

Introduction

Darktrace PLC (LSE: DARK) was founded in 2013 by mathematicians and cyber defense experts. Its headquarters is in Cambridge, the United Kingdom.¹ The company has about 2200 employees with customers present in over 110 countries.² It launched its initial public offering (IPO) in April 2021 and currently* has a market cap of \$3.1 billion.³ As of its fiscal year 2022 that ended in June, the company generated 37.9% of its revenue from Americas, with 34.3% from the U.S., 40.8% from Europe, 17.1% from Asia-Pacific and the rest from others.

Management

Chief Executive Officer Poppy Gustafsson co-founded Darktrace in 2013, and has served as the CEO of the group since 2016. During her tenure as CEO, the company listed on the London Stock Exchange (LSE) in 2021. She is a qualified chartered accountant, holds a BSc in Mathematics from the University of Sheffield and has a total of 16 years of industry experience.^{4,5}

Chief Technology Officer Jack Stockdale is the founding CTO at Darktrace. With over 20 years of experience in software engineering, he is responsible for leading the development of Bayesian mathematical models and artificial intelligence algorithms. He has a degree in computer science from Lancaster University.⁶

In May 2023, Darktrace appointed Chris Kozup as its Chief Marketing Officer. He has more than 20 years of experience in the field. His prior experience includes working in enterprise technology & cybersecurity companies such as Zscaler and Cisco.⁷

Recent M&A-related Update

The company's takeover discussions with Thoma Bravo, a U.S.-based leading private equity firm, were first announced in August 2022. This was in response to media speculation, and post several unsolicited, preliminary, and conditional proposals from Thoma Bravo.⁸ In September 2022, Thoma Bravo's takeover talks were terminated as the two sides could not reach an agreement on a sale price⁹. This negatively affected the company's share performance. There was a sharp rise in its market value, from £2.6 billion to £3.6 billion on Thoma Bravo's bid interest and a subsequent decline to a value of £2.4 billion¹⁰ after the takeover failure¹¹.

Growth Drivers/Highlights

Strong R&D and innovative AI-based products: Darktrace is a leading company in the global AI-based cybersecurity domain. Darktrace's strength is linked to its AI research center (200 R&D employees, with +28% year-over-year [y/y] headcount growth in FY2022¹²) based in Cambridge, UK. The research center consists of experts, with ~100 master's degrees and 20 doctorates in disciplines from astrophysics to linguistics to data science.¹³ It has conducted research establishing new thresholds in cyber security, with technology innovations backed by over 125 patents and pending applications.¹⁴ The company currently serves over 8,400 customers worldwide. It has the first at-scale deployment of AI in cyber security, and is a pioneer in autonomous response technology.¹⁵ Most AI-based cybersecurity products typically rely on identifying threats based on historical attack data and reported techniques. However, Darktrace's self-learning AI is the only solution that learns from the organization's data and detects cyber-threats, even without reference to historic events.¹⁶ The company is unique in terms of its emphasis on scalable AI-based products, which sets it apart from its competitors.

Promising total addressable market (TAM): According to the company, its AI platform can be applied to all sizes of companies, across sectors and geographies, and is complementary to traditional security solutions. Given the nature of its products, proven revenue generation capability and market condition, the company estimates its TAM to be at \$47 billion (as of June 2022) using a bottom-up approach.¹⁷ This TAM presents a substantial growth opportunity for the company in the coming years, based on Darktrace's annualized recurring revenue (ARR) of \$514.4m in FY 2022. Darktrace estimates there are approximately 150,000 companies that would benefit from its technology, which is ~20 times its FY 2022 installed base.¹⁸

Strong customer base: The company's customer base is expanding rapidly (32.1% y/y growth in FY 2022).¹⁹ The company has good revenue visibility and a large backlog of contracted revenue for future periods, given most of its products are sold under multi-year subscriptions. Moreover, Darktrace's self-learning AI technology has the potential to be applied beyond cyber security. In the future, the company expects to generate growth opportunities in the broader enterprise AI market.²⁰

Products & Solutions

Darktrace offers products under four families: 1. Prevent 2. Detect 3. Respond and 4. Heal. These four product families, as the names suggest, will help prevent, detect, respond, and heal from cyber disruption across the enterprise. According to the company, "Darktrace's four product families each feed back into a continuous, virtuous cycle, constantly strengthening each other's abilities. Cyber AI Analyst investigates threats throughout the cycle, delivering human-readable reports to keep the human in the loop."²¹ The family of products are listed below:

- **Prevent²²:** This family of products prioritizes threats, hardens defenses and reduces risks inside the organization and outside the attack surface. The services that come under this segment are:
 - **Attack surface management (ASM):** Continuously monitors attack surface for risks, high-impact vulnerabilities and external threats. The product typically surfaces 30% - 50% more assets than an organization realizes it has. It communicates findings to Darktrace's Detect + Respond family of products to harden protections around critical chokepoints.
 - **End-to-End (E2E):** Prioritizes high-value targets and pathways to secure vital internal systems and assets, and prevents cyber attacks proactively. This product will help in attack path modelling, and will continuously identify all potential pathways, analyze every digital touchpoint, simulate breach and attack, and provide security and awareness training to vulnerable users.
- **Detect²³:** Learns an organization's version of normal using Darktrace self-learning AI. It then analyzes thousands of metrics to reveal subtle deviations that may signal an evolving threat, including even unknown techniques and novel malware. It then feeds this data into Darktrace's Respond for it to disarm threats.
- **Respond²⁴:** Helps in stopping attacks in real-time across the entire digital estate and even detects fast-paced ransomware attacks. It autonomously disarms the attacks whenever they occur, working 24/7. It responds to novel threats on the first encounter, and also disarms threats regardless of whether they've been seen previously.
- **Heal²⁵:** Enables organizations to restore assets and systems affected by cyber-attacks without interrupting the business to trusted operational states through AI assistance. It also helps the security team in making decisions around restoring the assets during and after an attack.

