

Magnet Capital Investment Considerations

25th July 2022

Magnet Capital's Vision

We believe the future 'digital asset class' will be instrumental to technology, innovation and the next evolution of the internet. As a consequence, there exists an opportunity with an attractive risk/reward tradeoff in identifying and gaining exposure to key infrastructure and applications within this asset class . [The power of decentralisation](#) and the creation of a new asset class has created a surge of innovation that has attracted world class talent to transition away from traditional institutions to the crypto ecosystem. We see this as the next wave of innovation with a similar growth trajectory as the internet.

Blockchains changed everything

Web3 is the next evolution of the internet

The genesis of the internet, **Web1**, unfolded in the 1990s and was characterised by open and decentralised protocols such as SMTP for email and HTTP for the World Wide Web. The entire internet was web pages in read only mode. While its functionality was limited, Web1 embraced a model of community governance, even though the network itself held no intrinsic value.

Web2, materialising around the mid-2000s, brought with it a move towards centralised, corporate-run services – Google, Facebook, and Twitter serving as prime examples. While this phase of the internet introduced advanced functionality, value predominantly accumulated in the coffers of these tech titans, often at the cost of user privacy.

Web3, anchored on the benefits of decentralised blockchain networks like Bitcoin and Ethereum, represents a paradigm shift. Linking back to the community-governed spirit of Web1, equipped with Web2's sophisticated functionality, Web3 marks a new dawn in the internet's evolution. Its crowning achievement is the reallocation of value from corporations to network participants themselves, incentivising active contribution and nurturing a more equitable online landscape.



Characteristics

	Web 1	Web 2	Web 3
Interaction	Read-only	Read-write	Read-write-own
Activity	Informational pages	Interactive content	Create tokens
Outcome	Page views	Cost per click	Ownership

Market Behaviour

Cycles

Cycles exist in most asset classes, digital assets are impacted to a greater extent because of their liquidity and always available nature in a nascent asset class. Crypto has seen multiple bull market cycles that have concluded with market euphoria, 'this time is different' and 'the dawn of a new age' mentality as participants ignore fundamentals and overpay for assets. Inevitably, a steep correction results that is swiftly framed as 'the end of crypto'.

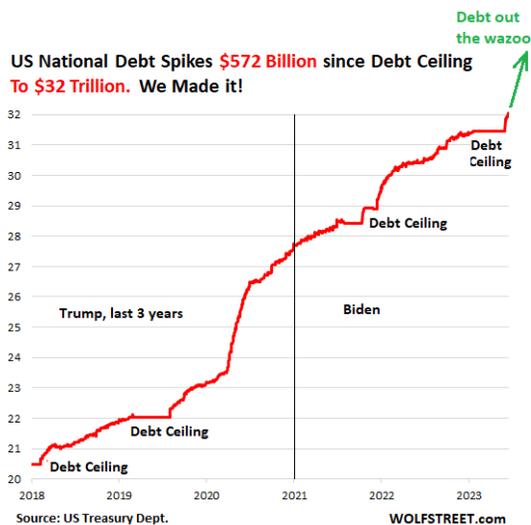
Historically, these cycles have been tied to Bitcoin halvings, and follow the associated ~4 year patterns. Whether they will be in the future as halvings become less and less relevant doesn't change the fundamental thesis that humans make decisions based on emotions, these emotions will guide a risk on or risk off environment - therefore creating cycles in all asset classes. Most of the time price is not correlated to high quality assets and is a factor of market cycles. This creates significant opportunity for the long-term investor focused on fundamentals that drive value over a long-term time horizon.

Interest Rates and Liquidity

The entire crypto asset class is currently judged as a risk asset and as such has heightened correlation to monetary policy. The low interest rate environment of the last 15 years has provided a conducive environment for rapid growth in the crypto ecosystem.

Moving forward we are in a position that few have seen before - high inflation, high interest rates, quantitative tightening and low unemployment. Liquidity is being drained off the market which impacts crypto significantly. The previous conditions for rapid market growth are changing.

