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Crypto's Dead, Long Live Crypto: The Path Forward in the Digital Transformation

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Jinal Surti

Head of Asset Management
jinal@menai.io

Matt Russ, CFA

Head of Institutional Solutions
matt.russ@menai.io

For more information, please contact IR@menai.io

*In this **Menai Quarterly Research Brief**, we aim to put recent crypto developments into context of the bigger technological advancement. We will highlight a real world example of digital value creation with Uniswap, providing a glimpse at a fundamental thesis for the long-term attractiveness of the "Liquid VC" digital asset class.*

Summary Takeaways

- Deleveraging is necessary for renewed progress in both traditional and digital asset classes, and it could continue in the near term in a risk-off environment.
- Efficiencies and scalability of decentralized networks can be key drivers of value creation within our complex economy.
- A major benefit today vs. the 1990s dotcom era is investors have access to early-stage opportunities in crypto-blockchain technology via liquid digital asset investing.
- Now is the time for investors to ramp up knowledge on the emerging digital asset class and consider the risk-reward merits of diversified exposure to this Liquid VC.

Introduction. After recent ructions in the digital asset markets, the dispersion of opinions on the future of crypto is as wide as ever. The Maximalists and the Naysayers continue to hold their ground—Musk, Saylor, Munger, Gates—all debating on the global stage. From Menai's conversations with institutional investors, private wealth clients and consultants, the sentiment shades toward the belief that emerging crypto-blockchain technologies have inherent value and should be owned for the long term. So, what is happening in crypto today?

By now, most people have heard about the collapse of the Terra Project and its native tokens LUNA and UST, the implosion of Celsius' "yield generation" strategies, the woes of crypto hedge fund Three Arrows Capital, and the unprecedented "emergency powers" vote(s) at Solend Labs.[1] We will not re-hash these shortfalls, but the fact that the digital asset class has endured these seismic events speaks volumes for its staying power. Large scale deleveraging and a purge of flawed protocols is a necessary part of the evolutionary process.

Deleveraging Cycles. During the GFC, Steve Eisman, formerly of FrontPoint Partners, said traditional financial institutions "mistook leverage for genius." We have seen episodes like this before in 2008 and 2002, even 1998. Mortgages, telecom, stat arb in emerging market debt with no posted collateral. Now, liquidity-driven asset inflation unleashed by the Federal Reserve in coordination with global central banks ("CBs") has reversed in a vicious way. Rate hikes are occurring around the world, with 23 of 30 OECD and G20 CBs hiking short-term interest rates.[2] What went up must come down—it is deleveraging, pure and simple. Yet it is exactly this deleveraging that the crypto market needs for the strongest to emerge stronger and survive.

In addition to the collapse of flawed protocols, over the Juneteenth weekend Bitcoin ("BTC") broke below the $20k level on higher volumes and printed $17,600 before bouncing as auto-liquidations cascaded and levered entities washed out, including CeFi firms closely tied to BTC and Ethereum through proxies. Cycles like this can take time, as we experienced during the Crypto Winter of 2018 when the consolidation lasted 52 weeks peak to trough. For context, it has been 34 weeks since BTC peaked in November 2021 (see Exhibit 1).

ICYDK

"The king is dead, long live the king!" is a traditional proclamation made following the accession of a new monarch, originally translated from French: "Le roi est mort, vive le roi," dating back to Charles VII's ascension to the French throne in 1422.[3]

[1] Menai had zero exposure to native tokens LUNA, UST, CEL, and SLND.
[2] https://www.cbrates.com, as of June 30, 2022.
[3] https://en.wikipedia.org/wiki/The_king_is_dead,_long_live_the_king!

Exhibit 1. Bitcoin Near Key Support of Dec 2017 Highs & 5-year Average Price ($19,102)

Source: Stockcharts.com; weekly chart from July 2017 through June 30, 2022.

Use-case applications of crypto-blockchain technology should be the fundamental driver of investor allocations to this Liquid VC asset class.

Excess liquidity and leveraged risk are reminiscent of the dotcom days in the late 1990s—an era that led to the birth of technology like Google and Amazon in the wake of countless failed tech companies. Today, long-game winners in digital are not yet certain, but Menai is a firm believer that *there will be winners*. Let us examine a use-case application of crypto technology and provide real world context for why we believe allocators should have actively managed, diversified exposure to this Liquid VC asset class.

