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DIGITAL ASSETS: THREE THEMES FOR EOY 2022 AND 2023

INTRODUCTION

In 2022, the digital asset space has been marked by a collapse in cryptocurrency prices and business failures—but also a renewed sense of the commercially valuable potential of the digital evolution. Over a long term, securities have moved from paper to electronic and are now beginning the transformation to a native digital form. While the current set of native digital transactions are too small to be relevant to the existing capital markets, they are illustrative of the path forward and illuminate the differences between current and future states. There may also be near-term effects visible now. For example, first, digital assets' carrying values that had been carried at cost may now require changes; second, many asset managers have begun to implement plans beginning as early as 2023 to prepare for this transformation; and third, significant asset managers have begun the tokenization of private equity funds to access additional pools of capital, including two funds from KKR and Hamilton Lane.

It is also worth noting the restructuring of three significant companies in the digital asset space—Celsius, Voyager Digital, and FTX—which brings a renewed sense of risk, opportunity, and maturation that is driving institutional investing. Our Capital Markets teams note that the change in outcomes since early 2022 has some well-funded investors waiting while others are seeking liquidity—but with each side far apart on the appropriate price.

This paper will discuss the structures and impacts of these events in terms of institutional investor participation in this asset class. Our focus is less on cryptocurrency like BTC and ETH and more on the types of private and illiquid investments that funds hold today: simple agreements for future equity (SAFEs) or token warrants, early-stage equity in companies based on blockchain technology, projects that are expected to result in tokens or token ecosystems, and a little bit of tokenization of real-world assets (RWA)—possibly even an NFT or two.

Before we start, we refer to our previous Digital Assets and Institutional Markets presentation of fundamental digital asset concepts for institutional investors.(1) This paper will extend that presentation by focusing on three timely themes: valuation, preparation, and tokenization.

VALUATION

As we approach year-end for 2022, cryptocurrency price declines (more than 60% in BTC and ETH year-to-date of this writing) are implying reductions across the spectrum of digital assets. Investors may not yet be reporting those assets at fair value in their financial statements. The scant industry guidance, uncertain regulatory environment, and market volatility have resulted in a limited consensus among valuation firms as to appropriate methodologies and source data. Houlihan Lokey has spoken with many investors holding digital assets and is prepared to produce valuations for financial reporting using appropriate methodologies, potentially including some of those listed below. However, we note the need for a collaborative, informative exchange of ideas between auditor, valuation agent, and investment manager to successfully navigate the valuation process for these relatively new asset classes.

1. Typical methodologies (e.g., typical business valuation, allocation with OPM, PWERM, or Current Value Method as appropriate) for venture capital or growth equity positions.
2. Project cost/replication approach (adjusted for probability of success) where the outcome may not have public guidelines or key metrics for benchmarking.
3. Data matrix where there may be many similar tokens with slight distinctions (although liquidity concerns, wash trades, and other data issues will be a heightened subject of analysis as compared with traditional financial assets).
4. Extension of RWA model with digital-asset-specific modifiers for assets that have been tokenized.

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(1) *https://hl.com/insights/insights-article/?id=17179876250.*

While all valuations should consider the relevant facts and circumstances, there may be enough commonality to use examples of certain valuation situations as a starting point for other valuations. Some examples of asset types we have seen and potential methodologies that may apply depending on the specific circumstances are shown below.

Asset Type	Example Description	Possible Methodology and Considerations
Token Warrant	Project that is expected to result in a token and an ecosystem; may be ancillary to the revenue-generating business	Project cost (if early stage) modified by success probability/scenario analysis
SAFE	Company offering services in Web 3.0 but not as a token ecosystem	Project cost (if early stage) or business valuation; option analysis capturing caps and floors
Series A Preferred Equity	Operating entity delivering products and services such as an NFT trading platform, realizing crypto and fiat revenue	Project cost (if early stage) or business valuation; allocation with OPM/PWERM/Current Value Method depending on circumstances
Seed Funding	Company developing new technology based on blockchain but is expected to earn fiat revenue	Project cost (if early stage) or business valuation; allocation with OPM/PWERM/Current Value Method depending on circumstances
LP Interest as a Token	Tokenization of LP interest in a new PE fund	Valued as a RWA but considers factors such as increased liquidity and lendability or shorting
NFT	Metaverse land deeds	Data matrix if there are sufficient observed transactions
NFT Loyalty Program	A token that gives holders specific enhancement rights such as backstage passes or early releases	Typical intangible asset valuation methodologies may apply here

Some digital asset types are not currently amenable to these valuation methodologies. For example, certain NFTs that reference a unique visual or auditory file may lack the necessary related price data. NFTs that confer rights may not have been tested to ensure contract rights and transferability, which may be prerequisites to appropriate valuation.

PREPARATION AND POLICY REVIEW

A common refrain heard in the crypto ecosystem is that digital assets change everything. Our perspective is slightly different: We think digital assets only *challenge* everything. The refocus of blockchain development companies away from chasing the potential of skyrocketing cryptocurrency prices to developing incremental advantageous solutions has begun to open doors with traditional investment managers. These managers need to update valuation, risk, and other policies to respond to the unique structures and features of native digital assets. Houlihan Lokey is prepared to review and comment, or prepare, policies for assets that are recorded in or fundamentally rely on a blockchain.