Financials

Darktrace reported H1 FY 2023 (ending in December 2022) revenue of \$259.3 million, up 35.8% y/y. Revenue grew across all geographic markets and customer sizes, driven by repeat customers (99.3% of revenue from recurring subscription-based contracts). However, the company experienced a slowdown in new customer additions.²⁶ The constant currency (c.c) ARR was \$556.6 million (+36.6% y/y). Gross margin was 89.7% (vs 89.2% in H1 FY 2022), while adjusted EBIT margin declined by 100 bps y/y to 12.5% (vs 13.5% in H1 FY 2022) as a result of “comparatively slower revenue growth” according to the company.²⁷

In FY 2022, revenue grew 45.7% y/y to \$415.5 million (vs \$285.1 million in FY 2021), primarily driven by 32.1% y/y growth in the customer base²⁸, while ARR was at \$514.4 million (+42.6% y/y). Gross margin was 89.2% (vs 90.0% in FY 2021) and adjusted EBIT margin was 12.0% (vs 1.3% in FY 2021).²⁹

As of its most recent guidance update in Q3 of FY 2023, the company expects revenue growth around 31% y/y with a 29% y/y (c.c) growth in ARR for FY 2023. Additionally, the company expects an adjusted EBITDA margin of ~ 19%.³⁰

Stock Performance³¹

Darktrace was added back to the the ISE Cyber Security UCITS Index (HUR) on April 18, 2022. Since then, its price return until June 16, 2023 was -4.8% (versus -12.6% for HUR and 0.4% for the S&P 500). Since its IPO date of April 30, 2021, its price return until June 16, 2023 was 5.2% (versus -11.0% return for HUR and 5.5% return for the S&P 500). On a year-to-date basis, as of June 16, 2023, its price return was 34.2%, outperforming the HUR and the S&P 500, which returned 21.6% and 14.8%, respectively.

Role in Cyber Security Theme

Darktrace generates 100% of its revenue from its cyber-threat defense technology offerings³², and is a market leader in global AI-based cybersecurity solutions.³³ According to Gartner, “Darktrace is a market share leader in network detection and response (NDR) with a share of 31.7% in Q1 CY 2022, up from 24.5% when compared with the previous year. Its definition of network extends to include, crucially, cloud and SaaS as well as network. Customers rated Darktrace’s email security product a 4.8 out of 5 stars, as reported in Gartner’s peer insights review”.³⁴ Moreover, the company has won several awards for its contributions and innovations in the cybersecurity domain, including Go:Tech Awards (for AI and Machine Learning), The National Cyber Awards in the UK (for AI cyber product of the Year) and Management Today Business Awards (for best use of innovation in business in the UK). The company’s featured partners include stellar names like Microsoft (MSFT), AWS (AMZN), and McLaren.³⁵

Darktrace’s cybersecurity journey started in 2013. In 2013, it set up its AI-research center, which rolled out its self-learning AI technology. From 2013-2023, the company rolled out its signature products. During the period 2014-2016, it delivered products which detect and respond to threats. In 2019, it delivered CyberAI Analyst, which delivered context reporting, greatly reducing time-to-meaning. In 2022, it delivered Prevent which hardens security by blocking paths to high-value assets. And in 2023, it delivered Heal which assists and automates remediation and recovery.³⁶

In 2023, in the wake of generative AI-based privacy/security concerns, the company introduced a new risk and compliance model for its 8,400+ customers which addressed IP loss and data leakage.³⁷ It also rolled out a major upgrade to its Darktrace/Email product, which defends organizations against an evolving cyber threat landscape, including generative AI business email compromises and novel social engineering attacks.³⁸

Major Risks (specific to the company)

Low growth in new customer additions³⁹: In FY 2022, the company's revenue was driven primarily by new customer additions. Darktrace added more than 1,800 customers (32.1% y/y growth). In contrast, in H1 FY 2023, total number of new customers added was 741, significantly less than the 926 additions during H1 FY 2022. Q3 FY 2023 results show that only 225 new customers were added (vs 359 during Q3 FY 2022), which suggests that there has been a continued slowdown in FY 2023. This has negatively affected its revenue growth trajectory at least temporarily, as Darktrace has attributed the slowdown to macroeconomic factors. As a result, Darktrace has begun focusing on larger account sales and upsells to drive increases in both average new contract and existing customer contract ARR. Indeed, a y/y increase in average contract ARR of 9.8% is helping to partially offset lower gross ARR added related to reduced new customer additions, and is allowing Darktrace to reiterate previous guidance on ARR and other financial metrics for FY 2023.

Allegations by short sellers⁴⁰: In February 2023, U.S.-based hedge fund, Quintessential Capital Management (QCM) said it had taken a short position on Darktrace and published a detailed report on the same. The report raised serious allegations against the company including comments such as "Deeply skeptical about the validity of Darktrace's financial statements and believe sales and growth rates may have been overstated". QCM suggested Darktrace may have inflated its revenues by booking unearned revenues as actual sales and accused Darktrace of having ties with individuals with organized crime, money laundering and fraud.

According to CNBC, "even before the QCM report, analysts have criticized the company over an allegedly aggressive sales culture and doubts over the value of its technology".

Note:

*Now/current/today means as of June 16, 2023, unless specified otherwise

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