Interspace
2122 TSE Mothers

31-Jul.-15

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FISCO Ltd. Analyst
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Reducing unprofitable social media, earnings to recover from the second half

Interspace <2122> operates in the Internet Advertising (Affiliate) and Media businesses with a focus on affiliate advertising. In addition, the company has launched affiliate service businesses in Southeast Asian countries such as Indonesia, Thailand and Vietnam, and plans to continue to focus on its overseas business in the future.

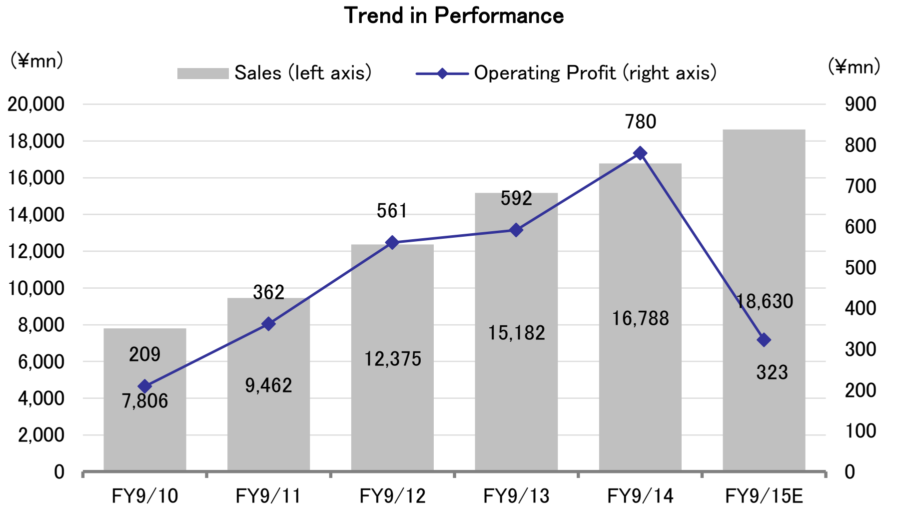
The consolidated results for H1 FY9/15 (October 2014 - March 2015) are strong, showing a sales increase of 15.6% year-on-year and sales of ¥9,106mn due to expansion of the Internet Advertising (Affiliate) Business. However, due to HR cost increases, startup costs for international operations and poor performance in the social media app business, operating profit fell by 75.2% to ¥111mn.

Full-year results for FY9/15 are expected to show a y-o-y increase in sales of 11.0% to ¥18,630mn, and operating profit is expected to fall by 58.5% to ¥323mn. In the Internet Advertising (Affiliate) Business, in addition to the expansion of affiliate advertising, profit margins will improve through strengthening and expanding service sales and cross-selling. In addition, in the Media Business, the company's policy is to reduce the unprofitable social media business, reducing staff by 30 people, corresponding to about half of the employees, in order to improve profitability by streamlining the business.

The company has set the targets of sales of ¥25,000mn and operating profit of ¥1,500mn in its mid-term plan. In the domestic Internet Advertising (Affiliate) Business, in addition to the expansion of affiliate advertising, double-digit annual growth is expected through the development of new services such as native advertising. On the other hand, in the Media Business, in addition to the development of new media following the information site for moms, "mamastadium", the company will proceed to turn around the business by strategically transforming the game development business.

Check Point

- More than 400,000 affiliate partners, strong in finance and insurance sectors
- Achieve operating profit of ¥1.5bn in 3-4 years
- Human resources investment as a source of differentiation

