CYBERHEDGE

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2020

Cyber Governance Alert

Hertz®

Hertz

	12M	6M	Current
	1 .25 (▼0.25)	1.11 (▼0.14)	1 (▼0.11)

Competitive pressure to further accelerate digital transformation coupled with significant financial constraints make cyber governance a key factor in Hertz's (HTZ's) 12-month outlook.

Though it makes money from renting cars, HTZ is increasingly dependent on digital technology to generate value. HTZ operates in a highly competitive market with stagnant growth in which costly technological transformation is required to maintain a competitive position. Coupled with poor profitability and weak key debt metrics, this leaves little room for error in its management of cyber risk. We expect technology governance to have share price implications in the next 12 months.

Why does cyber governance matter?

HTZ is a good example of why transparency on cyber governance is needed. **Investors do not know whether management is overinvesting or underinvesting in securing its most valuable asset—technology—relative to the increasing risks the company faces as a result of the ongoing digitization of the business.**

Digital transformation coming at expense of strong cybersecurity

HTZ (along with its primary rivals) is under pressure to digitally transform the way it operates to better meet customer expectations and optimize its fleet of vehicles. But there is evidence that this transformation is coming at the expense of the company's cyber governance. Current CEO Kathryn Marinello has been applauded for a much-neeeded increase in IT investment since taking over in 2017 (including new CRM system), but the company's 1-star rating is evidence that this IT investment has been focused mostly on facilitating revenue growth, and there has not been adequent investment in security to accompany the growth and cost-reducing benefits the investment has started to generate.

Cyberhedge has issued a Cyber Governance Alert on HTZ because:

1. It has been a consistent underperformer on cyber governance over 2019 against a backdrop of an increasing need to invest in technology to stay competitive.

2. Key financial constraints (low EBIT/Interest Expense, limited profit and FCF growth vs. peers) limit its ability to fix the underlying cyber problems. This creates an increased risk for investors over the next 12-18 months.

These challenges come at a time when Transportation Network Companies (TNCs), like Lyft, will transition from partners to competitors in 2020, further increasing HTZ's need to invest in growth-oriented technology.

Cyber-Financial (CyFi) Analysis

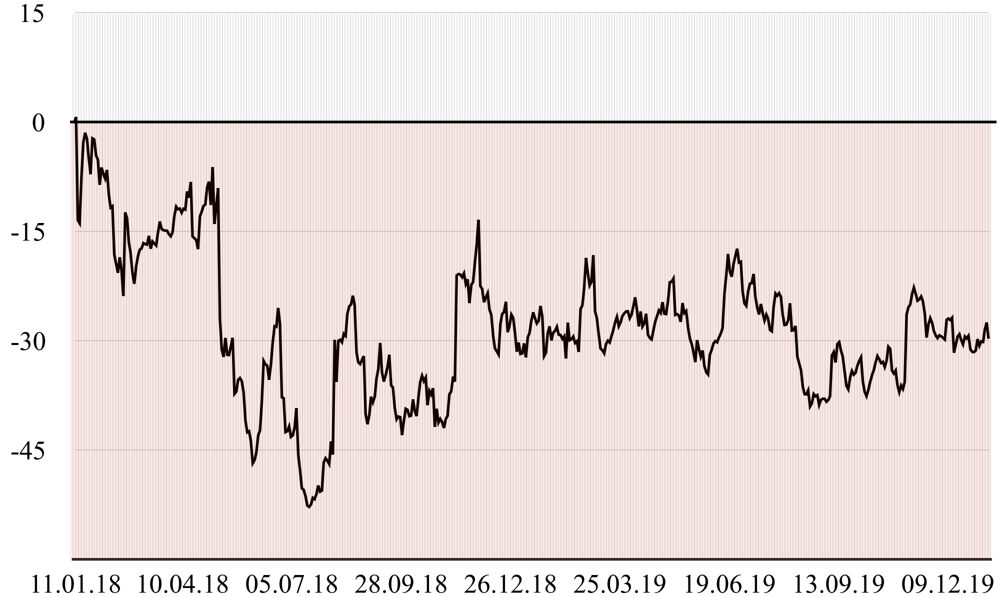
- **Strategic KPI for HTZ's business model: 1.** Use of behavioral data to improve personalization, which improves brand loyalty, lowers CAC **2.** Deployment of technology that improves operational efficiencies, resulting in better fleet utilization rates.

- **How do digital assets create value for HTZ shareholders? 1. Customer behavioral data** informs the purchase, volume, and location of HTZ's cars to maximize fleet utilization and control costs. This data also informs additional services the company introduces that improve personalization and lower CAC. **2. Data transmission** underpins operations, including the reservations system, pricing algorithm, and fleet management—all critical to growing margins and maintaining market share.

