

Cybersecurity

Industry Report & Investment Case - HXR

What is Cybersecurity and Why is it Important?

Cybersecurity focuses on protecting computers, networks, programs, and data from unauthorized and/or unintended access. Cybersecurity has become increasingly important recently as governments, corporations, and people collect, process, and store vast amounts of confidential information and transmit that data across networks. Data breaches have become almost commonplace in recent years. Over the last few years, high-profile cases of cyber hacks have increased the demand for sophisticated software and security products. Companies across the globe are growing more aware of the potential threat which is leading to a greater allocation of resources towards companies that help mitigate such risks.

The table below highlights the variety of ways in which industries were affected by different types of incidents. While certain industries experience cyberattacks from specific incidents (e.g. about 45% of incidents in 2019 in the Accommodation industry were because of Point-of-Sale)¹, this table shows that all industries are prone to cybercrime in numerous ways. As such, with the sophistication of cyberattacks, there has been an increased demand for cybersecurity services.

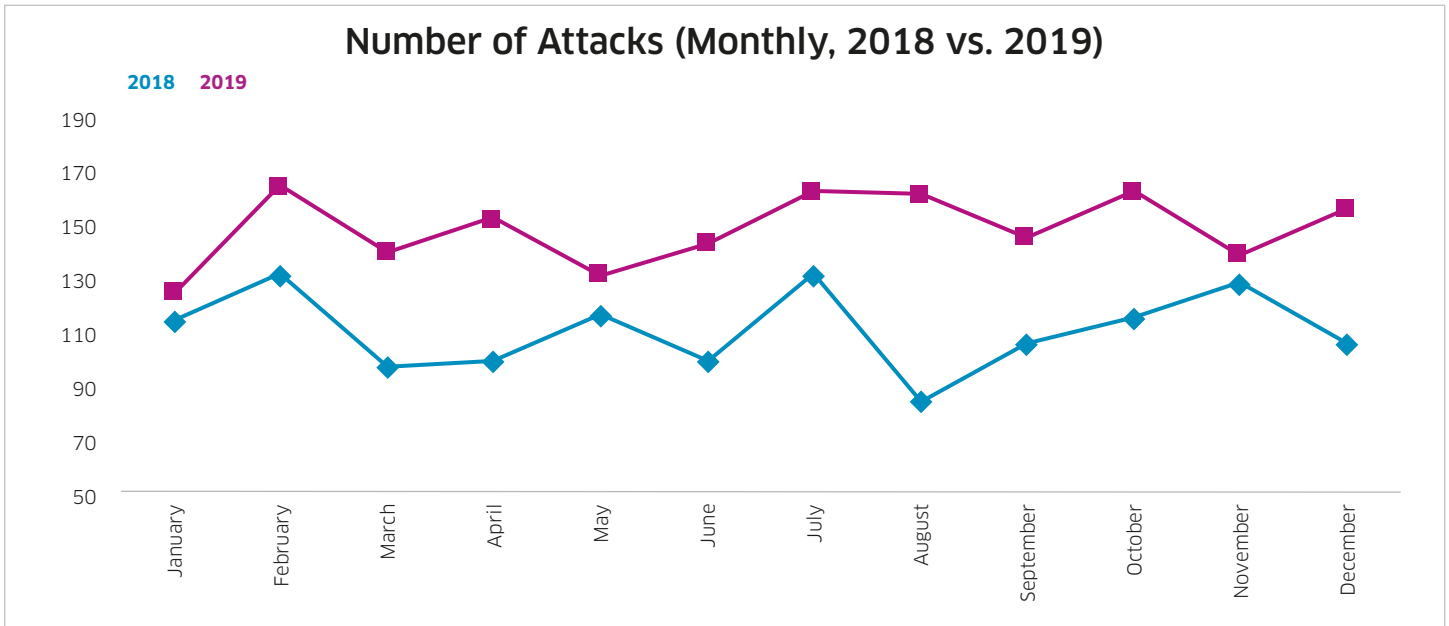
2019 INCIDENTS BY INDUSTRY	CRIME-WARE	WEB APPLI-CATIONS	PRIVILEGE MISUSE	EVERY-THING ELSE	DENIAL OF SERVICE	CYBER-ESPIONAGE	MISCEL-LANEOUS ERRORS	LOST AND STOLEN ASSETS	POINT OF SALE	PAYMENT CARD SKIMMERS
Accommodation	19%	16%	1%	8%	0%	1%	6%	4%	45%	0%
Education	8%	8%	5%	6%	59%	2%	10%	2%	0%	0%
Finance	6%	8%	11%	3%	62%	3%	4%	1%	0%	2%
Healthcare	16%	15%	23%	8%	1%	1%	22%	13%	0%	0%
Information	19%	7%	1%	2%	62%	2%	6%	0%	0%	0%
Manufacturing	16%	11%	10%	6%	46%	5%	4%	1%	0%	0%
Professional	9%	12%	2%	9%	61%	1%	4%	2%	0%	0%
Public	20%	0%	56%	0%	4%	1%	6%	12%	0%	0%
Retail	9%	39%	7%	6%	23%	1%	5%	3%	4%	4%

Source: <https://enterprise.verizon.com/resources/reports/2019-data-breach-investigations-report.pdf>

One way in which investors can get exposure to the cybersecurity industry is through the ISE Cyber Security Index (HXR). In order to adequately understand the reasons as to why cybersecurity is important from an investment perspective, it is first vital to understand the growth drivers for cybersecurity as well as the industry outlook. The following research will discuss the growth drivers and industry outlook for cybersecurity and then show the ways in which HXR is poised to capture these positive trends in the cybersecurity industry.