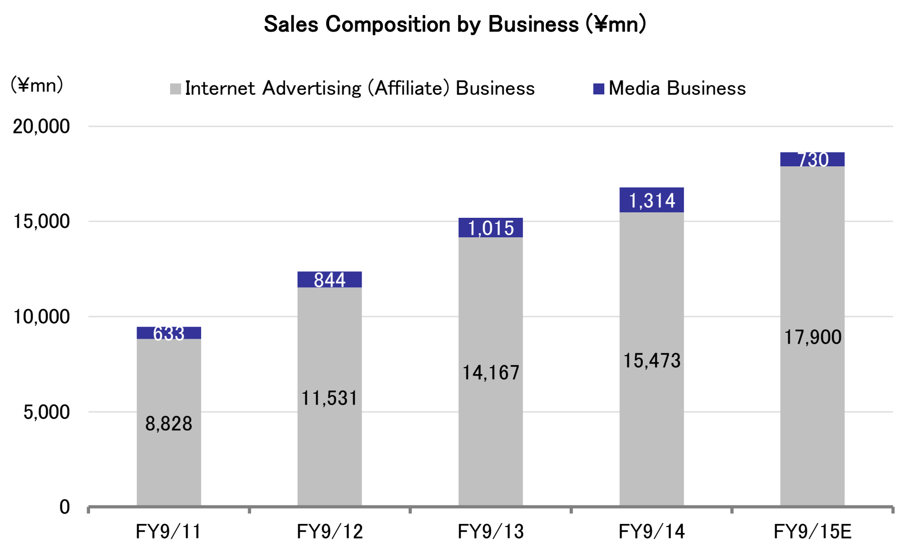


Business Description

Leverage profits from Internet Advertising to nurture the Media Business

The company's businesses are divided into the Internet Advertising (Affiliate) Business, focusing on affiliate advertising, and the Media Business. Looking at recent sales and operating profit, over 90% of total sales were accounted for by the Internet Advertising (Affiliate) Business. In addition, operating profit earned by the Internet Advertising (Affiliate) Business is able to continuously absorb Media Business losses.

The Interspace Group consists of seven subsidiaries: more games Co., Ltd. (which operates a social media apps business) is the main subsidiary, with 2 further advertising business related domestic subsidiaries, Dennou Koukokusha and Ciagram Co., Ltd. Overseas, the company has Internet advertising subsidiaries in China, Indonesia and Thailand, and in April 2015 it established a JV with a local partner in Vietnam (49% share).



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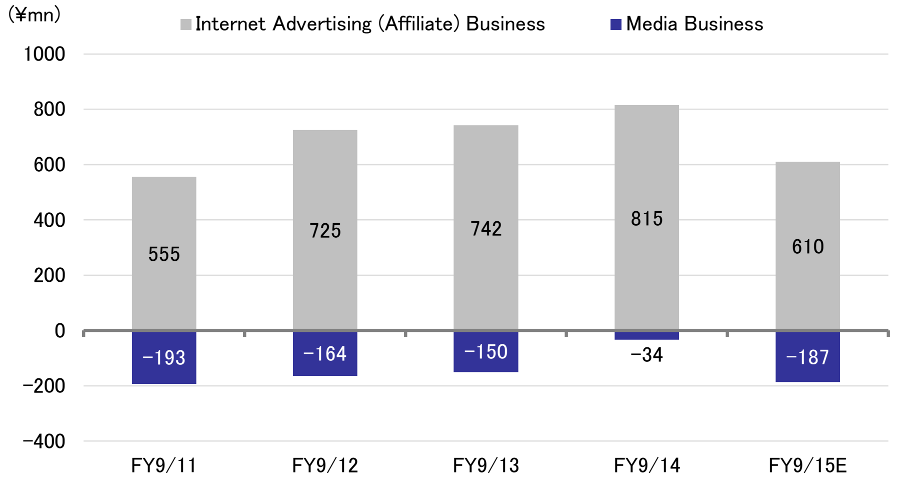
Operating Profit by Business (¥mn)



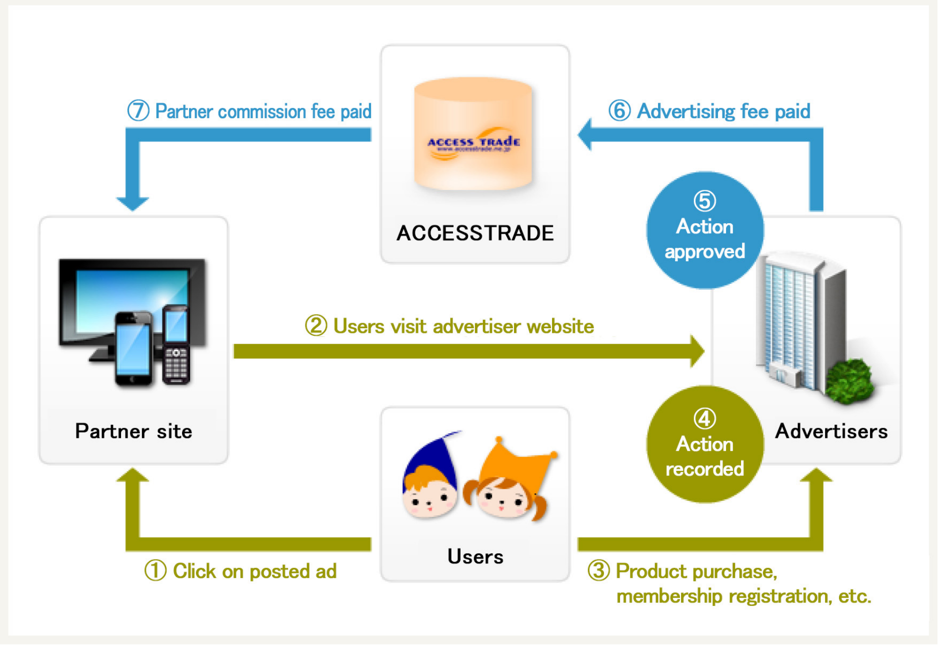
More than 400,000 affiliate partners, strong in finance and insurance sectors

(1) Internet Advertising (Affiliate) Business

The company's Internet Advertising (Affiliate) Business is mainly engaged in affiliate advertising, and in addition to offering SEO*1, listing advertisements, and DSP*2 advertisements, recently started offering native advertising*3. 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 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 advertisers and website operators. 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.