Understanding how macroeconomics affect the crypto ecosystem is essential. Over the long term as we come to understand the differences between individual assets or categories across digital assets, they will start to perform independently rather than the entirety of crypto be bucketed as 'Risk' assets. For example, Store-of-Value assets should be negatively correlated with loose monetary policy, like gold (for example, see below). Assets like Ether should be uncorrelated at best as the primary use case is to use for fees or stake for interest. Both of these assets while independent from one another currently move in lockstep with interest rates but do not need to.



Understanding the Asset Class

The Digital Asset class is unlike any other and in its infancy is developing at an extreme pace. There are key characteristics that need to be understood when investing in crypto. We have developed a framework for identifying and qualifying good investment opportunities called the four T's; **Technology, Team, Timing, Tokenomics**.

Taxonomy

In order to invest appropriately across this landscape one needs to first understand what are:

- the subcategories of the asset class,
- their core attributes and value drivers of each category, and,
- how they differ from non-crypto models.

It is also important to understand category by category what the need is for a solution against the maturity of the market.

Tokenised business models

Tokenisation has made it possible for businesses to reinvent their governance, business models and distribution methods. Tokenised business models replace the traditional share structures of companies in favour of digital tokens, the act of doing so comes with significant additional benefits.

Key benefits to a tokenised business model:

1. **Global Accessibility and Liquidity:** Tokens create immediate liquidity and can be onboarded to decentralised exchanges in hours.
2. **Fractional Ownership:** Traditional shares may have limits on divisibility. Tokens can be divided into smaller parts, allowing for fractional ownership, further increasing liquidity
3. **Real-Time Settlement:** Unlike traditional securities that can take days for settlement, blockchain-based transactions can be settled almost immediately.
4. **Cost Efficiency:** The use of blockchain technology reduces the need for intermediaries, which can reduce costs, and help improve economics
5. **Transparency and Security:** Tokens allow for greater transparency as every transaction is recorded on a public ledger reducing fraud and other forms of manipulation. Moreover, blockchain's encryption and decentralisation features make it very secure.
6. **Automation:** With the use of smart contracts, many processes can be automated, such as dividend distribution and voting rights. This can make the business operations more efficient and reduce the possibilities of human errors.
7. **Innovation and New Opportunities:** Tokens can be designed with various features that are not possible with traditional shares. For instance, they can have utility within the company's ecosystem, such as granting access to certain services or products.

Looking for value - the four T's

The Four T's is an internal framework we developed to help breakdown investment decisions at Magnet Capital. We have been using the framework as a basis for research and investing since inception in 2017. The framework identifies four key aspects of project analysis and itemises what questions, data points and criteria need to be answered in order to satisfy the investment process.