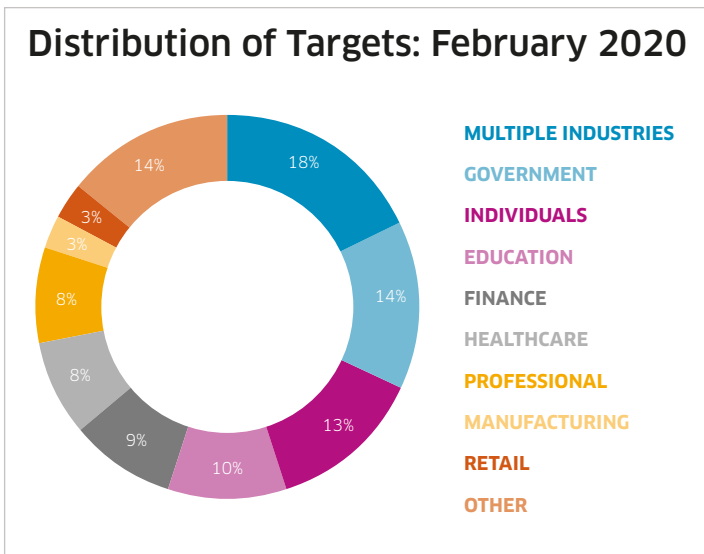
What is Driving the Growth in Cybersecurity?

The growth in cybersecurity is primarily driven by the measures needed to counteract the increasing number of cybercrimes that people, businesses, and governments face on a daily basis. As the chart below shows, the total number of major attacks reported in the news globally was higher in every month of 2019 versus the same month in 2018².

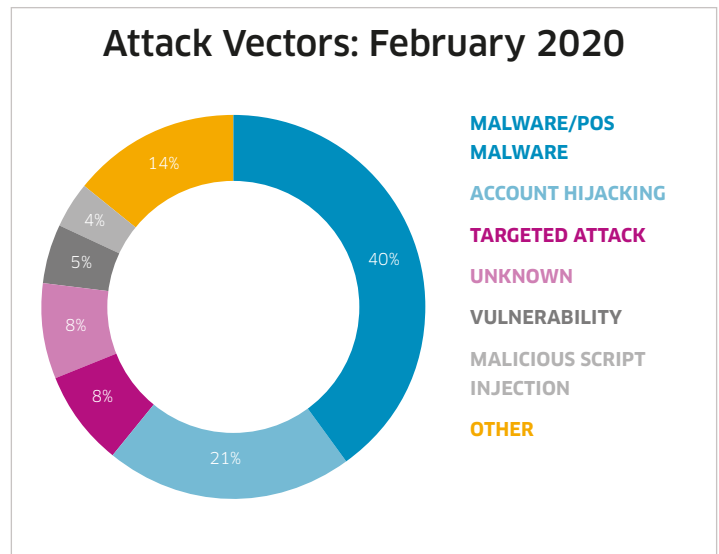


Source: <https://www.hackmageddon.com/2020/01/23/2019-cyber-attacks-statistics/>

In addition, the two charts below break down the attacks to highlight toward whom the attacks were targeted as well as the ways in which the attacks occurred. The charts illustrate that multiple industries, governments, and individuals were the most affected by cyberattacks in February 2020 and that most of those attacks were done via malware or account hijacking³.



