Interspace Co., Ltd.

2122 TSE Mothers

10-Jan.-17

Important disclosures and disclaimers appear at the end of this document.

FISCO Ltd. Analyst
Yuzuru Sato

Aiming for further profit growth with enhanced development structure

Interspace Co., Ltd. <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 Company announced FY9/16 consolidated results on November 15 with ¥23,293mn in net sales (+16.1% y-o-y) and ¥900mn in operating profit (+158.4%), setting all-time highs. Sales in mainstay affiliate service were strong with a double-digit gain led by e-commerce and services categories. Another factor was the stability of profits from the Media Business owing to benefits from restructuring reforms implemented in the previous fiscal year. Other positive trends were a rapid pick-up of sales growth around the end of the period for the new service X-lift, a native ad network, though the scale is still small, and steady development of an earnings base in overseas business despite still being in the investment phase.

For FY9/17 consolidated results, the Company forecasts ¥25,585mn in net sales (+9.8% y-o-y) and ¥1,000mn in operating profit (+11.0%). It expects to continue higher sales and profits. By segment, the Company anticipates earnings on par with the previous fiscal year in Media Business and a rise in earnings in the Internet Advertising (Affiliate) Business. It factors in growth in affiliate services mainly driven by the e-commerce category and realization of single-month profit in the native ad network business. While it projects continuation of a modest loss in overseas business, the Company plans to start ad network service business at the Singapore subsidiary it established in FY9/16 and forecasts steady expansion of sales.

The Company has announced a plan to promote reinforcement of development structure with the prospect of longer-term growth. It is actively recruiting talented system engineers as mid-career hires and is actively investing in the development of new businesses that utilize cutting-edge technologies. These efforts aim to boost earnings and fuel stronger earnings growth. The ratio of engineers in the Company's overall employment is currently at 12-13%, and management hopes to raise this portion to around 30-40% in the future (it had 371 employees at the end of September 2016).

Check Point

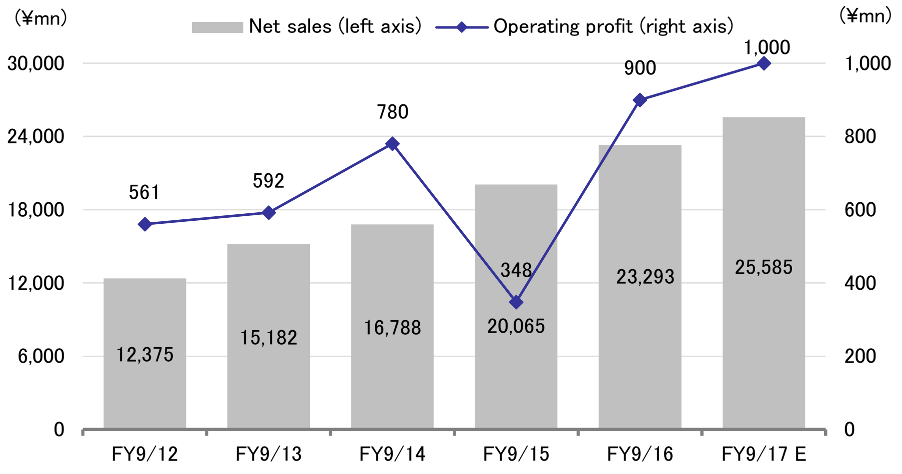
- Returned to profitability in the Media Business
- Net sales and profits climbed sharply in FY9/16, setting all-time highs
- Internet Advertising (Affiliate) Business likely to drive earnings growth again in FY9/17

