

# How Crypto is Transforming Venture Capital

A brief history of a bittersweet dance



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Source: Pixabay

In the past few years, an interesting dynamic between venture capital and the blockchain ecosystem has developed:

*VCs went from ignoring cryptocurrency to being left out of the ICO action, to reclaiming the throne, and, finally, starting to intertwine in interesting ways with crypto.*

This post starts with a recap of what happened so far and reflects on where we are now, whereas an upcoming follow-up post will speculate on what the future may hold.

*“First, they ignore you”.* One of the main reasons token sales gained so much traction was out of necessity: no traditional investor had any interest in funding projects with names like Mastercoin or self-proclaimed world-computers. By leveraging crypto assets as vehicles for fundraising, the public crowd-sales that grew into the ICO madness of

2017 emerged as an entirely new venture financing paradigm with a feel somewhere between Kickstarter and IPOs.

However, some VCs did see the potential of the technology early and invested (bought equity) in companies building on top of Bitcoin. However, it became clear that the bulk of the value did not accrue in the companies on top of decentralized networks, but rather in the assets native to them (for example, Bitcoin itself is more valuable and on average grows faster in value than the wallet provider Blockchain or even the leading exchange Coinbase). The guiding narrative that slowly spread in the VC (and blockchain investment) community to make sense of this phenomenon and that is still pervasive (but controversial) today, was around “fat protocols” (as introduced by then-USV’s Joel Monegro). The investment hypothesis proposes that protocols at the bottom of the tech stack (“layer 1”), such as Ethereum, will accumulate more value than projects in the “middleware” and application layer on top of it. In order to be able to invest in these protocols themselves, VCs had to figure out how to deal with crypto assets.

The first way that VCs found to get exposure to crypto assets is through SAFTs (“Simple Agreement for Future Tokens”), a kind of legal hack that was created by amending a standard framework for early equity investment and that grew immensely popular (despite constant criticism of the vehicle from lawyers and regulators alike). The approach was made popular by Filecoin who used it to place a \$200 million private round. Because the SAFT itself has been getting some heat lately, improved solutions (with acronyms that don’t mean “juice” in German) have been proposed. Some of the more nuanced iterations are called SAFTER, and RATE. Republic Crypto’s Token DPA adds elements of a convertible loan and CrowdSAFE is aimed at equity crowdfunding/security tokens.

One of the reasons for the success of the SAFT certainly is that VCs only have to change their processes minimally in order to participate—one legal contract is basically swapped for another. At one point, however, the “future tokens” will be distributed, and institutional VCs need to be able to hold and manage these assets in a secure way.

For this reason, the next step that needed to be figured out was *custody*. VC funds need institutional-grade custody, an exchange account or even a hardware wallet won’t do in terms of security (and, depending

on the size and jurisdiction of the fund, regulation). Although custody remains a major challenge that arguably hinders many institutional players from entering the asset class, the ecosystem went from having no viable solution at all to a growing number of offerings from both traditional finance and cryptocurrency-focused companies.

This includes qualified custodians that comply with fund regulations (relevant especially for larger funds) such as BitGo Trust and even efforts from finance giants towards other solutions viable within existing regulatory regimes such as Citi Group's Digital Asset Receipts (DARs). In addition to that, exchanges start offering custody and OTC solutions for institutions (e.g. Coinbase Custody), just like retail custody providers are rolling out institutional-grade cold storage solutions (e.g. Ledger vault). Even though there has been an enormous surge of activity in the custody space, many crypto funds still operate under a customized self-custody paradigm, indicating that current solutions are not quite viable for large parts of the market yet.

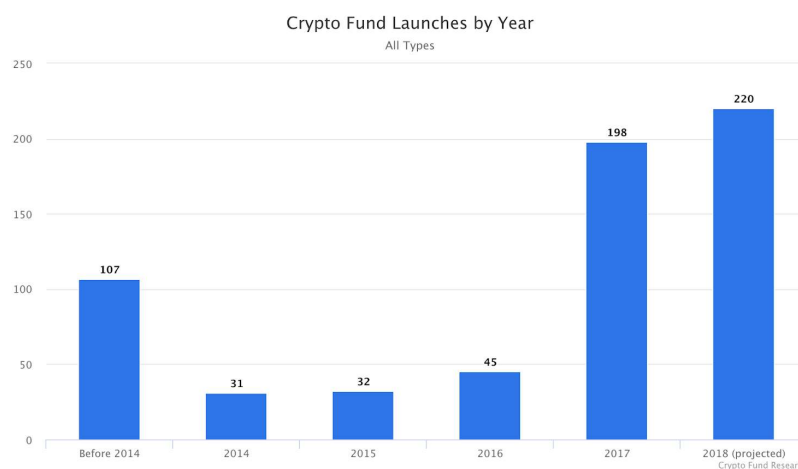
Armed with those two new workarounds, SAFTs (and their new iterations) and custody solutions described above, VCs in 2018 could invest in crypto assets directly. *And they did.* Following Filecoin, there was a range of seemingly ever-increasing private rounds, from projects like Basis with a \$133M private VC round (the project recently shut down due to regulatory concerns), all the way up to Telegram's mega pre-sale which raised a staggering \$1.7 bn. At first, these private sales had even more gigantic round sizes than ICOs (VCs may have been a bit over excited to be able to join the token bonanza and overcompensated for their previous FOMO). However, after the public sale space pretty much dried out with the recent market collapse, valuations have been getting more reasonable, albeit arguably still elevated towards the end of this year (e.g. this \$35M round for a high-profile project with a select round of Crypto VCs).

