Interspace
2122 TSE Mothers

Company Research and Analysis Report
FISCO Ltd.
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■Interspace Shows Growth Potential amid Expected Expansion of the Affiliate Advertising Market

The strengths of Interspace Co., Ltd. are found in its role as a major provider of affiliate advertising services in the financial and online game industry categories. In addition to strengthening its game application and media businesses, Interspace has expanded overseas by establishing affiliated companies first in China, Indonesia and Thailand.

Consolidated FY9/13 results saw a 22.7% year-on-year (y-o-y) increase in sales to ¥15,182mn, and a 5.4% rise in operating profit to ¥592mn. This was thanks to the ongoing robust performance of the company’s mainstay Internet Advertising (Affiliate) Business, which focuses on providing services to the finance and online game industries. Despite sluggish growth accompanying changes in sales mix, operating profit hit record highs for two consecutive fiscal years.

FY9/14 results are forecast to continue improving, with a projected 8.7% y-o-y rise in sales and 8.5% increase in operating profit. The Internet Advertising (Affiliate) Business is expected to remain the company’s sales and profit growth driver. FY9/14 also appears to be the year in which the company will take steps to build a foundation to achieve further growth in each of its businesses. The Internet Advertising (Affiliate) Business will work to boost sales to smartphones users as well as expand into the area of offline-to-online (O2O) marketing.

The Media Business engages in the development of “mamastadium”, a community site for mothers, and other new types of vertical media. Overseas, this business is planning to build sales networks and gain new customers in order to establish Internet advertising businesses in Thailand and Indonesia.

The company’s pay-per-click advertising service is an optimal advertising approach for advertisers in terms of cost efficiency. Accordingly, the domestic market for these services is expected to grow steadily in the future. In addition to the expansion of the domestic Internet Advertising (Affiliate) Business, the company’s growth potential is projected to increase further assuming it can improve profits in the Media Business and extend its operations into Asia.

■Check Points

- Posted record-high profits on the back of higher advertising revenue in FY9/13
- Maintain increases in sales and profits in FY9/14 mainly due to enhancing affiliate service sales
- Pursue capital/business alliances particularly with U.S. companies to gain access to new services

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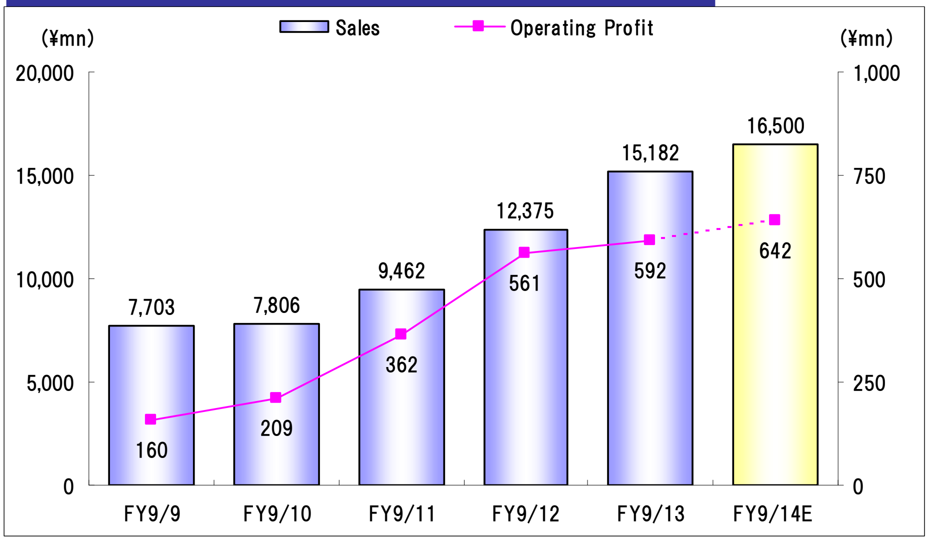
Sales and Operating Profit (¥mn)



■Business Description

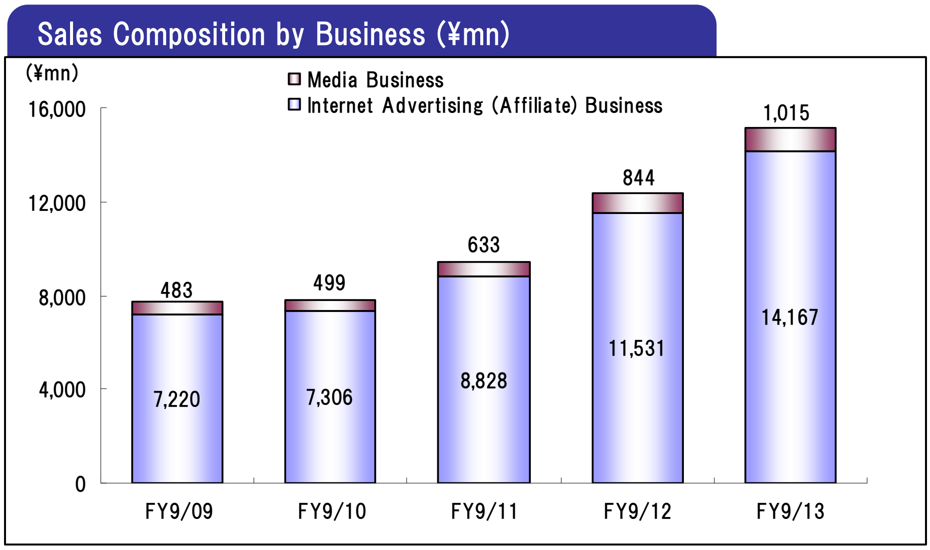
Affiliate-centered Internet Advertising (Affiliate) Business a profit pillar