FISCO

Interspace Co., Ltd.
2122 TSE Mothers

10-Jan.-17

Consolidated results trends

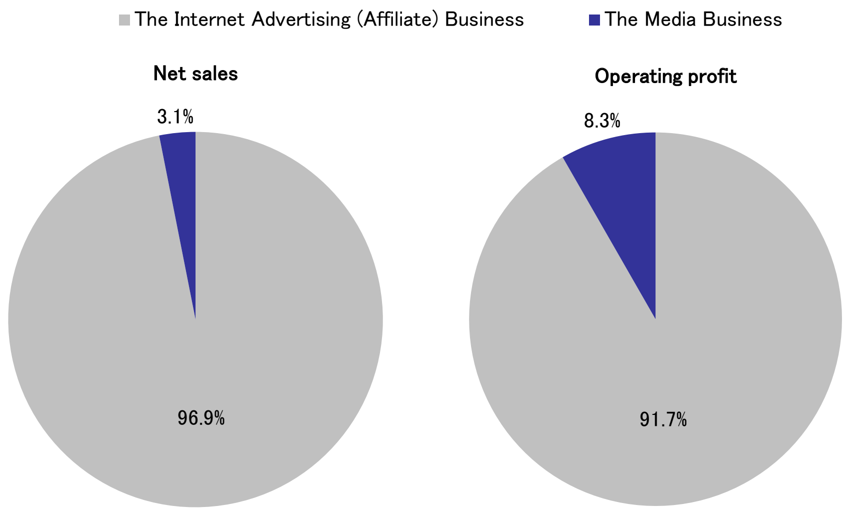


Business overview

Returned to profitability in the Media Business

The Company's businesses are divided into the Internet Advertising (Affiliate) Business, focusing on affiliate advertising, and the Media Business. Looking by business segment in FY9/16, Internet Advertising (Affiliate) Business provided 96.9% of net sales and 91.7% of operating profit as the core business. While the Media Business had been posting losses in recent years, the Company implemented structural reforms in the previous fiscal year, including the sale of an unprofitable game subsidiary, and has converted to a profitable business structure since FY9/16.

Results Composition by Segment



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 Indonesia, Thailand, and Singapore). 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 is developing an ad network service business targeting the client companies in various Southeast Asian countries.

FISCO

Interspace Co., Ltd.
2122 TSE Mothers

10-Jan.-17

*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.

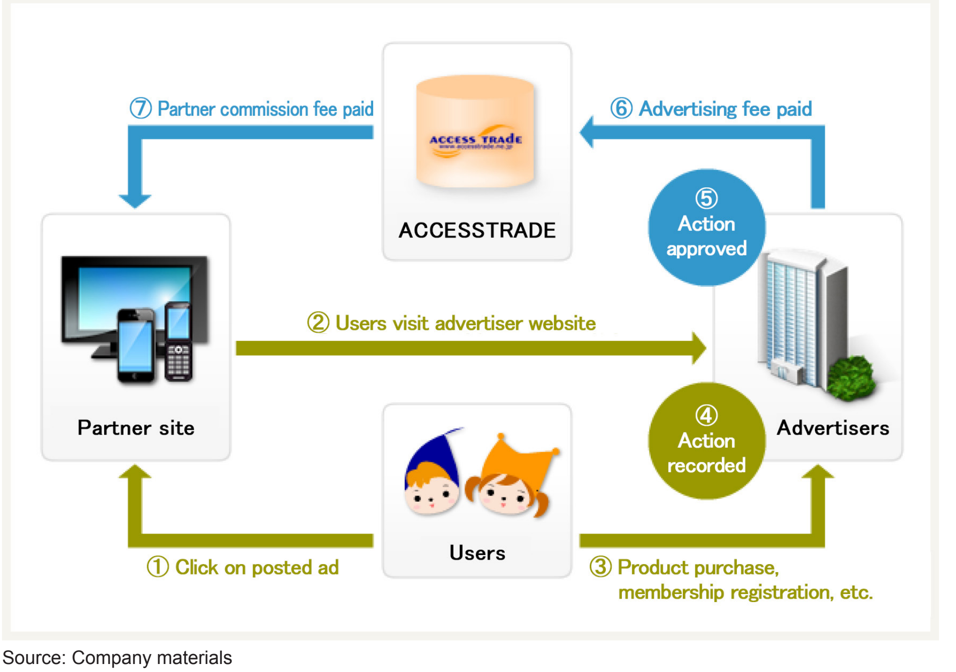
*2 Native advertising: an advertising method to deliver information that readers feel little resistance to by incorporating articles and other information in a natural (native) framework on websites that collect news and other information, such as curation websites and social media websites.

(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, DSP*1 advertising, and native advertising*2. With most of its sales coming from affiliate advertising, the Company has become a major player among the affiliate service providers. Rivals are F@N Communications, Inc. <2461>, the top industry firm, Adways Inc. <2489>, and ValueCommerce Co., Ltd. <2491>.

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.

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 September 2016, it was being used on approximately 480,000 partner sites and was handling around 17,000 advertising programs.

Also, one of the characteristics of the Company is that Store Front Affiliates (SFA) account for just below 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. Thus, SFA sales are closely correlated with the sales trends of mobile phones. 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. MTI Ltd. <9438> is the main rival.

(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 development and operation of smartphone game content, including for carriers. In game contents, the Company is refraining 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 and monthly fees as the main source of revenue. The scale of sales has become smaller in this business, but it incurs practically no development costs and constitutes a low-risk, low-return business model.

Results trends

Net sales and profits climbed sharply in FY9/16, setting all-time highs

(1) Review of FY9/16 consolidated results

The Company reported FY9/16 consolidated results with ¥23,293mn in net sales (+16.1% y-o-y), ¥900mn in operating profit (+158.4%), ¥901mn in recurring profit (+160.0%), and ¥542mn in net profit attributable to the owners of the parent company (+79.0%), surpassing the Company's target and posting all-time highs.

