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Virtual Event Series

How Do You Value Digital Assets?

Guest Speaker:

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Hosts:

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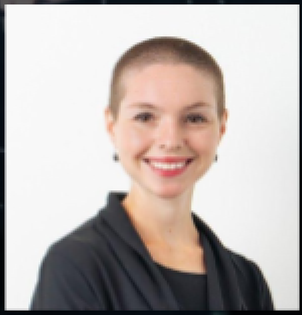

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DiffuseTap: How Do You Value Digital Assets?

Last time on DiffuseTap, Brian Dixon, President of Off the Chain Capital, talked to us about how traditional models can be used to value digital assets, why you should care about the FASB digital asset ruling, and information on Grayscale's lawsuit against the SEC.

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DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas)... straight from your armchair like a boss.

Meet the Speaker

BRIAN DIXON has a background in technology, digital assets, and investing. With over a decade working in digital asset markets, he has scaled several successful companies while managing robust investment portfolios. Brian is currently the President of Off The Chain Capital, a registered investment advisor that focuses on alternative investments at a deep discount in digital assets and blockchain companies. LinkedIn: @briandixon06

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Digital assets contain a high-degree of risk and uncertainty.

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KENNY ESTES: You're here to hear from Mr. Dixon from Off The Chain Capital. Brian, would you mind telling the folks a little bit about your background and what you're up to over at Off The Chain?

BRIAN DIXON: Absolutely. Thank you, Kenny. I really appreciate the opportunity to connect with everybody today and speak. A brief background on myself. My name is Brian Dixon. I'm the president of Off The Chain Capital. I entered the digital asset markets in 2012 when I was finishing my last year of law school. I spent about three months going down the rabbit hole before I had my light bulb moment, where I thought If this ends up working, this is going to change a lot of things. And so, after law school, I went all-in on crypto technology and investing.

I'm originally from St. Louis, Missouri and I built a venture company there where I raised and managed a series of three private venture funds focused on tech and consumer products startups. And then through my organization, I partnered with a fortune 500 energy company called Ameren, which covers the state of Missouri and Illinois. We built out their venture program. And then, I did the same thing for the federal government's National Geospatial Intelligence Agency to help them find new technology around satellite imagery and geospatial intelligence.

Throughout that time, I was building a lot of relationships in the blockchain space, and making a lot of personal investments in the space. And then in 2016, Off The Chain Capital was founded. We are now continuing to operate that business model, and what we do here is we have a deep discount, traditional Warren Buffett-style of investment strategy in the blockchain space. I usually tell people what we don't do to give them a little clarity on what we do.

We don't do any venture investing. We don't do any kinds of algorithmic trading. We're basically finding unique ways to buy a dollar’s worth of blockchain assets for 50 cents. That can be through private equity, or it can be through direct digital asset exposure, where we're buying Bitcoin out of bankruptcy proceedings, giving us a large discount on the spot price of Bitcoin. That, at a high level, is my background and what we do with Off The Chain.

AYLA KREMB: Sounds like this time is the best time for you, given your strategy. We’ll dig into some questions now. I'm sure we’ll circle back to how the current environment is treating you and your fund’s thesis. But when it comes to valuing digital assets, how are they different from other alternative assets that you might have touched in the past?

BRIAN: When you're looking at most assets, like companies for example or real estate properties, you have this physical asset, or you have an actual organization that's pumping out revenue and cash flow. You can really look at traditional ways to value these assets. But when you're looking at crypto and blockchain, you really have to shift your mindset in how you value these different types of protocols. There are a couple of ways that we do this with Off The Chain.

The first one that's most important to know is that since you're not valuing a traditional organization, or some type of asset that has these traditional metrics, you have to understand what it is that you're valuing. With Blockchain, you're valuing a software network. And so, there's four different models that help us value digital assets. One of the models that we use is just a traditional mapping on a logarithmic scale, where we map out the historical price of Bitcoin.

We run a line through that to help us predict what we think the future price of Bitcoin would be. That's one model that you can use to help you value Bitcoin and digital assets. Another one that's more specific to the valuing of a network would be called Metcalfe's law. And with Metcalfe's Law, this can be used to value Uber or Facebook or other types of software-enabled network effects businesses. With this particular model, you take the users in the network and you square them, and then you multiply that by the transactional value that's flowing through that network.