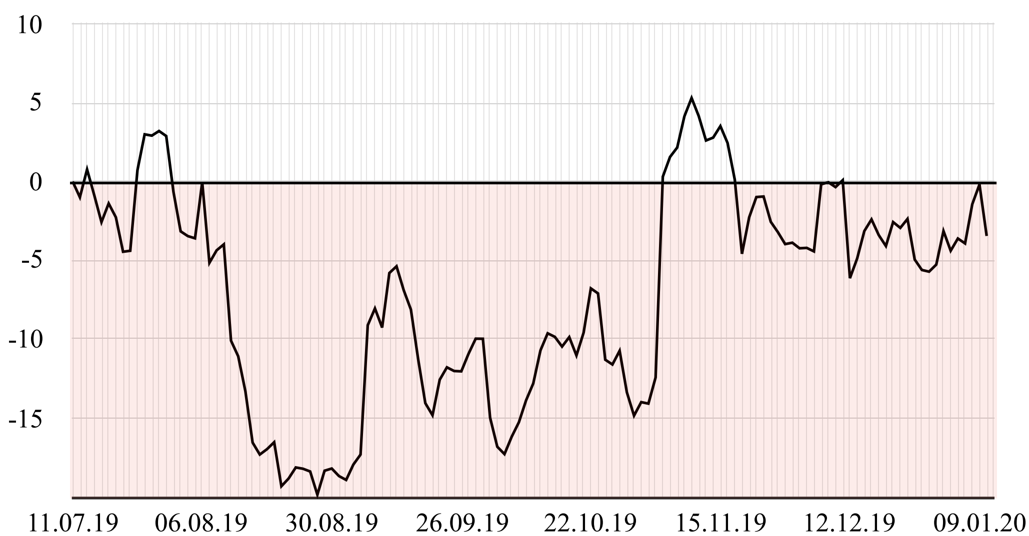
- **Biggest governance problem:** HTZ cannot afford an increase in interest expense related to a potential worsening of creditworthiness: our data shows 64% of CBH 1-star companies are also single B and CCC rated.

- **What financial metrics investors can track to measure cyber goverance:** Improvement relative to peers on Interest Coverage and EBIT / Interest Expense (see Table 1)

Two-year Underperformance as CBH 1-Star: HTZ Shareprice vs. S&P 600 Small Cap Index



Six-month Underperformance as CBH 1-Star: HTZ vs. Market Peers (S&P 600 Small Cap)



Pressure to digitally transform

Managing technology the right way, including security, is critical to the future of the company. HTZ sees itself in a fast-changing market, which is being disrupted by technology and changing customer demands. Industry experts have described a 'tech arms race' between the top three companies (Avis, Enterprise). Avis is in the process of connecting all of its cars to the internet. The goal is to enable better fleet management with features such as remotely gauging fuel levels and the ability to lock and unlock a car from a smart phone. The company can also collect data that it can sell to entities such as transportation departments and car manufacturers.

HTZ management makes clear that it needs to continue to invest in technology and digital services to keep pace with old and new rivals. Though it has been noted that the company can quickly reduce capital spending if industry or economic conditions warrant, technology spend (including on cybersecurity, which is reflected in the poor cyber governance rating) suggests security is not an area the company can afford to cut.

TNCs create further pressure to invest in technology

HTZ faces increasing pressure from TNCs like Lyft and Uber. Ride-hailing services accounted for about 60% of U.S. business-travel transactions on ground transportation as of 1Q18 vs. about 10% in 1Q14 (Bloomberg). Each of the big three have taken steps in recent years to form partnerships with the TNCs (Express Drive), making a concerted effort to rent vehicles to TNC drivers in order to increase fleet utilization.

HTZ even highlights TNC growth as a key part of topline growth (Q319). More recently, the dynamic has transitioned from partnership to competition, as Lyft announced plans to launch a car rental service of its own in California. Though Lyft's own financial constraints will limit the actual dent it can make in HTZ and other established players' car rental market share in the short term, it reinforces the perception that HTZ and its peers need to continue to accelerate digital investments or risk falling behind. This is what HTZ describes as the **'need to have a comprehensive and systemic process related to emerging or disruptive competitors or technology.'**

Examples of steps to digitize operations include:

- **Biometrics to shorten wait times:** HTZ partners with security startup Clear to offer Fast Lane, a biometric check for car rentals, and is committed to reducing customer wait time by 75%. CEO Marinello emphasizes the importance of improving overall process and customer experience.
- **'Digitizing customer experience':** This includes allowing customers to connect to vehicle via mobile phone Bluetooth.
- **Connected cars:** HTZ makes free wifi available in cars via Hertz SuperStart.

Most concerning digital risk for HTZ investors: business disruption.

As HTZ highlights in its 10K: "We rely heavily on communication networks and information technology systems to, among other things, accept reservations, process rental and sales transactions, manage our pricing, manage our revenue earning vehicles, manage our financing arrangements, account for our activities, and otherwise conduct our business."

