Investing in the metaverse

While the blockchain markets – alongside many other global markets – experienced broad downturns in the first half of 2022, this has not deterred founders and investors in the industry, who continue to see the long-term prospects for the technology and so have maintained a tremendous level of interest in building new projects in the space, including those focused on the metaverse.

Prior to the downturn, 2021 saw a range of big-ticket crypto M&A announcements, highlighted by Galaxy Digital's $1.2 billion purchase of digital-asset custodian BigGo, as well as deals like Mastercard's foray into the industry with the acquisition of crypto intelligence firm CipherTrace, Nike's purchase of NFT development and production house RTFKT, and a wide variety of other major transactions.

Reports indicate that we can expect 2022 to continue to be an extremely active time for investment in the space. According to PwC, the total amount raised by companies in the crypto industry in 2021 was almost eight times higher than it was in 2020, reaching a total of $34 billion, which was more than all prior years combined. Early indications are that 2022 may yet outpace that record year, with capital inflows from crypto VC firms topping $14.6 billion in the first quarter, which is equal to about 48 percent of the total raised in all of 2021.

With big institutional investors such as a16z and FTX raising new multibillion-dollar funds in 2021, and other familiar names, including Sequoia and Bain Capital, taking in hundreds of millions of dollars of their own, investment interest in this space can be expected to persist for years to come. Investment in the blockchain industry is no "flash in the pan," and has captured the attention of entrepreneurs and investors who wish to align to create valuable products and reap the benefits of their efforts.

Compared to conventional technology start-ups, investing in a metaverse or blockchain project can be more complex in some respects, but also more attractive in others.

The basic assumption for conventional tech start-up investments is that the value of the enterprise is captured through equity interests in the company that houses the project. The project founders and other key participants pool the intellectual property and other key assets relating to the project into a corporation or other legal entity, and that entity is tasked with building a business that will eventually generate profits that can be distributed to its owners. The potential for future profits to be generated by the enterprise is also captured by the share value of the entity, which is expected to appreciate as the business grows, execution risks are mitigated, and the business proposition is validated.

In this conventional start-up context, the assumption is that the value of the enterprise is mirrored 1:1 by the value of its shares. Consequently, investing in the enterprise almost always involves acquiring shares of the company that houses the project. The company sells shares to investors to raise capital to build the enterprise, and investors acquire shares on the assumption that the shares will appreciate in value if the venture is successful. Investors expect to make a return on investment through receiving a share of profit distributions – or, more importantly, by selling their shares at a profit at a later point. The opportunity to sell is expected to come through a sale of the company, through an IPO or exchange listing that generates a public market for the shares, or through private secondary sales.

Equity interests in a conventional technology enterprise also play another important role – they facilitate governance mechanisms to ensure that the interests of the external stakeholders in the enterprise are adequately protected. Investors in tech companies will often participate in governance of the enterprise through rights to vote on and approve key events – such as a sale of assets or additional financing transactions – and rights to elect company directors to directly oversee its management. These governance functions are enabled through voting rights attached to the shares investors hold.

In the context of a metaverse project, however, some of the base assumptions for traditional venture investments may not be present. For one thing, the declared goal of many blockchain projects is not to create a profit-making enterprise. On the contrary, web3 projects are often designed to avoid a result where the originators of the project profit at the expense of the community that eventually adopts and uses the platform to be developed. Instead, the professed motive is often to build an infrastructure that generates benefits shared equally among the community. Therefore, there may not be a stream of expected future profits to be captured by shares of the legal entity that originates the project. Moreover, the likelihood of an "exit event" generating liquidity for holders of these shares may be questionable. Outright acquisitions of web3 companies have – to date at least – been comparatively rare. And public offerings and exchange listings of equity interests in the blockchain projects have been rarer still.

For investors, holding shares in the company they invest in may not afford much assurance of involvement in governance matters either. In part, this is due to the fact that the legal entity that accepts investor capital may not be the entity that ultimately launches and operates the project – many blockchain projects evolve to operate under the auspices of multiple legal entities, often spread across several legal jurisdictions. Moreover, many projects aim to ultimately place much of the authority for steering the project in the hands of their user community through decentralized governance processes.

All of this may make investing in a metaverse start-up seem like a daunting proposition. However, the flip side is that web3 projects may offer investors paths to liquidity not present with conventional venture investments.

That's because these projects often entail building an economy around tradeable digital assets created by the project. A central mechanism of metaverse or other blockchain projects is often one or more digital "tokens" that enable access to features, functions, and services offered by the platform, or, in some cases, digital currencies that act as a medium of exchange within the online economy enabled by the project. For instance, a digital virtual world project may employ a token to enable users to vote on referenda about the evolution of the online platform, or to access tools to build their presence within the online universe. The project may also support a digital currency that enables actors in the digital universe to exchange goods or services within the online realm.

