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THE Asset 財資

January 2019

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ISSN 1561-4050

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TOKENIZATION SEEKS TO BE MORE THAN A GAMBLE

As 2018 proved a bumper year for ICOs, close-knit industry looks to introduce new investors

Against all odds, initial coin offerings (ICOs) continued to flourish in 2018. Start-up ventures across the world raised more than US$15 billion through such offerings, roughly half of which originated in the Asia Pacific region. This is despite a blanket ban of ICOs in mainland China and a poor track record for the vast majority of offerings. Applying the technology behind ICOs may trigger a second growth wave

By ***Sven Leichhardt***

WHEN mainland Chinese financial regulators banned ICOs in late 2017, many observers expected the move to be a death kneel for the market. While that expectation proved wrong and cumulative funding quadrupled in the 12 months to follow, ICOs still conjure mixed emotions among observers. Indeed, nearly eight in ten ICOs were deemed to be "scams" in a study by New York based Satis Group in early 2018. Of the remaining ones, few returned a positive yield for investors.

Ressos: *In 10 years, most securities will be tokenized*

While track records for most ICOs are meagre at best, the advantages to issuers are obvious. Although the term suggests similarities to an initial public offering, most ICOs have very little in common with funding mechanisms on established equity markets. Typically, they are issued as so-called utility tokens, which provide investors neither financial nor voting rights in a company. As such, they remain clear of being classed as financial securities and the obligations associated with such instruments.

Alexander Ressos, a Hong Kong and English qualified solicitor and founder of ICO law firm Ressos, explains the fine but important distinction. "We have to distinguish between utility and security tokens. Much of the regulatory trouble that deals have run into in the past has to do with the fact that a token often fell foul of the securities laws of the countries in which they were marketed. Security tokens have to comply with prevailing securities regulation. In Hong Kong that is mainly the Securities and Futures Ordinance, in Singapore the Securities and Futures Act."

"Utility tokens are effectively consumable, similar to a cinema ticket that can be bought and then redeemed for a service or other receivable. A utility token usually grants access to a blockchain based platform."

Utility tokens are not regulated in Hong Kong and Singapore, and therefore provide startups with an alternative means to raise significant funding. The median transaction size of coin offerings using this structure was US$12.1 million in 2018, with nine transactions exceeding US$100 million.

Going the extra mile

One company looking to benefit from the tide is East2, a Hong Kong and Spain domiciled startup seeking to revolutionize the loyalty rewards programmes of airlines around the world. Seeking to raise up to US$16 million, the company is currently in the midst of a private sale of its utility tokens, the so-called EOS. A public sale follows in April.

"We are creating a sophisticated front end consumer traveler application that allows the traveler to take control of their own destiny by showing their intent to vendors. We work with airlines on their backend platform to allow them to tap into other ancillary revenues," explains Stephen Bartlett-Bragg, co-founder of East2 Limited. "We looked at the airlines and found that they actually have the most touch points with a traveler but airlines do not capitalize on them. The ancillary travel market is worth some US$770 billion but airlines capture only about 10% of that."

"The travel industry hasn't really moved forward in the last 20 years," he adds. "If we plan to travel, we usually spend hours researching various websites and end up booking the airline ticket on one website, the hotel on another and the car on a third. It is a very fragmented market."

Similar to established public fundraising exercises, East2 has held meetings with cryptocurrency investors around the world to drum up support for its backend solution and consumer-focused app. An extensive roadshow spanned Hong Kong, Singapore, Seoul, Shanghai and locations around the Europe.

"On the back of seeing the power of what blockchain and smart contracts can do, we looked into doing ICOs, which are very topical," explain Bartlett-Bragg. "The alternative would have been to invest our personal funds to build a proof-of-concept and then go through the normal VC channels to raise funds and build the product."

Issuer benefits

Bartlett-Bragg's points to an important advantage of ICOs over traditional venture capital financing. Whilst utility tokens sell a stake in the idea that underpins a startup, they do not give away direct ownership in the company that came up with the idea. "One of the biggest advantages of doing an ICO from the perspective of a token issuer is the fact that you are raising funds without diluting equity," explains Ressos. "This makes ICO funding a powerful alternative to traditional venture capital financing. You don't give away equity in your company and you're still raising significant funding. You tap into additional pools of investors as well."