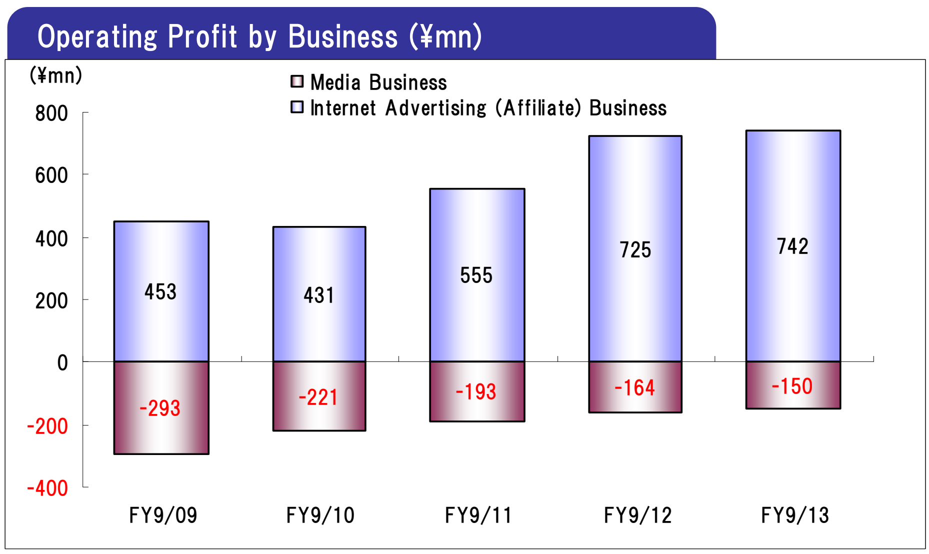
Business Outline

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 during the past five years, over 90% of total sales were accounted for by the Internet Advertising (Affiliate) Business. In addition, operating income earned by the Internet Advertising (Affiliate) Business is able to continuously absorb Media Business losses. Based on this, the Internet Advertising (Affiliate) Business has become the company's profit pillar.

The Interspace Group consists of seven subsidiaries: more games Co., Ltd. (which develops social games), DENNO ADVERTISEMENT Co., Ltd. (which manages the Internet Advertising (Affiliate) Business), Ciagram and Interspace Global (both of which develop other businesses), and three overseas subsidiaries established to undertake Internet advertising operations in China, Indonesia and Thailand (until FY9/13, overseas subsidiaries were nonconsolidated).

■Business Description





Main advertisers are the finance/insurance and entertainment industries

(1) Internet Advertising (Affiliate) Business

The company's Internet Advertising (Affiliate) Business is mainly engaged in affiliated advertising, offering SEO (*1), listing advertisements, and DSP advertisements (*2). With most of its sales coming from affiliate advertising, the company has become a major player in the affiliate service sector.

Affiliate advertising uses pay-per-click-based Internet advertising that enables advertisers to compensate operators for the number of final product purchase, document request 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 advertisers and website operators.

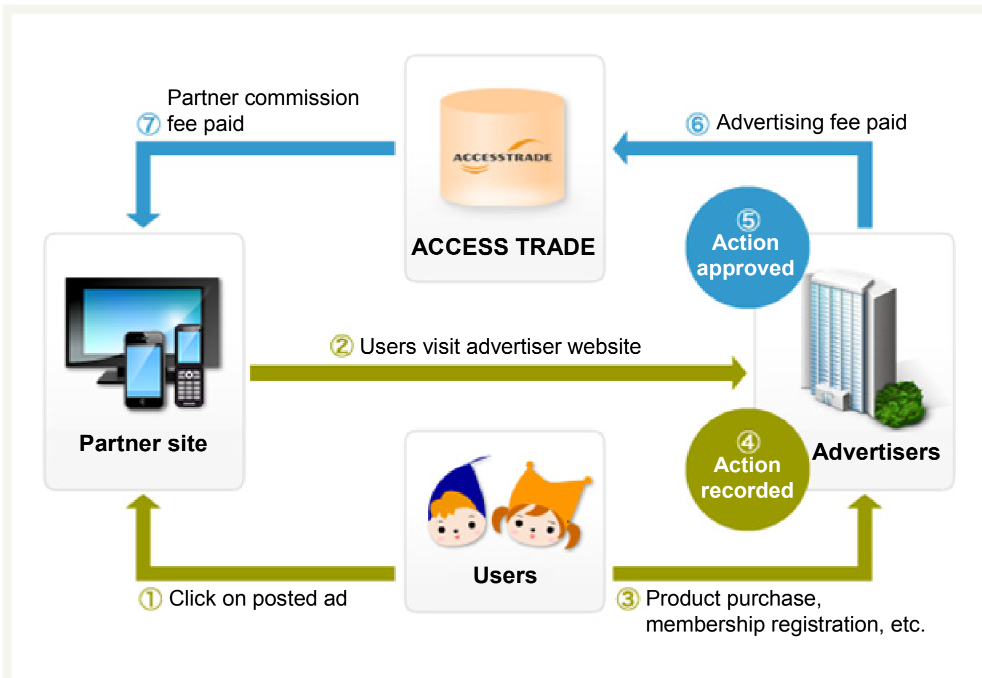
■Business Description

Affiliate programs are easy-to-use tools provided by companies that enable operators to place advertisements on their own websites. The company developed the affiliate program "ACCESS TRADE" in 2001, which as of September 30, 2013 is being used on 380,000 partner sites.

