

Venture Capital and Crypto-Currency Investing

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Summary

Venture investment in the blockchain and crypto-currencies fell sharply after the collapse of FTX in 2022 and the subsequent realization that many areas within the space were driven by hype rather than fundamental value. In recent quarters, though, investment levels have begun to climb again, in tandem with the prices of major cryptocurrencies such as Bitcoin, Ethereum, and Solana. This webinar explored whether this is a case of history repeating itself, with venture capitalists failing to learn the lessons of the last boom/bust cycle, or if the investments this time around are more careful, reflecting the fundamental economic promise of the sector.

Introduction

On June 5th, 2024, a panel of industry experts and academics provided insight into the crypto space's current state and future prospects. From various backgrounds, the panelists began by describing their journeys into the crypto space. Several admitted that they were skeptical at first and misunderstood blockchain technology as merely a way to write code in the cloud without worrying about the infrastructure it was running on. However, they now believe that the crypto space is becoming an interesting technology class with considerable potential to transform marketplaces and how we do business more generally.

The panelists noted that the recent boom/bust cycle in the crypto-currency market was a necessary catalyst to drive innovation in the space. They explained that there is a dual nature of participants in the market—those who use crypto-currencies and other digital assets for their utility and those who speculate on its future value. Too many investors in the latter group entered the market, driving up valuations.

While this type of speculation led to volatility, the panelists believe that it also brought the necessary capital to fund early-stage technologies and attract talent.¹ Furthermore, the collapse of the market was pivotal in bringing new leadership that has brought managerial talent and credibility in this space. Currently, with new pools of capital, including exchange-traded funds (ETFs), entering the space, there is the potential for exciting new opportunities.

Blockchain

The panelists highlighted the uniqueness of blockchain-based digital assets compared to traditional digital assets that historically have been controlled by a single platform. The blockchain is a database hosted by a network of computers instead of a single server. It offers users an immutable and transparent way to store information.² The panelists explained that the decentralized nature of blockchains allows users to own and control their assets, independent of the organizations or platforms that created them. This decentralization can lead to new paradigms for ownership, market design, and user engagement that has the potential to change the ways of doing business.³

¹ For a discussion of how speculative booms can open the door to major innovations, see Ramana Nanda and Matthew Rhodes-Kropf, "Investment Cycles and Startup Innovation," *Journal of Financial Economics*, 110 (2013) 403-418.

² Thomas Stackpole, "What is Web3?," *Harvard Business Review*, May 10, 2022, and Ramana Nanda, Robert F. White, and Alexey Tuziko, "Blockchain, Cryptocurrencies and Digital Assets: Industry and Background Note," Harvard Business School Publishing. November 2017, <https://hbsp.harvard.edu/product/818066-PDF-ENG?Ntt=818066>.

³ Chris Dixon, *Read Write Own: Building the Next Era of the Internet*, New York, Penguin Random House, 2024.

The panelists highlighted key areas of opportunities and the potential challenges:

- the growing trend toward tokenization of real assets;⁴
- the potential of nonfungible tokens (“NFTs”) for brand building and digital identity formation;⁵
- shared ownership as an incentive mechanism in Web3;⁶ and
- the enduring issues of educating investors, managing liquidity, and getting users to adopt the new platforms.⁷

Tokenization of Real-World Assets

One of the biggest use cases of crypto infrastructure is the tokenization of financial assets, which has significant benefits. For one, tokens provide more liquidity, allowing investors to transact more efficiently. In addition, given the ease of buying and selling tokens, one panelist noted that tokenization could potentially enable the public valuation of assets to better reflect true value. Thus, unlike traditional venture capital investments that are not marked to market (with the exception of secondary markets which are reserved for only the best investments and often feature large bid-ask spreads), crypto markets can provide more transparent valuations.

Another benefit of tokens in financial markets is that they allow more people to participate. One panelist viewed tokens as coordination mechanisms, aligning stakeholders (equity holders, debt holders, management, developers, and users) in a decentralized ecosystem. Currently, many people are shut out of wealth creation. For instance, venture capital and private equity investments are typically only available for high-wealth individuals. Similarly, users of products and/or platforms typically do not share in the wealth creation. For example, the first Uber drivers and AirBNB housing providers, who helped the success of both companies, did not receive benefits from their participation proportional to the value they helped create. Tokens would allow people to share in the value of the platform created. Lastly, one speaker added that tokenizing real-world assets could create opportunities for businesses to streamline their back office and administrative tasks.

