

# Research on Profit Model of Sohu Company

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## ABSTRACT

In the age of Internet economy, information is the most valuable resource. Portal site companies give priority to provide information and network services, so, portal companies play a important part in the Internet business. With several exploitations, portal companies in our country has recognized the one—sided pursuit of market share and brand awareness should be forbidden and what more important is to find a suitable profit model of development, so as to maintain the core long—term competitiveness and profitability in the market competition. Sohu is the largest Chinese web portal and leader in profit model among its industry, so analyzing its profit model is of significant importance. Based on relevant theories, the paper dissects the profit model of Sohu, analyzes its profit ability, profit quality, profit source and profit leverage using financial data from 2011 to 2015 and raises strategies of exploring new profit source and strengthen profit barrier.

**Index Terms:** Sohu Company, Profit Model, Profit Analysis, Profit Source

## I. INTRODUCTION

Joan. Margherita & Nan.Stone (2003) pointed out that profit model is a coping strategy gradually developed by a company in response to intense competition in the industry[1]. It makes a company better cope with market competition and identify its own methods of profitability and target customers. In brief, profit model is the approach and source of high profits. On July 12, 2016, Internet Society of China and MIIT Information Center announced the top 100 competitive companies in China's Internet industry in 2016. Portal companies rely on their portals and diversified businesses to make rich revenues. On the one hand, it is benefited from the rapid development of Internet; on the other hand, portal companies gradually find a profit model that matches their own industry development. Recently, more and more attention has been paid to profit model research of web portal. A successful profit model can help a company make full use of its own resources and core competence and structure of its products and services. Thus, it can take appropriate business activities to make profit and achieve win-win cooperation with its customers. In recent years, researchers in China and abroad haven't conduct in-depth research into profit model of web portal. Therefore, it is urgent to analyze it and summarize its advantages and the problems to be solved. Michael Rappa 's (2004) definition of the profit model is determined according to the perspective of network economics, the main idea is similar to Yi Ying, the profit model is a management method which can achieve enterprise profit and ensure the enterprise's continuous operation, and the profit model can reveal the enterprises' position in the value chain fundamentally[2]. CHAO(2010)raised a new profit model classification method' dividing profit model into 10 components. He wrote in his essay that profit model must point out the output orientation and type of the product, how to define the product value and how to keep the product competitive compared to competitors' products[3]. Goran (2011) believes that the profit model is that enterprises increase revenue, reduce costs, and achieve larger sales revenue with smaller expenses. He defines the profit model within the range of costs and revenues. For managers, increasing revenues and reducing costs are key to increasing profits. Many profitable factors are listed, such as advertisement, promotion, direct selling, production mode, output mode, enterprise relation, technology, brand, channel, talent, knowledge, capital and other enterprise resources[4]. Xi (2014) pointed out that the focus of the profit model lies in the key resources and capabilities or core competitiveness of enterprises, and through building the core strengths of the enterprise to enhance the profitability. First of all, he emphasizes the importance of core strengths of enterprises, and create the competitive advantage named "I have but you don't". Meanwhile, the key resources and ability of enterprises or core competitiveness are elements that the researchers mentioned frequently and the problem to solve mainly refer to rely on what to make a profit[5]. Ana (2014)

thought that the profit model of a company was closely related to the change of business environment, which means that a company should make adjustments according to the environment. No profit model can always guarantee the prosperity of a company because they are in the change[6].

As the largest Chinese portal in the world, Sohu provides 24-hour news, searches, E-mails, videos, games and other services for 80% of Chinese Internet users. Its profit model provides a good example for other Internet web portals to improve themselves.

