

What Happens Now That the [Latest] Crypto Bull Market Is Over?

Crypto, an industry famous for frequent boom/bust cycles, arguably had its most arduous year on record in 2022, and the impact on the industry will likely be felt for years to come. The carnage was broad-based as most public crypto tokens experienced large drawdowns and several high-profile crypto companies failed. Were the wounds of last year, many of them self-inflicted, avoidable? The answer is more complex than a simple “yes” or “no.” We also think it is important to continue to point out that “crypto” and “blockchain” are linked, but not synonymous. While the crypto bear market creates short-term turmoil, we think there may be some silver linings for the broader blockchain ecosystem.

Looking deeper than the headlines, we continue to see a burgeoning crop of start-up companies achieving early product-market fit across a new and expanding set of use cases for blockchain technology. To us, this continues to illustrate that blockchain isn't just a theoretical idea, but something more tangible. At the same time, riskier and arguably less innovative segments of the industry, such as traditional lenders and levered hedge funds, built less durable businesses vulnerable to a crypto drawdown, and several of them failed when the crypto boom reversed. This past year's events will likely have a lasting impact. However, we think in the long run we may look back at 2022 as a necessary cleansing of speculative excesses that allowed the industry to recalibrate itself toward the companies and protocols harnessing the real disruptive potential of blockchain technology.

Now that this bubble has burst, how will the industry move forward? In this piece, we share our thoughts on the larger trends we expect to see.

Decentralized Technology Returns to Center Stage

There have been many distractions in recent years that have taken attention and capital away from what we think matters most, namely the growth of new protocols and applications using blockchain technology to improve or disintermediate existing business models, or create entirely new business models enabled by this innovative technology. After the “DeFi Summer” of 2020, attention turned to trading and profiting from an expanding liquid market of cryptocurrencies and tokens. Crypto's market capitalization grew from nearly \$200 billion at the start of 2020 to a peak of almost \$3 trillion near the end of 2021. And this growth came not only from Bitcoin but from a rapidly expanding set of alternative coins. Many of these coins had little utility but saw their prices boom due to the same speculative impulses driving other markets (*e.g.*, meme stocks). This trend started to reverse in early 2022, causing the undoing of many centralized crypto lenders that had built businesses levered to rising token prices and trading volumes. It is disappointing to

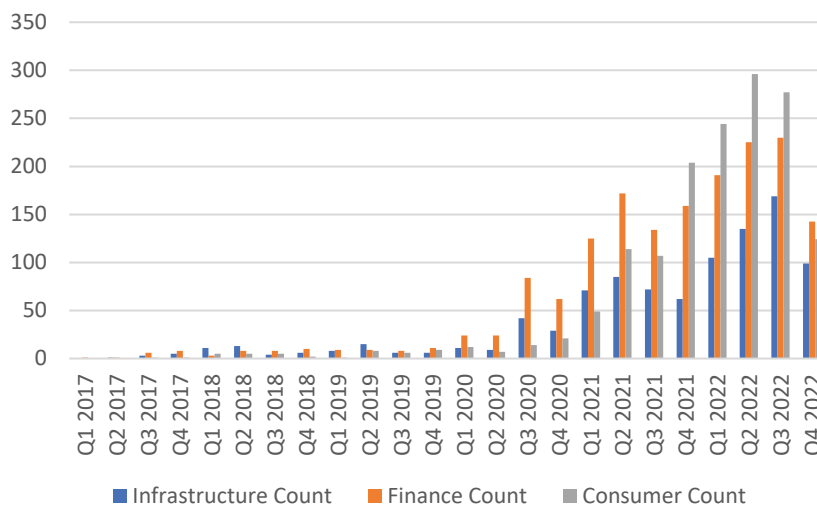
see an industry born in response to the 2008 financial crisis concentrate so much capital in entities that succumbed to the same poor risk management, opaque operations, commingling of businesses, and asset/liability mismatches that felled 2008's financial titans.