Affiliate Advertising



Source: Company document

*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.

*3 Native advertising: An advertising method used in curation sites such as those that collate news or social media sites whereby the ad is naturally (natively) incorporated into the frame of the article such that the reader receives the message without feeling resistance.

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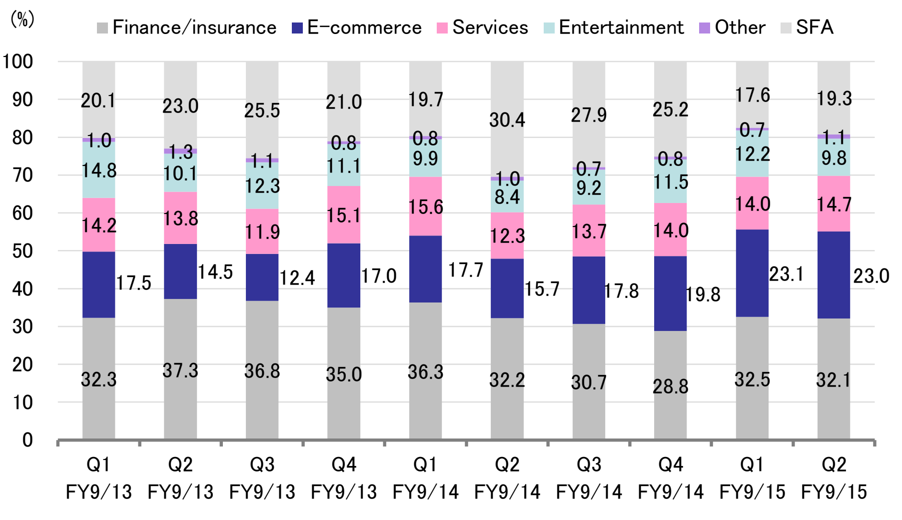
Affiliate programs are easy-to-use tools provided by companies that enable operators to place advertisements on their own websites. The company developed “ACCESSTRADE" in 2001 and it has been used in more than 400,000 partner sites as of the end of March 2015.

As shown in the graph, the company’s sales by industry for Q2 FY9/15 (January to March 2015) show finance/ insurance leading at 30%+, with e-commerce next at 20%+ - these two industries comprise over half of sales. The next largest industry is SFA (Store Front Affiliates) with around 20%.

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’s services form an industry leading network with about 11,000 stores contracted. It should be noted that SFA sales are closely correlated with sales trends of mobile phones.

Sales Mix by Affiliate Advertising Industry

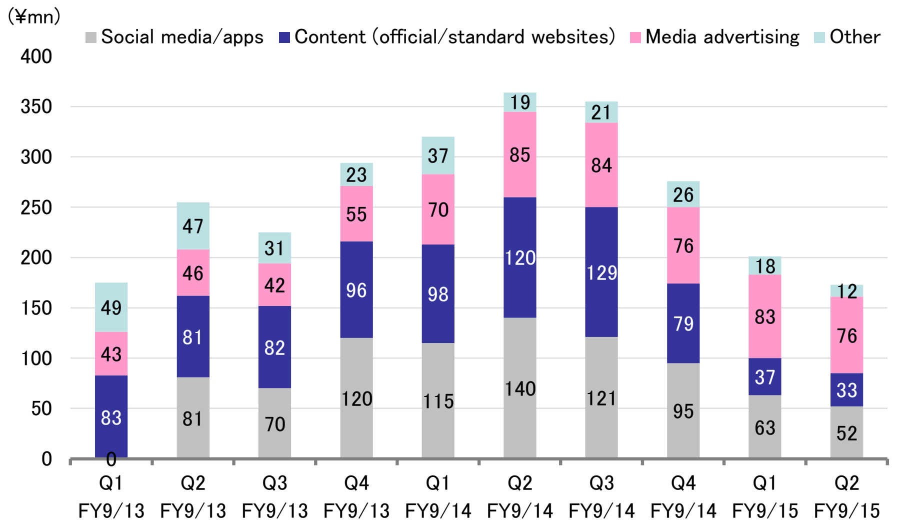


Expanding operation of mamamedia, its own media for moms and developing native apps

(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 and native apps.

Media Business Sales by Service



Earnings Trends

HR increases and poor performance in social games led to poor performance in Q2

(1) Results for H1 FY9/15

The first half consolidated results of FY9/15 (October 2014 - March 2015) announced on May 12 showed sales of ¥9,106mn, an increase of 15.6% y-o-y, operating profit of ¥111mn, down 75.2%, recurring profit of ¥117mn, down 74.0%, and first-half net profit of ¥1mn, down 99.2%.