*1. Search engine optimization (SEO): A method and technology for gaining more customers via search engines. SEO displays advertiser websites at the top of search results based on desired keywords.

*2. Demand-Side Platform (DSP): A tool that assists in maximizing online advertising results for advertisers.

Affiliate advertising

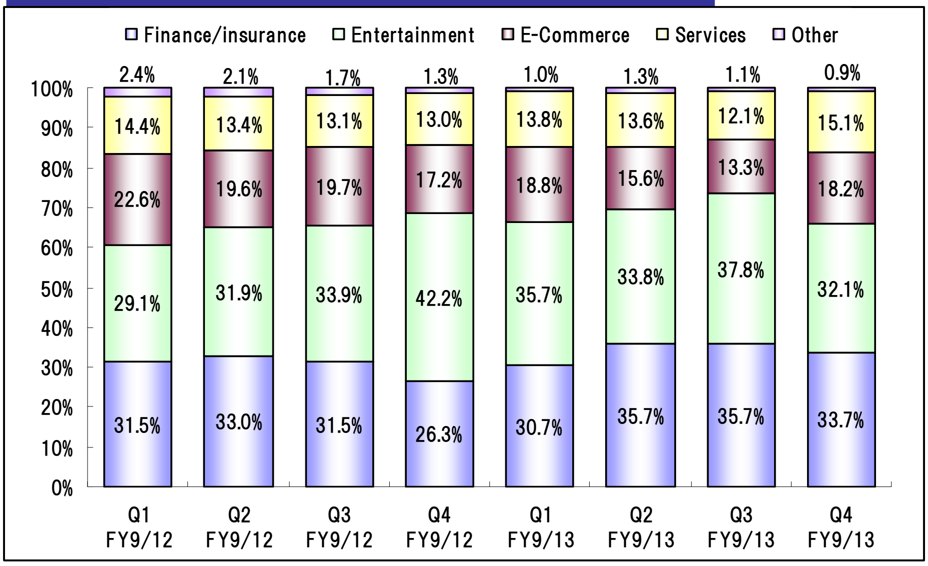


Regarding sales and profits, the company records advertising fees provided by advertisers as sales. These include commission fees received by the company's partner sites, which are posted as sales costs. The company's cost-to-sales ratio has been gradually increasing over the past several years. This is believed to be the result of changes in customer composition and an increase in the sales ratio of mobile devices, for which the percentage of paid commission fees is high.

As shown in the table entitled, "Sales mix by affiliate advertising industry", the finance/insurance and entertainment industries account for over 60% of the company's sales, at over 30% each. In the finance/insurance industry, foreign exchange operators are dominant, while online games account for a high percentage of sales to the entertainment industry.

■Business Description

Sales mix by affiliate advertising industry



Dividing the Internet Advertising (Affiliate) Business' sales by type, affiliates targeting personal computer users accounts for around 60% of sales, which includes numerous commission fees for product purchases and other services resulting from, in actuality, users viewing advertisements via smartphones. The growing popularity of smartphones appears to be driving growth in the affiliate advertising market.

Store Front Affiliate (SFA) is an affiliate advertising service marketed to actual brick-and-mortar stores. Provided primarily to mobile phone retail outlets, SFA services enable sales staff to recommend advertiser-provided content apps and services to mobile phone purchasers, for which commissions are paid when these apps are downloaded or services commence. The ability of sales staff to offer products directly to customers makes SFA a highly cost-effective advertising service for advertisers. The company has developed an SFA network for mobile phone retail outlets that boasts industry-leading performance.

Finding ways to form partnerships with highly popular website operators and bloggers is an important strategy for boosting profits from these types of affiliate advertising services. This strategy is based on the idea that websites with numerous page views undoubtedly have a higher probability of generating advertising commission fees. The company has increased the number of its partner sites to over 380,000 (F@N Communications, Inc. (2461) is the industry leader at approximately 1.8 million sites). Of these, the top 50 sites account for around 80% of total sales, which underscores their importance.

■Business Description

Expanding mamastadium community site for mothers, social games and other services

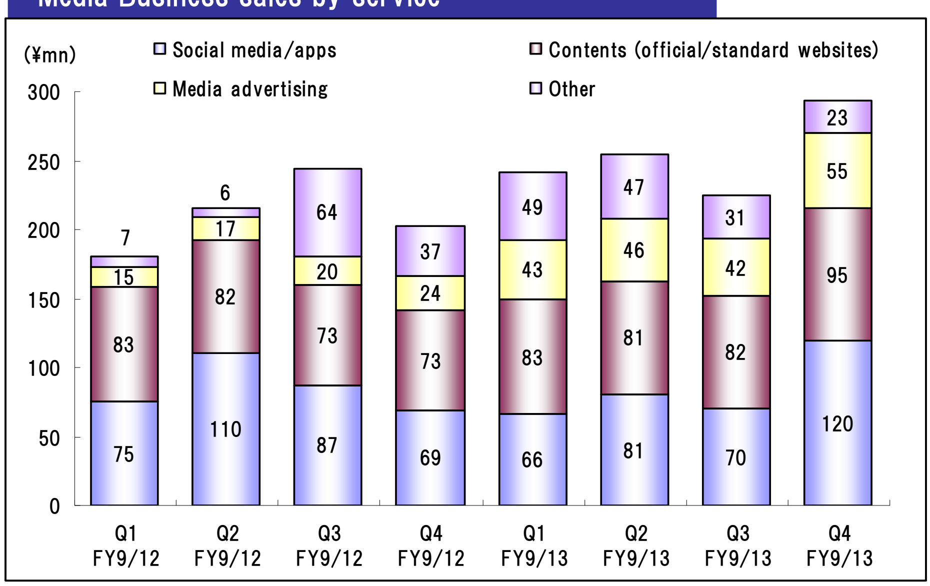
(2) Media Business

The Media Business focuses on media advertising services that sell advertising space on the company-operated community site for mothers, mamastadium, and the social media apps business managed by the company’s subsidiary, more games. In addition to developing apps used in dating simulation games marketed mainly to women, more games also creates game content for the official websites of telecommunications carriers.