Despite last year's noise, our conviction remains that decentralized finance ("DeFi") protocols represent a new blockchain-powered financial ecosystem that offers the possibility of long-lasting, structural improvements to the fundamental nature of the incumbent financial system. Last year, DeFi protocols demonstrated how they are different than their centralized counterparts – they have predictable and consistent operating rules, they provide transparency via publicly-available blockchains, and they largely functioned as expected through numerous bouts of volatility. While we can't yet say the industry is fully cleaned up, the reality is that most centralized crypto lenders are no longer operating. At the same time, we expect regulatory agencies to step up their oversight to reduce the future risks from these centralized business models. We believe this should turn attention back to the opportunity for protocols and applications. A new wave of blockchain start-ups have formed over the past few years, and most have yet to launch their products or applications. We are excited to see how these companies and their broadening set of use cases develop over the next few years.

Infrastructure Moves to the Forefront for Investing and Innovation

The early years of crypto were focused on building the infrastructure that could eventually enable mainstream applications. Coming into 2021, there was a belief among many in the industry that much of the infrastructure needed was in place and the focus could shift to building the application layer. As you can see from the graph below, we saw this shift from investing in infrastructure to more of a focus on finance and then consumer applications in 2020 and 2021.

Count of Crypto VC Deals by Sector



Source: Dove Metrics, Galaxy Digital

The euphoria of the bull market gave a false sense that everything at the infrastructure layer was working flawlessly. While strong user adoption of a few breakout applications demonstrated a degree of scaling success, the industry is realizing that more infrastructure development is needed to make blockchain a seamless technology for mainstream users.

Current shortcomings of blockchain technology include:

- **Poor User Experience:** interacting with the blockchain can often feel clunky and overwhelming, particularly for less tech-savvy users. Users have to go through different wallets and exchanges, learn how to transfer fiat-to-crypto or move crypto across applications. An experience a user would normally expect to be quick and easy can often require several complex steps. Developers need to improve user interfaces similar to how the intricacies of the internet are invisible to a user streaming their favorite Netflix series.
- **Security Vulnerabilities:** while this revolution is built on the idea of open-source software, one of the drawbacks is that it leaves applications and the bridges between them and their underlying protocols potentially vulnerable to malicious actors. While these actions can be quickly identified on the blockchain, today it can be “too late” when they are found.
- **Scalability and Processing Constraints:** blockchains have limitations in handling and validating large amounts of transaction data. The result of not having enough room on the blockchain can be long waiting times and higher fees. There are emerging alternative chains (Layer 1s) to Ethereum offering advanced capabilities, but they are still early in their adoption curve and suffer from a smaller ecosystem and community. There are also new scaling solutions (Layer 2s) to enhance Ethereum’s capabilities, but what we think are the most interesting technological advances (*i.e.*, Zero-knowledge proofs) remain early in their lifecycles.

Within infrastructure, we think more of the near-term focus will be on developer tools, fiat on- and off-ramps, security, data storage, custody, and scaling solutions. We expect continued investment in new Layer 1 blockchains, but anticipate this will be less prevalent than in the past as there are already several established Layer 1s with growing developer ecosystems.

NFTs Expand Beyond Art and Collectibles

Many first learned about NFTs (or digital property rights stored on the blockchain) in 2021 when the mainstream media began to cover the new craze. Even Saturday Night Live did a [skit on NFTs](#) (which may in time be seen as an echo of [clips from the mid-1990s about the internet](#)). Their emergence centered around digital art and collectibles. It provided a new way for artists to sell their digital work online and allowed customers to effectively prove ownership of digital assets for the first time. It also demonstrated the advantages of on-

chain ownership, including increased transparency, programmability, and exchangeability. You weren't alone if you scratched your head about how big of a phenomenon NFTs quickly became, and the astounding prices certain digital art was selling for, including the piece *Everydays* by well-known artist Beeple, which sold for \$69 million at auction. While the NFT craze has certainly cooled since, and trading volumes are well off their peak of \$17 billion hit in January 2022, many of the collections viewed as "blue chip," such as Bored Ape Yacht Club or CryptoPunks, have maintained their relevance and prestige through the downturn. The emergence of NFTs also catalyzed the launch of an entire ecosystem built to support this new asset class, with notable marketplaces such as OpenSea, Magic Eden, and Rarible becoming one-stop shops where collectors could go to buy and sell various NFTs.