Key sources of the steep profit gains were robust momentum in Internet Advertising (Affiliate) Business led by affiliate services and the return to profitability in Media Business thanks to benefits from structural reforms implemented in the previous fiscal year. While profits temporarily slipped in FY9/15 because of significant personnel increase to bolster sales structure and recording of earnings structure reform costs for the Media Business, positive contributions from these measures appeared in FY9/16. Segment trends are reviewed below.

FY9/16 consolidated results

(¥mn)

	FY9/15		FY9/16				
	Result	% of sales	Company plan	Result	% of sales	y-o-y	vs. target
Net sales	20,065	100.0%	22,400	23,293	100.0%	16.1%	4.0%
Cost of sales	16,661	83.0%	-	19,132	82.1%	14.8%	-
SG&A expenses	3,055	15.2%	-	3,260	14.0%	6.7%	-
Operating profit	348	1.7%	800	900	3.9%	158.4%	12.6%
Recurring profit	346	1.7%	789	901	3.9%	160.0%	14.2%
Net profit attributable to the owners of the parent company	302	1.5%	436	542	2.3%	79.0%	24.3%

Note: Company plan reflects updated values from July 2016
Source: Prepared by FISCO from the Company's financial result summary

FISCO

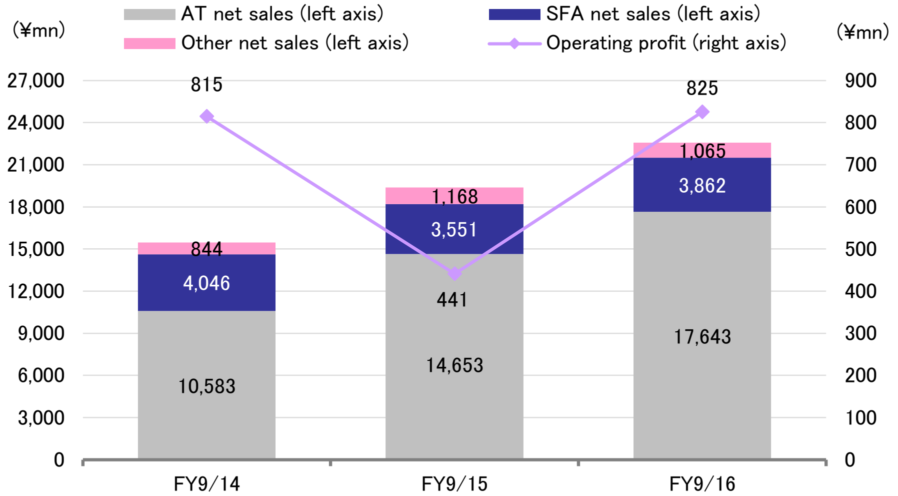
Interspace Co., Ltd.
2122 TSE Mothers

10-Jan.-17

○ **The Internet Advertising (Affiliate) Business**

In this business, net sales increased 16.5% y-o-y to ¥22,568mn and segment profit rose 87.2% to ¥825mn. In FY9/15, profits fell from the effects of the reduction in the gross profit margin owing to strategic partial hikes in partner commission fees, including in the finance category, and also due to higher personnel expenses. But in FY9/16, these effects had run their course, and so the higher sales translated directly into higher profits.

Internet Advertising (Affiliate) Business results trends

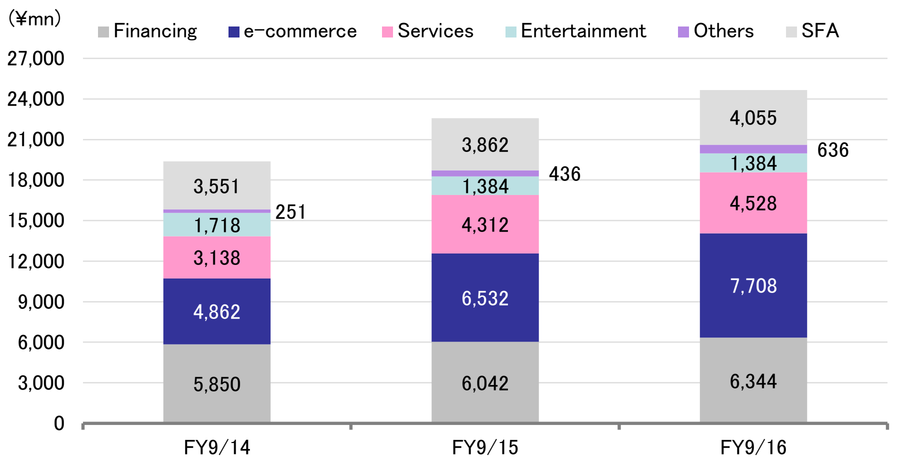


Source: Prepared by FISCO from the Company's results briefing materials

Affiliate advertising sales rose 20.4% to ¥17,643mn, SFA sales increased 8.8% to ¥3,862mn, and other sales (listing ads, ad network ads, and others) fell 8.8% to ¥1,065mn. Strong affiliate advertising business stood out.