From the start of the period the company expected a decline in profits due mainly to increased HR costs associated with the increase of personnel, advertising expenses, and increase in development costs. However, due to payments to partners rising more than expected in the Internet Advertising (Affiliate) Business, and revenue in the Media Business from new social games deteriorating the company faced a downturn. The drop in first-half net profit appears larger because the company does not adopt the consolidated tax return system, and deficits at subsidiaries have affected the result.

H1 FY9/15 Consolidated Results

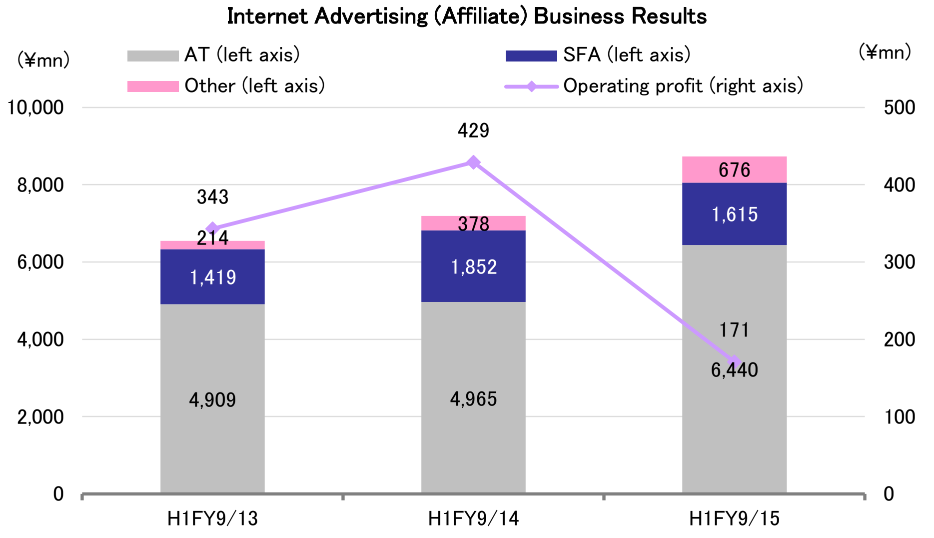
(Unit: ¥mn)

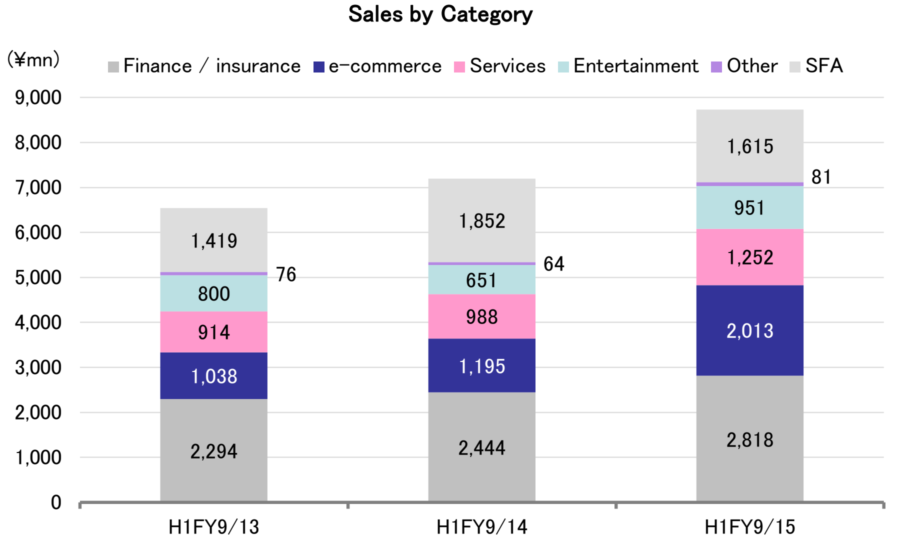
	H1 FY9/14		H1 FY9/15				
	Result	Ratio	Initial target	Result	Ratio	y-o-y	Change from the target
Sales	7,879	-	8,949	9,106	-	15.6%	1.8%
Cost of sales	6,242	79.2%	-	7,567	83.1%	21.2%	-
SG&A expenses	1,186	15.1%	-	1,427	15.7%	20.3%	-
Operating profit	449	5.7%	219	111	1.2%	-75.2%	-49.3%
Recurring profit	450	5.7%	216	117	1.3%	-74.0%	-45.8%
Extraordinary gain/loss	-2	-	-	-6	-	-	-
Net profit	254	3.2%	63	1	0.0%	-99.2%	-98.4%

(2) Internet Advertising (Affiliate) Business

In the Internet Advertising (Affiliate) Business, sales increased by 21.3% y-o-y to ¥8,731mn and operating profit fell by 60.0% to ¥171mn. Regarding sales, although SFA fell due to sluggish mobile phone sales, the trend in the company's main area of affiliate services was positive, focused on finance and e-commerce. In particular, in e-commerce for health food, cosmetics and fashion, sales grew significantly by 60% compared to the previous period. Other advertising services also showed a positive trend due to affiliate service cross-selling and the start of native advertising.