When you do that, it gives you an estimate of where the digital asset network should be valued at that time. And then, you can determine whether it's overvalued, fairly valued, or undervalued. Another two models that we use, and there's been some controversy over these in recent months over the last year, is the stock-to-flow model. The stock-to-flow model is basically used to measure scarce assets like platinum, palladium, or gold. The stock is the amount of that asset already in circulation, and the flow is the new amount that's being issued into circulation on predictable timelines.

Since we know that around 90% Bitcoin has already been mined and is in circulation, and we know exactly how much is being mined every 10 minutes, you can use this model to help you figure out if it's overvalued, undervalued, or fairly valued. We use two different stock-to-flow models. We use the traditional one that uses US dollars to measure that value. And then, we also use gold as the monetary unit. That basically means we remove cash and replace it with gold.

That's actually our most accurate model. It has a 99% correlation to the historical price of Bitcoin, and it allows us to see when the digital asset is overvalued, undervalued, or fairly valued. Those are the four core models that we use to help us understand how to value digital assets.

One other thing I'll share is a great quote when you're thinking about models. I forget the person that said this, but they said, “All models are wrong, but some can be useful.” If you think about models from that perspective, you're never going to have a model that's going to be accurate all the time. But they can be useful from time to time.

KENNY: That's great. There is a lot to unpack there. We don't want to go into too much detail on your secret sauce there, but obviously you use these models to figure out the value for digital assets like Bitcoin. And then, you find creative ways to get access to it. It sounds like a lot of it is buying balance sheets, or buying companies and picking it up on the balance sheets by plays. What's changed there? I heard something about an FASB ruling around balance sheet holdings and what that has an impact on. Do you want to talk a little bit about what balance sheet holdings in digital assets look like right now?

BRIAN: Yeah. I think there are different organizations specifically impacted by the FASB rule that you noted. This applies to public companies. There are some public companies in the market that have begun to acquire digital assets for their balance sheet, and they're using this as part of their treasury reserves strategy. Now, FASB, which is the Financial Accounting Standards Board, is responsible for writing the rules for GAAP accounting.

There was a rule that was contemplated for quite some time and passed recently. It's very, very important but barely got any media coverage. Let's use MicroStrategy as an example. Michael Saylor, the CEO and executive chairman of MicroStrategy, who focused 100% of his time on Bitcoin, was the first pioneer that really started buying Bitcoin as part of their treasury reserve strategy because his team could not find a better asset to hold its value through space and time. That software business was generating cash to invest in Bitcoin.

So, they built this large position in Bitcoin and they continue to acquire it. And what occurred before and still today is that if you're a public company, and you buy Bitcoin for your balance sheet, if Bitcoin goes up in value, you cannot show that appreciation on your books for the current FASB rule. If it goes down in value, you have to mark that depreciation against your earnings because FASB characterizes Bitcoin today as an intangible asset. So, it's actually prohibitive for a public company to buy Bitcoin right now.

However, recently it was voted seven to zero. It was unanimous approval, and FASB voted to recharacterize Bitcoin into what will likely be an investment asset. That means if a public company buys Bitcoin to put it on their balance sheet, and Bitcoin goes up in value, you can now show that appreciation on your books. Once that rule takes effect, which I think is going to be over the next three to four months, I believe we're going to see a large inflow of public companies that are going to start acquiring Bitcoin and other digital assets for their balance sheets.

KENNY: Just to make sure I understand what you're saying, for example, I'm the CFO of a company and I want to buy some Bitcoin. In the past, you could never mark it up. You will never be able to see what the true value of it or the market value of it is on your financial statements. But now you can, which makes it a lot more appealing, because it looks like you're not massively underperforming if there is a rally in Bitcoin or crypto. Is that correct?

BRIAN: Yeah. One clarification is that previously, you could not show Bitcoin when the price went up. But if the price went down, you had to mark that against your earnings. It would negatively impact your financials historically. But once the new rule takes effect, you’re correct. You'll be able to mark it at the spot price up or down, and will be able to show that on your financial statements.

