ROSENBLATT SECURITIES

Investment Banking – FinTech Viewpoint

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Analyzing the Last 100 Funding Deals in Crypto, Blockchain, and DeFi

A Sector Gearing Up For Greater Institutional Adoption

Current Status of Crypto and Digital Assets

Crypto, Blockchain, and DeFi are the hottest sectors in financial services, attracting record amounts of funding. While the absolute amount of funding in this sector is smaller than mature FinTech sectors like Payments and Challenger Banks, our analysis reveals a burgeoning sector at the cusp of explosive growth. Leading investors are plowing billions into institutional-grade infrastructure for services like credit, custody, and prime brokerage, addressing the obstacles that have held back institutions, including pension funds, endowments, hedge funds, family offices, and corporate treasurers. Here are observations from our analysis of the last 100 funding deals in this sector:

- $9.5B of venture funding went into crypto/blockchain companies in Q1/Q2 2021, more than three times 2020's total funding(according to TheBlock Reserarch)
- There's a clear trend towards funding infrastructure and services being built especially for institutions, a departure from the last funding cycle, which supported retail participation
- Prime Brokerage, Lending, and Liquidity provision are top sectors: 60% of the funding went to companies in these three sectors ahead of execution, payments, and wallets
- The average funding round has almost tripled to $15.8Mill this year, up from $5.7Mill in 2019 (according to PitchBook) due to rising valuations and faster growth, which demands more capital
- Almost half the funding went to Seed/Series A rounds, evidence of the early-stage nature of this sector and investor belief that there is room for more innovation and capacity for more participants
- Some of the biggest fund-raising deals of all time in this sector have occurred in Q1/Q2 2021: Circle's $440Mill, BlockFi's $350Mill, and Dapper Lab's $305Mill. Several companies in this sector have matured enough to get listed via SPACs at rich valuations: Bakkt ($2.1Bill) earlier this year, Bullish ($9 billion), and Circle ($4.5Bill) expected in Fall 2021.

Rosenblatt Securities believes that institutional adoption of crypto and digital assets will grow significantly over the next few years, and there will be continued investor interest in building infrastructure to support this growth. Our 13th Rosenblatt FinTech Summit held on May 19-20, 2021 titled *Building Tomorrow's Marketplaces* focused on the future of digital assets and new marketplaces where they trade. We hosted the CEOs of 15 leading FinTechs that operate new marketplaces, build infrastructure for digital assets, and help protect these nascent markets from fraud and market manipulation. Please read about the topics presented at our Summit and listen to the panel recordings here.

This Viewpoint shares highlights from our analysis of the last 100 funding rounds in this sector. Key things to observe are which functions and activities within crypto/blockchain are attracting the most funding, how investors are thinking about this space, and an indication of where we are in the long-term evolution of digital assets. One important caveat is that as this sector is immature, people define the terms and concepts vaguely, and there is a wide divergence in how deals can be categorized.

Growing Institutional Interest and Adoption of Digital Assets

While retail investors have dominated the cryptocurrency market until now, institutions are getting more familiar with digital assets, negative perceptions are gradually improving, and firms are increasing exposure, which has accelerated over the past year. According to Fidelity Investments' Digital Assets survey of 800 institutional investors, 36% of the respondents say they are already invested in digital assets, and 6 out of 10 say they would increase allocations. Crypto hedge funds and VCs hold higher amounts of digital assets than endowments, pension funds, high-net-worth individuals, and family offices. In the next five years, 91% of the investors willing to invest in digital assets expect to have 0.5% of their portfolios allocated to digital assets. Perhaps most importantly, the extreme negative sentiment around digital assets is receding quickly with 80% of investors finding them appealing for three reasons: low correlation with other assets, high expectation for price appreciation, and an exposure to innovative technology.

Building Institutional-Grade Infrastructure: Paving the Way for Greater Adoption

Three major obstacles to greater institutional adoption of digital assets are concerns around security and market manipulation, liquidity aggregation/execution, and a lack of institutional-grade prime broking with sensible pricing. Rosenblatt believes that such concerns are due to immature infrastructure and will get resolved over time, paving the way for significantly higher institutional adoption. Investors are funding critical infrastructure and services like prime brokerage, securities lending, credit, and risk management, supporting greater institutional adoption. Safe custody and execution with low slippage, two of the biggest problems cited by institutions in 2019, are already being addressed by several FinTechs like Anchorage and FalconX and traditional institutions like Fidelity Investments that now have full-fledged digital asset platforms. Having said that, institutional adoption faces several challenges:

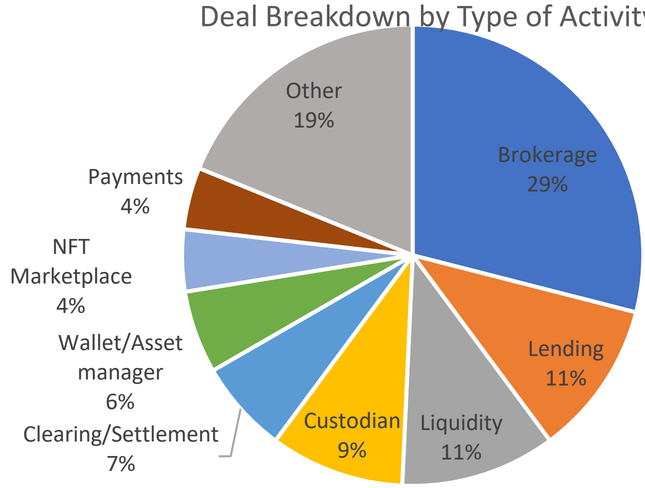
- Security and Fraud: Major crypto exchanges custody assets in hot wallets on their platform, which can attract hackers and fraudsters. Despite an impressive record of exchanges like Binance, Coinbase, and Kraken to safeguard clients from hacking/fraud, trustees of risk-averse institutional investors like pension funds and endowments consider this a major concern and often restrict portfolio allocations to such assets. While Mt Gox remains the largest crypto hack of all time, recent incidents at crypto exchanges and custodians (CoinCheck, Kucoin, and QuadrigaCX) underline the risk for investors
- Market manipulation: Besides outright fraud and security concerns, institutional investors are concerned about high levels of market manipulation in the crypto market, including wash trading, layering and spoofing, and pump/dump practices. By some estimates, almost 45-50% of crypto trades experience some level of manipulation during different times. Manipulative traders take advantage of low liquidity in crypto to manipulate prices across spot and futures markets.
- Fragmented liquidity: Unlike equities, no regulatory requirement exists for execution venues or brokers to follow National Best Bid Offer (NBBO) rules (which is standard practice in equities), causing all kinds of bad trading practices. Despite recent progress in liquidity aggregation using algos and smart order routing, finding adequate liquidity with firm pricing across different crypto exchanges remains a big institutional challenge, a problem being addressed by firms like FalconX.
- Operational risk and a drag on capital: The immaturity of blockchain-based decentralized systems and the lack of interoperability between different platforms means that investors must maintain accounts with different custodians, banks, and trading venues. This creates real (and often perceived) operational risk and is a significant drag on capital as institutions have to post collateral on every platform/venue they transact on, discouraging institutional adoption.

Observations From Our Analysis of Recent Funding Deals

Private investors are increasingly making it clear that they believe in the long-term success of crypto/blockchain and digital assets. Q1/Q2 witnessed tremendous growth of funding in this sector. Far from fear that the pandemic would dampen excitement, digital asset firms have raised $3.5Bill from private investors YTD. Here are key observations from our analysis of the last 100 funding deals in this space:

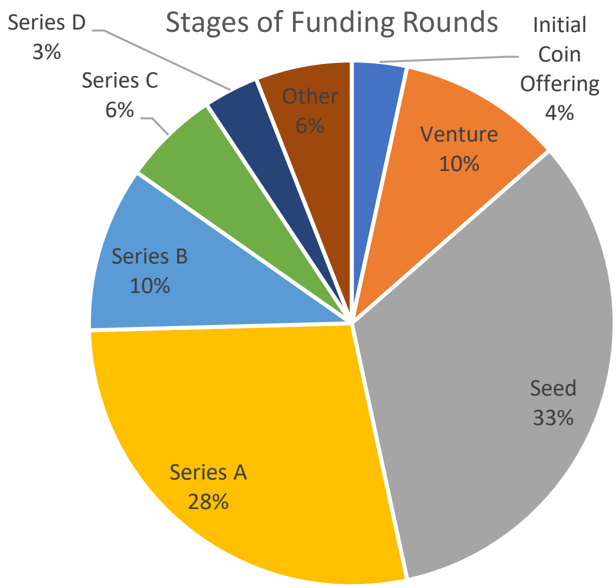
- **Post-trade businesses attract the most investment.** The top three market segments that received funding were prime brokerage, lending, and liquidity services, with custody a close fourth. Analyzing which activities and functions receive funding is important because it reflects the market's current stage of growth and maturity. While pure execution platforms were receiving a lot of the funding in 2019 and 2020, the last two quarters have seen more money flowing into prime brokerage, liquidity management, and securities lending. These are critical pieces of the supply chain that are necessary to encourage greater institutional adoption.