## II. THE PROFIT MODEL OF SOHU COMPANY

Given that the value chain is an important origin of ideas for profit model, we should first look at the value chain of Sohu before studying the profit model of Sohu, by parsing the entire value chain, you can clearly find the value creation process of Sohu, which will tease out the elements of its profit model. Diagram as shown in Figure 1 is Sohu company's value chain, we can see that Sohu company begins with attracting Internet users, taking the Internet users' needs and preferences as a starting point, developing products that customers like or providing personalized services to attract more targeted users, so the idea is to develop competitive products or to develop special services, which is a reflection of the upper part of the value chain. Through the lower part of the value chain, you can tease out the true source of profit for Sohu. Sohu provides corporate customers with access to online advertising, allowing corporate customers to advertise their products and services through advertising to get the customers' ordering, Sohu also provides advertising platforms for corporate clients to obtain income, which is the real source of revenue for Sohu. Corporate clients are a direct source of profit for Sohu and its target customers, corporate clients pay Sohu for advertising, and Sohu provides advertising platforms for corporate clients to gain win-win result.

Zhen Guohong (2007) thought there are five basic elements of profit model: profit point, profit target, profit leverage, profit source and profit barrier[7]. The whole channel process of Sohu's profit source is clear after combing its value chain. According to current situation and value chain, its value-creative activities are user orientated, aiming at improving its core competence. Thus, the profit model of Sohu consists five elements: profit point-"T.R.M.I" service matrix, profit target-user and customer orientation, profit source- online advertisement + online games, profit leverage- operating activities and profit barrier- research technology + portal resources. Figure 2 is the profit model of Sohu.

Comparison method is the best way to evaluate the pros and cons of the profit model of a company, because the ultimate goal of profit model is profit. Based on financial data released by Sohu from 2011 to 2015, this paper analyzes its profit ability, profit quality, profit source and profit leverage.

## III. EMPIRICAL ANALYSIS OF PROFIT ABILITY OF SOHU 'S PROFIT MODEL

### A. Analysis of Profit Ability of Sohu 's Profit Model

In order to analyze Sohu's overall profit ability, this paper uses the most important performance evaluation index—ROE (Rate of Return on Common Stockholders' Equity), which is not only the core element of DuPont analysis, but

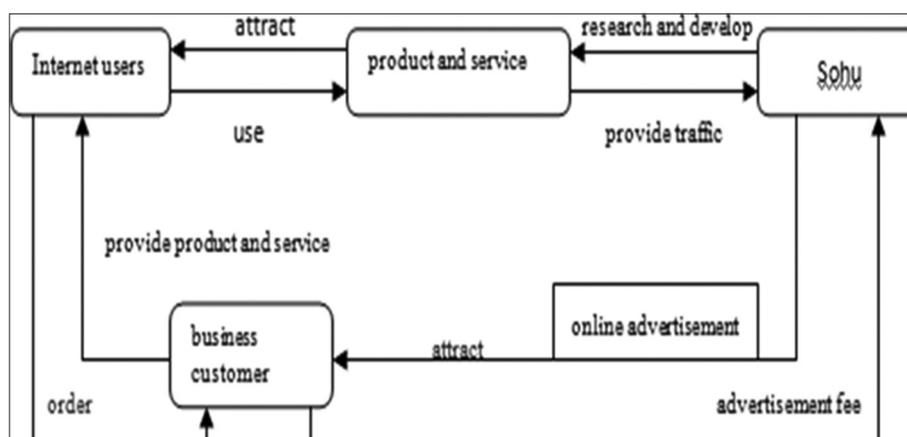


Figure 1: Value chain of Sohu

also can reflect the profit ability of a company. Sina and Sohu are both web portal companies with similar business scope. Therefore, this paper chooses to compare Sohu and Sina's ROE to analyze the effectiveness of Sohu's profit model.

It can be depicted from Figure 3. that Sohu's ROE reaches a peak in 2013 and remains stable from 2011 to 2013. In 2014, ROE of Sohu drops suddenly to negative, then returns to normal in 2015. The level of Sohu's ROE from 2011 to 2015 basically keeps higher than Sina. ROE of Sina rises from negative in 2011 to 1% in 2012 and then keeps stable. Overall, the web portal companies have stepped into weak period after developing for more than ten years. Their transformation is facing with many problems. Data shows that Sohu's ROE is higher than Sina, indicating that the profit ability of Sohu is still in domination among integrated web portal companies. Built on a solid capital foundation, Sohu's prospects are worth looking forward to. It is believed that Sohu can continue exerting its media innovation and development.