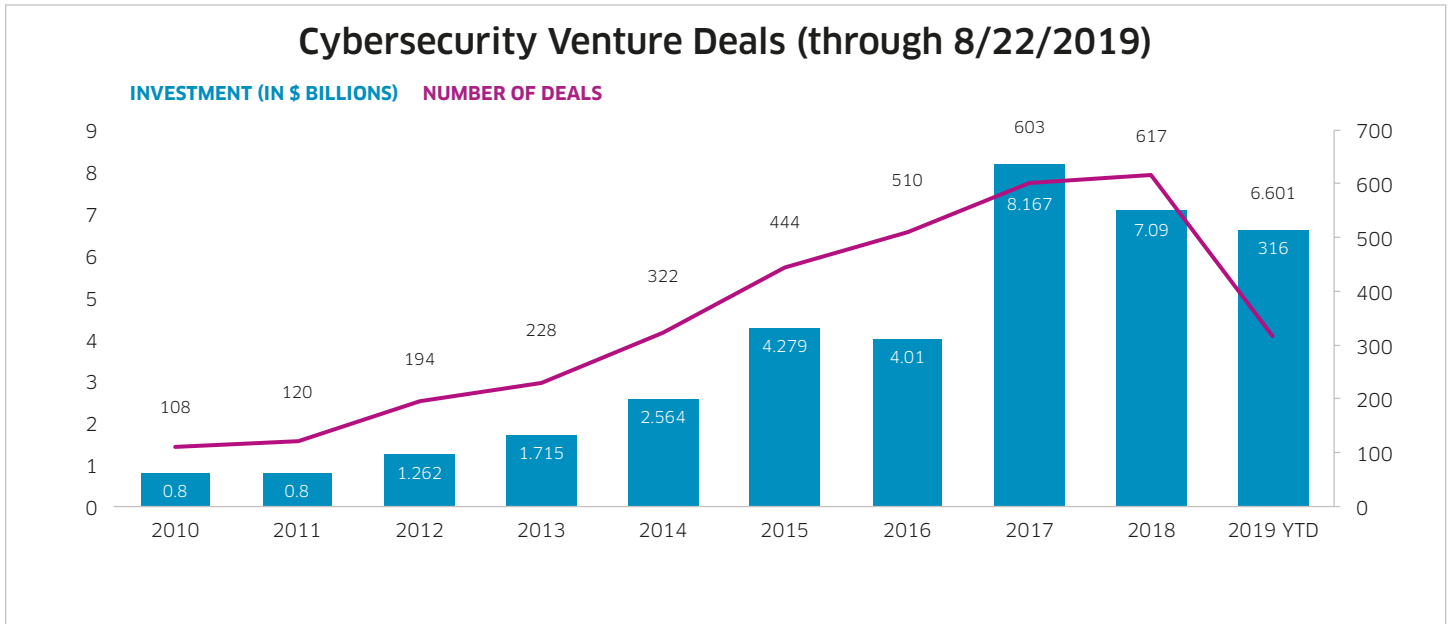
Source: <https://www.hackmageddon.com/2020/03/19/february-2020-cyber-attacks-statistics/>



Source: <https://www.hackmageddon.com/2020/03/19/february-2020-cyber-attacks-statistics/>

The impact of cyberattacks has grabbed the attention of the White House, as President Trump has deemed cybercrime one of the biggest issues facing national security. In addition, the President's 2020 Budget is proposing to allocate \$17.4 billion in spending to fund critical initiatives and research in the cybersecurity space, a 5% increase from the 2019 budget⁴.

Aside from the rising number of targeted attacks that is driving the growth in cybersecurity, the number of cybersecurity venture deals also highlights the dynamism in this space. The chart below shows that venture capital firms have invested more than \$37 billion into cybersecurity companies since 2010⁵.



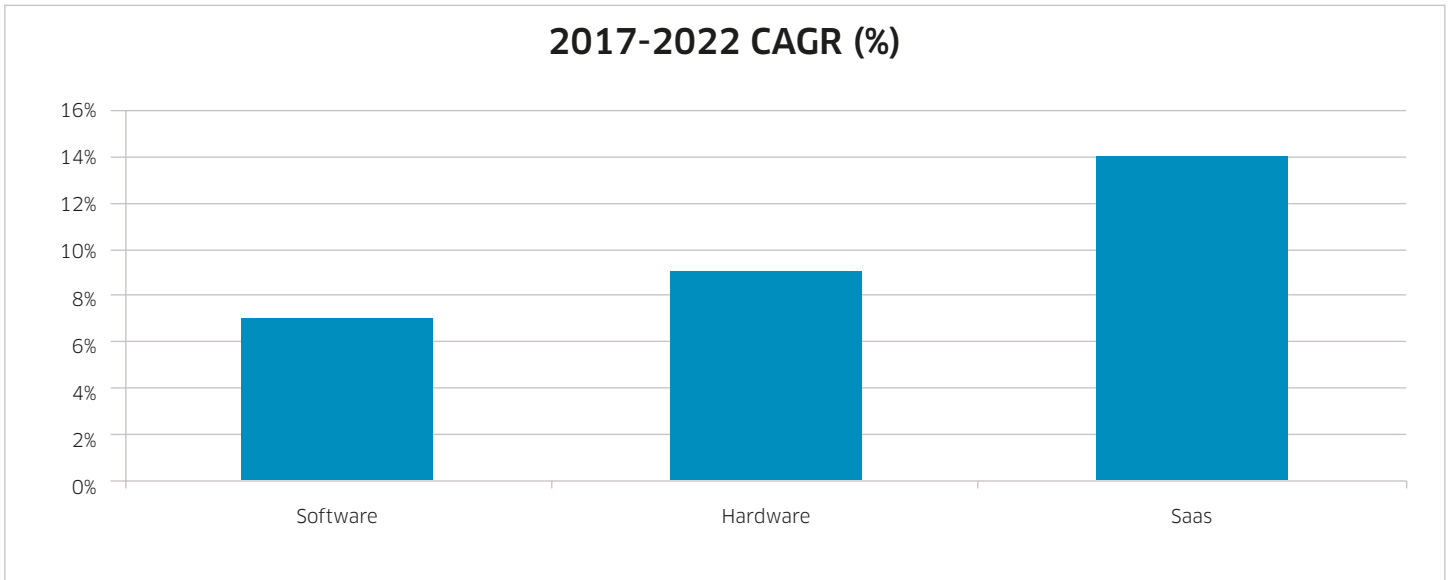
Source: <https://www.cbinsights.com/research/smart-money-vcs-early-stage-cybersecurity-startups-expert-intelligence/>