Deal Breakdown by Type of Activity



Note: "Other" includes Staking, Social Networks, NFT Miners, Surveillance, DeFi API

- **The digital asset space is still in the early innings.** 61% of the deals we analyzed were Seed/Series A rounds which demonstrate the early nature of this sector and reflect investor optimism to fund new growth. This contrasts mature FinTech sectors (e.g. Payments, Challenger Banks) where late-stage companies constitute a high proportion of overall funding. Investors allocating a larger proportion of capital to new companies rather than doubling down on current late-stage players is a healthy sign for this segment, signaling many more years of funding and growth ahead as these firms grow and mature, requiring follow-on capital.



- **Digital asset is one of the few sectors where the US is behind its international peers in attracting investment dollars.** Unlike other FinTech sectors like Payments and Lending, where US companies attract almost 70% of total funding worldwide, non-US crypto/blockchain firms have attracted nearly half the capital raised YTD 2021. Different regions are actively competing for leadership in this sector, and investors are directing funding to the most promising firms, irrespective of their location. 49% of the last 100 fund-raises were for companies headquartered outside the US, evidence that this is truly a global industry with no borders. A notable example of an international cap raise outside the US was the $170Mill Series B round for Austrian firm Bitpanda, led by Valar Ventures.

Leading Investors in Crypto, Blockchain, and DeFi

A handful of key investors are most active in the digital asset space, being involved in 47% of the analyzed deals. Here's a deeper look at five top investors:

- **Alameda Research:** Primarily a quantitative trading firm that provides liquidity in crypto markets worldwide, it manages over $100 million in digital assets. Its investments are very diverse and geared towards promoting overall market growth. It has led investments globally across Amsterdam, Berlin, Hong Kong, and Singapore. Prominent holdings are Oxygen, Serum, and Solana. Alameda also operates FTX, one of the largest crypto derivatives exchanges
- **Andreesen Horowitz:** a16z is one of the biggest VCs in Silicon Valley and an early cheerleader of crypto and blockchain. It was the largest shareholder in Coinbase and just launched a dedicated $2.2 billion crypto fund called Crypto Fund III, bringing its total funding devoted to crypto investments to $8.5 billion
- **Coinbase Ventures:** Backed by the formidable crypto exchange, its VC arm has access to high-quality deal flow with investments in prominent companies including BlockFi, Bitwise, Cointracker, Curv, and Tesseract. The group often invests in companies that compete with Coinbase with the rationale that an innovative ecosystem is beneficial to the overall market
- **Digital Currency Group (DCG):** Less of a typical venture fund and more like a strategic investor, DCG has the largest early-stage investment portfolio in the crypto, blockchain, and DeFi ecosystem. A few of its prominent investments that have scaled up are Circle, Chainanalysis, Dapper Labs, Elliptic, and Fireblocks
- **Pantera Capital:** A pioneer in crypto, having launched the first US dedicated fund in 2013, has 75+ blockchain investments and 54 early-stage token deals. The fund focuses on investing in core digital asset infrastructure, including exchanges, custodians, trading tools, DeFi, and Nextgen payment systems.

The high quality of such investors, the sheer amount of capital being deployed, and a proven commitment to this sector, ensures that neither seed-stage startups nor growth companies in this space will be constrained by capital anytime soon.

Concluding Thoughts

2021 is turning out to be a monumental year for the growth of crypto, blockchain, and digital assets. Growing investor allocations, the entry of traditional giants like Fidelity and State Street, and keen interest among a wide variety of investors to fund this sector are massive tailwinds. While US regulators haven't enacted much regulation yet, their cautious yet open-minded approach to this sector are big pluses and augur well. Two caveats deserve mention. First, a significant number of industry participants remain highly skeptical about Bitcoin, other cryptocurrencies, and the potential of blockchain. Second, the high degree of fraud and market manipulation in this sector could force the regulator's hand in enacting strict restrictions that could dampen growth. Our view is that this space is maturing rapidly, getting battle-tested, and could be at the cusp of its next leg of growth. We suggest you remain prepared and call us should you need help.

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