Real World Example of the Digital Transformation. Efficiencies of various crypto protocols are tremendous. Put simply, the value of digital assets comes from their ability to disrupt business models across every sector of the economy. It is difficult to find a business model that was not affected fundamentally by the Internet. We believe the same will happen with blockchain and digital assets, changing how we store, transfer and process value.

Blockchain's fundamental innovation is the ability for individuals to remove the need for trust in a centralized intermediary (e.g., banks, markets, art dealers) and engage in commerce in a completely peer-to-peer environment. Cryptocurrencies perform two essential functions on any open and decentralized blockchain:

The value of digital assets comes from their ability to disrupt business models and change how we store, transfer and process value.

- First, they are units of value that are an essential part of open and decentralized blockchains to moderate usage and allocate resources in the decentralized network. Crypto is often the "currency" or "postage stamp" needed to engage in commercial activity on that blockchain. Without cryptocurrencies and associated transaction fees, open and decentralized blockchains would have no mechanism to protect against spam and DDoS attacks.[4]

[4] "Distributed Denial-of-Service Attacks" flood a server with internet traffic to prevent users from accessing connected online services.

- Second, crypto represents units of ownership to which economic benefits can accrue from the usage of a blockchain. Think of this as a form of "fees" that users of that blockchain pay to use the application or seigniorage, effectively creating a cash flow or more appropriately, a "token" flow.

Crypto represents units of ownership to which economic benefits can accrue from blockchain usage—effectively, a "token" flow.

These decentralized networks (blockchains *with* cryptocurrencies) have enabled products (i.e., user experience) as well as business processes (e.g., accounting, payments) to be highly automated and capable of running without a central operator in a trustless manner. This is a key factor in unlocking new efficiencies when delivering products and services digitally.

Uniswap – A cryptocurrency exchange using a decentralized network protocol

Uniswap is a decentralized exchange that allows users to "swap" one cryptocurrency for another, including stablecoins. It runs entirely on smart contracts on the Ethereum blockchain, with no central operator. It has seen explosive growth since its launch and its daily volumes now frequently surpass those of Coinbase. The pace of growth is the result of Uniswap's many structural advantages inherent in its decentralized construct, which we discuss below:

Low Capital Intensity

It took Coinbase five and a half years and approximately 700 employees to get to $1B in daily trading volumes, while Uniswap did the same in only two years with less than 10 core contributors.[5] This is because the decentralized exchange leverages existing blockchain infrastructure such as a decentralized settlement layer, standardized user wallets, and native bookkeeping. Uniswap's developers do not need to buy hardware, commission servers, or bookkeeping systems to operate their exchange. They were able to simply leverage a global operational platform with infrastructure that is application-ready, illustrating capital efficiency of decentralized business models.

Full Automation

The entire user experience in Uniswap is fully automated:

- <u>Onboarding</u>: The client onboarding process is automated and trustless. The client can seamlessly connect their wallet through a simple point-and-click process using a browser plug-in. Before and after the swap, all assets remain custodied with the user.
- <u>Accessing Liquidity</u>: The client can use the Uniswap interface across a number of trading pairs to trade tokens or provide liquidity. All assets are swapped through smart contracts, such that no entity or person can intervene in that transaction.
- <u>Fee Payment</u>: The fees set on the protocol are transparent to the user and cannot be changed or manipulated by individual users or bad actors because they are fixed in code (the protocol smart contract). These fees can either be paid directly to the liquidity provider or a "protocol treasury," which could accrue to the Uniswap token holders.[6]
- <u>Fund Withdrawal</u>: All assets resulting from the swaps or removal of liquidity show up immediately in the user's wallet (and their custody).

It took Coinbase five and a half years and about 700 employees to hit $1B in daily trading volumes—Uniswap did the same in only two years with less than 10 core contributors.[5]

Uniswap's fully automated process removes or mitigates the possibility of human error, judgment or ill intent.

[5] Nomics, Comparably (Archive), Pitchbook (Archive).

[6] Note that the protocol fee accrual feature for UNI token holders is not activated yet.

"Infinite" Operating Leverage

Fully automated user experience and business processes, in many cases, remove the variable costs and allow the business to scale with almost infinite operating leverage within the capacity constraints of the blockchain it operates on. Because Uniswap is a fully decentralized and automated exchange, the fees that are charged to users (e.g., 5, 30, or 100 basis point spread for every transaction) are automatically paid out to the liquidity provider or the protocol treasury (i.e., value of which could accrue to the UNI token holders).[7] Given the automated and trustless nature of processing the revenues to pay the liquidity providers or the protocol token holders, Uniswap has no variable costs—making the operating leverage of the model extremely high, if not infinite.