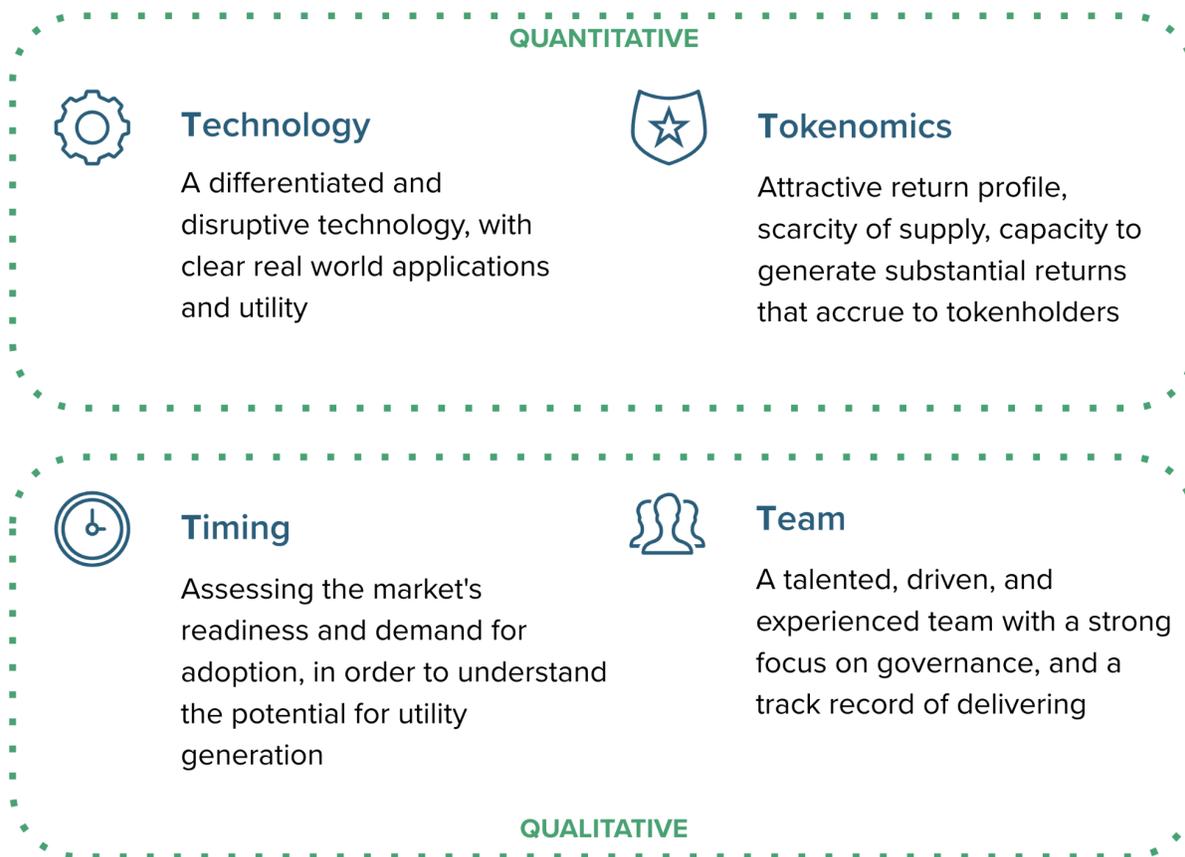


Fig 1. Magnet Capital '4 T' Architecture

Technology - Quantitative

When we look at Technology, we focus on the basic building blocks. This process provides us with a comprehensive view on the project's technical landscape. Technical design, code quality and operability is measurable and makes the first of our 4 pillars.

Criteria

- **Technical design** - how does it work?
- **Product** - MVP, launched, working, design phase?
- **Blockchain centric** - identifying how blockchain technology improves this product.

Assessment - Answering questions like:

- How does it leverage blockchain technology and characteristics such as decentralisation?
- What blockchain is it built on?
- How easy or hard is it to understand?
- Does it use proprietary technology or does it take from existing best practice?
- Is the core innovation new?
- Do new users need additional tools to use the product?
- Does it absolutely need to exist or can it be done using existing technology?
- What is it trying to optimise for?
- Is the code base open sourced?
- Has it undergone audits to verify the strength of the codebase?

Technology when looking at an Ethereum application for example is focused around the smart contracts, web front end and build components.

- Have the smart contracts gone through a security audit?
- Does it use complex architecture like ZK-roll ups?
- What have they built/designed from scratch and what is industry best practice?

The more complex the greater the risk for error, the greater the surface area for risk and attack vectors.

A brand new technology running on its own chain needs to be tested under stress in a live environment. New Layer-1 platforms or new blockchains are extremely hard to simulate, which is why testnet are launched, often platforms only attract attention once they've amassed significant economic value. The major risks here are that a project fails on its main intention because of poor code, technical design or that it gets hacked and investors are left with the same outcome.

On the other side of this, when the technology has been tested, launched, verified, validated by the market and continuously used - the early outsized opportunity diminishes.