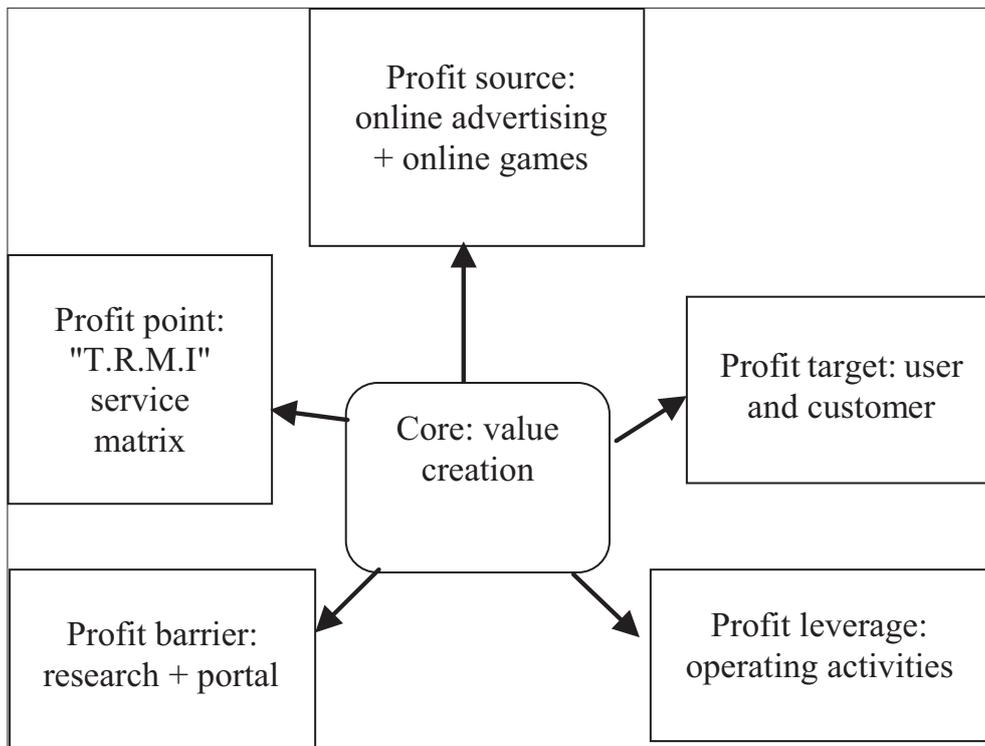


Figure 2: Profit model of Sohu



Figure 3: Comparison between Sohu's ROE and Sina's ROE from 2011- 2015

## B. Analysis of profit quality of Sohu company

### 1) Cash flow analysis

The ratio of operating cash flow to net profit ratio, operating income ratio and main business income ratio reflect a company's ability to generate cash from operating activities. The higher these ratios, the better the profit quality. The higher the degree of enterprise's profit, its currency amount is larger, it's convenient to improve the solvency of an enterprise and the ability to pay cash for the enterprises.

Ratio of operating activities cash flows and operating profit reflects the book operating profit of the operating activities cash flows and implementation and enterprise real received cash profits. The greater index value showed paper profit of enterprise implementation of more inflows of cash profit, the higher quality of operating profit for the enterprises.

Cash flow liability ratio = net cash flow/current liabilities of operating activities

Operating cash flow per share = (operating cash flow-preferred dividend)/outstanding common stock

Table 1 shows that the ratio of operating cash flow to net profit ratio and operating profit ratio in 2015 are high and are the peak in recent years, indicating that the net profit generated by the company can be covered by cash. The negative value in 2014 results from the negative net profit, indicating the company can't afford the fixed cost. Although Sohu is able to meet the needs for normal business activities, it still needs to improve its product profit ability. However, according to the analysis of net profit above, Sohu is in its transition period during 2014 and 2015, and the investments in all aspects are relatively large. Thus, net profit appears abnormal. In addition, from data in 2015, we can see that Sohu keeps a good momentum of development and the profit quality is getting better. At the same time, the ratio of cash flow from operating activities to main business income keeps stable, indicating that Sohu's current main business income can be realized in a timely manner, and the cash flow is basically good.