On the other hand, the fall in operating profit was caused by increased HR and hiring costs due to the strengthening of personnel (domestic +19 people, overseas +22 people), and partner pay-per-click payments increasing more than expected. In the current fiscal year, in order to scale-up its affiliate services, the company increased its share of media publishing, focused on the financial sector. However, the company suffered due to its slow response to the increased pay-per-click payments to leading financial partner sites. In addition, from the second half of FY9/14, the overseas businesses, currently in the start-up phase, were added to the scope of consolidation, which caused an operating loss of ¥40mn.





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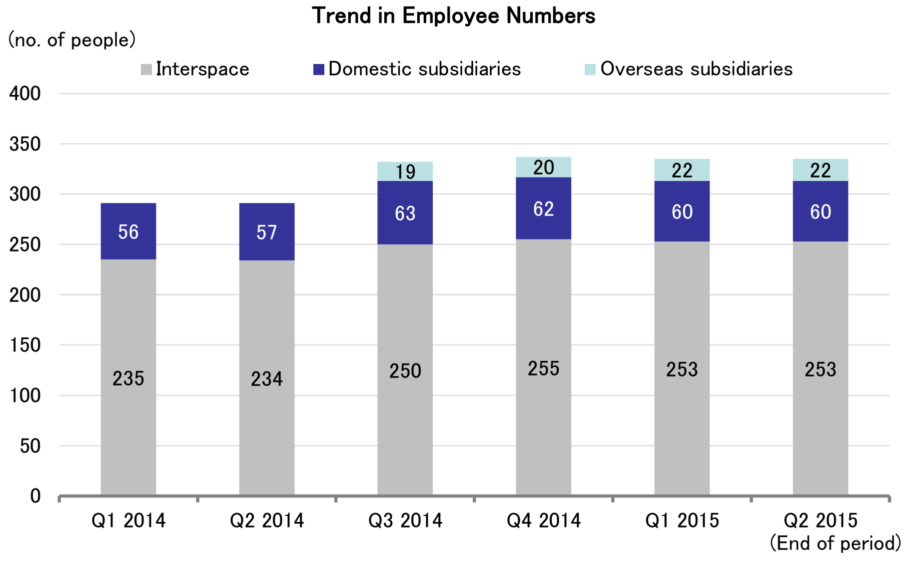
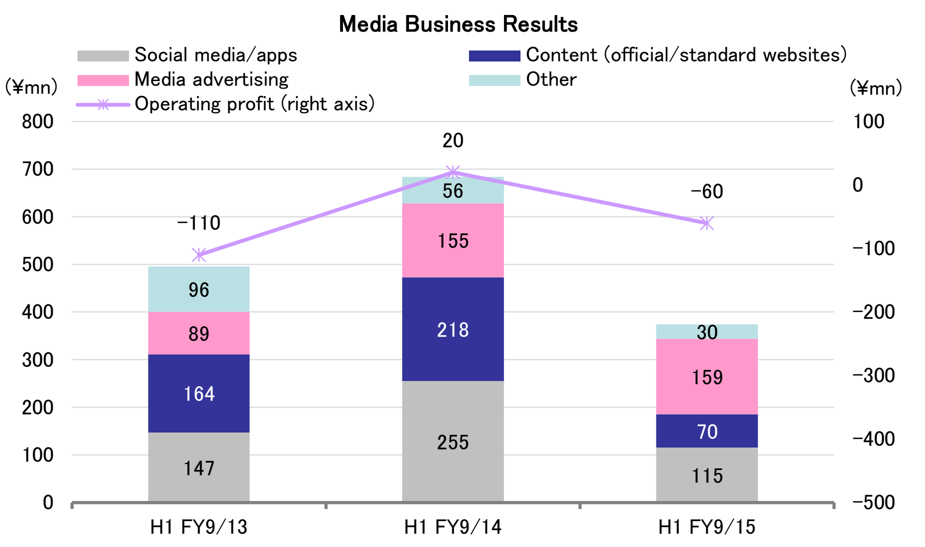


○ **Media Business**

In the Media Business, sales decreased by 45.1% y-o-y to ¥375mn and operating loss was ¥60mn (the previous year showed a ¥20mn operating profit). Looking at the breakdown of sales, although media advertising income, focused on "mamastadium", was firm with increased users, in the social media apps business a new social game introduced in December 2014 performed poorly and official content for "au SmartPass" lowered, leading to a decline in income.