Little margin for error: digital transformation touches every aspect of HTZ's strategy.

"We look to shape Hertz's future as a more efficient, progressive, fleet management company that drives operational growth, leverages Hertz's iconic brands, leads through technology and unlocks asset value."

— CEO Kathryn V. Marinello
(Innosight CEO Summit)

HTZ's limited financial resources in a very competitive market means that it cannot invest in growth initiatives, reduce debt, and increase spending on cybersecurity all at the same time. Its clear choice to prioritize growth at the expense of improving cybersecurity leaves it vulnerable to potential brand damage from cyber breaches (and subsequent market share loss and customer churn).

HTZ generates an estimated 92% of its revenues from renting vehicles (FY18 10K), and digital technology now underpins its entire operation.

The cost of a breach that disrupts the company's network or systems would reach far beyond the initial cost of repairing it. The specifics of "brand value loss" related to such an event would include: an increase in costs of acquiring future customers, a decline in y-o-y sales growth, and an increase in the likelihood of a credit downgrade, all factors that would undercut the significant investments Marinello and leadership have made in the past three years to revitalize HTZ.

Furthermore, the strength of HTZ's "brand value" factor is what the company views as key to maintaining 'modest' top-line growth and pricing power.

HTZ is one-third the size of industry-leading Enterprise, so this would be further ground it cannot afford to lose, and it is facing increasing competition from the likes of Uber and Lyft.

Secondary digital risk for HTZ investors: personal and financial data of customers

A secondary risk is the wealth of personal customer data HTZ possesses, including financial data that is of high value to hackers.

In this way, HTZ and other rental car companies face greater challenges relative to other service industries.

They need to secure an outsized amount of personal data for their millions of customers—information essential to day-to-day operations.

In addition, allowing customers to connect to vehicles via personal phones creates an ongoing expansion of additional nodes across an already complex network that is costly to adequately protect from current and future attacks.

All of these risks serve as a reminder that protecting digital assets should be considered equally alongside the growth, productivity, and cost-reducing benefits of digital transformation.

Financial constraints limit investment in security despite growing risks

HTZ's high debt burden is a key constraint, although most of this is vehicle debt ($14.1B of $18B total debt end-3Q19 is vehicles) and higher debt ratios are more common in the car rental industry.

Avis is slightly better on key metrics, but overall faces a similar constraint to HTZ. Sector leader Enterprise is a private company with a much better debt rating than HTZ (A- vs. B+), lower debt service cost, and is also investing in transformational technologies to take increasing market share. This puts pressure on HTZ to devote budget resources from a scarce base to additional digital transformation initiatives to maintain a competitive product not only with market leader Enterprise, but also with peer Avis and disruptors Uber and Lyft.

Limited profits ($65mn in 9mo19) with modest growth expected in 2020 coupled with limited FCG growth constrain HTZ management's ability to allocate more resources to network security, as well as service debt without increasing interest expense payments.

Overall, HTZ has an uphill climb with little room for error before reaping the financial benefits of its digitial strategy. If that isn't enough, it has to navigate a market share and pricing environment that is arguably more competitive than it has ever been.

To succeed in its digital transformation strategy, HTZ needs to take Avis' advice and "try harder" on improving its network security and key credit metrics where they underperform.

Credit Metric	HTZ	10 Pctl	Range	90 Pctl
Debit/Equity (%)	1457.5	0.0		296.0
Int Coverage	**0.6**	**-19.3**		**22.3**
ROA (%)	-1.1	-88.2		12.5
Liab/EBITDA	158.0	-133.9		274.1
EBIT/Int Exp	**0.6**	**-19.3**		**22.3**

● HTZ ♦ Median ♦ Wtd Avg

Source: Bloomberg

Table 1. **HTZ vs. Peers on Interest Coverage and EBIT / Interest Expense**

Bottom Line:

- HTZ operates in a highly competitive market with stagnant growth in which costly technological transformation is required to maintain a competitive position. Coupled with poor profitability, weak key debt metrics, and high debt, this leaves little room for error in its management of cyber risk.
- **How HTZ manages its technology is existential to the future of the business, and it is currently managing technology risks poorly.** A legacy transportation services company is now a technology company that is reliant upon the ability to gather increasing amounts of customer data to inform its fleet management and improve services in a way that increases brand loyalty.
- HTZ's future prospects and brand value (as transportation becomes technology) is as dependent on how well it manages its cyber risk as it is on hitting successful growth, productivity, and cost-reduction targets of digital transformation. HTZ's poor management of cyber risk should be of note to investors as the company enters its fourth year of a turnaround effort.
- Immense pressure to digitally transform has led to the introduction of an array of digital services and technologies aimed at improving customer experience and operational efficiency, but it is coming at the expense of cybersecurity.

Research

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