### 2) Analysis of financing and payment capacity

Cash coverage ratio is the guarantee degree of a company's debt from its existing cash flow. In general, the higher the value, the better the liquidity of the asset. It can be seen from Table 2 that the cash coverage ratio of Sohu in recent years is not particularly high. However, the trend of recovery in 2015 compared with 2014 shows that the pressure to repay short-term liabilities has been lowered and the liquidity has been improved.

Operating cash flow per share reflects the average cash flow per share of common stock issued outside, and also reflects the cash inflow per share. We can see that Sohu's operating cash flow per share between 2012 and 2015 has a stable growth. According to the data, the number of common stock in the past few years remains stable, so the decline in operating cash flow per share in 2014 arises from the reduction of cash flow from operating activities. In 2015, the operating cash flow per share has not only recovered, but also indicates a growing trend. The increase in the ratio shows that the amount of cash earned by every common stock in an accounting year has increased, and the dividend payment capacity has increased.

In summary, comparing Sohu and Sina in profit ability, we can find that each financial index of Sohu is basically better than Sina. So, we can conclude that Sohu's profit ability is quite good, and has a great advantage compared with its competitor.

**Table 1: Analysis of SOHU'S profit ability OF cash flow between 2012-2015**

Years	2012	2013	2014	2015
Ratio of cash flow from operating activities to net profit ratio	2.27	2.42	-0.89	4.65
Ratio of cash flow from operating activities to operating profit ratio	1.80	2.20	-0.74	6.14
Ratio of cash flow from operating activities to main business income ratio	0.38	0.29	0.09	0.26

Source: compiled data in financial reports of Sohu from 2012 to 2015

**Table 2: Analysis of financing and payment capacity of Sohu between 2012-2015**

Ratio	Year			
	2012	2013	2014	2015
Cash coverage ratio	0.72	0.36	0.19	0.40
Operating cash flow per share	10.57	10.49	3.95	13.09

It can be seen from Sohu's revenue and cost structure that its revenue scale is expanding rapidly while its cost remains basically stable, indicating that the development of Sohu is more stable to a certain extent. The above financial analysis shows that the current profit model of Sohu has its advantage in the fierce market competition, which guarantees the steady growth of its income and cash flow. In other words, the excellent financial index is a result of the superiority of its profit model.

### C. Analysis of Profit Source in Sohu's Profit Model

Profit source is businesses that can bring profits to the company. Sohu's profit sources include online games, online advertisements and other businesses. We can analyze Sohu's profit source from the proportion of each profit source and its trend of change.

#### 1) Revenue composition analysis of sohu in 2015

According to Sohu's full-year data from financial statement in 2015, the total annual revenue reaches \$1937 billion, including online advertising \$1117 billion, online games (another major business) \$637 million and other business \$184 million. From Figure 4, it is clear that online advertisements and online games are two main sources in four quarterly revenue streams in 2015. Besides, other businesses contribute insignificantly to the total revenue. Thus, online advertisements and online games become the mainstay of operating income in four quarterly revenue streams in 2015.

#### 2) Quarterly analysis of revenue proportion in 2015

Figure 5. is the quarterly analysis of revenue proportion in 2015. We can find that Sohu's revenue from brand advertisements, search advertisements and online games accounted for almost the same proportion in total income. Among them, the income of online game is on a rise, from 23.09% in the first quarter of 2015 to 32.45% in the fourth quarter. It indicates that Sogou search engine's strategic cooperation with Tencent is conducive to its business development. However, the revenue of online games appears the opposite trend, from 40.63% in the first quarter decreases to 27.25% in the fourth quarter. This shows that after experiencing the peak of online games "Dragon Oath", Sohu CYOU's game business fail to maintain its profit ability without new business. The revenue of brand advertisements, to be more specific, the revenue of each news portals and video advertisements has maintained a stable trend. The growing trend of income in other business indicates that Sohu's other value-added business has gradually caught up, and become a stable profit growth point to Sohu.