In response to the earnings deterioration of the social media apps business, the company announced in May rationalization measures in order to improve profitability of this business. The company decided to move 30 people, about half of the staff, from its subsidiary more games to other companies, and to basically withdraw from the development of social games. Regarding the development of official content and native apps for communication carriers, the company will continue since development costs are low. The effect of reducing personnel is about ¥10mn per month.



Financials continue in a healthy state

(3) Financial standing and management indicators

Looking at the financial situation as of end of March 2015, total assets were ¥5,763mn, an increase of ¥168mn versus the previous fiscal year-end. The main factors were increases in trade receivables of ¥278mn and in fixed assets of ¥212 mn and a decrease in cash and deposits of ¥327mn due to payments such as taxes.

On the other hand, liabilities increased by ¥200mn to ¥2,960mn versus the end of the previous fiscal year. Accounts payable -trade increased by ¥352mn and unpaid corporation tax fell by ¥123mn. In addition, net assets fell by ¥29mn to ¥2,717mn versus the end of the previous fiscal year. A decrease in retained earnings due to the payment of dividends was the main cause.

Looking at safety management indicators, as net assets decreased slightly, the equity ratio reduced from 49.1% to 47.1%. Since cash and deposits accounted for just under 40% of total assets at ¥2,143mn, and there is also virtually no debt, the financial situation is deemed to have remained in a healthy condition.

Balance Sheet (Consolidated)

(Unit: ¥mn)

	FY9/13	FY9/14	Q2 FY9/15	Change
Current assets	4,098	4,670	4,626	-44
(Cash and deposits)	2,387	2,471	2,143	-328
Fixed assets	810	924	1,137	213
Total assets	4,908	5,595	5,763	168
Current liabilities	2,371	2,759	2,960	201
Fixed liabilities	104	88	85	-3
(Interest-bearing debt)	86	58	44	-14
Total liabilities	2,476	2,847	3,046	199
Net assets	2,431	2,747	2,717	-30
Main management indicators				
(Safety indices)				
Current ratio	172.8%	169.3%	156.3%	
Equity ratio	49.5%	49.1%	47.1%	
Interest-bearing debt ratio	3.5%	2.1%	1.6%	

Future Outlook

Forecast to turn around results from Q2

(1) Company forecast for FY9/15

At the same time as the earnings announcement for Q2 FY9/15 (January - March 2015), the company also modified the full-year earnings outlook. The forecast was revised down from the initial plan to sales of ¥18,630mn, an 11.0% y-o-y increase, operating profit of ¥323mn, down 58.5% y-o-y, recurring profit of ¥340mn, down 57.0% y-o-y and net profit of ¥69mn, down 82.1%. However, the company forecast that the first half of this fiscal year will be the bottom and there will be a recovery in the second half.

FY9/15 Consolidated Results Forecast

(Unit: ¥mn)

	FY9/14		FY9/15				
	Full FY	Ratio	Initial target	Revised target	Ratio	y-o-y	Versus initial target
Sales	16,788	100.0%	19,000	18,630	100.0%	11.0%	-1.9%
Operating profit	780	4.7%	660	323	1.7%	-58.5%	-51.5%
Recurring profit	790	4.7%	654	340	1.8%	-57.0%	-48.0%
Net profit	386	2.3%	284	69	0.4%	-82.1%	-75.7%

Sales, Profit by Segment

(Unit: ¥:mn)

	FY9/12	FY9/13	FY9/14	FY9/15E	Growth
Sales by segment					
Internet Advertising (Affiliate) Business	11,531	14,167	15,473	17,900	15.7%
Media Business	844	1,015	1,314	730	-44.4%
Total	12,375	15,182	16,788	18,630	11.0%
Profit by segment					
Internet Advertising (Affiliate) Business	725	742	815	610	-25.2%
Domestic business	-	742	855	690	-19.3%
Overseas business	-	-	-40	-80	-
Media Business	-164	-150	-34	-180	-
Total	561	592	780	323	-58.5%

(2) Forecast by business segment

○ Internet Advertising (Affiliate) Business

Internet Advertising (Affiliate) Business sales are forecast to increase 15.7% y-o-y to ¥17,900mn and operating profit to fall 25.2% to ¥610mn. Within this, the overseas business, on the assumption that the loss in the second half continues at the same level as that in the first half, is forecast to show an operating loss of ¥80mn for the full year. In the domestic business, alongside an increase in sales, the operating profit margin is forecast to recover from the 2% range in the first half to the 4% range in the second half.

Although the average profit margin for the period ending March 2014 remained low at 5-6%, given that in the current fiscal year the company is actively engaged in investment in human resources and that pay-per-click payments to partner sites have increased, it can be said that this is a reasonable level. It should be noted that the company added 22 new employees in April.

