



IS CYBERSECURITY UNDER ATTACK?

At a dinner dedicated to technology stocks, if you want a consensus, all you have to do is mention your enthusiasm for the cybersecurity segment. This is understandable, given all the factors pushing in its favour.

And yet, judging by cybersecurity's fundamentals and sentiment among cybersecurity companies, the outlook appears to have darkened considerably in recent months. Shares in Fortinet, one cybersecurity giant, collapsed by 20% in August, after the company stated flat out that the coming years would be far more challenging, and that the economic environment would be working against cybersecurity. Even two rapidly growing companies, Rapid7 and Sentinel1, are now publicly offering themselves for sale, even with their share prices at a low. This runs counter to the previous seller's market, which had consisted in selling out at high multiples to eager buyers, without the need to put up a "for sale" sign.

Meanwhile, Palo Alto Network, whose aggressiveness is legendary both commercially and on the M&A front – and in how much it paid its managers – kept its growth levels up during the quarter but only after setting up a vendor financing subsidiary for its customers, a previously almost unheard of practice in the industry.

A DEMAND-SIDE CRISIS OR THE LAW OF LARGE NUMBERS?

From 2018 to 2022, aggregate annual revenues of big cybersecurity specialists¹ rose from 7.3 billion dollars to almost 20 billion – annualised growth of about 22%, driven by four factors: (1) the cloud boom, which engendered new needs; (2) the Covid-inspired expansion in remote-working and the new vulnerabilities that this created; (3) an environment very favourable to IT spending; and (4) a detrimental geopolitical context.

Regarding the first two points – the cloud and the morphing of remote-working into "hybrid work", companies' needs are now more behind us than in front of us, as they have already completed their installation phase, moreover in synchronised fashion in every sector and geographical location. Even if demand is sustained over the next four years and even if the industry achieves additional revenues equivalent to the 2018-2022 period, annual growth would slip, on average to 10%, driven down by the law of large numbers.

¹ Fortinet, Palo Alto Networks, Checkpoint, Qualys, Tenable, Zscaler, Sentinel 1, Rapid7, CrowdStrike, and CyberArk.

EMERGENCE OF NEW TRENDS

Identity management is becoming increasingly crucial, and cybersecurity and everything that consists in protecting users from identity theft of all types, should continue to be driven by the potential irruption of deepfakes augmented by generative AI. A second trend is making the rounds, but we see very little potential in it – consolidation around platforms that would emerge from a turnkey, or quasi-turnkey solution.

If we compare a Chief Information Security Officer (CISO) with an asset allocator specialising in equities, should that allocator opt for a MSCI World ETF, even if it has a strong track-record? Seems unlikely. Even so, he might use a platform in two cases – to lower the price of a specialised solution, or to reduce his total budget for items regarded as “standardised”.

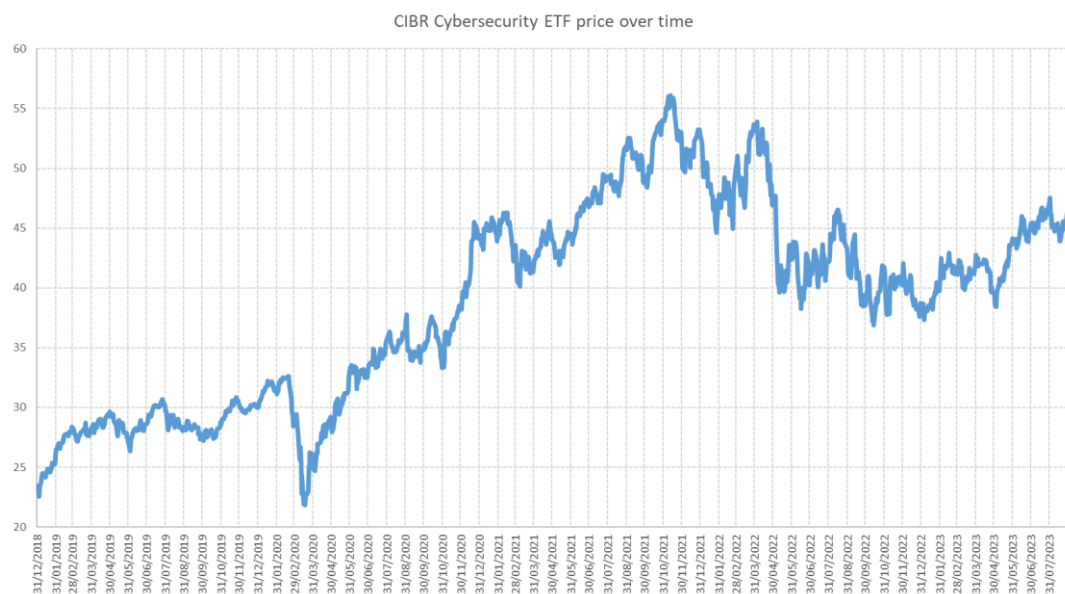
These two trends therefore suggest that stock-picking will have an important part to play in cybersecurity in the coming years, as the underlying wave subsides somewhat.

CYBER-DEFENCE: THE NEXT SOURCE OF GROWTH

Identity management and user protection have been our main cybersecurity investment stories in recent years, via stocks such as Mimecast, SailPoint and ForgeRock, all of which were taken over at high premiums. We still believe this is the most promising theme in cybersecurity. In our view, cyber-defence – i.e., cybersecurity on a governmental scale – will be the next source of growth, via companies such as Booz Allen Hamilton. However, it will now be necessary to regard cybersecurity beyond its growth component and to take a closer look at its defensive, visibility and cashflow components. This is where companies such as Akamai and Checkpoint may also be worthwhile and are among the few generating positive cashflow, when adjusted for stocks options.

Keep in mind that of the aforementioned sample of leaders – which are the biggest cybersecurity market caps, at more than 150 billion dollars – 60% of them are not profitable and can therefore not be assessed in P/E terms.

They face the challenge of having to boost their profits rapidly against a backdrop of slower growth and a potential platform-triggered price war. Here again, stock-picking within the sector will be the only way to generate returns.



Source: Bloomberg. Data as at 31/08/2023.

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