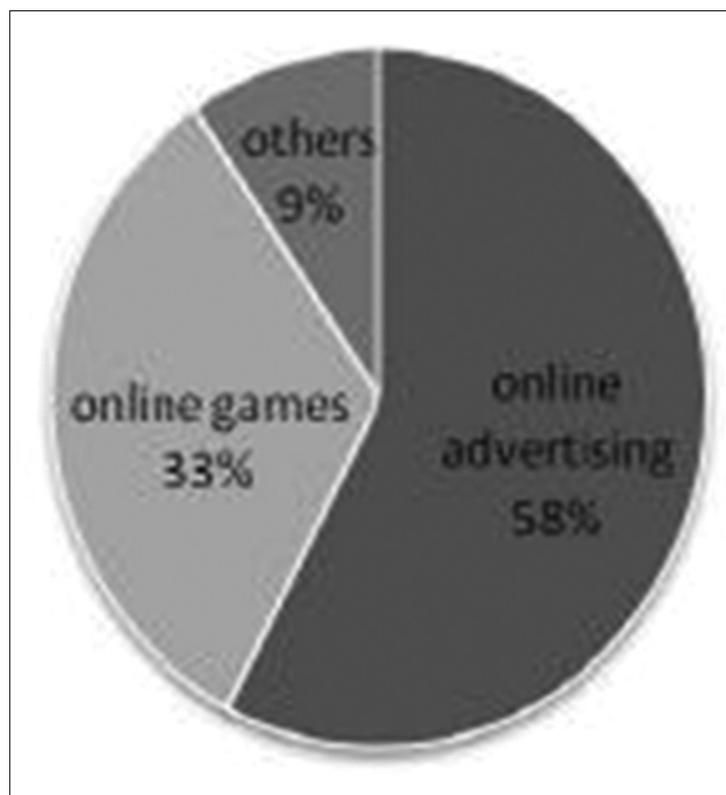


Figure 4: Revenue Composition Analysis of Sohu in 2015

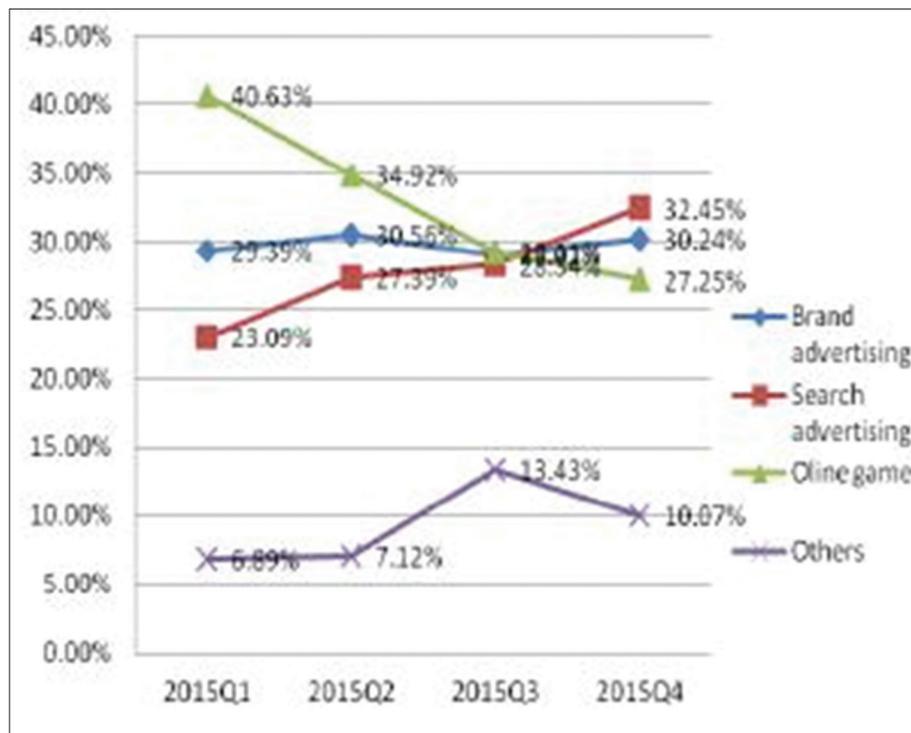


Figure 5: Quarterly analysis of revenue proportion in 2015

#### D. Profit Leverage Evaluation of Sohu's Profit Model

Profit leverage is a company's leveraging tool for profit. Sohu's profit leverage is mainly for marketing and management activities of its online advertising business development. We can begin analyzing profit leverage from the cost. Figure 6 (US \$millions). and Figure 7, are Sohu's cost and expenses change, and changing trend of its proportion in total cost of revenue from the second quarter in 2015 to the third quarter in 2016.

According to Figure 6-7, we can find that Sohu has an overall trend of quarterly increase in cost. Up to the third quarter of 2016, total cost of revenue increases to \$223 million, total sales/general/administrative expenses increased to \$ 149 million and research and development costs increase to \$90 million. Apart from R&D expenses, which keeps an unchanged proportion in total operating income, the cost of revenue and sales/general/administrative costs shows a significant upward trend in proportion of the total cost of revenue and their proportions increase with the quarter. It proves that Sohu pays more and more attention to the establishment of profit leverage. Meanwhile, it also reflects the growth of cost exceeds that of its income, thus affecting its final net profit. On the other hand, although Sohu has steadily invested in R&D, compared to the other two costs, it is decreased in recent years, which is unfavorable to the overall innovation of product and service. Sohu should adjust the proportion of different expenses and pay more attention to R&D investment, so as to guarantee financial support to technical innovation and ensure a better profit leverage to ultimately achieve sustainable profits.

### IV. SOHU'S PROFIT MODEL IMPROVEMENT STRATEGY

#### A. Strengthen the Profit Point of Innovation

Sohu company has abundant profit point products, and the four major business products also have certain characteristics, which is a competitive advantage that Sohu has. But the problem about a variety of competition enterprises in the same industry and product homogeneity problems exist, through the analysis of network news, online video, search engines and online games, the four major industries and the positive development trend, Sohu should seize this environmental opportunities, increase the existing product innovation development, and input greater research and development expenses. For the news business, Sohu can optimize the direction of business from the layout design, content innovation, update and so on. For the video business, Sohu should adhere to the "independent broadcast and premiere" form, and enhance the quality of homemade drama, so as to attract more users. And for the online game business, Sohu can recruit game design and development staffs, design more innovative games, which can attract more and more game enthusiasts to join. According to the survey data, the four major