Mamastadium community site for mothers
Number of users per month exceeds 1 million

Source: Company

Media Business sales by service



■Earnings Trends

Posted record-high profits on the back of higher advertising revenue in FY9/13

(1) FY9/13 Results

Turning to consolidated results for FY9/13 announced on November 12, sales increased by 22.7% y-o-y to ¥15,182mn, operating profit rose by 5.4% to ¥592mn, recurring profit grew by 7.5% to ¥597mn, and net profit improved by 18.2% to ¥197mn. FY9/13 sales, operating profit and recurring profit all reached record-high levels.

Summary Consolidated Balance Sheet (¥mn)

	FY9/12		FY9/13				
	Result	Ratio	Initial target	Result	Ratio	YOY	Change from the target
Sales	12,375	-	14,616	15,182	-	22.7%	3.9%
Cost of sales	9,805	79.2%	-	12,331	81.2%	25.8%	-
SG&A expenses	2,008	16.2%	-	2,258	14.9%	12.5%	-
Operating profit	561	4.5%	750	592	3.9%	5.4%	-21.1%
Recurring profit	555	4.5%	750	597	3.9%	7.5%	-20.4%
Net profit	166	1.3%	366	197	1.3%	18.2%	-46.1%

The main factor for higher sales in FY9/13 was an increase in the Internet Advertising (Affiliate) Business' revenue on the back of strong affiliate advertising sales. Nevertheless, advertising sales generated by the Media Business also contributed to this ongoing upswing in sales. In addition, the increase in operating profit remained in the single-digit range. This was primarily due to a 2.0 percentage-point rise y-o-y in the ratio of sales costs to 81.2% following a rise in the sales share of high-cost categories in the affiliate advertising business. The SG&A expenses ratio fell by 1.3 percentage points to 14.9% as a result of higher revenue; however, this was insufficient to cover a rise in the cost-to-sales ratio. Consequently, operating profit margin decreased by 0.6 of a percentage point to 3.9%. The company recorded a double-digit increase in net profit thanks to a decrease in losses posted by consolidated subsidiaries.

In addition, although sales exceeded the company's initial targets, profits fell short. This is largely due to a greater-than-initially forecasted delay in profit improvements for social games. The company initially projected the Media Business (including social games) to show a profit from Q3 (April-June) onward, but this has been pushed back to Q4 (July-September).

The Internet Advertising (Affiliate) Business enjoying robust sales to the finance/insurance industry

(2) Internet Advertising (Affiliate) Business Trends

In the Internet Advertising (Affiliate) Business, sales increased by 22.9% y-o-y to ¥14,167mn, and operating profit grew by 2.4% to ¥742mn. By industry, sales to the finance/insurance industry jumped by 38% amid active stock and financial exchange markets, while smartphone app advertising sales to the entertainment industry continued growing at the robust pace of 23%. In addition, the company's personnel dispatch- and esthetic clinic-related advertising sales targeting the service industry were strong.

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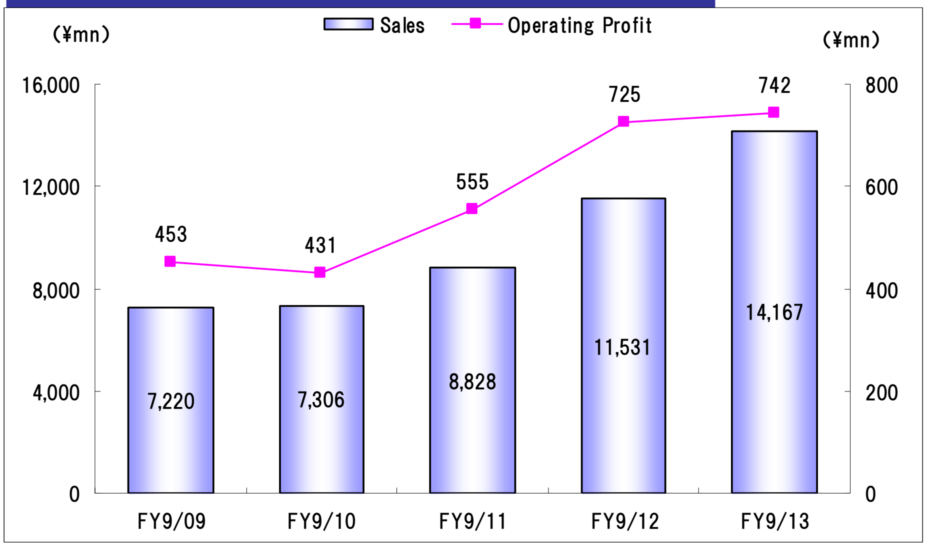
■Earnings Trends