This explicitly demonstrates that the increasing number of targeted attacks and cybercrimes is driving the growth in cybersecurity and is continuing to augment the demand for these services, as venture capital firms have continued to pour money into this space. The above also shows that the growing raft of cybersecurity measures taken by governments, corporations, and other organizations bodes well for the cybersecurity industry from an investment perspective.

What is the Industry Outlook for Cybersecurity?

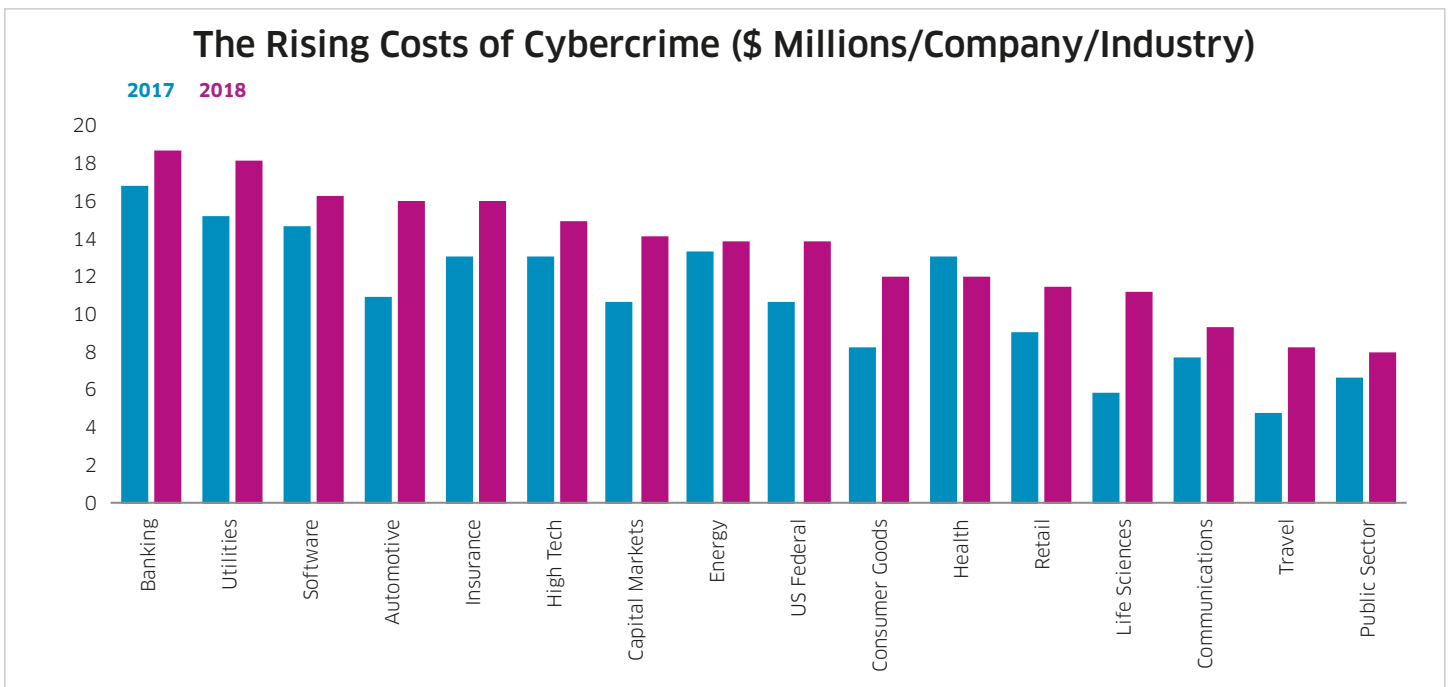
In addition to the increasing cyberattacks driving the industry's growth, the overall outlook for cybersecurity from an investment perspective is also positive.

A forecast from International Data Corporation (IDC) estimated that worldwide spending on security-related hardware, software, and services will reach more than \$151 billion in 2023 with a compound annual growth rate (CAGR) of 9.4% over the forecast period of 2019-2023⁶. According to Bloomberg and IDC, the largest area of growth within cybersecurity is likely to come from software-as-a-service (SaaS) companies⁷. The chart below forecasts that while traditional software and hardware are going to continue to grow and play an important role, network security will begin to meaningfully shift to the cloud, as most providers will keep boosting their cloud capabilities organically and via acquisitions⁷. As such, this reveals that cloud-based cyber security will continue to propel and expand the cybersecurity industry going forward.