Building on existing infrastructure can be advantageous and can significantly speed up the process, token launch, staking contracts, pricing contracts, oracles and many other core tooling has been created and often is underpinned by billions of dollars. This is one of the biggest network effects of the digital asset industry, it allows for open and seamless information sharing between best practices.

Tokenomics - Quantitative

Criteria - Tokenomics serve two main purposes;

1. Build value for token holders
2. Grow the business

Assessment - Tokenomics build a picture of the economic profile of the token and provide insight into how the token design plans to accrue value to its holders. It contains:

1. **Utility** (governance, ownership, access, discounts)
2. **Supply** (total amount of tokens, tokens in circulation)
3. **Distribution** (vesting, lockups and circulating)
4. **Mechanism** (staking, mining, inflationary etc)
5. **Allocation** (team, VC's, mechanism etc)
6. **Market Capitalisation** (intended supply * price)

Token utility identifies the purpose of the token. Purpose is extremely important to understand as it can make an excellent project completely uninvestable.

Token utility

For a token to be valuable and meaningful, it must have a clear and well-defined purpose. At the most basic level, a token can serve as a loyalty reward, but such a token is essentially a novelty item, lacking any intrinsic function or rights. Unfortunately, many tokens in the market are disguised as governance, voting or DAO tokens but in reality, they offer no real value or purpose beyond their superficial branding. To truly succeed, tokens must offer tangible benefits and serve a meaningful role within the underlying protocol.

Attractive token utility can be the following:

- Provide network support like staking, liquidity or security
- Burn or deflationary in nature to create scarcity and demand
- Used for fees, execution or payments
- States ownership, equity or identity

Tokenised business models (Blockchain Enterprises) have an incredible use case, platforms and protocols operate like traditional business but on blockchain rails. Blockchain-based enterprises where you can tangibly;

1. Provide quantifiable utility,
2. Generate revenue, and;
3. Distribute earnings to tokenholders

Meaning true utility as participants can see the token value accrual progress in-real time.

Disclaimer - There are other token use cases like NFT's, digital art, DAO tokens, voting and governance - we acknowledge they exist but exclude them from our investment thesis as the primary reason for the token falls outside of the two main purposes and is built for a non-value additive way. While useful to have a token like a vote on a council, we are still too early to understand the value mechanisms.

The cold start dilemma

The cold start problem describes the inability of a new service to generate (valuable) network effects with a subscale number of users.

It is a catch-22, the network is only valuable when users join, but early users have no incentive to start. Tokens are an effective solution, and work by incentivising early adopters and providing alignment with the success of the protocol.

For example, the native token of Gains Network (a decentralised trading platform) is used to;

- Incentivise early adopters to utilise the platform
- Reward token holders by earning a % of platform trading fees in real time
- Provide collateral for platform trades
- Support trading liquidity in the native token

Once a network has hit critical mass for self-sustainment, it is no longer necessary to issue new tokens as an incentive, and new issuances can be phased out.

Large incentives are distributed for early participants, contributors and developers to try to overcome the cold start problem. Especially important in the early stages, where you need to convince talented individuals to build, treasuries often need to be robust to continue to keep interest and output high throughout a projects life. This also translates to distribution mechanisms, the allocation of distributed tokens needs to align to benefit new holders, while supporting existing participants. Tokens that over incentivise investors at the beginning are often seen in negative light because the expectation is new community members provide the exit liquidity for early participants.

To increase long-term value for all token holders, teams must ensure that incentives align with the protocol's value creation. This requires distinguishing between short-term liquidity and long-term goals that drive desired behaviours among team members, early participants, and advisors.

Timing - Qualitative

Criteria - Timing reflects four core areas:

1. Market maturity
2. Asset landscape
3. Market cycle
4. Asset price

Items 1-3 are subjective, item 4 is quantifiable and is closely aligned with Tokenomics.