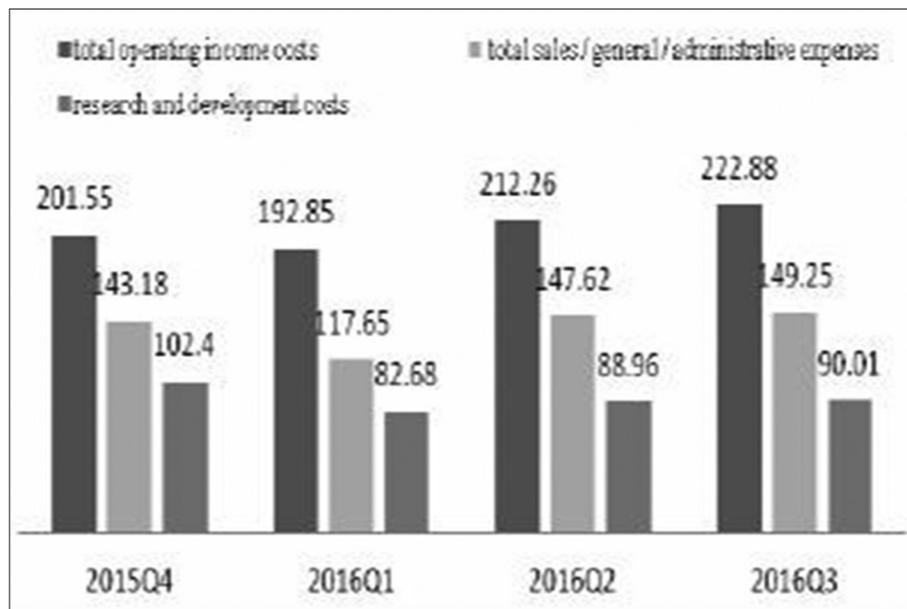


Figure 6: Analysis of cost and expenses change of Sohu company

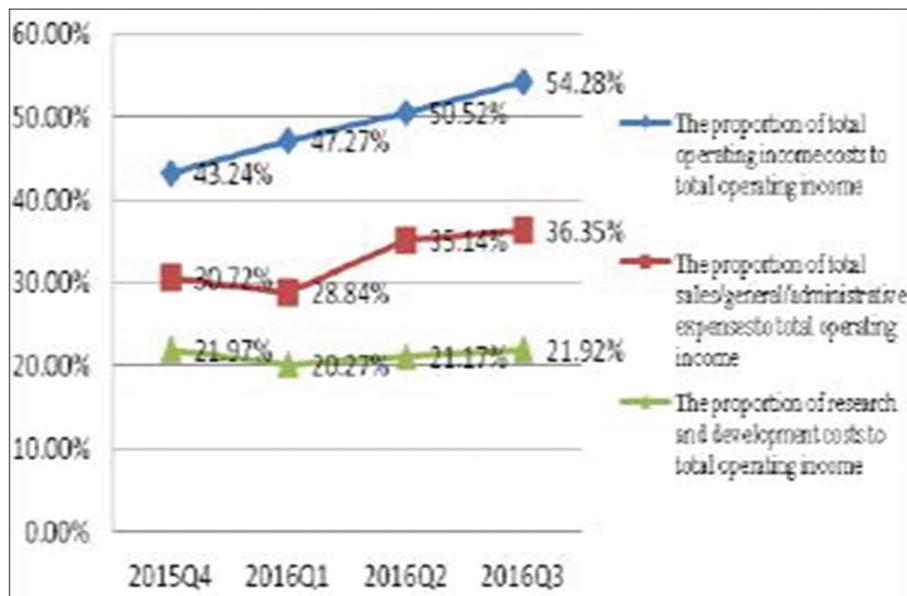


Figure 7: Analysis of changing trend of proportion of all costs and expenses in total cost of revenue

businesses not only the development prospects is getting better, its business also appears the transfer trend from the PC side to the mobile side, therefore, Sohu should increase development of the network news, video, search and game mobile client, and attach great importance to the team management and product development of the mobile side.

### B. Find the New Profit Source

First of all, survey data earlier showed that e-commerce industry is becoming more and more popular. Not only national policy to support the development of e-commerce industry, many companies of internet industry are also developing the business e-commerce. For example, Suning Appliance has found the profit point of e-commerce, from the previous substance below the line developed into the current Suning Commerce, and has achieved a diversified development strategy. As a veteran portal website business, it can be seen that the development strategy of Sohu is diversified from the service matrix of its product line. But so far it has not been involved in the field of e-commerce business. It is easily believed that after seeing the profit of e-commerce industry in recent years, Sohu can be considered to enter this industry gradually through strategic cooperation with other manufacturers. Sohu can also choose the business area of third-party e-commerce payment. Ali group's Alipay was not optimistic from the beginning, and now has almost occupied a large part of the third-party party e-commerce payment areas.

