AUGUST 2021

Down the crypto rabbit hole

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How should investors begin to analyze crypto networks? Is the work of researching these firms by traditional measures a square peg/round hole exercise? I think that the answer is no. Crypto companies are worth paying attention to as many of them are now creating tangible value, and investors do have tools to help analyze them.

Crypto extends beyond the creation of an alternative currency. Within the trading world, there are now decentralized peer-to-peer exchanges; additional endeavors include efforts to reorganize buying and selling of insurance, the creation of smart contracts, gaming platforms and efforts to tokenize assets, from art and music to personal information to real estate.

There is not a company at the center of the crypto platforms, but rather a decentralized protocol that seeks to remove layers of transactional bureaucracy and inefficiency, reduce our reliance on "trust" and limit the control one party can exert over another. Crypto businesses achieve this by being open in many ways in which traditional businesses are not. They achieve this through:

- **Open database ledgers:** The blockchain is termed open because the data is public for anyone to read and use (while specific data is public, privacy can be maintained. Not all info and data need be shared).
- **Open-source code:** Anyone can read the code that underlies a crypto network and propose changes to it. Or copy it, change it and create a "fork" of the code.
- **Being "permissionless":** Both users and suppliers (e.g., Bitcoin miners) can freely join and participate in a crypto endeavor without asking an owner or authority. This prevents a centralized entity from taking control or shutting down a crypto network.

Crypto networks are also interoperable and composable platforms, meaning that they will work (or operate) together and that developers can build (or compose) on top of existing code and combine pieces of services. Increased composability allows development teams to specialize on different parts of the value chain. This type of specialization can improve efficiency by allowing teams to stay smaller and more focused and can accelerate innovations (progress across the industry can be very fast).

While there are elements of crypto businesses that are unique to their digital origin and focus, it is possible to gain an understanding of these companies through more traditional metrics. If we first take a step back and think about some leading crypto applications, we can see that like traditional companies, they are organized to address a need for a particular service — trading, for example, or recordkeeping. As a firm, we are not yet investing in crypto networks, but we are thinking about how to analyze these companies, particularly as they begin to compete with more established brick-and-mortar players. Research might consider:

- **Analyzing the revenues (i.e., cashflows):** Crypto businesses earn fees. Decentralized peer-to-peer exchanges, for example, take a cut of the fees earned by the liquidity providers.
- **Valuation:** Many of the websites that quote cryptocurrency prices show the market cap in terms of the current circulating supply of tokens, which can help investors in establishing a valuation. In our view, using the total approved supply of tokens, i.e., the fully diluted share count, may provide a truer reckoning of valuation.
- **Moats:** In our credit and equity analytical work, we often look at the sum total of differentiating and competitive advantages that a company may rely on to defend its position. For crypto companies these advantages may include coding, access to liquidity providers and users, and the usual cast of intangibles — IP, branding, culture, etc.
- **ESG/responsible investment:** There are responsible investment factors related to crypto networks, which investors should also consider. Most assume that crypto has negative ESG characteristics because of news headlines about energy usage, but that is not the complete picture. For example, a large portion of the world is unbanked or underbanked, and by lowering the bar to financial services, crypto (and fintech) can help spur economic activity and improve their wealth. Crypto networks have been used in some of the recent ransomware attacks; however, the openness of crypto networks make them easily trackable, which can allow cryptocurrency businesses and law enforcement to work together to reduce ransomware attackers' ability to turn their profits into cash.
- **Regulatory environment:** Regulation is top of mind for many when it comes to crypto networks as the space has been likened to the Wild West. Most expect governments to begin regulating if not outlawing cryptocurrencies. The crypto industry itself is lobbying the U.S. government to provide more regulatory clarity. Understanding the regulatory environment will be a key component of evaluating any crypto opportunity.

Given that value is being created in crypto networks, I believe that more investors will begin considering their place in a diversified portfolio. Employing analytical tools in place for more traditional equity may help researchers assess the risks and opportunities of a specific crypto investment. At its heart, analysis of crypto business is still a matter of understanding cashflows and assigning a current and future value to those flows.

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