Assessment

Market Maturity

Explores how technologically advanced the end user is. The key questions are around the maturity of the market to be able to adopt this product, for example a decentralised identity is building trend but is unlikely to capture the institutional audience for many years as typically ID is controlled by governments.

Asset landscape

Looks at the current solutions (crypto and real world). The key questions are around suitability, why they need to be decentralised and what the benefits of bringing these services, applications and data on-chain.

Market cycles as described above look at timing based on general market and global economic conditions.

Asset price refers to either the live market price that exists if there is a token in circulation or [the ICO](#) price of the token. Prices can vary widely, by understanding the four core areas above gives an indication of why the price of a token is either under or overvalued.

Below is the adoption curve and reward curve of the digital asset class. We are currently in Stage 2 where we start to see pockets of novel innovation that financially rewards early participants. The next stage has standout winners which innovate on traditional business models by generating revenue and distributing real rewards to protocol participants.

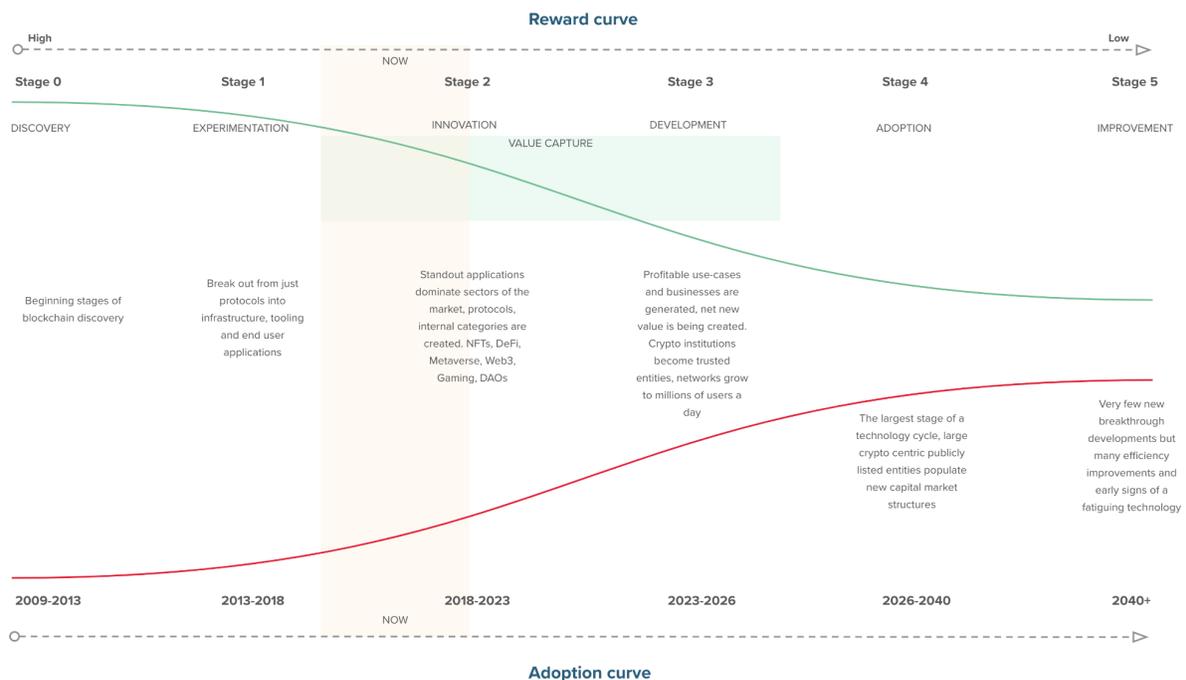


Fig 2. Adoption Curve

Team - Qualitative

The digital asset market shares some similarities from traditional Venture Capital, in instances where a single developer has built a protocol or platform that has been widely adopted in its field. Without raising capital, marketing or support. This is however an anomaly, assessment of the team is a vital part of investment management. Considering the competitive nature, projects must have great *vision, strategy, execution, adaptability, culture and community* and must be able to *raise funding*. In the absence of all of that, building and shipping exceptional products that users love.