Looking at the sales trend (y-o-y) by category, financing sales were solid at a 3% increase, mainly driven by credit and card loans, e-commerce sales rose 34%, primarily driven by health foods, home-delivered water, and other standalone commerce firms, and services sales were up 37% with strong gains in low-cost SIM and other communications services and HR and beauty related. Entertainment sales, meanwhile, fell 19% because of an ongoing market slump in its core PC online games.

Sales trends by advertising category



SFA sales climbed 8.8%, despite slowdown in mobile phone sales volume, thanks to initiatives to raises operating rates at existing sales sites and exploit sales sites in Hokkaido and other regional areas and increases in music, drama, weather forecasts, and other content as well as security packs.

FISCO

Interspace Co., Ltd.
2122 TSE Mothers

10-Jan.-17

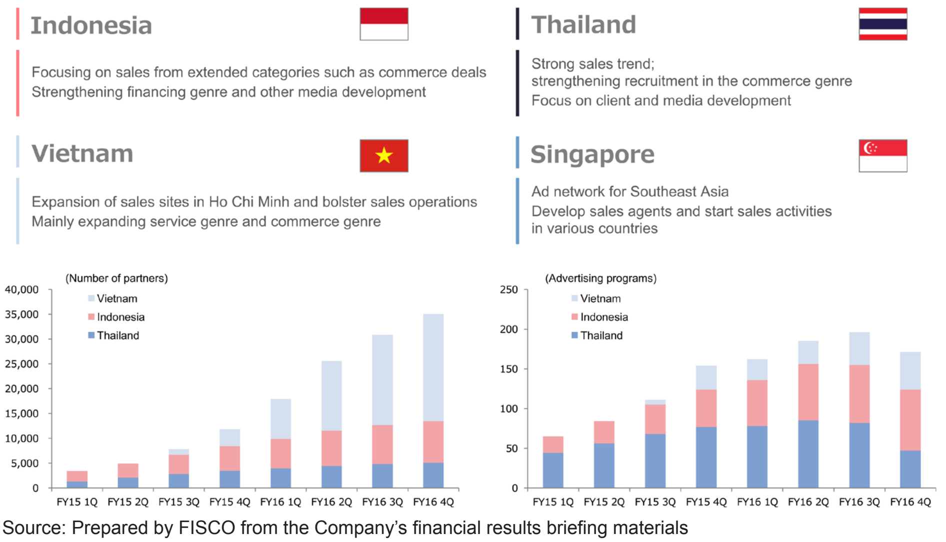
The X-lift distribution platform of native advertisements, which the Company released as a new service in August 2015, has focused on arranging partnerships, mainly with major curation media operators, and securing slots. Impressions (*) hence expanded sharply from 600mn times in June 2016 to 1.4bn times in September, and sales grew considerably in the second half of the period and reached ¥200mn for the full year. Yet we think this business had a modest loss in FY9/16 due to the priority placed in securing slots.

* Number of times an Internet advertisement is shown

In overseas business, the Company is operating affiliate services through consolidated subsidiaries in Indonesia and Thailand and a joint venture in Vietnam. It is also operating an ad network distribution service in Singapore. Overseas business is currently at a stage of developing advertisement programs and recruiting partner sites mainly for e-commerce and financing categories in Indonesia and Thailand and the e-commerce category in Vietnam and is steadily expanding its presence to about 170 programs (vs. about 150 programs at the end of FY9/15) and roughly 35,000 partner sites (vs. roughly 12,000 sites) on a combined basis for the three firms at the end of September 2016. The drop in Thai advertising program volume in 4Q stemmed from temporarily halting activity in the financing category.

The Company is still at the point of making inroads with affiliate services in all of these countries, and we think it needs some time to reach full-fledged expansions. This is because of lower demand in market environments where products sell without affiliate advertisements. We also attribute the lack of rapid proliferation to the reality of transaction settlement and fund transfer processes and tax processes differing in each country and the greater complexity of these processes than in Japan. We estimate that overseas businesses generated a few tens of million yen in sales and a few tens of million yen in operating losses in FY9/16 for an increase in sales y-o-y and about ¥30mn reduction in loss value. Profit from the Vietnam joint venture is recorded in entities accounted for using equity method under non-operating profit/loss, and we think it had a modest loss in FY9/16.

