FSI Sector Briefing

Digital Assets in Crisis? An opportunity for M&A deal-makers

FSI Sector Briefing: Digital Assets in Crisis? An opportunity for M&A deal-makers

Innovation in blockchain-based digital assets[1] is booming – as evidenced by the speed of the recent technological advances in this space. The massive potential of blockchain technology to reshape today's business models also has the financial markets intrigued. So, it was hardly a surprise to see funding for digital asset firms reach an all-time high in 2022, with a whopping USD 92 billion in equity raised during the first quarter of this year.[2] We also saw an increase in M&A deal-making as a result. Whether they are looking to expand the value chain, embrace new technologies or completely change the way they do business – today's enterprises have high hopes of transforming their existing business models by acquiring digital asset innovations and expertise. In this Deloitte analysis, we highlight five critical factors that will help your M&A deals succeed.

Last fall, the big cryptocurrencies were breaking one market cap record after another. Bitcoin traded above USD 65,000/BTC multiple times in October and November 2021.[3] And a number of lower-tier cryptocurrencies trading in the shadows of more established coins reached highs on their respective exchanges – with potential use cases that may or may not stand the test of time.

As value continued to fluctuate yet ultimately soar over the past few years, we have seen more and more use cases and applications emerging for crypto-currencies, which has meant further growth in the digital asset market (among other trends).

This ultimately led to decentralized financial markets (DeFis) operating alongside trading platforms, funds and other players that either directly or indirectly support investment in cryptocurrencies. DeFis with blockchain infrastructure enable customers to for example buy insurance policies or take out mortgages in addition to the core lending and trading business via smart contracts. There is clearly potential for these protocols to disrupt a whole range of businesses.

With so many of innovations coming to market, a predictable oversupply ensued and only certain applications and use cases managed to gain a foothold in the crypto-world. The challenging macroeconomic environment meant that it was only a matter of time before a meltdown was inevitable. A rise in M&A deal-making followed, with buyers coming to the rescue of ailing crypto players. In the following section, we will take a more in-depth look at the market for crypto M&A deals.

Cryptocurrency crash leads to a realignment of business models

Business models that rely on crypto markets continuing to rally have proven particularly vulnerable this year. With all of the talk about Bitcoin's excessive energy use, the crash in technology stocks (which are closely linked to crypto shares) and the collapse of certain coins, the cryptocurrency market took a massive dive in the first half of 2022.[4] A few digital asset hedge funds and other lenders went bankrupt as well, mainly large "crypto lenders" operating in the margins between traditional and crypto markets as well as FinTechs for example in Germany.[5] [6]

With digital assets facing an uncertain regulatory future and some investors risking a total loss with certain cryptocurrencies, we will have to wait and see whether confidence in digital assets is permanently damaged – or whether the meltdown might be able to deliver positive change over the long term and make digital asset-driven businesses more robust.

Funding for digital asset businesses hit record highs once again in the first half of 2022

The funding rounds in the first quarter of this year showed no sign of the meltdown to come. Industry network CB Insights reported that global funding for businesses based on digital assets rose to a new high at USD 9.2 billion in Q1 2022, continuing a months-long climb. This amounts to a 5 percent increase over the previous quarter and a 156 percent increase year-on-year.

At USD 6.5 billion, global funding in Q2 underperformed the first quarter by 30 percent as expected, though it was USD 1 billion higher than the same figure from Q2 2021. The number of successful funding rounds remained high at 460. European ventures, by contrast, raised a record USD 1.4 billion in funding in Q2 2022, up 40 percent on the first quarter of 2022.

Start-ups with investments in NFTs[7] and DeFi are driving the trend. Of 921 funding deals in H1 2022, the vast majority were early-stage investments. At USD 19 million, the average deal volume in H1 2022 was just below prior-year figures. The US remained the most important funding source during the first half of 2022 at over 40 percent. We are seeing signs that US regulators are gearing up to introduce new initiatives, which may make it easier for traditional financial institutions and institutional investors to trade cryptocurrencies.

