Daiwa SB Investments

# PM'S PERSPECTIVES

## VALUE + ALPHA GROUP

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## Key Issue to Assess Internet Service Providers

How many **Google** apps do you have for your smartphones? I believe that you may have multiple apps such as Gmail, Google Maps, Google Photos, Google Calendar, Google Drive and YouTube etc. in addition to the search application, Google

When search engines emerged as a new service in the 1990s, Google was lagging behind competitors such as **Lycos**, **Infoseek** and **Excite.** Google had to expand its market share from scratch as a follower company. Although the search engine service was the mainstay for Google at first, **Alphabet** (holding company of Google) now operates many other businesses, diversifying sources of growth.

In other words, it was important for internet service companies to win a race for market share in the early days. While now it is more important for them to provide second or third services to existing customers, with which they have built relations in their core businesses. For example, the domestic e-commerce businesses generated nearly all the earnings at **Rakuten** in the FY2000, while the ratio declined to approximately 35% in the FY2018[*1], with non-e-commerce businesses such as credit cards, banking, and securities driving the growth instead.

I think there are three reasons why the business model for internet service companies has changed. Firstly, it became difficult for them to develop innovative services, as PCs and smartphones became common without any alternative devices.

Secondly, they can save customer acquisition costs by selling different services to their existing customers. They often have to spend huge costs to build a customer base from scratch. For example, **AbemaTV**, an internet TV station, is spending as much as JPY20 billion a year in costs in order to acquire 10 million WAUs (weekly active users). To save these costs, internet service companies such as Rakuten and **Yahoo** are increasingly spending on ads targeted for existing customers rather than non-targeting ads.

Internet services have distinctive characteristics. We can connect to them easily anytime and anywhere, and they are also cheap. Looking at their various services from the viewpoint of users, users of Google search might have started to use related services such as Google Maps and YouTube, because they noticed their icons on the upper right of the search button. I believe that users of Rakuten Market had applied for its credit cards and securities accounts because they may have seen messages saying "10% bonus points back" on its top page.

Thirdly, internet service providers can increase the value of customer data by providing multiple services to the same customers. Most of them depend on advertising revenue to make profits, and the more they get customer information such as gender, age and address in detail, the more the unit price of commercial messages rises. They can use the customer data not only for advertising but also for financial services as well as for the improvement of existing products.

Key issues in investing in internet service providers in the past were as follows; which companies entered into e-commerce and online advertising, how much market share each company has and which companies are likely to win the competition. However, as the increasing number of companies move into various businesses with fewer innovative services, we believe that how they utilise their customer assets will become a focal point in the future. In addition, as each company is diversifying its businesses, we have to assess the valuation in accordance with its business composition ratio. Investors tend to pay attention to organisational cultures and the quality of engineers in a non-financial analysis for this industry, but I think customer assets are also worth their attention.

*1 This figure includes profits of businesses such as travel agencies. Pure domestic e-commerce business is likely to account for less than 35% in profits

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Mr Kamiishi joined Daiwa SB Investments in 2009 and covered US & European equities as a strategist from 2010 to 2013. He moved to Hong Kong in 2013 as an analyst for the auto & industrials sector in Asia Pacific ex-Japan equity. In 2015, he returned to Japan and covered the IT & services sector as a Japan equity analyst. In 2016, he became a portfolio manager in the Value + Alpha group.

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