In order to achieve the full-year targets in addition to further strengthening sales in the successful e-commerce and service industries for the company's flagship affiliate services, we forecast a recovery in revenue as a result of further strengthening of cross-selling through the expansion of service sales. Also, in order to raise capacity utilization in stores with respect to SFA, the company will take steps to increase the unit price for adverts, strengthen training systems, and continue to engage in channel development of new genres.

In addition, native advertising is one example of a new advertising service that can expect future growth. This service will see expanding demand mainly from media such as curation sites and social media, and because it can deliver advertisements to a specific target it is attracting attention as a highly cost-effective advertising service. The company has been working on native advertising since the March 2014 period, and in FY9/15 sales have grown to about ¥100mn on a quarterly basis. The number of customers has also increased, focused on the ecommerce field.

In order to accelerate the growth of native advertising the company is developing its own advertising media at the same time, and plans to release this within FY9/15. Since the target is expected to be curation sites and photo-based sites, the company can categorize users to some extent, and the media will be able to create databases. In addition to increasing native advertising revenue by expanding the number of UUs [*1] while also actively connecting with other companies' sites, the company also plans to strengthen sales of targeted advertising by combining with recommendation engines [*2]. We forecast native advertising revenue to rapidly expand in FY9/16 to more than double FY9/15 at over ¥800mn.

*1 Abbreviation of Unique User. Number of people who visit a particular website or website page.

*2 A system that automatically recommends products to users.

○ Media Business

Media Business sales are forecast to be ¥730mn, down y-o-y by 44.4%, operating loss is forecast to be ¥180mn (in FY9/14 a loss of ¥34mn). As described above, this will be due to reduction in social games and low sales of official content.

For the media advertising business, the monthly number of UUs at "mamastadium" for April was 2.8 million, and continued to expand to 3 million in May, but the growth rate is slowing. For this reason the company' policy is to introduce high-quality new content and events in order to expand the number of UUs. In addition, the company has also embarked on the development of new media.

As described above, with respect to the game development business, the company is reducing the business and personnel for social media apps, and from the second half it will take steps to develop native apps and expand official content sales to other major telecommunications carriers besides "au". In the second half the deficit is expected to remain, but we forecast that through these measures the company will return to profitability in FY9/16.

(3) Overseas business

The overseas business is still at the start-up stage for affiliate services; the company is currently raising awareness among advertisers and taking steps to develop partner sites.

In Indonesia the company has a business alliance with PT. Agranet Multicitra Siberkom, which operates the leading local portal site "detik.com", and in addition to providing the company's affiliate service, the company is providing affiliate advertising on the price comparison site "StarPrice" operated by its subsidiary. Currently, monthly sales have increased to just under ¥1mn, and if all goes well we expect a monthly surplus within FY9/16. On the other hand, in Thailand the company is still making efforts to raise awareness of affiliate services for the future. Its local subsidiary operates a financial portal site "Moneyhub" and is working to acquire affiliate customers.

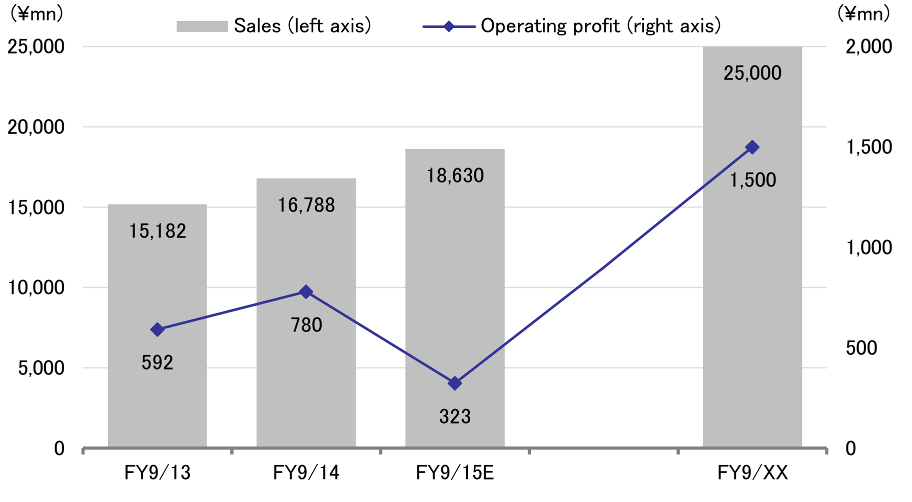
In addition, in April 2015 the company established a joint venture with MWORK Corporation which provides one of the largest advertising networks in Vietnam (Share 49%). MWORK offers the affiliate network "mwork" for mobile use which is currently used by over 58,000 people. Currently billing and settlement services for smartphone games are the main source of income. In the joint venture, the company will provide its affiliate system “ACCESSTRADE” to MWORK’s network. By fusing the company’s know-how in advertising for a variety of industries and MWORK’s network, the company will further expand the Vietnam affiliate advertising market, and aim to become the largest affiliate service provider in the country.