Source: Bloomberg Intelligence (Mandeep Singh - Senior Analyst), December 26th, 2019 and IDC

Research conducted by Accenture suggests that cybercrime costs for organizations continue to rise as the average cost of cybercrime per organization was \$13 million in 2018, up from \$11.7 million in 2017 and a 72% increase in the last 5 years⁸. In addition, as the chart below illustrates, banking, utilities, and software industries have the highest cybercrime cost per company among all industries⁸.



Source: https://www.accenture.com/_acnmedia/PDF-96/Accenture-2019-Cost-of-Cybercrime-Study-Final.pdf#zoom=50

This suggests that, as cybercrime costs continue to rise for corporations, so will overall spending for cybersecurity measures, thus positively impacting the cybersecurity industry.

Survey-based research from Deloitte (gathered from 500 C-suite leaders of major corporations with at least \$500 million in annual revenue) emphasized that most executives planned as many as six different initiatives within the enterprise identity security market, including migration to cloud security, access management, and multi-factor authentication. This illustrates the depth and breadth of security measures that are being undertaken in many organizations and further highlights the continued investment in cybersecurity initiatives⁹.

In most instances, corporations are hesitant to reveal breaches and cyberattacks that they've been exposed to, primarily for fear of reputational damage. As such, Cybersecurity Ventures is predicting slightly higher growth rates, at about 12-15% year-over-year through 2021, which is higher than the 8-10% being predicted by other industry analysts¹⁰. *As a result, the actual spending on cybersecurity may be far more than what's revealed publicly, as companies may be understating their cybersecurity budgets in order to protect their reputation.*

Overall, the above shows that the industry outlook for cybersecurity is very positive. Due to the increasing number of cyberattacks the expectations for cybersecurity spending going forward remain very high. Some of the key growth areas within cybersecurity, such as cloud-based security, will help sustain overall growth, even if other areas decelerate. The rising costs of cybercrime – and corporations' willingness to invest time and money into various cybersecurity initiatives – further justify the elevated growth expectations for the industry, as well as the likelihood of it remaining a profitable investment for the foreseeable future.

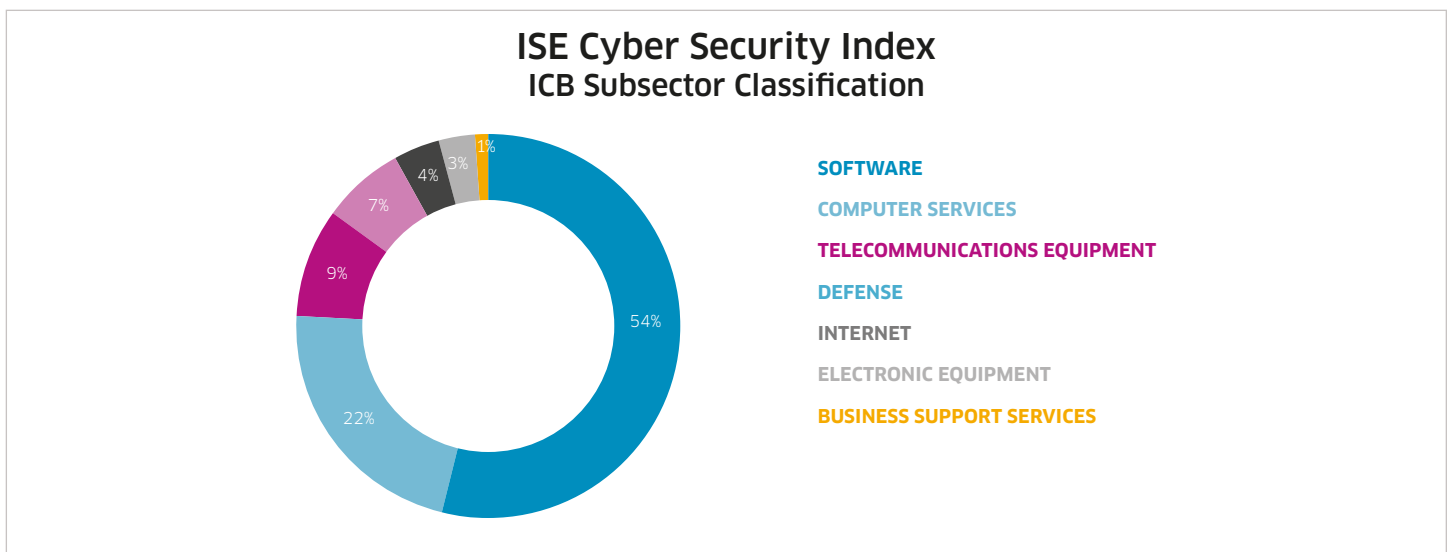
How can People Invest in Cybersecurity?