Another very interesting development is that crypto VCs started buying up tokens directly from public crypto markets, such as a16z's purchase of 6% of the total MKR token supply for \$15M. This is a completely novel territory for VCs and, assuming this develops into a major trend, it could change the competitive dynamics in the space when it comes to accessing investments: Even though a16z is a premier crypto VC, anybody could have bought MKR on the open market, unlike pre-sales where often only the most reputable VCs get access. Note that this

could start blurring the boundaries between “Crypto VCs” (buy-and-hold) and Crypto hedge funds (liquid long/short strategies), as it is just as easy to sell a position on the open market than to buy it.

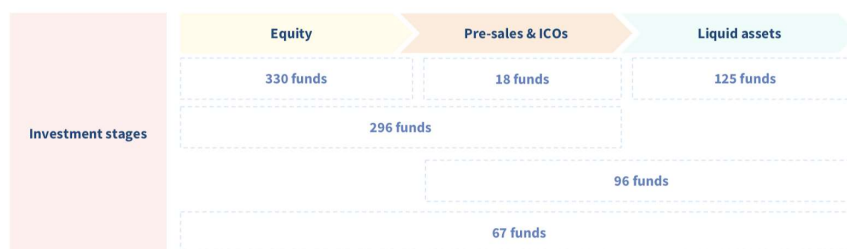
Although it feels like ICOs were so 2017, the numbers tell a different story: According to [Coinschedule](#), more than \$20bn have been raised in token sales in 2018, almost tripling the \$6.5bn raised in 2017. However, a large part of this volume was not ever offered publicly but only to private investors (and not only VCs, but, increasingly, family offices, HNW individuals, etc.). One reason for this is increased regulatory scrutiny—financial authorities like the SEC have started to prosecute cases that could be considered as unauthorized sales of securities to the public, which has made a placement with VCs (and other groups of ‘professional’ or ‘accredited’ investors) much more attractive. In addition to that, VCs also have an important signalling effect for an eventual public sale. The market downturn in crypto assets overall will also have contributed to much less demand from retail investors, whereas institutional investors purposefully invest in an anti-cyclical manner (or try to do so, at least).

Increased institutional participation is also visible in terms of the numbers of crypto funds launched. There are now over 900 crypto funds, up 10x from before 2014.



Source: Crypto Fund Research

Of those 900+ funds, relatively few invest across different stages like A16z Crypto (equity, pre-sales & ICOs, public crypto markets), whereas most specialize in one or two clusters.



Source: Crypto Funds List

So, VC went from not having access at all to capturing a large part of the market for token sales. But not so fast—there is yet another twist: An ever-increasing number of projects are launching models where either tokens can only be “earned” through providing some value to the network (as opposed to being sold), or there isn’t even a token in the first place. The latter is often the case with so-called “layer 2” technologies (scaling infrastructures added on top of blockchain platforms). This brings VCs back to the apparent investment paradox of how to capture the value of decentralized technologies directly?

The latest buzzword in the space, “Generalized mining” ([introduced by CoinFund](#) and discussed by [Fabric](#) and [Cambrial](#); [Notation](#) prefers “[Mining 2.0](#)”), provides an answer to that. The idea essentially is that investors will actively participate in the networks in which they invest. So instead of just contributing capital, VCs would participate directly in the crypto network by providing supply-side services that help bootstrap the network towards usability. In other words, investors serve as “miners, stakers, validators, bonders, curators, dispute resolvers, nodes, hubs, watchers, routers for networks, etc.”. In practice, active participation is most often combined with direct investing, but some projects do not offer opportunities to invest, and participating in their underlying networks is the only way to capture the value of these particular technologies.

In some sense, the development of generalized mining can be seen as a continuation of the trend of VCs providing added value to their portfolio companies, applied to crypto (because [crypto networks are not companies](#)). Supply-side services to decentralized networks may be the most striking example yet of how crypto investors start developing specific capabilities geared at this unique asset class ([this post](#) by [Multicoïn Capital](#) elaborates more). I am excited to see how else early-stage investors can participate directly in the networks they fund.

*To recapitulate, we have explored how VCs have found ways to get exposure to wonderfully weird Cryptoland by modifying their infrastructure for the emerging paradigm of tokens and crypto assets. VCs investing in tokens have adapted their processes (custody for crypto assets and legal frameworks for token sale participation) and crypto-native VCs are starting to change their behaviour more drastically: They buy assets straight from public markets and participate in crypto networks directly through generalized mining.*

These more advanced operations are still unthinkable for most traditional VCs, who will likely get exposure indirectly by investing in crypto-native funds in a fund-of-funds model (arguably, this trend has already started).

*We can make sense of the market shifts sketched out above through the increased need for differentiation. New sources of capital (especially during bull cycles) including retail investors, traditional VC, family offices, business angels, etc. make the competition to invest in the best crypto projects tougher than ever. By specializing on the unique needs and capabilities of the token economy, crypto-native VCs are creating a competitive edge.*

I believe we have only just started to see the impact that blockchain technology will have on the Venture Capital landscape and in an upcoming post, I will explore different scenarios and possibilities of where this could all lead and what exciting developments the future may hold.

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*Thanks [@NancyFechnay](#) for providing feedback on early drafts.*