⁴ Tokenization can be defined as the process of creating a digital representation of a tangible object. Tokenization can be used to protect sensitive or to efficiently process large amounts of data. Tokens can represent assets, including physical assets like real estate or art, financial assets like equities or bonds, intangible assets like intellectual property, or even identity and data. (“What is Tokenization?,” McKinsey & Company, March 6, 2024, <https://www.mckinsey.com/featured-insights/mckinsey-explainers/what-is-tokenization>).

⁵ Steve Kaczynski and Scott Duke Kominers, *The Everything Token*, New York, Penguin Random House, 2024.

⁶ Jad Esber and Scott Duke Kominers, “Why Build in Web3”, *Harvard Business Review*, May 16, 2022, and Chris Dixon, “Why Web3 Matters”, *a16zcrypto*, September, 26, 2021, <https://a16zcrypto.com/posts/article/why-web3-matters/>.

⁷ Andrew Chen, *The Cold Start Problem*, New York, Harper Business, 2021.

Nonfungible Tokens

Nonfungible Tokens (NFTs) are not just digital assets, but rather unique pieces of digital property that cannot be replicated, providing a digital proof of ownership that people can buy and sell.⁸ The assets associated to NFTs can take various forms: art, music, in-game items, videos, and more. One panelist underscored the unique potential of NFTs for brand building and digital identity formation. The speaker explained how NFTs, by granting people ownership of a digital asset, pave the way for the creation of various forms of function and utility on top of them. This process encourages individuals to form an identity around the asset and eventually build a community that propels the brand forward.⁹ More broadly, NFTs open up possibilities for using blockchain infrastructure to foster and support brand loyalty, giving brand enthusiasts direct ownership of brand assets that they can use throughout digital space.

The panelists also discussed the role of decentralized social media platforms like Farcaster, which offer a new design paradigm for social media engagement and value creation.¹⁰ These platforms empower users to control their data, identity, and audience, and transfer it seamlessly across social media clients.¹¹ (This is as if you could directly port your Twitter posts and following to Facebook, and *vice versa*.) These sorts of user-owned account paradigms reduce the dependency on any given platform and should hopefully enhance platform competition.¹²

Challenges and Opportunities in Crypto Investing

The discussion then highlighted challenges faced by businesses built on a blockchain to manage the liquid nature of tokens properly and, at the same time, build durable long-term organizations. The panelists emphasized the importance of educating investors and managing expectations around the speculative nature of tokenization. They also discussed the complexities of operating in a market where assets are highly liquid from “Day 1,” making balancing short-term speculation with long-term development goals essential. One panelist pointed out that while the token market's volatility can be challenging, it also presents opportunities for creating more transparent and honest valuation mechanisms.

In addition, the panelists explained that in such markets, competitors can easily enter, which can make it challenging to build something durable. Operating a business is more difficult, especially

⁸ Steve Kaczynshi and Scott Duke Kominers, “How NFTs Create Value”, *Harvard Business Review*, November 10, 2021.

⁹ The model described here is the “NFT Staircase” described in *The Everything Token* by Kaczynski and Kominers.

¹⁰ Scott Duke Kominers, Shai Bernstein, and Liang Wu, “Farcaster.” Harvard Business School Case 824-178, April 2024.

¹¹ Scott Duke Kominers and Liang Wu, “Threads Foreshadows a Big—and Surprising— Shift in Social Media”, *Harvard Business Review*, July 13, 2023.

¹² Christian Catalini, “Can WEB3 bring back Competition to Digital Platforms?”, *Competition Policy International*, February 23, 2022, <https://www.pymnts.com/cpi-posts/can-web3-bring-back-competition-to-digital-platforms/>.

when it comes to recruiting and retaining employees. However, the panelists added that these aspects often force organizations to be efficient and lead in other ways to convince people to stay for something other than monetary compensation.¹³

Conclusion

The panel agreed that the crypto space is still in its early stages, with significant potential for growth and innovation. There are many applications using blockchain technology, but it remains to be seen whether there will be mass adoption. There is a potential for brand building and digital identity formation that will enable third-party innovation embedded in tangible assets and a more decentralized social media. The panel underscored the importance of continued research, education, and thoughtful investment in the evolving landscape. The discussion provided valuable insights into the complexities and opportunities within the crypto space, encouraging participants to delve deeper into this dynamic and rapidly developing field.

¹³ Scott Duke Kominers and Liang Wu, "Porter's Five Forces and Competitive Advantage in WEB3", *a16crypto*, May 20, 2024, <https://a16zcrypto.com/posts/article/porters-five-forces-and-competitive-advantage-in-web3/>.