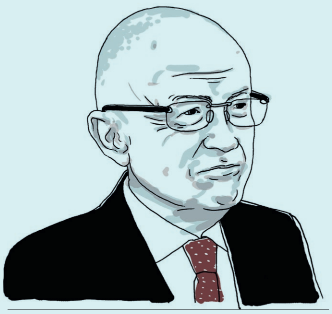
Jon Moulton's Diary

Venture, crypto and the behaviour of herds



Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

One of our fund managers wrote to us this week: "...many well capitalized investors who have the option to invest in public or private companies are prioritizing public market investments due to the comparably favorable valuations of public vs private companies." (US spellings from source!)

And FTX has just collapsed with estimates of the losses at up to $10bn (in "real" money) as its crypto assets lost value and liquidity with remarkable pace. Since I started drafting this article two more substantial apparent crypto frauds of scale and complexity have been reported.

Comparison of valuations

It might offend some readers but a comparison of valuations in venture capital and the crypto world is a useful brain stretch.

Shares and crypto currencies and tokens are both methods of exchange. Both rely on the confidence of users that there is a means of exchange to set a value, based largely on supply and demand.

Crypto is mostly traded on the blockchain system. Very briefly, a blockchain differs from most other databases in that its ledger is distributed, publicly available and replicated on numerous computers — or "nodes" — around the globe. Rather than a centralised entity, like a bank, stock market or a tech platform, to ensure that the ledger is accurate, it is verified by a non-centralised network of traders.

Crypto tokens and the like can (rarely) even come with gold or similar "backing". But most crypto currencies trade at a price reflecting the best guesses of the market as to what it will trade for in real currency terms. Venture capital is not that different.

But all assets have their relative values (whether cash, crypto or barter) set by individuals' views of the information available to them.

Information is only useful if it is credible and available. Clearly crypto has a disturbing mixture of poor transparency and meaningful levels of fraud which results in big price swings on fragments of information (or rumour).

'Crypto has a mixture of poor transparency and meaningful levels of fraud'

The widespread use of involved financial instruments of limited understandability (with echoes of the CLOs of 2008) magnifies the volatility. Failure can be swift and rapid. There are winners too. Market manipulation is easy in the crypto world.

In venture capital, fraud is not common. The recent conviction of Elizabeth Holmes for faking Theranos' blood-testing capabilities was the first big example (pushing $1bn or more) of investee company fraud for quite a while.

Overstating progress

Short of deliberate fraud, the scope, and motives, for overstating progress in a pre-revenue investment are obvious – you can often see examples of selective and overly optimistic presentations on investments. Better story = better valuation! Many of the recent severe down rounds reflect previously optimistic investors catching up with reality.

Special purpose acquisition companies resulted in very overpriced public offerings, often of venture capital backed deals, which rapidly sank. In the 12 months to 30 September this year a representative sample of US-listed Spacs dropped an average of 70%. Were the presentations honest and balanced? Or were investors following fashion?

Venture capital returns were apparently good over the past five years but about 80% of the returns were unrealised mark-ups. A lot of this was comparative and infectious. If XYZ Ltd is worth £zillion then our similar business must be worth zillions too. Very crypto like?

Long term, maybe very long term, company valuations tend to a number determined by realistic estimates of future cashflows denominated in a solid currency. Longevity may be required to see this though.

In the nearer term, it seems likely that venture capital companies will increasingly be valued by comparison with listed analogues.

Which mostly seems to mean lower values as our investee GP has now advised us.

The sentencing of Elizabeth Holmes last month was the first example of big fraud in VC for some while

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