Overview of the overseas business



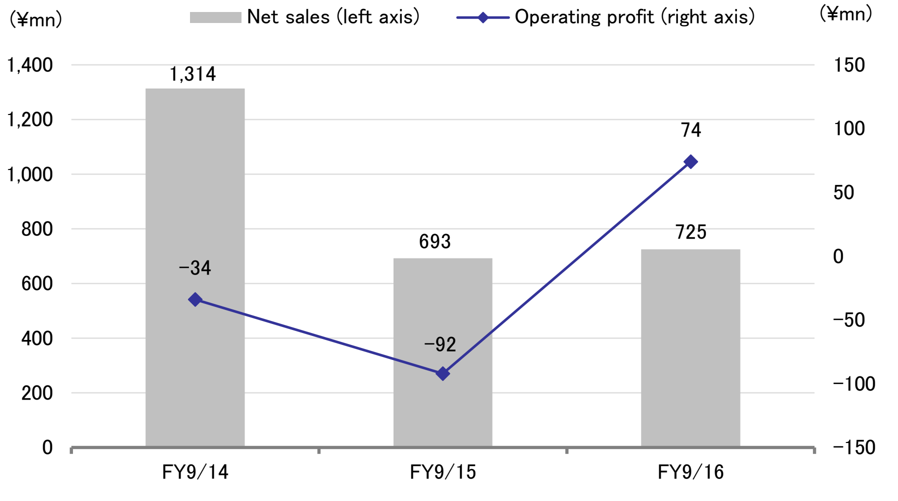
Source: Prepared by FISCO from the Company's financial results briefing materials

○ **The Media Business**

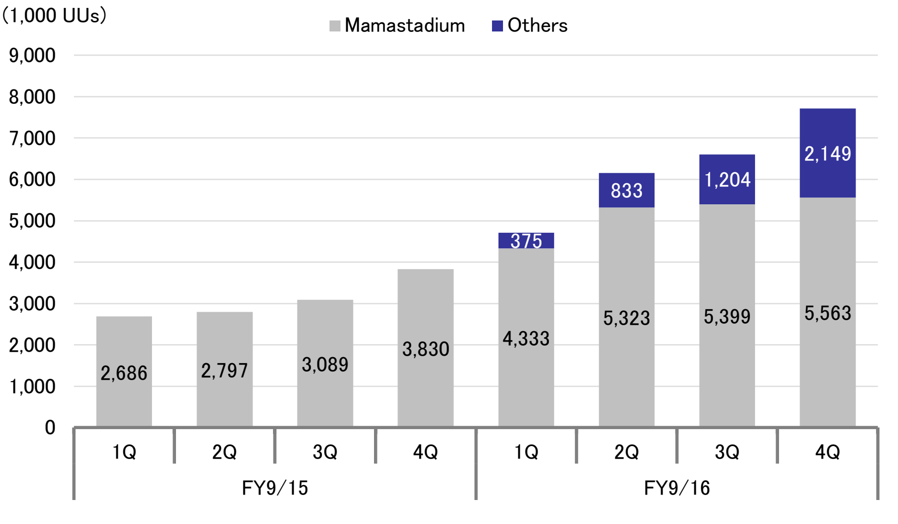
The Media Business posted ¥725mn in net sales (+4.5% y-o-y) and ¥74mn in segment profit (vs. a ¥92mn loss in the previous year. Web media (advertising income) recorded a firm 6.0% increase in sales to ¥246mn thanks to improved media value, including an advance to over 5mn UUs for “mamastadium.” While contents-related sales fell 7.5% to ¥319mn accompanying shrinkage of the game business, the Company returned to profitability owing to consecutive releases of 16 casual apps with low development costs and this contributed to the segment profit.

In media businesses, besides “mamastadium,” the Company operates “saitaPULS” jointly with SEVEN & i Publishing Co., Ltd. as well as the “MOFMO” pet curation media released in FY9/15, and “KOIMEMO,” a romance-based curation media. It has attracted a few tens of thousands of UUs for each of these media offerings. While they do not contribute sales yet, we expect advertising income once they move above 1mn UUs. The Company is aiming for synergies with native advertising by raising the media value of these Company-operated sites.

The Media Business results trends



Operated media UUs (monthly average)



Source: Prepared by FISCO from the Company's results briefing materials

FISCO

Interspace Co., Ltd.
2122 TSE Mothers

10-Jan.-17

Highly stable financial position with practically debt-free management

(2) Financial conditions and management indicators

Looking at the Company's financial position at the end of September 2016, the balance of total assets had risen ¥1,321mn from the end of September 2015 to ¥7,665mn. This was due to the increases in cash and deposits and sales receivables of ¥1,147mn and ¥281mn, respectively, under current assets. These increases offset the decreases in income taxes refund of ¥154mn and investment securities of ¥34mn under fixed assets. Exceeded the decrease in income tax receivable of ¥154mn. Also, non-current assets dropped ¥34mn mainly for securities.

Total liabilities rose ¥858mn compared to the end of September 2015 to ¥4,180mn. Main factors in the change were increases of ¥394mn in accounts payable and ¥346mn in income taxes payable. Additionally, net assets climbed ¥462mn to ¥3,484mn. While retained earnings were up by ¥487mn, valuation income on other securities dropped ¥16mn.