We think the story around NFTs is starting to shift from digital art and collectibles to utility NFTs. Put simply, utility NFTs offer their holders a variety of privileges, rights, and rewards. Corporations and brands have begun to view NFTs as a way to onboard and retain a new breed of tech-savvy consumers. Recent examples of corporate adoption have included: Starbucks integrating NFTs into their popular loyalty program; Adidas pairing NFTs with physical merchandise; and Reddit launching avatar NFTs, which have amassed over 4 million unique holders since its launch. It's early, but innovative use cases for utility NFTs are beginning to emerge. A prime example is in blockchain gaming, where NFT technology allows gamers to purchase, own, and transfer digital characters or in-game items. As property of the gamer rather than the game developer, users have the ability to keep these assets in-game or take them out for use in the broader crypto ecosystem. Another simple use case is the launch of tokenized funds, providing investment firms access to wealthy individuals without the intensive process that typically comes from investing in private funds. A number of asset managers have already launched such funds, including KKR, Apollo, Hamilton Lane and Partners Group. The application of NFTs is much broader than digital art and collectibles, and we think utility NFTs will become a larger and more compelling investment opportunity over time.

Go-to-Market Strategies Evolve for the Better With Token Launches Cooled

During the bull market, blockchain entrepreneurs were quick to launch tokens to try and jump-start their user base and gain broader market appeal. Even though some companies were still in their infancy, they saw their token values appreciate as if they were more established businesses achieving true product-market fit. In the short term, the strategy to launch tokens early may have appeared to be working well, but as we entered the downturn, the weaknesses with this approach have become more visible. In many cases, the growth in users and token prices has proved fleeting. A vivid example of this is Axie Infinity, a blockchain game developed by Sky Mavis that popularized the play-to-earn model. During COVID, the game took off in low wage countries such as the Philippines where people, many unemployed due to the pandemic, bought or rented NFT-enabled digital creatures, known as an "Axies," to play and earn tokens in the game as a way to supplement or replace lost income. At its peak, Axie Infinity's monthly players

reached ~2.8 million and the token valuation hit \$30 billion. When the token's price dropped alongside the rest of the market last year, the forces that had propelled the game's popularity evaporated and usage fell off a cliff. Not to diminish the novelty and potential utility of the play to earn model, but in the case of Axie Infinity, the game relied on relatively cheap labor and a rising token price to fuel its growth rather than quality gameplay that could create a more sustainable user community. Axie Infinity and several other blockchain companies took the shortcut available to them during the bull market and built businesses that were over-reliant on unsustainable token speculation.

While it is easy to be critical of the token funding model because of these outcomes, we think it is important to remember that tokens can provide meaningful utility to a protocol or application in a variety of ways:

- Tokens can provide governance rights to their holders that enable the protocol or application to be managed via a decentralized structure.
- Tokens can support the build-out of an active user base by conferring ownership of the network to its users. A user-owner is often more engaged than just a user.
- Tokens can be integrated into a protocol in a way that incentivizes pro-social actions by users and service providers (*e.g.*, rewarding market makers that provide liquidity on a decentralized exchange or rewarding users to form a wireless network).
- Tokens can serve as the currency (*i.e.*, cryptocurrency) necessary to facilitate transactions within a blockchain.
- Tokens can be used to raise capital from investors.

New token launches have meaningfully declined since the market drawdown, and we believe entrepreneurs have become more thoughtful about the need for and timing of launching a token in relation to the progress of the protocols or applications they're building. We think the bear market will force entrepreneurs and venture managers to think hard about go-to-market strategies that can create a more sustainable user base. This change should also hopefully filter out the type of entrepreneurs who come into the industry only looking to make a quick buck.

