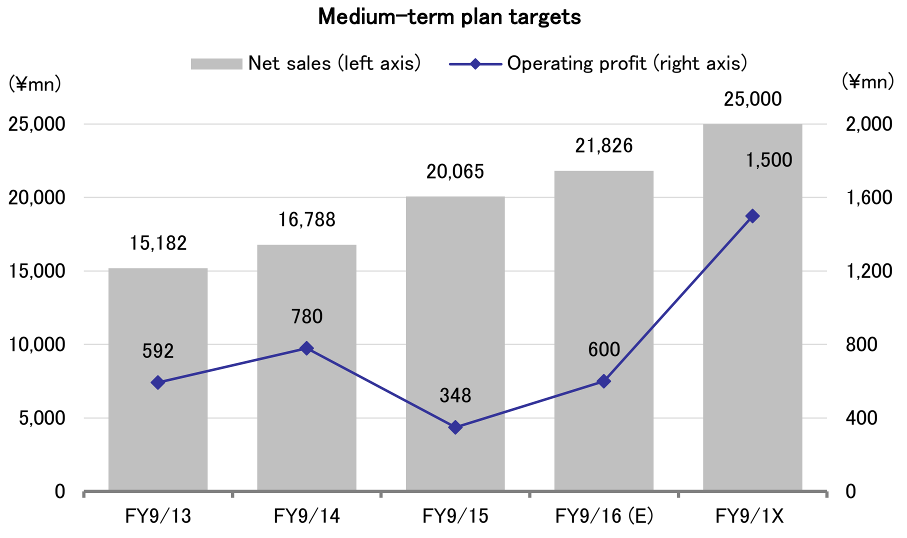
Expectations are particularly high for media advertising revenue, particularly from the child-care support site "mamastadium." This is because the media value of "mamastadium" is rising alongside the increase in its number of unique users, so tie-up advertising from industries with high affinity to this website, like education, cooking, and entertainment, have started to increase. Until now, affiliate advertising provided the majority of sales in this business, but going forward, advertising revenue is expected to grow to the next level from the higher sales from tie-up advertising, native advertising, and other forms of advertising.

Also, as a new initiative, in April 2016 the Company launched services on the power liberalization information site "My Energy." This site publishes various information, such as news relating to the liberalization of power and word-of-mouth information, and the plan is to provide various services on it, including to simulate power plans and to change contracts directly with power companies based on the results of a diagnostic test. This site is expected to contribute to an increase in advertising revenue in the future.

The targets in the medium-term business plan are consolidated net sales of ¥25bn and operating profit of ¥1.5bn

(2) Medium-term targets

The Company is targeting consolidated net sales of ¥25,000mn and operating profit of ¥1,500mn as the targets in its medium-term business plan, and we believe that if the Company continues its current pace of growth, it will achieve them in 3 to 4 years. From the previous fiscal year to this fiscal year, it has invested in order to build the foundations for growth in the future, including by investing in personnel and in the development of new businesses, and from the next fiscal year onwards it will enter the phase of recovering this investment and therefore revenue growth is expected to accelerate.



The driving force behind the Company's revenue growth is the expansion in market share from strengthening sales for affiliate services in the domestic Internet Advertising (Affiliate) Business, and in addition, the progress it is making in raising-up the profit margin by improving productivity. For native advertising, it is aiming to increase sales while expanding the X-lift site partners. Initially costs will be incurred, such as to produce content, so the profit margin is likely to be low. But as it is an advertising method that is highly cost effective for customers in the medium-to-long term, the Company expects this business to grow and to start contributing to profits from FY9/17.

In addition, in the Media Business, the policy is to maximizing profits for the Company as a whole by continuing to develop and grow new media following on from "mamastadium," and thereby increase advertising revenue.

With regards to the overseas business, it is considered that the Company is aiming to acquire the leading market share in each country where it provides affiliate services, and expects it to start contributing to profits from FY9/18, when net sales will be 3 times their current amount. The scale of the e-commerce market in Southeast Asia was $7bn in 2013 and it is predicted to grow rapidly to a scale of $34.5bn in 2018, which will be a level of about one third that of Japan. Therefore, the growth potential of the Company's overseas affiliate services can be said to be large.

Comparison with industry peers and policy of returning profits to shareholders

Targets a dividend payout ratio of 15 to 20%

(1) Comparison with industry peers

There are four other major affiliate management companies besides Interspace – F@N Communications, Inc. <2461>, Adways Inc. <2489>, ValueCommerce Co., Ltd. <2491>, and LinkShare Japan K.K. (unlisted, a subsidiary of Rakuten <4755>) – and their sales are in the region of ¥10bn to ¥40bn. These five companies, including Interspace, hold an industry market share of about 60%.