Looking at the management indicators, the equity ratio fell slightly, from 47.6% in FY9/15 to 45.5% in FY9/16, but the Company practices debt-free management and the current ratio is also trending stably at above 160%, so it is judged that the Company is continuing to maintain a sound financial position. Furthermore, while profitability temporarily dropped in the previous fiscal year, ROA, ROE, and operating profit margin improved YoY in FY9/16. Operating profit margin is somewhat low at 3.9% and has room for improvement, but ROE is holding at a high level of over 10%.

Balance sheet (consolidated)

(¥mn)

	FY9/13	FY9/14	FY6/15	FY6/16	Change
Current assets	4,098	4,670	5,227	6,650	1,422
(Cash and deposits)	2,387	2,471	2,335	3,483	1,147
Fixed assets	810	924	1,115	1,014	-101
Total assets	4,908	5,595	6,343	7,665	1,321
Current liabilities	2,371	2,759	3,263	4,108	845
Fixed liabilities	104	88	58	71	13
(Interest-bearing debt)	86	58	-	-	-
Total liabilities	2,476	2,847	3,321	4,180	858
Net assets	2,431	2,747	3,021	3,484	462
The main management indicators					
(Stability)					
Current ratio	172.8%	169.2%	160.2%	161.9%	
Equity ratio	49.5%	49.1%	47.6%	45.5%	
Interest-bearing debt ratio	3.5%	2.1%	-	-	
(Profitability)					
ROA (recurring profit return on assets)	12.6%	15.1%	5.8%	12.9%	
ROE (return on equity)	8.4%	14.9%	10.5%	16.7%	
Operating profit margin	3.9%	4.7%	1.7%	3.9%	

Future outlook

Internet Advertising (Affiliate) Business likely to drive earnings growth again in FY9/17

(1) Outlook for FY9/17

For FY9/17 consolidated results, the Company forecast ¥25,585mn in net sales (+9.8% y-o-y), ¥1,000mn in operating profit (+11.0%), ¥1,000mn in recurring profit (+11.0%), and ¥620mn in net profit attributable to the owners of the parent company (+14.4%), projecting higher sales and profits. The Company expects a flat trend in the Media Business and looks to the Internet Advertising (Affiliate) Business as the driver. The Company plans to strength its recruitment of talented engineers to improve development structure for native ads and new businesses in FY9/17 and is factoring in a roughly ¥100mn increase in costs, including development costs and personnel expenses. Segment outlooks and measures are reviewed below.

FY9/17 consolidated results outlook

(¥mn)

	FY9/16 Result		FY9/17 Targets			
	Full year	y-o-y	1H	y-o-y	Full year	y-o-y
Net sales	23,293	16.1%	11,997	8.3%	25,585	9.8%
Operating profit	900	158.4%	407	0.6%	1,000	11.0%
Recurring profit	901	160.0%	411	2.2%	1,000	11.0%
Net profit attributable to the owners of the parent company	542	79.0%	239	1.9%	620	14.4%

Source: Prepared by FISCO from the Company's financial results summary

○ The Internet Advertising (Affiliate) Business

The Company anticipates a 10% y-o-y increase in net sales to ¥24,900mn and higher operating profit owing to stronger sales in Internet Advertising (Affiliate) Business. It expects affiliate advertising to remain strong with a double-digit gain in e-commerce at an 18% increase and a roughly 5% rise in other major categories. The Company intends to continue to bolster collaboration with partner media and develop new genre and clients. It hopes to recruit more business in the financing category with cross-selling to credit and card loans, where it had been weak, and making price revisions.

In SFA business, it will focus on raising store operating rates, exploit mobile shops in regional areas, developing new products, and building up sales channels other than mobile shops amid an environment of sluggish mobile phone sales. The Company is projecting continuous sales of smartphone security packs in FY9/17, for products. It also intends to promote improvements in productivity and projects a modest y-o-y rise in SFA gross margin.

The Company targets sales expansion in X-lift distribution service for native advertisements from ¥200mn in FY9/16 to ¥300-400mn in FY9/17. It still expects a modest loss in FY9/17 because of ongoing efforts to secure slots and promotion of development activities that enhance X-lift functionality. Yet native advertisement distribution is increasing monthly and the Company expects a single-month profit in the latter half of the fiscal year. We will be looking for a profit contribution from FY9/18.

The Company forecasts a roughly ¥100mn y-o-y sales gain and an operating loss on par with FY9/16 in overseas business. This outlook means a rise in sales of over two-fold. While Thai business might stall due to a slump in the financing category, the Company expects sales boosts from the business in Indonesia and ad network distribution service newly launched in Singapore. The Company intends to steadily expand this business by cultivating advertising partners and recruiting advertising clients.