Venture Fund Landscape Becomes More Concentrated

As emerging use cases like DeFi and NFTs found user adoption, the universe of investable opportunities expanded meaningfully and the blockchain venture industry grew substantially in concert. There was more venture capital deployed into the blockchain space in 2021 than all the years prior to that combined. Dedicated blockchain venture managers grew from a cottage industry of small-sized funds primarily investing at the seed stage to an industry with more than 200 to 300 players investing across early to late-stage companies. Generalist venture managers, many who had never invested in blockchain

before, jumped onto the bandwagon and became significant participants. Alongside this, several corporate industry mainstays, like Coinbase and Galaxy, saw their balance sheets swell, allowing them to become active venture participants as well.

Looking forward, the landscape appears to be changing again. Generalist venture firms have historically been the first to back away in bear markets and many have again abruptly stopped or slowed their pace of investment in the space. A number of formerly active crypto companies either no longer exist or find themselves on weaker footing that necessitates less strategic investment activity. However, the dedicated blockchain venture managers remain steadfast. We have firmly believed from the start that this cohort has a leg up investing in this industry compared to their generalist peers due to their: dedicated expertise, history of investing through multiple crypto cycles, and customized value-add platforms built to support the unique needs of their entrepreneurs. We think this advantage likely deepens further in the bear market, but with important nuances. The influx of capital into the industry during the bull market enabled a new crop of dedicated blockchain venture managers to launch inaugural funds, despite the fact that some had limited experience investing in the space. We think a number of these new participants are likely to fall away after deploying their existing funds. We also think that fund sizes and the pace of deployment will adapt to the new realities of the market. Smaller funding rounds, slower deal flow, and weakened investor sentiment all would seem to point to these managers raising smaller funds, especially the name-brand managers who raised massive funds during the bull market. In addition, as managers slow their deployment of capital, the investment timelines for funds are being stretched out, returning us to a more normalized (pre-bubble) pace.

Broad U.S. Crypto Regulation May Take Time

There is hope that one positive outcome of FTX's collapse and last year's other crypto failures will be that Congress and/or regulators will formalize oversight of the industry. Most industry participants recognize that regulatory clarity is a necessary step toward fostering broader institutional adoption. In the past, crypto regulation wasn't prioritized by U.S. regulatory agencies due to its status as a fringe industry. Instead, regulation was primarily conducted through enforcement actions, focusing on companies that were blatantly overstepping regulatory lines. With this lack of clear guidance, companies were left to determine their own baseline rules and guidelines to follow.

Despite several bills being introduced and considered over the last year, we remain skeptical that a narrowly split Congress can find common ground on a broad piece of regulation covering the industry. We think it is more likely they look to find agreement on something narrower such as stable-coin regulation or spot market oversight. In the absence of a broader package of reforms coming from Congress, and considering the black eye that FTX and other crypto failures were for regulatory agencies, we think they will continue to largely regulate through enforcement.

Conclusion

Despite last year's challenges, we think the progress and breakthroughs that blockchain technology has made over its relatively short life should not be ignored. However, we also recognize that this remains a nascent industry with several shortcomings that need to be addressed. It will be important for the industry collectively to exhibit a degree of self-reflection and take the lessons learned from what went wrong in 2022 to move forward in a stronger and more sustainable way.

Despite the turn in investor sentiment, we continue to have conviction in the long-term potential of blockchain technology. It is in the crypto bear market periods like today, when the hype and distraction dies down, that builders can focus on creating the protocols and applications that will help drive the industry forward. It's also a time for venture managers to double-down on their support of the most promising founders and entrepreneurs with the benefit of doing so at more attractive entry valuations. In fact, it was during the 2018 and 2019 bear market when many of today's most notable blockchain companies were incubated, including Uniswap, Fireblocks, Dapper Labs, Sorare, and The Graph. During this next cycle, we expect to see further advances in core blockchain infrastructure that will enable the creation of the next generation of category-leading applications that will help drive long-term mainstream adoption of this technology.

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