These digital assets are often designed to be transferable and tradeable, whether within a trading system operated by the project itself, or on a variety of third-party digital asset exchanges (including popular "centralized" asset exchanges such as Coinbase, Binance, and FTX, as well as smart-contract-based "decentralized" exchanges such as Uniswap and Sushi).

These digital assets also typically serve as a mechanism for incentivizing the teams of developers that create and support the project, including the founders that originated it, by allocating certain of these tokens or coins to these key players. And, importantly, such digital assets can serve as a mechanism for rewarding early investors in the project for their support. A common practice for web3 projects is to devise a digital asset economy with a limited supply of digital assets (to support a sustainable long-term value for these assets), with a defined portion of the available supply allocated to rewarding and incentivizing different constituencies supporting the project, including investors that helped underwrite the cost of developing and launching the project.

This means that investors supporting a web3 project may be able to count on access to a class of digital assets that are liquid and act as a proxy for the overall value of the project the investors supported. As a result, investors in these projects are often not solely reliant on the equity interests they purchased to realize liquidity. Multiple paths to liquidity may be available if investors hold both equity in the legal entity that originated the project and the digital assets that the project produces. Indeed, some of these paths may offer a much shorter time horizon to liquidity than traditional venture investments – whereas the timeline for exiting an early-stage equity investment through an M&A transaction or public stock offering is measured in years, if not a decade or more, a liquid market for digital assets of a web3 venture could emerge within a year or less of the project raising initial external funding.

The key consideration for investors in blockchain start-ups is therefore often to ensure that they are positioned to participate in all potential sources of value – including ownership not only in the legal entities they support but also in the digital asset economies the projects aim to create.

Once the parties have aligned on structure, the question of valuation becomes important. While the valuation of traditional start-ups is often difficult, the valuation of metaverse and other blockchain start-ups is even trickier. For one, there are few established comparators to use as benchmarks with respect to a newly proposed deal (and even fewer that are public), particularly in the metaverse space. Further, the technology underlying these projects is still evolving and many metrics, such as daily active users, are estimates, lending even more uncertainty to the medium- and long-term forecasts of a particular investment's value. Using a discounted cash flow analysis is also difficult, as the token structures used by many metaverse and other blockchain start-ups effectively amount to indirect and non-regular income streams, and thus do not cleanly align with this kind of conventional modeling. In addition, the uncertainty over the ownership of data and intellectual property in the metaverse casts doubt over key factors traditionally used to value start-ups.

Beyond the structuring of the deal itself, investors conducting their due diligence in the blockchain space must be mindful of the unique regulatory compliance issues affecting the industry, as compared to traditional venture capital deals.

Often, the most prevalent and pressing compliance concerns for a crypto project relate to the potential classification of its associated digital assets as securities under the laws of the United States and other jurisdictions. In the past, the U.S. Securities and Exchange Commission (SEC) has provided rough guidelines regarding its thinking around which digital assets may be deemed to be securities. However, even if these guidelines are taken to still represent the SEC's working framework (which is not guaranteed, given the recent changes in regulators heading the SEC and other agencies), such guidelines are incredibly complex and nuanced – there are around 40 factors that must be evaluated and weighed against each other regarding any given digital asset, just to glean a rough probability on how the SEC may land regarding such an asset's securities status.

Classification of a project's digital assets as securities could have substantial negative implications for the value of the assets and, therefore, for an investor's investment in the project. Digital assets that are deemed to be securities may have far fewer options regarding centralized exchanges that are willing to list the asset, thus limiting the market liquidity for the asset. And the assets would likely be subject to restrictions on transfer for considerable periods of time, even further impacting the assets' salability and the enterprise's commercial viability. Depending on the degree to which a project operates in a decentralized manner, certain reporting requirements imposed by current securities laws could even be impossible for the project to comply with.

Beyond the complicated analyses that must be conducted regarding federal securities laws, certain crypto projects could also implicate several other U.S. legal, regulatory, and monetary regimes, overseen by agencies such as the Commodities Futures Trading Commission (CFTC), the Financial Crimes Enforcement Network (FinCen), the Internal Revenue Service (IRS), the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the Department of Justice (DOJ) and any number of other international and state-level oversight bodies. Investors must also bear in mind that many web3 projects are designed in ways that are not limited geographically, and as such, their compliance obligations are inherently global. The fact that the regulatory framework for digital assets is largely unsettled – both within and beyond the borders of the United States – presents unique challenges and risks for industry participants beyond those faced by most conventional start-ups.

In summary, while differences between investment in conventional start-ups and in metaverse or other blockchain projects may deter some would-be participants, it is clear that these novel risks and considerations have not deterred a large class of investors from entering the industry. Those seeking to join in on the excitement in this space should do so with clear eyes and an understanding of how best to structure crypto-related projects and avoid regulatory pitfalls associated therewith.

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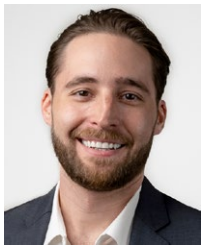

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