○ The Media Business

The Company expects about ¥600mn in net sales, a modest y-o-y decline, and flat operating profit in the Media Business. It is actually targeting flat sales because of the modest decline stems from a change in the basis for recording sales (from gross to net sales) for some products from FY9/17. The Company projects flat Web media (advertising income) sales, despite continuation of an upward trend in "mamastadium" media value, because of a downturn in advertising prices on ad network for the entire industry. It is also sticking with a policy of continuously releasing causal apps for the contents business. Additionally, the Company plans to develop and release about two new social media during FY9/17.

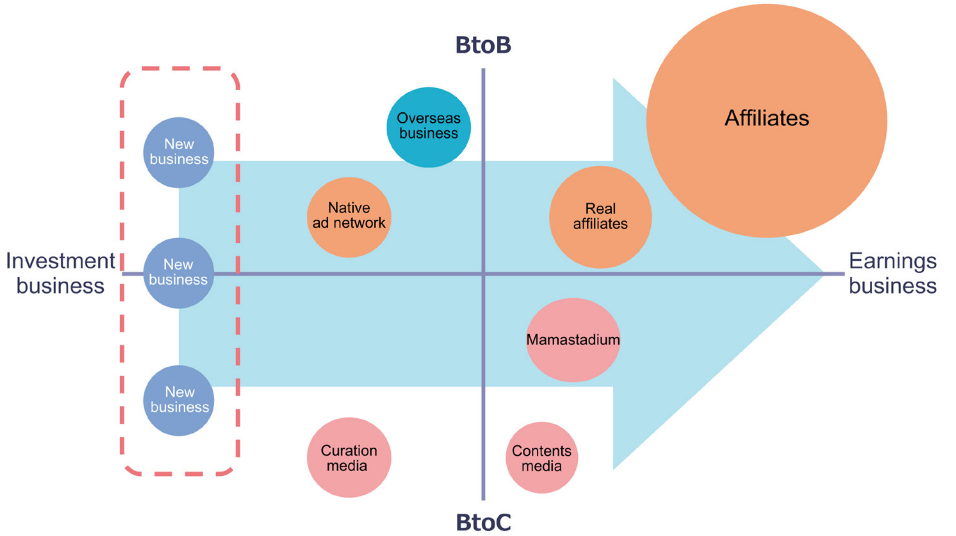
Actively investing in human resources and new business development

(2) Medium-term business plan

The Company focuses on net sales and operating profit as management indicator goals, and it aims to outpace growth in the affiliate market with sales. Previous medium-term business plan targets were consolidated net sales of ¥25,000mn and operating profit of ¥1,500mn, but it is on track to reaching the net sales target in FY9/17. While it has not announced new goals yet, the Company intends to continue pursuing new business creation, profitability improvement, and hiring and training of talented personnel in its efforts to promote earnings growth.

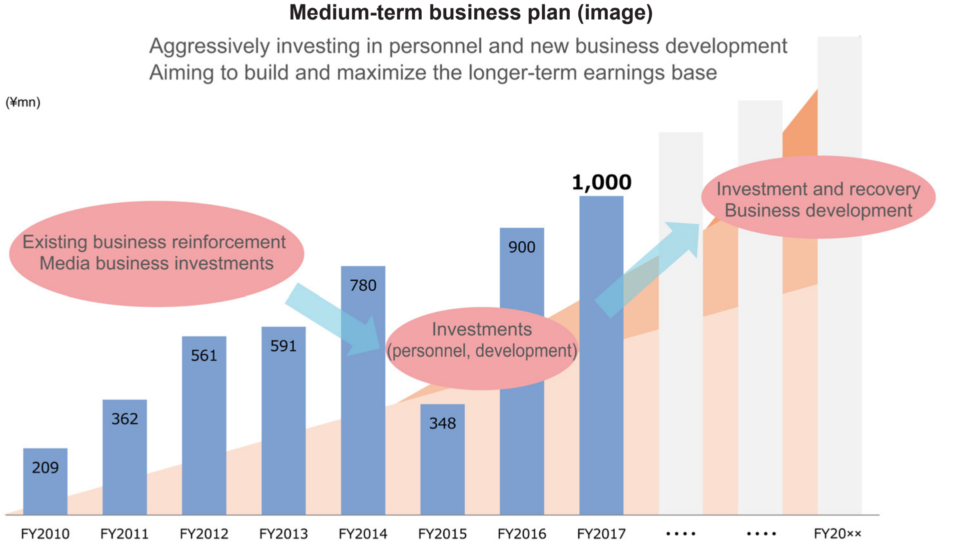
Hiring and training of talented personnel is particularly important to creation of new businesses. The Company hence aims to hire talented system engineers more aggressively from FY9/17. It had 371 consolidated employees at the end of September 2016 with system engineers at 12-13%. The Company wants to increase this ratio to 30-40% over the longer term. It will be mainly trying to hire talented people with in-depth knowledge of the latest Internet technologies, such as data scientists to handle big data analysts. The Company plans to assign these additional engineers to new business development and make aggressive investments while steadily ramping up these businesses in order to build the earnings foundation and realize further growth.