Scalability

Decentralized business models are scalable and globally accessible from day one—there is minimal friction in acquiring and servicing customers. On the customer acquisition front, onboarding users is fully automated in a secure way where client assets remain in the custody of the client. There are a few instances of other protocols where KYC/AML processes are automated with digital identities attached to a customer's wallet. Most customers are onboarded within seconds and the product is available with rules and fees integrated through smart contracts, easily customizable by the product or the client.

Uniswap's structural advantages include:

- ***Low Capital Intensity***
- ***Full Automation***
- ***"Infinite" Operating Leverage***
- ***Scalability***

Exhibit 2 below puts into context the scalability enabled by decentralized infrastructure which has allowed Uniswap to achieve comparable volumes to Coinbase with better economics and more attractive customer offering, yet it appears undervalued vis-a-vis its centralized counterpart.

Exhibit 2. Scalability Comparison	Uniswap	Coinbase
Daily Trading Volume (30-day MA)[8]	$2.74B	$2.87B
Years in Operation	4 years	10 years
Active Contributors / Employees[9]	50+	3700+
Fees to Customers (basis points)[10]	5, 30 or 100bps	50 to 450bps
Market Capitalization[8]	$5.37B	$39.80B
Volume Multiple	1.96x	13.87x

As of March 31, 2022.

Uniswap is just one example of disruptive technology in the crypto-blockchain ecosystem. Inherent value creation from applications like this will continue to drive investment opportunities and requires deep fundamental research, informed by a mosaic of diverse perspectives from crypto-natives and experienced TradFi investment professionals. Menai believes that these use-case applications of crypto-blockchain technology should be the fundamental driver of an investor's decision to allocate to this Liquid VC asset class. In forthcoming ***Quarterly Research Briefs***, we will explore other examples of digital value creation.

[7] https://docs.uniswap.org/protocol/concepts/V3-overview/fees
[8] CoinGecko.
[9] LinkedIn, Coinbase.
[10] Nerd Wallet.

Summary Thoughts. Investors should be encouraged by the fact that the digital asset class has taken the recent collapse of flawed protocols in stride and that levered entities are washing out. Deleveraging is necessary for renewed progress in both traditional and digital asset classes, and it could continue in the near term. Even though this part of the cycle is painful, and many will question the viability of digital, Menai strongly believes that emerging crypto-blockchain technology will continue to develop and innovate the world of tomorrow.

Decentralized business models are inherently more efficient, scalable, accessible, and profitable than their centralized counterparts. Crypto-blockchain technology is disintermediating traditional processes in our complex economy and has the potential to unlock trillions of dollars in value. Just as winners of the Internet Revolution revealed themselves over decades, so too will protocol applications that drive the next leg of the Digital Transformation. A major benefit today is all investors have access to early-stage digital opportunities in the form of liquid token investing, whereas participation in the early-stage growth of the Internet in the '90s was largely limited to VC investors.

A major benefit today is all investors have access to early-stage opportunities in blockchain technologies in the form of liquid digital asset investing.

Institutional and private wealth investors have actively allocated to emerging technologies and venture capital for decades. Through those investments, countless ventures have failed while select winners have thrived in ways that establish new industries and drive life-changing innovation. Today's opportunity in crypto-blockchain technology is no different, except it has clear advantages: liquidity, accessibility and flexibility. Now is the time for investors to ramp up knowledge on the emerging digital asset class and consider the merits of diversified exposure to this Liquid VC within their investment programs.

Like the Internet Revolution crowned Google and Amazon, the Digital Transformation too shall have its royalty—long live crypto.

Editor's Note

In conjunction with Menai's quarterly publications, we will be launching our more frequent short-form ***Menai Insight Series*** designed to address educational topics integral to the Digital Transformation, including crypto valuations, regulatory developments, operational alpha, and much more. If you would like to receive our ***Insight Series***, have comments or questions, or would like to talk digital assets, please contact us at IR@menai.io.

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Menai Asset Management LLC is a wholly owned subsidiary of Menai Financial Group LLC, a women-owned and -led global financial institution founded in 2020 by Zoe Cruz and specializing in the management, proprietary trading, and market-making of digital assets.

With offices in New York, London and Tokyo, Menai is an active participant in the Digital Transformation 24/7/365.

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MENAI

520 Madison Avenue
New York, NY 10022

100 Liverpool Street
London, UK EC2M 2AT

Toranomon Hills Business Tower 15F 1-17-1
Minato-ku, Tokyo 105-6415

www.menai.io