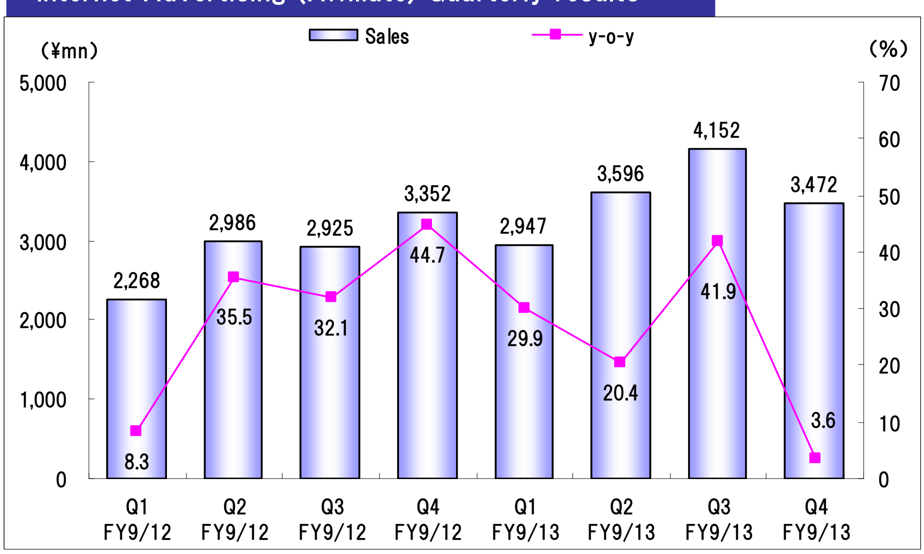
Internet Advertising (Affiliate) Business results



As mentioned above, with smartphones now accounting for approximately half of affiliate advertising, the growing popularity of smartphones is driving the expansion of the affiliate advertising market. In particular, SFA recorded a 31% y-o-y increase in sales thanks to the robust performance of content apps promotions for smartphone purchasers.

Looking at quarterly sales, a significant jump was seen in Q3 but lost momentum in Q4. In Q3, this increase in sales was due to the major impact of television commercials for game content. In Q4, SFA sales fell from ¥990mn y-o-y to ¥730mn following the release of iPhone by NTT DOCOMO, Inc. (9437). This is because the majority of the content apps being sold via SFA target Android terminals.

Internet Advertising (Affiliate) Quarterly results



■Earnings Trends

Users of Community Site for Mom's Increases in Media Business

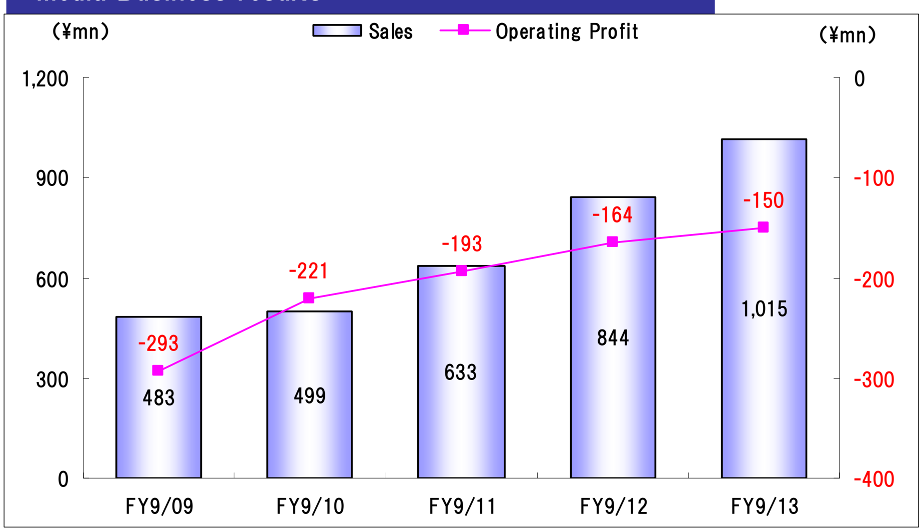
(3) Media Business Trends

The Media Business recorded sales of ¥1,015mn, up 20.3% y-o-y, and an operating loss of ¥150mn (compared with an operating loss of ¥164mn in FY9/12). As a component of sales, media advertising revenue rose from ¥76mn in FY9/12 to ¥186mn in FY9/13.

The company has focused on redesigning its mamastadium website and upgrading its content by regularly posting columns featuring TV personalities and entertainers, and other changes. As a result, as of September 2013, the number of monthly users sharply increased to just under 1.4 million from a little over 0.2 million and its monthly page views surpassed 100 million, thereby raising its value as an advertising medium. In addition to releasing three new game titles during the year, including dating simulation games for women, sales of its own content and that offered on mobile phones and "au SmartPass" were strong.

However, the company's losses have declined only slightly. Although media advertising remains profitable, the cost of developing social media game apps has been a big financial burden.

Media Business results



Three women's dating simulation games are released yearly

Source: Company

■Earnings Trends

Safety Indicators (equity ratio, etc.) are Excellent

(4) Financial Standing and Management Indicators

Interspace's financial standing as of September 30, 2013 (FY9/13) was total assets of ¥4,908mn, an increase of ¥363 million y-o-y, due to an increase in its business scale. Although intangible fixed assets declined ¥61mn y-o-y, this was due to a lump-sum payment of ¥76mn for the goodwill of a subsidiary. On the other hand, total liabilities increased ¥186mn y-o-y to ¥2,476mn mainly due to a ¥164mn increase in accounts payable-trade accompanying the sales increase.