Achieve operating profit of ¥1.5bn in 3-4 years

(4) Medium-term business plan

The company’s medium-term business target is consolidated sales of ¥25bn and operating profit of ¥1.5bn. We believe that if the company continues its current growth it will achieve this in 3-4 years.

Medium-term Plan Targets



The driving force of the company’s revenue is the domestic Internet Advertising (Affiliate) Business, and in addition to increasing its market share in affiliate services by strengthening sales, the company will expand its business by strengthening new services such as native advertising and video advertising. In addition, in the Media Business, as well as "mamastadium", the company aims to establish new media while building a stable earnings structure.

For the overseas business, the company is aiming to establish a No. 1 market share in affiliate services in each country, and the company has the immediate goal of achieving a surplus within three years. In the medium to long term we expect the businesses to become a driving force of the company's revenue.

Comparison with Industry Peers and Policy of Returning Profits to Shareholders

Human resources investment as a source of differentiation

(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>. Their sales are around ¥10bn to ¥40bn. These five companies, including Interspace, 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 2 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 about 50% dependent on the mobile Internet (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>, makes an overwhelmingly high percentage of its sales from the PC advertising business at around 70% (on a project basis) 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 listed companies is that, in addition to the low profitability of the Media Business, the company has high staff levels for partner sites and advertiser development, even in the Internet Advertising (Affiliate) Business, so personnel expenses as a percentage of sales are relatively high.

In order to maintain and improve sales expansion and quality of service in FY9/15, the company actively engaged in human resources investment and this has become a negative factor for profit; however, in the medium term we believe that these human resource investments will become a plus for earnings.

Comparison with Industry Peers

	FY	Sales	y-o-y	Recurring profit	y-o-y	RP margin	EPS	DPS	PER
Interspace Co., Ltd. <2122>	FY9/14	16,788	10.6	790	32.3	4.7	57.18	8.0	-
	FY9/15E	18,630	11.0	340	-57.0	1.8	10.19	8.0	88.6
F@N Communications Inc. <2461>	FY12/14	31,990	40.8	5,948	44.2	18.6	47.14	15.0	-
	FY12/15E	38,700	21.0	7,170	20.5	18.5	59.45	17.0	17.7
Adways Inc. <2489>	FY3/15	35,890	13.9	1,197	42.4	3.3	16.81	3.36	66.2
	FY3/16E	Undisclosed							
ValueCommerce Co., Ltd. <2491>	FY12/14	13,373	11.3	1,647	8.3	12.3	28.86	11.0	-
	FY12/15E	15,900	18.9	1,590	-3.5	10.0	31.01	10.0	18.8

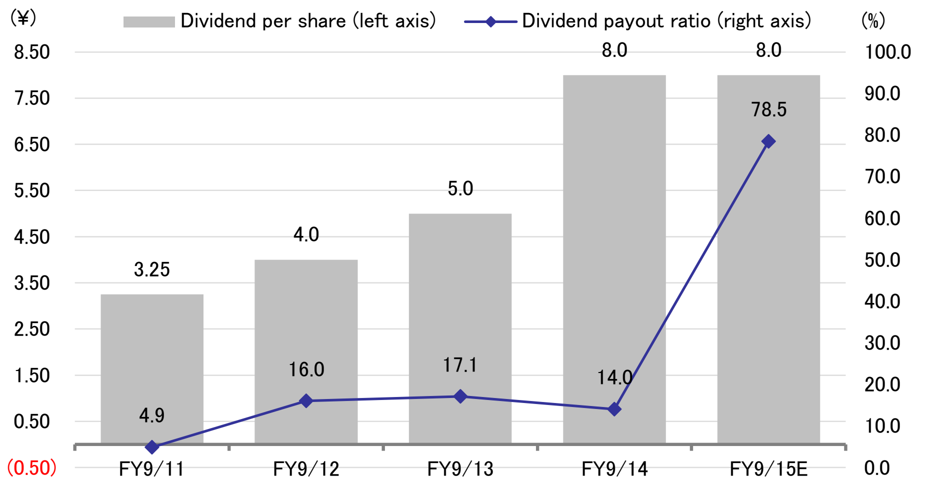
Forward PER is calculated based on the closing price on May 25. Adways is based on FY3/15 PER

Note measures directed at the First Section of the TSE

(2) Policy of returning profits to shareholders

The company determines dividends by taking into account factors such as earnings trends, financing needs and internal reserves for future business development in a comprehensive manner. The dividend payout ratio has been set as a guide at about 20%, and the dividend for FY9/15 is expected to be ¥8.00, on a par with FY9/14.

Dividend and Dividend Payout Ratio



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