As mentioned above, one way investors can gain access to the cybersecurity space is through the ISE Cyber Security Index (HXR).

The methodology for HXR is as follows:

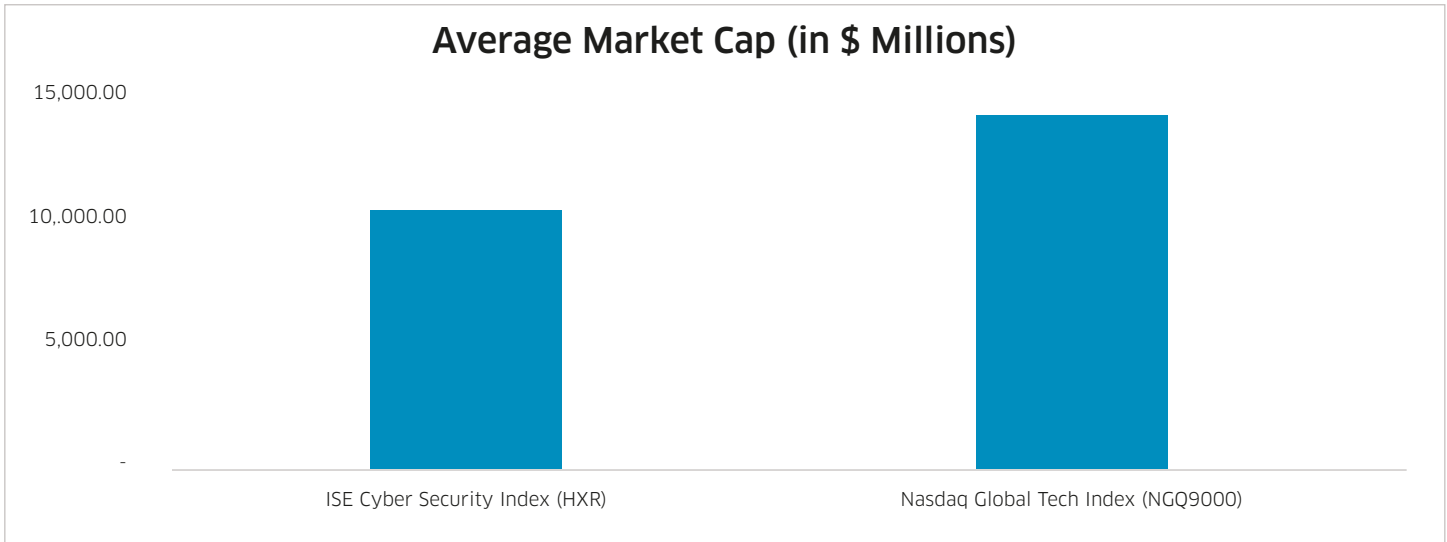
ISE Cyber Security Index: Provides investors with a product allowing them to quickly take advantage of both event-driven news and long term economic trends as the market for cyber security technology continues to evolve. It includes companies that are service providers (hardware/software developers) for cybersecurity and for which cybersecurity business activities are a key driver of their business, as well as companies that directly provide cybersecurity services and for which cybersecurity business activities are a key driver of their business¹¹. Each component in the index must have a float-market capitalization of at least \$100 million and a three-month average daily dollar trading volume of at least \$1 million¹¹.

In looking at the ICB sub-sector breakdown of HXR, one can see the focus on technology companies, specifically in the Software and Computer Services sub-sectors. This illustrates that investors are getting strong exposure to technology companies when they invest in the products tied to this index.