Longer-term image



Source: Prepared by FISCO from the Company's briefing materials

Medium-term business plan (image)



Source: Prepared by FISCO from the Company's briefing materials

Comparison with industry peers and policy of returning profits to shareholders

Decides the dividend through a comprehensive assessment of earnings, funding needs, and internal reserves

(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 50% 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.

Interspace has a lower profit margin than the listed companies mentioned above because of its active use of costs to develop alliance sites and advertising customers in the Internet Advertising (Affiliate) Business and high ratio of mobile-related sales at around 70%.

In the FY9/16 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 upfront investment costs and budget cutbacks at some customers towards developing new businesses.

Comparison with Industry Peers

(¥mn, %, times)

	FY	Net sales	Growth rate	Recurring profit	Growth rate	Profit margin	PER
Interspace <2122>	FY9/16	23,293	16.1	901	160.0	3.9	
	FY9/17 Company forecast	25,585	9.8	1,000	11.0	3.9	12.5
F@N Communications Inc. <2461>	FY12/15	35,789	11.9	6,179	3.9	17.1	
	FY12/16 Company forecast	38,000	6.2	6,240	1.0	16.3	13.8
Adways Inc. <2489>	FY3/16	39,613	10.4	744	-37.8	1.9	
	FY3/17 forecast	42,500	7.3	300	-59.7	0.7	1,984
ValueCommerce Co., Ltd. <2491>	FY12/15	16,658	24.6	1,656	0.5	9.9	
	FY12/16 Company forecast	17,300	3.9	910	-45.1	4.9	31.4

Note: Forecast PER based on closing prices from November 30; Adways FY3/17 values are medians from the company outlook range

FISCO

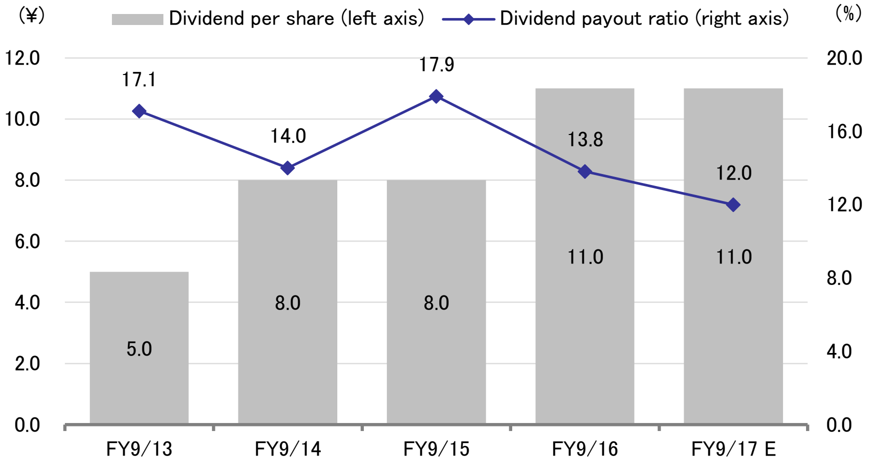
Interspace Co., Ltd.
2122 TSE Mothers

10-Jan.-17

(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 15-20%, and the dividend for FY9/17 is expected to be ¥11.00, the same as in FY9/16. However, we see a possibility of a dividend hike if earnings meet the Company forecast because this puts the dividend payout ratio at 12.0%, the lowest level in the past few years.

Dividend and dividend payout ratio (consolidated)



Disclaimer

FISCO Ltd. (the terms “FISCO”, “we”, mean FISCO Ltd.) has legal agreements with the Tokyo Stock Exchange, the Osaka Exchange,and Nikkei Inc. as to the usage of stock price and index information. The trademark and value of the “JASDAQ INDEX” are the intellectual properties of the Tokyo Stock Exchange, and therefore all rights to them belong to the Tokyo Stock Exchange.

This report is based on information that we believe to be reliable, but we do not confirm or guarantee its accuracy, timeliness,or completeness, or the value of the securities issued by companies cited in this report. Regardless of purpose,investors should decide how to use this report and take full responsibility for such use. We shall not be liable for any result of its use. We provide this report solely for the purpose of information, not to induce investment or any other action.

This report was prepared at the request of its subject company using information provided by the company in interviews, but the entire content of the report, including suppositions and conclusions, is the result of our analysis. The content of this report is based on information that was current at the time the report was produced, but this information and the content of this report are subject to change without prior notice.

The final selection of investments and determination of appropriate prices for investment transactions are decisions for the recipients of this report.

FISCO Ltd.