Yet, whilst the appeal to issuers is easy to grasp, the incentives for investors are less obvious. Unlike traditional debt, ICO investments will not benefit from a higher tier creditor status in the event of insolvency. At the same time, investors are not granted ownership or voting rights that go hand in hand with most equity finance solutions.

"Unlike security tokens, utility tokens do not promise any financial return, nor a share in the company," agrees Ressos. "However there is an element of speculation that comes into play when the token gets listed on a crypto exchange. This creates a secondary market for the token, with significant upside potential for tokenholders, including the promoters behind the ICO who usually receive a token allocation."

Existing offerings do, however, show that such upside potential is elusive for most projects and their investors. In US-dollar terms, only 29 out of 323 ICOs tracked on trade source ICOdrops.com showed a positive return on investment since their offering, though many of them suffered from the weak exchange of Ethereum and Bitcoin cryptocurrencies since their offering.

Contributing to the continued growth in such offerings may be another factor. ICOs offer venues to monetize investments for the growing number of cryptocurrency holders in countries that enforce strict currency exchange rules. "In countries where currency controls are in place and fiat money cannot be easily remitted across borders for regulatory reasons, for example in China or Indonesia, crypto investments are often abused as a means of circumventing regulatory restrictions," Ressos points out.

Yet, he adds, ICOs seen to date are just the beginning of a much wider revolution in fundraising. The technology that makes them possible could be applied to a range of financial and physical assets, and not only projects (obscure, at times) that will appeal to a well-versed group of cryptocurrency investors.

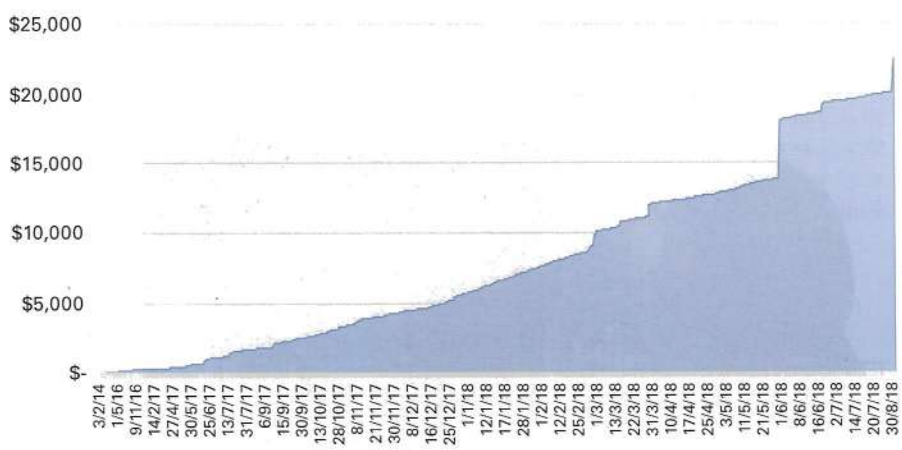
"Security token offerings make it possible to hold securities and physical assets like real estate or art in digital form," he says. "This is both threat and opportunity to financial institutions. I predict that in 10 years, most securities will be tokenized."

Ressos points to a proof-of-concept 'tokenized venture capital fund' that issued security tokens that grants investors a digital token that reflects the interest in the underlying fund. Whereas traditional shares in a unit trust would be a direct interest in the fund, typically held until maturity, a security token promises to be much more liquid and tradable on exchanges.

"Tokenization is a natural evolvement of securitization," Ressos sums up. "Conceptually they are the same."

Security token exchanges are on the horizon, with some of the more open-minded regulators in Asia actively exploring the benefits and drawbacks. "Both Hong Kong and Singapore are favourable environments to do an ICO with clear regulation and excellent reputation, which adds investor confidence," Ressos observes. "ICOs have evolved into a completely legitimate way of corporate financing. This is a trend which will continue. Security token offerings and asset-backed tokens are the next big thing. We will also see institutional investors enter the market once institutional-grade token custody services are available."

Cumulative ICO Funding (US$million)



A practical challenge until then is the lack of cryptocurrency custodian services. Asked about whether such services might be made available to institutional investors soon, a State Street spokesperson responds that the institution has seen an uptick in interest in cryptocurrency as an asset class since 2017 and is consideri ng "all appropriate service offerings that may be developed" in the segment.

"There is much work still to be done however, from regulation to security and governance, but we will continue to work closely with our clients to ensure we are aligned and ready to meet their needs as the market evolves," the spokesperson adds. ■