1. Valuation policies for native digital assets must evaluate many dimensions, including fair value leveling, evaluation of active vs. inactive markets, measurements of liquidity in already highly volatile markets, and fragmented market makers and platforms. Policies for contracts such as token warrants/SAFTs or decentralized autonomous organization (DAO) tokens might require a different diligence process or legal or technological reviews.

2. Custody and risk frameworks may be challenged by digital assets. Robust custodial services are just becoming available, and with highly volatile price histories (or gaps in available markets), the measurement of exit pricing will be impacted.

3. Native digital assets or tokenized RWA are all tokens—they facilitate borrowing, lending, and shorting. These may be very new risk profiles and liquidity contributors for assets that were otherwise considered hard to transfer and difficult to borrow against. As an example, in the tokenization of a PE fund, a relatively illiquid asset becomes an asset that can be sold short, used as collateral for borrowing, or lent to increase cash flow to an investor.

4. As a matter of policy, it will be more important than ever to read and understand the documentation of the instrument (including its underlying code). As an example, tokens for DAO may challenge existing policies because their business models may re-allocate rights and obligations among utility and governance tokens, resulting in different economic profiles than traditional asset structures. Combinations of policies for debt, equity, and warrants may be necessary to capture the economic benefits fully.

5. The existence of self-executing contracts that operationally transfer economic benefits despite potentially conflicting legal structures must be considered. As an example, a token protocol that self-executes may be effectively distanced from traditional bankruptcy stay provisions.

TOKENIZATION

The evolution of securitization is tokenization, where a RWA is immobilized in a legal structure and ownership of its rights, benefits, and obligations are transferred to one or a series of tokens that live on a blockchain (a native digital asset). In traditional securitization, the form of the asset is reconfigured by contractual provisions within the traditional legal and ownership system, but tokenization adds an additional layer in which the mechanism of evidencing ownership changes from an electronic or physical form to a native digital asset. The effect is to convert contractual value streams (traditional loan pools but also LP interests, real estate, natural resources, etc.), which traditionally have high friction costs to transfer, monitor, sell, and manage, to a token that can be easily bought and sold, borrowed and lent, and owned long or sold short. The consulting firm BCG estimates that *$16 trillion of such assets will be tokenized by 2030.*[2]

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[2] https://web-assets.bcg.com/1e/a2/5b5f2b7e42dfad2cb3113a291222/on-chain-asset-tokenization.pdf.

1. Many market participants believe that this native digital form of ownership offers little benefit over traditional forms, that the cost and difficulty of one system will be replaced by costs and difficulties in another system, or that blockchains are not a stable technology for asset ownership because they rely on economic incentives rather than trusted institutional centrality. Examples of existing institutions that may require alternate forms under a tokenized regime are DTCC, Fedwire, CUSIPs, clearing houses, and ACH.

2. BCG describes the potential for new uses and innovative allocations of rights, benefits, and obligations that may drive the use of tokenization.[2] If efforts toward tokenization are successful, the economic incentive to convert high-friction assets to low-friction ones may create markets that distribute information and discover price more easily, market-valued instruments that can be presented as collateral for borrowing, and the ability to short assets, which, in traditional markets, could only be shorted by proxy. These potential advances with tokenization technology are similar to the characteristics of the enormous expansion of financial markets that followed the legal and technological advances of ERISA and REMIC legislation in the '70s and '80s.

3. Alternative asset managers may be affected by tokenization on both sides of their balance sheet. Both KKR and Hamilton Lane have participated in pilot programs that have tokenized LP interests in one or more of their private equity funds. The idea behind these programs is that a class of investors may exist who are interested in purchasing the economic risk profile of an LP interest in a fund with the lower-friction ownership structure of a blockchain-based token. On the liability side of the balance sheet, tokenization may thus become a route to new capital raising and a source of incremental AUM. On the asset side, certain managers may find benefits in exposure to tokens, while others may take a more cautious approach. In either case, however, token markets may result in increased price discovery and information transparency for assets that have historically been illiquid and opaque.

4. Native digital assets that are regulated by the SEC as securities may be traded by a new kind of dealer: an alternative trading system. These dealers, along with technology-enabled custodians, transfer agents, and valuation agents, will underpin the ecosystem for an institutional investor with exposure to native digital asset forms of risk. Each of these ecosystem members are developing ways of offering lower-friction services and higher-frequency information as structured data via APIs that can directly feed managers' risk, trading, and accounting systems. The result may help enable increased frequency of marks, more granular and accessible investor reporting, and a generally richer decision-making environment for increasingly smaller asset managers. Again, assuming the success of these efforts, their impact on the financial system may mirror the increase in information flow seen beginning in the early 1980s with electronic services offered by Reuters, Bloomberg, and others.

CONCLUSION

Digital assets continue to gain acceptance as an alternative institutional asset class. The opportunities range in form from traditional—venture capital, project finance, cash-flowing business, and restructurings—to native digital, such as tokens, SAFT, NFT, and tokens of RWA. Investors will need to prepare by amending their policies, risk preferences, and regulatory understanding, while GPs will also consider the application to capital raising. Across all investors, valuation for financial reporting will need to coalesce around a broad standard, which will aid transparency and facilitate the participation of institutions. Houlihan Lokey is offering valuation and advisory services to assist asset managers, LPs, and GPs in this journey.

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