AYLA: Fascinating, and extremely disadvantageous to folks trying to earn this asset. Maybe I'll take one of the questions out of the chat. Do you see the current diversion of Bitcoin from traditional stock-to-flow as an invalidation of the model, or a buying opportunity?

BRIAN: We look at it as a buying opportunity. That's just one of the models we use to help us understand if something is undervalued. I think if you look at stock-to-flow over a longer period of time, there are certain periods historically where the model has appeared to be invalidated. And then, there's other periods of time where the model seems to be revalidated.

It really depends on the state of the market we're in. That's just one of the several ways that we look at the markets to help us understand if we think something is fairly valued, overvalued, or undervalued. And as of today, all of our models indicate that Bitcoin, and I'm not talking about anything else, is an undervalued asset.

KENNY: Fascinating. That makes sense. We actually have three more clarifications on the FASB rules. I'm going to try to combine them all into one. First, you mentioned Bitcoin. What are the digital assets that fall under that? What are the restrictions, and is it final? Also, do you think that it has any connection with the most recent rally in Bitcoin?

BRIAN: I don't believe it has anything to do with the most recent rally we saw over the last week. The passage of the rule is final. I think now they're just going through the specifics around what digital assets will be included, but they did vote on it to say, "Yes, we are going to recharacterize this."

I know that from my readings on it, I think Bitcoin, Ethereum, and a couple other ones they've noted will probably be included within this rule. And moving forward, I would anticipate that if something is characterized as a digital asset, they are likely going to be able to show its movement up or down on their financial statement. But I don't think FASB has specifically released yet exactly which digital assets it applies to.

AYLA: I'll pick up another one from the audience here. How will the assets of FTX, Alameda, and 3AC be valued? I guess they probably mean both the liquid assets and the venture investments that they might have. Maybe you could touch on both of those.

BRIAN: In terms of the venture assets, I guess what you're talking about are the ones that are leftover after their bankruptcy. Those probably get bundled up and sold off for a big discount to people. That's my anticipation. They're the actual liquid digital assets. What's likely going to happen is the same thing that we experienced with the Mt. Gox bankruptcy. In Off The Chain, we have been very active in Mt. Gox, which went bankrupt in 2014.

It was the largest Bitcoin custodian in the world at the time before the exchange was hacked. About 850,000 Bitcoin was stolen, but they were able to recover 141,000. I'm just going to paint the picture of what happened with Mt. Gox because I believe it's going to be very similar with these other organizations.

So what happened with Mt. Gox is, since they recovered those Bitcoins, everybody that was a customer on the exchange was due back a percentage of that recovered Bitcoin. It's the same thing that's going to happen with FTX, Alameda, and 3AC. Whatever the recoverable assets are, people that are customers are going to be due back a percentage of that.

People are going to hold the legal rights to a bankruptcy claim for whatever their pro rata percentages of that remaining pool of liquid digital assets, and then they can elect whether, "Do I want to sit on this bankruptcy claim until those liquid assets are paid out probably in five to 10 years from now? Or do I want to sell my bankruptcy claim to an institutional buyer or another individual at a discount to get liquidity today?"

That's what I anticipate happening, and we're already seeing that in the market. With FTX, Three Arrows Capital, and Alameda, we're seeing large institutional buyers that are sizing up investment funds specifically to take advantage of this bankruptcy opportunity with these organizations.

KENNY: We'll go off script here and dig into Mt. Gox a little bit. That's coming along pretty quick. People are actually getting liquidity in around two to three months, or something like that. What's the magnitude of unlocking that had to be done? And then, what type of impact would you expect that to have on Bitcoin pricing?

BRIAN: When you look at the total amount of Bitcoin that will be released into the market from this, there's been a lot of FUD that spread, and it's like once Mt. Gox comes in the market, it's going to drive the price down because all these people are going to sell. I completely disagree with that, because Mt. Gox's amount of assets is probably going to be somewhere between just one to 2% of Bitcoin daily trading volume when it comes in the market. The Bitcoin market could absorb that relatively easily.

I also think among the people that are holding the claims today, depending on their strategy, there are still a lot of individual holders. I think those people are more likely to hold the Bitcoin today than they would have been five years ago, whenever this event took place or a little bit longer than that.