The company's safety management indicators including current ratio, equity ratio, and debt-to-equity ratio are all at problem-free levels. Even cash and deposits at ¥2,387mn and comprising nearly half of total assets reflect a favorable position. However, the operating profit margin of 3.9% was down slightly y-o-y, falling to a level below that of its industry peers and making earnings improvement a future management issue.

FY9/13 Balance Sheet (¥mn)

	FY9/10	FY9/11	FY9/12	FY9/13
Current assets	2,470	2,887	3,928	4,098
(Cash and deposits)	1,461	1,624	2,366	2,387
Tangible fixed assets	157	74	82	120
Intangible fixed assets	135	270	306	244
Investments	257	365	227	445
Total assets	3,020	3,598	4,545	4,908
Current liabilities	1,280	1,462	2,164	2,371
Fixed liabilities	91	32	125	104
(Interest-bearing debt)	93	0	100	86
Total liabilities	1,371	1,495	2,290	2,476
Total equity	1,649	2,103	2,254	2,431
Total liabilities & equity	3,020	3,598	4,545	4,908
(Ratios of financial security)				
Current ratio	192.9%	197.5%	181.5%	172.8%
Equity ratio	54.6%	58.2%	49.5%	49.5%
Debt-to-equity ratio	5.7%	0.0%	4.4%	3.5%
(Ratios of profitability)				
ROA	7.0%	10.9%	13.8%	12.5%
ROE	4.0%	23.3%	7.7%	8.4%
Operating profit margin	2.7%	3.8%	4.5%	3.9%

Earnings Outlook

Sustaining increases in sales and profit though stronger affiliate sales

The consolidated earnings outlook in FY9/14 is sales of ¥16,500mn, up 8.7% y-o-y, operating profit of ¥642mn, up 8.5%, recurring profit of ¥639mn, up 7.1%, and net profit of ¥319mn, up 61.7%. Major factors behind the sharp growth in net profit are the absence of an extraordinary loss (lump-sum goodwill payment) and a reduction in losses at subsidiaries.

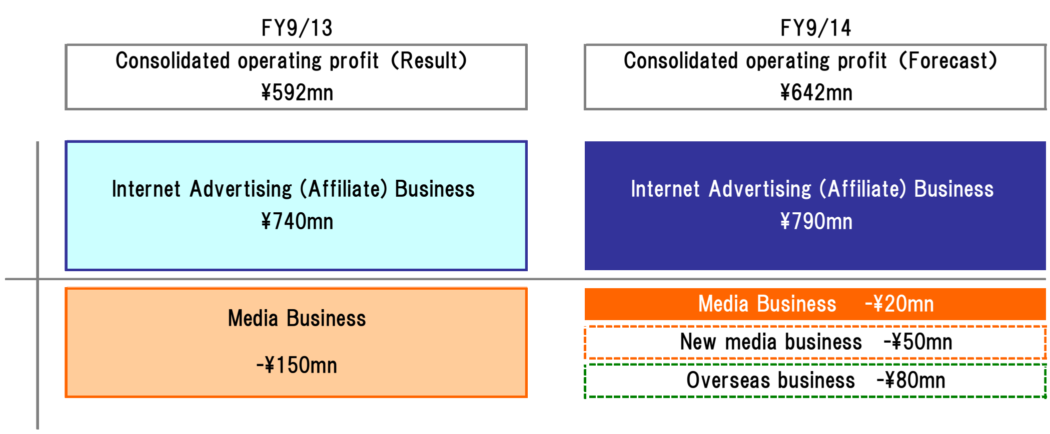
Company Forecasts for FY9/14 (¥mn)

	FY9/13		FY9/14		
	Result	Ratio	Target	Ratio	YOY
Sales	15,182	-	16,500	-	8.7%
Cost of goods sold	12,331	81.2%	-	-	-
SG&A expenses	2,258	14.9%	-	-	-
Operating profit	592	3.9%	642	3.9%	8.5%
Recurring profit	597	3.9%	639	3.9%	7.1%
Net profit	197	1.3%	319	1.9%	61.7%

The Internet Advertising (Affiliate) Business will continue to reinforce affiliate sales and carry out new product development of SFA. The Media Business will strengthen its branding of mamastadium and take steps to develop new vertical media (domain-specific media focused on particular themes). The company’s policy concerning social apps is to roll out dating simulation games (native apps, provide games that run on other company’s platforms, etc.) and increase profitability by reducing the development time for each game title. Further, the company will get local sales activities into full swing in Indonesia and Thailand, markets that it has recently entered.

Based on the above, the forecast for operating profit by business is ¥790mn in the Internet Advertising (Affiliate) Business, a ¥50mn increase, and a reduction of its loss to ¥20mn in the Media Business. On the other hand, as new media development costs and startup costs for overseas business are expected to increase by ¥50mn and ¥80mn, respectively, total operating profit should increase by 8.5% to ¥642mn.

Result forecast summary (Operating profit)



Business Strategy

Capital and business alliance with US company and others provides foothold in new service

(1) Internet Advertising (Affiliate) Business

The Internet Advertising (Affiliate) Business, in FY9/12 Interspace got a later start than its competitors in offering services for smartphones and tackling social networking services such as LINE. As a result, the company reorganized its business in October to again strengthen its affiliate business. In the past, the business was divided by customer category, but from now it will be structured around three businesses: the Affiliate Business Division, Smartphone Business Division, and Storefront Business Division. The company's strategy is to continue strengthening its business in each of these fields.