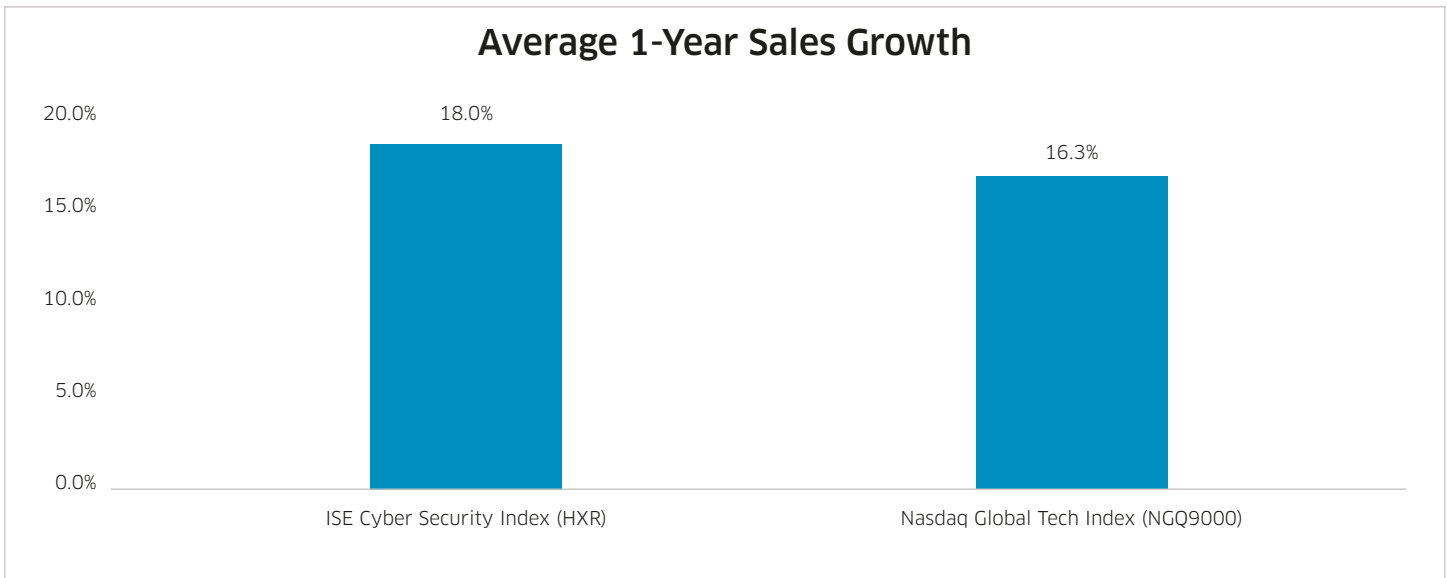


As of 3/31/2020

The components in this index are noticeably smaller, on average, than those in the Nasdaq Global Technology Index, which suggests that they may experience higher growth in the future. In fact, as the subsequent chart shows, components in this index have experienced better sales growth over the last year, on average, when compared to the Nasdaq Global Technology Index.