Within them, F@N Communications is the largest industry player with about 2 million affiliate sites and in excess of 2,000 advertising programs. It has been engaged for many years in the advertising business for SMEs and its dependence on e-commerce is relatively high. Adways is about 60% dependent on mobile Internet sales (compared to domestic advertising sales) and is strong in games. Because of its heavy dependence on the mobile Internet, its profit margin is relatively low. ValueCommerce, a subsidiary of Yahoo! <4689>, obtains an overwhelmingly high percentage of its sales from the PC advertising business, at around 70% (on a project basis), while on a category basis, its services for finance constitute nearly 50% of sales. Alongside F@N Communications, it maintains a high level of profitability.

The reason that Interspace has a lower profit margin than the companies mentioned above is that in addition to the low profitability of the Media Business, the Company has high staffing levels for its partner sites and for advertiser development, even in the Internet Advertising (Affiliate) Business, so its personnel expenses as a percentage of sales are relatively high. However, it is improving earnings in the Media Business, such as through the sale of a subsidiary, and in the Internet Advertising (Affiliate) Business also, the effects of its strengthening of the HR structure will be felt in the future. Therefore, we forecast that the difference in profitability between the Company and its industry peers will gradually become smaller.

In the FY16 results outlook, profits of two of the four companies are forecast to decline, and the Company's profit growth rate stands out. For those companies in which profits are expected to decline, this would seem to be due to them having to incur upfront investment costs, such as to develop new businesses.

Comparison with Industry Peers

(units: ¥mn, %, times)

	FY	Net sales	Growth rate	Recurring profit	Growth rate	Profit margin	PER	EV/ EBITDA
Interspace <2122>	FY9/15	20,065	19.5	346	-56.2	1.7		
	FY9/16 Company forecast	21,826	8.8	600	73.1	2.7	20.2	4.94
F@N Communications Inc. <2461>	FY12/15	35,789	11.9	6,179	3.9	17.3		
	FY12/16 company forecast	38,000	6.2	6,240	1.0	16.4	14.2	7.14
Adways Inc. <2489>	FY3/16	39,613	10.4	744	-37.8	1.9		
	FY3/17 (F)	42,500	7.3	300	-59.7	0.7	307.7	15.99
ValueCommerce Co., Ltd. <2491>	FY12/15	16,658	24.6	1,656	0.5	9.9		
	FY12/16 company forecast	19,000	14.1	1,260	-23.9	6.6	14.3	5.40

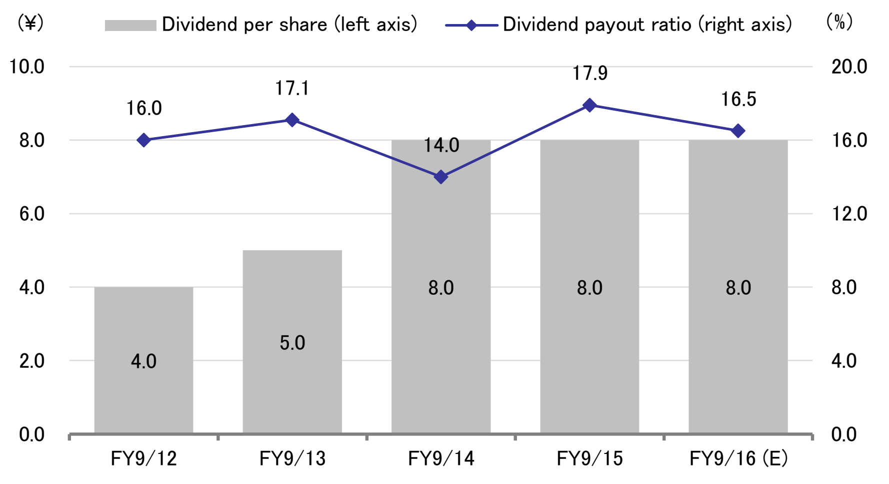
Note: Forecast PER was calculated based on the closing price on May 18, 2016, and the result for Adways for FY3/17 is the median value in the range of the Company forecast.

EV/EBITDA = (market capitalization + interest-bearing debt - cash and deposits, securities) ÷ (operating profit + depreciation)

(2) Policy of returning profits to shareholders

The Company determines dividends by comprehensively taking into account factors such as earnings trends, financing needs, and internal reserves for future business development. It targets a dividend payout ratio (consolidated) of 15 to 20%, and the dividend for FY9/16 is expected to be ¥8.00, the same as in the previous fiscal year.

Dividend and dividend payout ratio (consolidated)



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