To strengthen its affiliate business for smartphones, Interspace released "RocketStart", a new app pre-registration service in September 2013. With native content increasing, RocketStart enables users who are highly interested in learning about and have a strong desire to play the latest apps and games to obtain them before they are released.

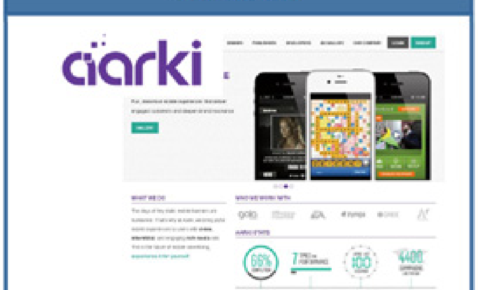
In October, Interspace formed a capital and business alliance with U.S.-based Aarki, a company that is operating rich media advertising (ads that incorporate video and animation) for smartphones globally. By fusing Aarki's rich media advertising technology with Interspace's affiliate service platform ACCESS TRADE, Interspace seeks to expand sales by providing highly effective advertising, including video advertising for affiliates and ads that have a game-like feel.

With SFA, the company is developing channels outside those of traditional mobile phone stores. Its first step in this direction was a capital and business alliance with moggy, Inc. an O2O marketing solution provider, which was announced in November. Moggy is a company that provides a next-generation electronic coupon platform called "moggy". Moggy is a system wherein smartphones loaded with the moggy app can generate digital tickets and coupons whose stubs can be torn off, which enables ticket issuing companies to manage ticket use (i.e., who used what ticket and when it was used). Because tickets are managed by the terminal ID code of each smartphone, they cannot be transferred or resold to others.

Further, because it can process big data, this is one electronic coupon system attracting interest that is expected to spread and grow. Interspace plans to expand and upgrade its SFA service and develop sales channels outside of mobile phone shops as a result of its alliance with moggy. It also plans to jointly develop a new affiliate service that works in conjunction with coupons.

New capital/business alliances

Aarki, Inc	Moggy, Inc.



Source: Company

■Business Strategy

Focus on Developing New Media to Come Next After mamastadium

(2) Media Business

The Media Business will continue to increase the number of unique users (UUs) and page views (PVs) of mamastadium per month, thereby further raising this medium’s value and increasing advertising revenue. It is also developing new vertical media (domain-specific media focused on particular themes). Interspace wants to invest in new media domains with a view to recovering the investment in two or three years.

Its strategy for social apps is to reduce the time it takes to develop dating simulation games designed for women and to improve profitability while lowering the break-even point for each game. The lifecycle per game title will continue to get shorter, so the company will continue to pump out one to two new titles each quarter. Further, as it seeks to become profitable as quickly as possible, its strategy is to strengthen development of native apps that are platform independent.

Overseas Business Moves into Full Swing in Indonesia and Thailand

(3) Overseas Expansion

In overseas business, after establishing a subsidiary in China in 2012, Interspace established one in Indonesia in July 2013 and another in Thailand in October. These subsidiaries provide the entire spectrum of Web services with a focus on Internet advertising. In Indonesia and Thailand, the Internet has entered a period of rapid diffusion, and the mobile Internet market centered on smartphones in particular is swiftly expanding.

In Indonesia, the number of Internet users is expected to increase from 70 million in 2012 to over 100 million in 2016. At present, the rate of use of social games and e-commerce has risen. In September, Interspace began providing ACCESS TRADE, an affiliate service for overseas markets and is now at the stage of developing a sales network including advertisers and affiliate sites. Further, with e-commerce spreading locally, Interspace plans to offer an online comparison shopping site.

In November, it began offering ACCESS TRADE in Thailand. In Thailand, the Internet market is expanding while credit card demand is rising. The e-commerce market is growing rapidly and it is believed that there is still much room for others to get into affiliate site services. In Thailand and Indonesia, even though the affiliate advertising market has still not gotten off the ground, companies are becoming more confident of the investment benefits of advertising, and the basis for acceptance of pay-per-click affiliate services has been established.

In the Chinese market, Interspace is in the sales development phase with a focus on smartphone advertising, but this has still not lead to sales. A change of strategy might be considered if the company shows no results for the next six months to one year. Further, the company has set the goal of making overseas sales 20% of Group sales in three years. To that end, M&A is considered an effective option.

Comparison with Industry Peers

Aiming for higher profitability through sales channel expansion and new business development

(1) Internet Advertising (Affiliate) Business

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). These five companies, including Interspace, appear to control nearly 60% of the industry market share.

Looking at the features of each company, F@N Communications is the largest industry player with about 1.8 million affiliate sites. It has been engaged for many years in the advertising business for SMEs and its dependence on e-commerce is relatively high. Adways is highly dependent on the mobile Internet 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), has an overwhelmingly high percentage of the PC advertising business and is strong in e-commerce. Alongside F@N Communications, it remains highly profitable.

The reason that Interspace has a lower profit margin than the above three listed companies is due to losses in its Media Business and the large staff that it fields to develop affiliate sites and advertisers, giving it high fixed costs. Interspace places a premium on its relations with customers and tries to maintain and improve the quality of its customer service by verifying the effectiveness of its advertising and proposing improvements. By expanding its sales channels and developing new services, Interspace seeks to expand the scale of its business and raise profitability as a strategy for closing the gap with its top ranked competitors.