Criteria

1. Leadership
2. Development and engineering
3. Marketing and distribution

Assessment

1. Leadership

Leadership in digital assets comes in a number of different forms, DAO's, public individuals, ex-CEO's/Founders or just one core developer to begin with. Effective vision, strategy and talent acquisition is important to extract. It is considerably easier to raise funds from a publicly known leadership team than it is from an excellent product stand-alone.

2. Development Team

Technical success depends largely on the quality of the core development team and their ability to deploy code effectively. Core developers are at the heart of a business, smart engineers often attract like minded individuals, the most successful projects have teams of developers solving complex issues, working on smart contract design, creating UX friendly front-ends and constantly testing for security vulnerabilities.

3. Marketing/Distribution/Community/Partnerships

Great project don't always need internal marketing or sales roles, this function can come in many variants:

- Project tokenomics sometimes reflect a spend on ambassadors or advisers, this is effectively outsourcing your marketing and BD effort to Twitter influencers, podcasts, YouTubers etc.
- Lead investors simply by advertising an investment can provide sufficient coverage
- Leading industry partners like large brand names, large digital asset funds or endorsement from a key public figure (e.g. Vitalik, Mike Novogratz, CZ)

Community building is very important, the community if supported properly can build the project credibility by working on tools, advertising and usage, examples include, dashboard, explorers, wallets.

Teams are important for the success of a project as there are very few edge cases where small teams have accomplished success without doing two of the three criteria well. Often the people

required to excel at these tasks are fundamentally different. In the extreme cases, exceptional projects rarely raise money, as they're funded by insiders who know the development and leadership teams and seed the early launch for huge rewards. Evaluating the team means understanding previous projects, experience, influence, connections and technical ability.

SUMMARY

Summarising the 4 T's:

- **Team**
- **Timing**
- **Technology**
- **Tokenomics**

Two qualitative and two quantitative measures which underpin our 4 pillars of investing, they help position projects against each other, once we understand their place in the ecosystem.

In a developing asset class investment opportunities are common. Understanding the market, cycles and project value is part of the 4 T's process illustrated above. There is no silver bullet but a process for better understanding and evaluating the quality of an investment opportunity.

At Magnet, we can see first hand the development of crypto, that productive assets that produce real revenues for their token holders, the number of people that would never have normally touched this asset class if it wasn't for NFTs and digital art. We can see the growth and to us it has never been clearer.

Prudent market investing dictates that time is spent focusing on the entire ecosystem and why it matters. Taking a view on where we are in the market, what is working and what is driving user adoption - then trying to find category winners and investing slowly.

What can't be controlled is the macro environment, for most investors this is the first time they are in a growing interest rate, high-inflation environment, the last time we have seen this is the 70's. We acknowledge this time is different, there is no wave of liquidity sitting on the side lines ready to save us, there are a lot more opportunities in traditional markets now than there have been over the last 10-years as prices and valuations have pulled back everywhere, crypto is no longer the only place to make great returns but we are looking at the metrics that matter. For Magnet, this is the most exciting asset class to be invested in.

Going back to first principles, we invest where we think the market is going and where we find value in under-priced or growing projects. We are still early.

Our investment strategy and thesis has also never been clearer and hasn't changed since Magnet started nearly 6 years ago. The asset class is far from critical mass and far from unpacking all of the potential use cases, which means there will be an abundance of opportunities.

Magnet Capital uses the process and strategies above to uncover value, it keeps us focused on the right kind of businesses and the right kind of people to back. We use the framework as a guide to identify where we spend our time and use what we know about the market forces to establish when the right time is to invest and at what size. The framework allows us to break the entire market down into segments and prioritise where we find the best 'fit'. This rounds out to more time spent on assets that deliver value and outperform the market over the long-term. Importantly it helps us avoid pitfalls, weak narratives and hype investing.

