

July 12, 2019

## Dear Clients and colleagues:

Last week Eurofins, a leading provider of forensic services, paid the required ransom after being infected by a ransomware virus that disrupted its IT systems. It is the latest in a long line of events that has brought the issue of cybersecurity into focus. From interfering in elections to breaches of customer data, barely a week goes by without news of some major event involving viruses, known and unknown malware, spyware, intrusions, unwanted applications, spam, policy abuse or data leakage.

At Global Alpha, we wanted exposure to this extremely large and growing addressable market. To give you an idea of its size, cybersecurity software is a \$46-\$50 billion market, and if you add in other additional services, you are looking at least double that amount. Currently, only 7% of the total \$1.6 trillion global IT budget is being spent on cybersecurity, and according to IBM, the recommended spend is 9.8%-13.7%. In other words, the market should be at least 50% larger, or even double its current size. And yet it is a market that is still growing at a healthy 8% per year – some sub-segments more, some less.

Which brings us to Sophos, a recent addition to our portfolios. Sophos is a 30-year-old UK-based cybersecurity company that focuses on small- and medium-sized enterprises (SMEs). These mid-market companies (ranging in size from 100 to 5,000 employees) account for approximately 70% of all IT security spending, but they are underserved by IT security vendors that tend to focus on larger enterprises. SMEs face the same IT security threats as larger enterprises, but they have fewer resources, capacity and personnel to address them. Sophos offers products and services that provide the advanced cloud-enabled protection capabilities typically available only to larger enterprises but without complex deployment or maintenance and at a lower cost.

So why add Sophos now? As with other subscription-based businesses, revenues lag billings, hence losses are incurred as expenses must be recognized against billings while revenues are deferred. After a period of significant investment to drive billings growth, Sophos is now at an attractive inflection point where revenue growth has caught up with billings and it is simultaneously benefitting from healthy profits as operational leverage kicks in.

The growth strategy for Sophos is via distribution partners which allows the company to (a) focus resources on building products and programs and (b) quickly scale in new markets as distributors plug Sophos into their existing grid. Sophos has over 40,000 registered Channel partners, but more importantly, 8,000 blue chip partners that generate the majority of its billings. Sophos wants to grow

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Source: MSCI. The MSCI information may only be used for your internal use, may not be reproduced or disseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. This report is not approved, reviewed or produced by MSCI.

its customer base worldwide and increase its product footprint within its existing customer base. Currently only 10% of Sophos' customers use both its endpoint and network products.

Opportunities for growth include increasing the cross-sell and upsell of its products. The company continues to invest in the Sophos Central platform, a single, integrated cloud-based management and reporting platform that makes it easier to manage, update and configure Sophos products, and it also helps drive cross-sell and upsell opportunities. One of the keys here is to educate and incentivize its current Channel partners to promote an integrated product portfolio. Another opportunity will come from increased regulation. The European General Data Protection Regulation was introduced last year and states that companies with insufficient procedures in place or that fail to report breaches of their network are subject to a possible fine of up to 4% of revenue or €20 million, whichever is larger. Just this week, the UK's Information Commissioner's Office said it intends to impose a fine of \$123 million on Marriott for its data breach last year and a fine of \$230 million on British Airways for failing to sufficiently protect its website. We believe that regulation will continue to be a tailwind.

Cybersecurity products are often considered not sticky, but Sophos has industry-leading renewal rates. The sector continues to attract new competition, and there is always the possibility that one of these new competitors will come up with a better product. Microsoft is spending significant amounts on cybersecurity R&D and this, combined with their huge cloud presence, could represent serious competition down the road.

The competition in endpoint security comes from established players like Symantec and McAfee, as well as some new players like Carbon Black. Network security competition tends to come from Checkpoint, Fortinet and Palo Alto, but their focus is on large enterprises. The advantage that these incumbents have is their large databases, built over time, that contain the signatures of previously detected malware. Newer players in AI and machine learning don't have a large database to rely on, but instead act on suspicious behaviour. Sophos has a foot in both camps as it has 30 years of data and has acquired technology that enables machine-learning-based security capability.

Sophos provides Global Alpha with exposure to a fundamentally attractive market, and we believe the company will continue to benefit from the long-term trend of increased cybersecurity spending.

Have a great weekend.

The Global Alpha team

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Source: MSCI. The MSCI information may only be used for your internal use, may not be reproduced or disseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. This report is not approved, reviewed or produced by MSCI.