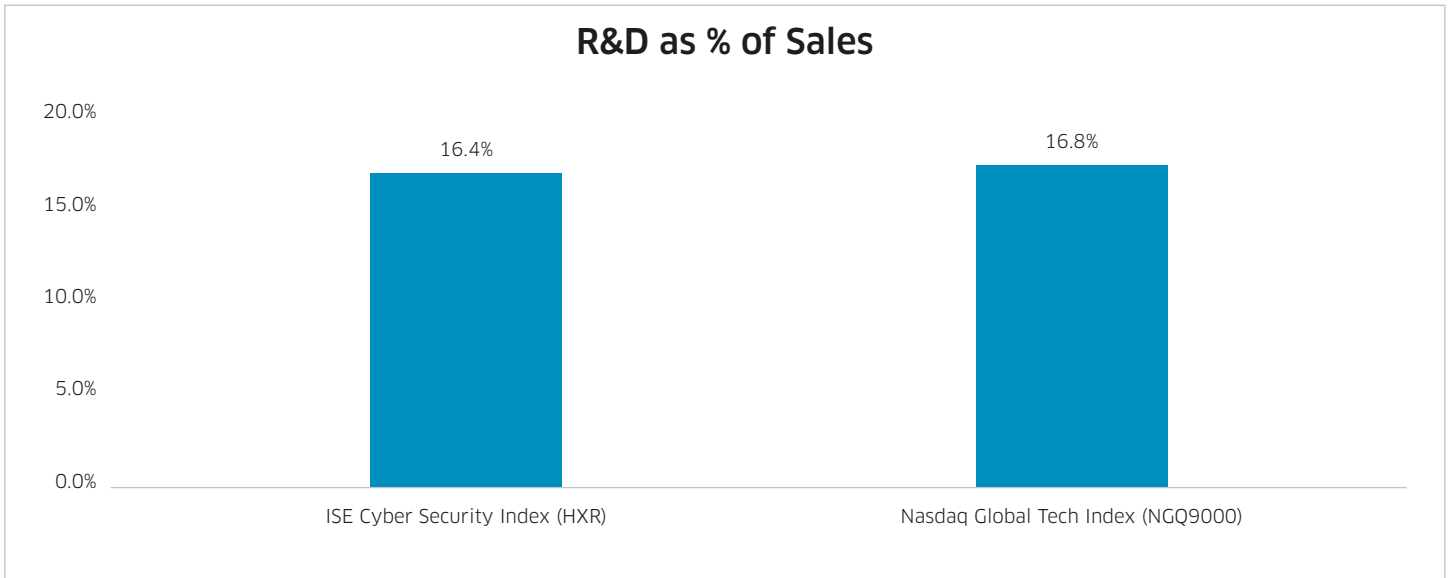


As of 3/31/2020



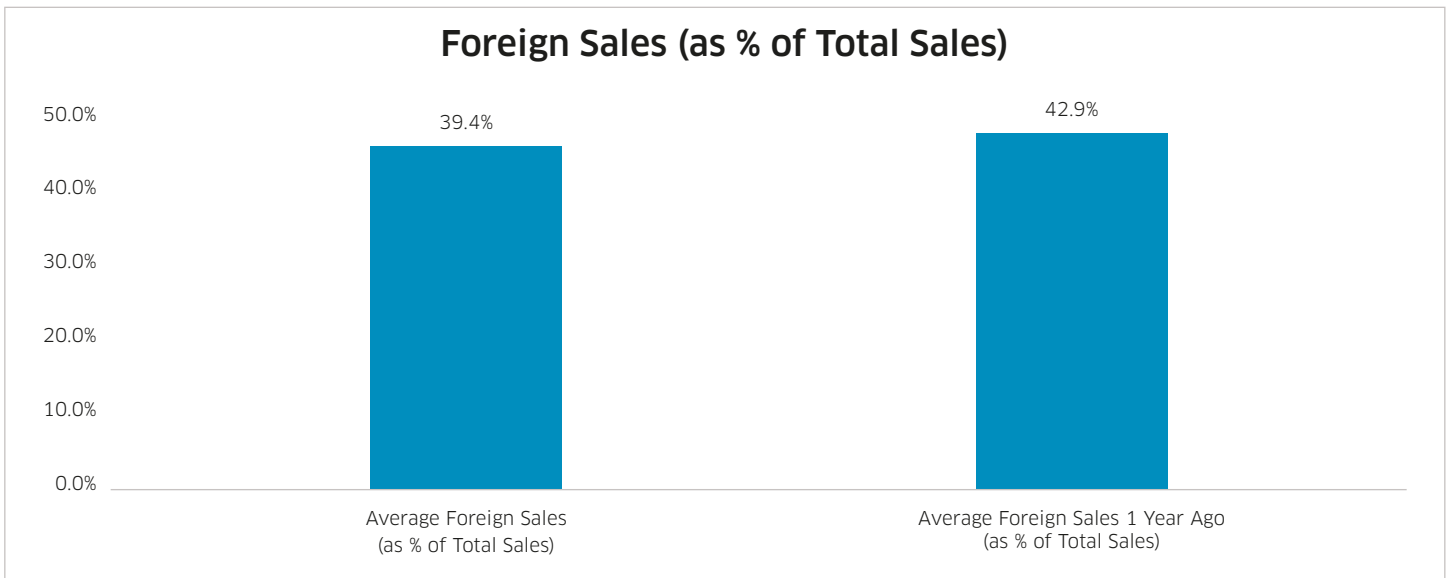
As of 3/31/2020

Since the components in this index are smaller and faster-growing, it would be reassuring to know that they are adequately investing their earnings into research and development to remain competitive in the fast-evolving cybersecurity landscape. On average, companies in HXR are investing roughly the same into R&D as those in the Nasdaq Global Technology Index.



As of 3/31/2020

In addition, because cybercrimes affect people, governments, and organizations all over the world, the components in this index should strive to capture the demand for cybersecurity services globally. The proportion of sales derived internationally averages around 40% across all companies in this index currently and one year ago, which suggests that they are indeed taking advantage of the global nature of cybersecurity demand (note: “foreign sales” refers to revenue derived from countries outside of the company’s domicile).



As of 3/31/2020

Conclusion

In summary, the analysis covered herein illustrates that cybercrimes have increasingly affected multiple industries in numerous ways, thereby boosting corporate demand for cybersecurity services. The continued rise in targeted attacks is also driving growth in cybersecurity services from major governments, including the US, while venture capital firms are investing many times more into the space versus only a few years ago. In addition to the high projected growth rates by various industry research firms and analysts, cloud-based security services and increasing cybercrime costs are going to continue to underpin spending in this industry moving forward.

The ISE Cyber Security Index offers investors technology-focused exposure to the cybersecurity industry. The index is comprised of components that have experienced strong sales growth and a high proportion of sales derived internationally, showing that they have adequately captured the demand for cybersecurity services thus far. More importantly, the components in this index continue to meaningfully invest into research and development, which will help drive their revenue growth as the cybersecurity industry continues to evolve.

Footnotes:

1. <https://enterprise.verizon.com/resources/reports/2019-data-breach-investigations-report.pdf>
2. <https://www.hackmageddon.com/2020/01/23/2019-cyber-attacks-statistics/>
3. <https://www.hackmageddon.com/2020/03/19/february-2020-cyber-attacks-statistics/>
4. https://www.whitehouse.gov/wp-content/uploads/2019/03/ap_24_cyber_security-fy2020.pdf
5. <https://www.cbinsights.com/research/smart-money-vcs-early-stage-cybersecurity-startups-expert-intelligence/>
6. <https://www.idc.com/getdoc.jsp?containerId=prUS45591619>
7. Bloomberg Intelligence (Mandeep Singh – Senior Analyst), December 26th, 2019 and IDC
8. https://www.accenture.com/_acnmedia/PDF-96/Accenture-2019-Cost-of-Cybercrime-Study-Final.pdf#zoom=50
9. <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/finance/us-the-future-of-cyber-survey.pdf>
10. <http://cybersecurityventures.com/cybersecurity-market-report/>
11. https://indexes.nasdaqomx.com/docs/Methodology_HXR.pdf
12. Data mentioned in the piece is from Nasdaq Index Research, Bloomberg, and/or FactSet, unless otherwise stated.

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