Tencent's QQ and WeChat also opened the function of Wallet purchase, the business of red envelopes fuels other business of Tencent every Spring Festival.

### **C. Strengthen Content Development and Marketing Activities Campaign**

. According to the survey data of CNNIC which showed that netizen quantity has been increasing yearly, in addition, the internet users are subdivided into different internet fields ranging from news, video, search to computer games, thus, Sohu Company's profit potential has big space. As a veteran internet company, Sohu already has a large user scale, however, with the rapid development of the internet industry, many internet enterprises face more and more serious problems such as homogeneity of services and products. Users' loyalty and satisfaction cannot be guaranteed, when using the portals or search engine, users are always expecting more out of them. In order to meet customers' personal preferences, Sohu Company needs to creatively design its portal and increase users' preferences and loyalty, so as to bring more consumer groups for Sohu, ultimately achieve sustained profitability of enterprises. As for Sogou, it also needs to strengthen research and development efforts, developing unique search engine features which differ from Baidu and other search engine, so as to attract and maintain its loyal users.

### **D. Strengthen Existing Profit Source**

Sohu's profits are concentrated in its online advertising and online gaming revenues, and other businesses account for only about 10% of the business. Sohu has maintained advertising business income accounted for the proportion of total revenue at more than 55% in recent years, the online game accounted for more than 30%, profits are relatively single is probably one of the factors that affect Sohu's profit. According to table 3.7, Sohu's revenues have declined over the last three quarters, and net losses have been rising. As a result, Sohu should strengthen existing sources of profit and identify factors that increase revenue from online advertising and online gaming. Its online ads fall into branded ads and search ads, so Sohu can increase its revenue from advertising innovation, cost control, and search engine development. Online games business can boost revenue growth by developing new games, ramping up marketing campaigns and increasing video games.

### **E. Solve the Problem of Profit Leverage**

Profit leverage is the management and organization activities that ensure the profit point. First of all, Sohu should pay attention to the serious loss of personnel. The management team of an enterprise plays an important role in the Steady growth of an enterprise. At the same time, a large number of executives will also be detrimental to the loss of corporate image, eventually, some users will lose. The core advantage of enterprise is cultivation and management of talents. Sohu should set up a better reserve of talent. The enterprise can introduce new professionals in management, strategy, marketing etc. Company should establish a professional and long-term talent training system which can cultivate executives suitable for enterprise management, so it will provide guarantee for the stable development of Sohu company. Secondly, the development strategy of Sohu company is not clear, it should clearly focus on the development of the business, go a step further, the company should focus resources development of several key aspects. Although the Sohu business is extensive, some messy layout has made the whole business of the company unclear, therefore, it can not reflect the maximization of the company's overall value.

### **F. Firm Profit Barriers**

A firm profit barrier can protect the profits of an enterprise from being swallowed, eliminated or imitated. But all of this is based on the continuous innovation of products or services, and the establishment of strategic alliances with customers and partners. According to the survey, in order to get a better development, the Internet industry has adopted the form of "mutual cooperation and strategic alliance" and then establish a strong profit barrier to achieve profitability. Therefore, Sohu should not only increase the R&D of original core technology, but also implement strategic alliances with other Internet companies to speed up the development process of each other. In addition, it is necessary for Sohu to pay attention to personalized needs to strive for more users. With the development of the Internet industry, consumers are paying more and more attention to the satisfaction of their own needs. Sohu should pay attention to the maintenance of customer satisfaction and increase after-sales service. Also, Sohu needs to strengthen core product development and stabilize users, so that it can achieve the purpose of getting a sustainable profitability.

## **V. CONCLUSION**

Based on background case of Sohu, this paper analyzes Sohu's existing profit model and conducts profit analysis of the mode under the mature condition of web portals' profit model. In conclusion, Sohu should further strengthen the innovation of profit

point, find new profit source, solve the problem of profit leverage and keep profit barriers steady At last, this paper provide the suggestion to improve the profit model.

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