Peer Comparison (¥mn)

	FY	Sales	y-o-y	Recurring profit	y-o-y	RP margin	PER
Interspace Co., Ltd.	FY9/13	15,182	22.7%	597	7.5%	3.9%	
<2122>	FY9/14E	16,500	8.7%	639	7.1%	3.9%	27.9
F@N Communications, Inc.	FY12/12	14,482	36.7%	2,304	28.8%	15.9%	
<2461>	FY12/13E	20,300	40.2%	3,480	51.0%	17.1%	58.9
Adways Inc.	FY3/13	22,639	26.0%	429	-67.8%	1.9%	
<2489>	FY3/14E	29,500	30.3%	550	28.0%	1.9%	240.3
ValueCommerce Co., Ltd	FY12/12	9,507	22.1%	1,057	27.1%	11.1%	
<2491>	FY12/13E	11,700	23.1%	1,530	44.7%	13.1%	46.3

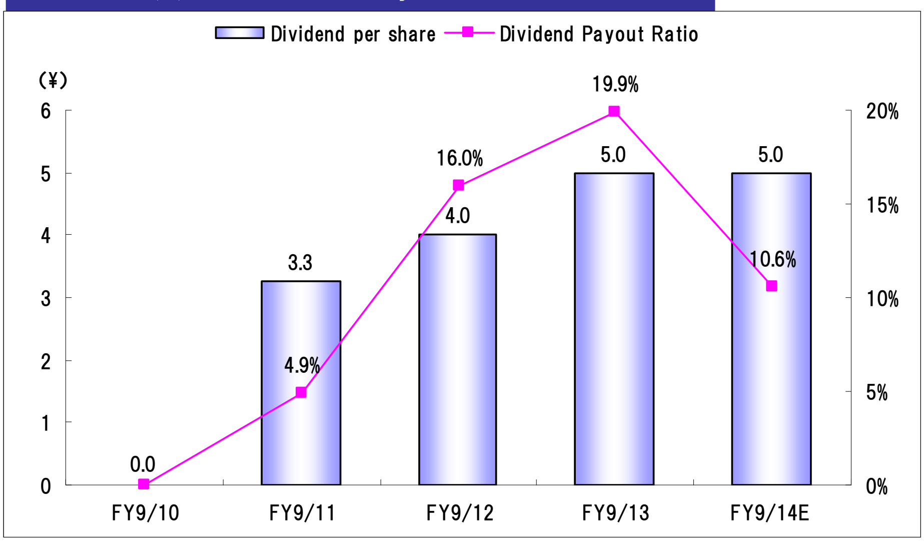
Forward PER is calculated based on the closing price on December 17

■Policy of Returning Profits to Shareholders

Sufficient dividend reserves, could increase dividend depending on performance and capital needs

As Interspace has not established a particular dividend payout standard, it determines it by taking comprehensively into account earnings trends, capital needs and its internal reserves for future business expansion. After it first started paying dividends in FY9/11, its dividend has increased for three consecutive fiscal years, showing its forward-looking approach on the return of profits to shareholders. The company's cash and deposits amount to more than ¥2,000mn, giving it sufficient dividend reserves. Interspace expects to pay a dividend of ¥5.0 in FY9/14, the same as in FY9/13. However, as long as earnings are favorable and it does not generate any capital needs, such as for M&As, its dividend could increase, in our view.

Dividend (¥) and Dividend Payout Ratio



Note: On April 1, 2013, the company implemented a stock split at a ratio of 200 shares to one. FY9/11 and FY9/12 dividends list dividend amounts in the case of retroactive revisions that take into account the effect of this stock split.

Consolidated Income Statement (¥mn)

	FY9/10	FY9/11	FY9/12	FY9/13	FY9/14E
Sales	7,806	9,462	12,375	15,182	16,500
y-o-y	1.3	21.2	30.8	22.7	8.7
Cost of goods sold	6,034	7,312	9,805	12,331	-
Sales ratio	77.3	77.3	79.2	81.2	-
SG&A expenses	1,561	1,787	2,008	2,258	-
Sales ratio	20.0	18.9	16.2	14.9	-
Operating profit	209	362	561	592	642
y-o-y	30.8	72.7	55.0	5.4	8.5
Sales ratio	2.7	3.8	4.5	3.9	3.9
Recurring profit	216	372	555	597	639
y-o-y	33.5	72.1	49.2	7.5	7.1
Sales ratio	2.8	3.9	4.5	3.9	3.9
Extraordinary profits	1	0	2	0	-
Extraordinary losses	1	90	63	75	-
Pretax profit	215	282	494	522	-
y-o-y	-	31.0	74.8	5.5	-
Sales ratio	2.8	3.0	4.0	3.4	-
Corporate taxes	150	-151	349	329	-
Effective tax rate	69.9	-53.5	70.7	63.2	-
Net profit	65	435	166	197	319
y-o-y	-	569.4	-61.7	18.2	61.7
Sales ratio	0.8	4.6	1.3	1.3	1.9
Number of shares outstanding (thousand)	6,680	6,770	6,892	6,934	-
EPS (¥)	10.04	66.84	24.98	29.29	47.26
DPS (¥)	0.00	3.25	4.00	5.00	5.00
BPS (¥)	253.89	318.04	335.34	360.24	-
Dividend payout ratio	0.0%	4.9%	16.0%	19.9%	10.6%
ROE (%)	4.0%	23.3%	7.7%	8.4%	-

Note: On April 1, 2013, the company implemented a stock split at a ratio of 200 shares to one. Per-share data prior to FY9/12 lists figures in the case of retroactive revisions that take into account the effect of this stock split.