King regards,

Egor Sidelska, Benjamin Celermajer and the Magnet Capital team.

Appendix

Non-fungible Tokens (NFTs)

Non-fungible and fungible - NFTs are a specific token standard. The basis of which means that no two tokens are the same. Fungibility means that all tokens are the same and carry the same value. The difference here is all ETH is equal, but not all BAYC NFTs are equal. Both are tokens.

NFT's represent property, they can be independently verifiable and serve as art, collectables, certificates of ownership, club membership, identity and voting. We are at the early stages with NFTs, while an extremely exciting space with lots of promise, we are cautious here as the fundamentals are still under development.

Extended considerations

Prioritisation

New categories are introduced over time as the market matures, prioritisation starts with desperate needs, adoption opportunities and fun. We say fun because it needs to be about more than just making money, historically this has never been a great driver for success. Fun drives new users where users never existed, fun allows for creativity, art, music, human expression and so on. The major question here is 'what does it do for the people?'

New narratives

Blockchain gaming, WEB3, NFT's are all opportunistic, they bring legions of new users into the asset class but most of all they're fun, exciting and interesting. How many people get excited about Ethereum's sharding transaction throughput vs funny cat memes. One is for the builders, the visionaries, the other is for everyone else. New narratives create exciting investment opportunities.

Decision making process

Once you understand where you are, what is important, what is being adopted, what the market is desperate for and what people will pay for, then you can start the decision matrix for specific projects and solutions to category problems. Below is an example of a top down approach to identifying and qualifying opportunities for one small segment of Decentralised Finance.

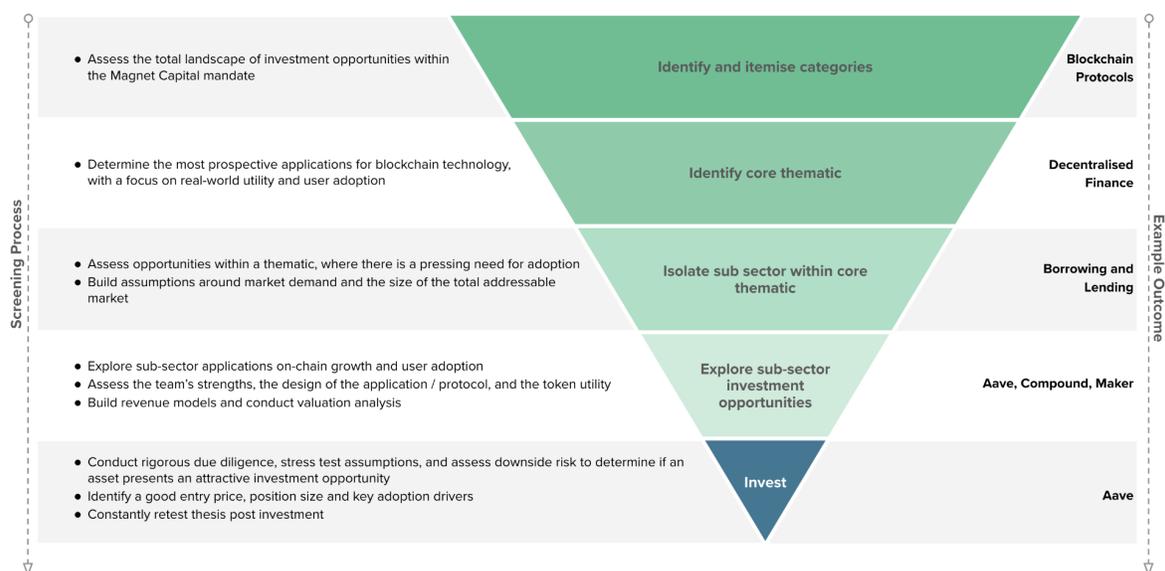


Fig 3. Investment Process

RESEARCH DISCLOSURE

At the time of publication:

The Magnet Trust 1.0 invests across a variety of digital assets.

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