Because at that time, we didn't know how the Bitcoin and digital asset ecosystem was going to evolve. But today, we're so much more advanced. In my eyes, there's a higher percentage chance that a lot of these individual claim holders will hold the Bitcoin and not sell them. And then, if you're an institutional investor, depending on what your strategy is when you receive the Bitcoin, they may sell part of it or keep some of it. They may sell all of it and re-allocate to other opportunities as well. That remains to be seen.

But I don't agree with the fear that I've seen in the Bitcoin market around not being able to absorb when the Mt. Gox bankruptcy assets are released. Because I think that they can be absorbed pretty easily, probably over a course of a week.

AYLA: Interesting. Do you anticipate the FTX resolution to be around the same 10-year timeframe, or do you think it might be faster because they seem to be moving?

BRIAN: When it comes to bankruptcy proceedings, one thing they definitely are not is fast. In the early stages, they may seem to be fast, where it's still going on and it's top of mind. But Mt. Gox happened in 2014. And according to the most recent public information that was published by the trustee in Japan that manages this bankruptcy, those assets are not supposed to get released until September of this year.

There are usually very long timelines on the bankruptcy side of things. When people structure these different bankruptcy vehicles, they will say, “Okay, we're going to buy these different claims and you get liquidity when we do.” That could be three years from now, five years from now, or 10 years from now. It just really depends on how that bankruptcy process is managed.

I anticipate FTX is probably taking a very long time because there are so many different assets on the platform. The scale of it and the complexity of everything that went into it is huge. I think that will just extend the runway in terms of when those assets are actually paid out in the future.

KENNY: Love it. Well, as we got you, and we're talking about discounts to equity or to actual holdings, it would be remiss to not talk about Grayscale. We have the Grayscale Bitcoin trust and Ethereum trust. Apparently, there is a bit of a discount there. Maybe you could tell the audience a little bit about what's going on and why you think they should care.

BRIAN: One thing I will note, which I forgot to mention at the beginning, is that we are a registered investment advisor with the SEC. And so, from a compliance perspective, some of the comments I make may be forward looking, so please don't place any undue reliance on that. Also, we are a shareholder of the parent company of Grayscale, which is a digital currency group. Everything I will say is public information. I will just share how I've interpreted this.

In terms of the Grayscale situation, Grayscale today is the largest digital asset manager in the world. They own approximately 3.6% of the world's Bitcoin within their Grayscale Bitcoin fund. And historically, that's traded at a discount or a premium depending on the state of the market.

But with everything going on recently, the Grayscale Bitcoin trust has been trading at a large discount. It's actually been the largest discount from the net asset value of the stock than it's ever traded historically. A while back Grayscale filed to get their Bitcoin product approved as a spot ETF with the SEC, but the SEC declined it. They blocked the approval of the ETF, just like they've done with several other providers that have tried to file for this.

And the very same day that they blocked it, Grayscale filed a lawsuit against the SEC. The legal argument that Grayscale is making for this is that the SEC is being arbitrary and capricious, because they've already passed a futures-based Bitcoin ETF. And now, they're declining a spot ETF. It doesn't make a lot of sense for the SEC to pass an inherently more risky product, which is a futures ETF, than they would a spot ETF, which tracks the spot price of Bitcoin.

And so, if you really go in and look at the public information that's out there, and you read the legal briefs, I think Grayscale has a very strong legal argument here because it doesn't make a lot of sense that the SEC passed the futures ETF and not the spot ETF just based on the risk profile of each. I do believe we're at a point that the markets should have an ETF product from some provider.

Grayscale is moving through this legal proceeding. This is being adjudicated in early February, and they will be selecting the judges that will be ruling over the case. And then I believe by fall, we will probably get a decision around this based on how things are moving right now. The judges are going to decide, whether yes, the SEC should have passed this, or no, the SEC was right. That remains to be seen yet. But I do think that Grayscale has a very strong argument.

We'll see how that plays out in time. But one thing to add to that is, the reason that is important to the market is because if, for example, Grayscale's Bitcoin ETF does get approved, they're going to unlock about $4 billion worth of value, and it's going to open up a huge opportunity specific to Bitcoin for people to be able to access that asset class in a very easy fashion.

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