Fig. 1: Crypto funding from a global and a European perspective

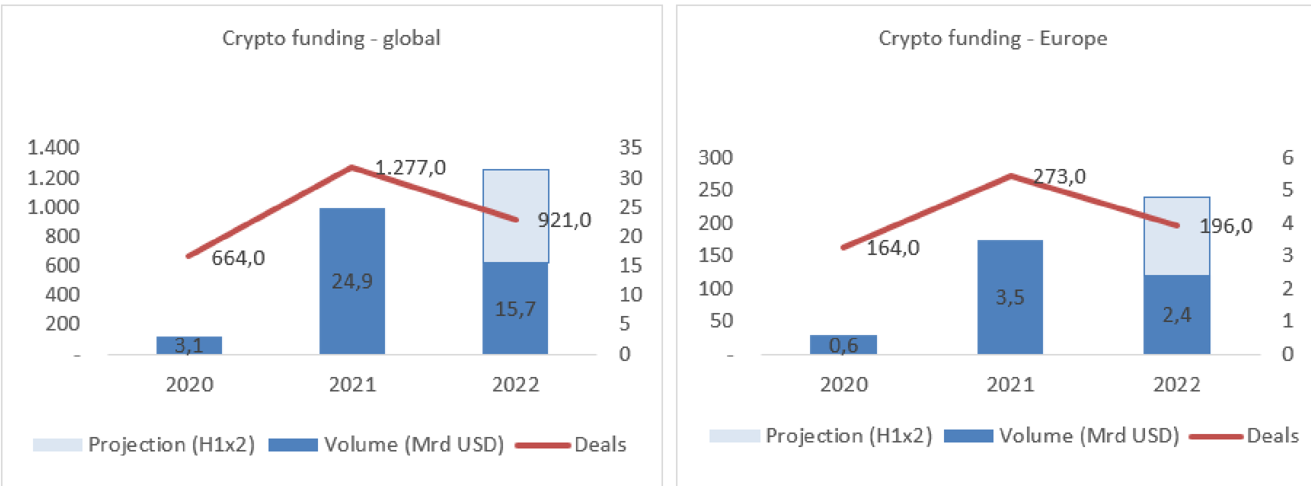

Figure 1 describes the trends in global crypto funding, with the number of deals in H1 2022 already exceeding 70 percent of the overall 2021 figure and the total deal volume already at 62 percent of the prior-year total. Funding in Europe reported a similar trend, with H1 results hitting roughly 70 percent of the total 2021 deal volume and 72 percent of total number of deals in 2021. On the basis of this first-half data, it looks like funding for digital asset ventures is heading for another record year.

As expected, there was a slight decline in terms of deal volume from Q1 to Q2. Businesses unable to fully convince the venture capitalists ultimately failed to find backers, while others continued to successfully raise funds.[8]

M&A soars despite crypto crisis

We saw a similar trend in the M&A market. Unable to let a good crisis go to waste, market players are on the lookout for M&A deals that give them an opportunity to expand or round out their businesses. Perhaps the most high-profile acquisition in the current environment was when FTX closed on the deal to buy BlockFi.[9]

According to MergerMarket, there were 59 M&A deals in the digital asset space in the first half of 2022, as compared to 114 deals in the full twelve months of the previous year. This includes done deals as well as deals that have been announced or that are rumored to be in the works. North America accounts for around 36 percent of these M&A deals, with another roughly 29 percent closed in Europe. It remains to be seen whether M&A activity will decline in terms of volume in the first half of the year, which would track with the lower valuations for FinTech stocks seen recently and the decrease in the average funding raised by new digital asset ventures. This may suggest a spike in distressed M&A activity on the horizon.

Fig. 2: Digital asset M&A activity from a global and a European perspective

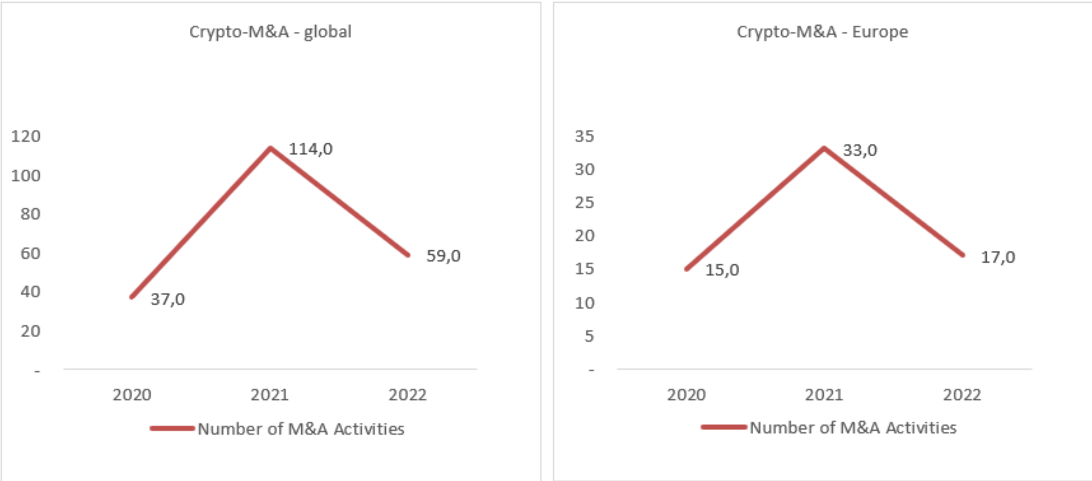

Figure 2 shows that the number of global M&A deals focused on digital assets in H1 2022 was equal to roughly half of the total deals done in 2021. The situation in Europe is similar. Based on the figures we have for H1 2022, we can expect the M&A activity in the digital asset space to be about the same as the previous year.

But why are M&A deals in the dynamic digital asset ecosystem so successful?

Five success factors for digital asset M&As

The market for digital assets and many related FinTechs feels like uncharted territory, even within the world of start-ups. There is such uncertainty in this space, not to mention the limited experience and lack of reference companies and deals, so it will take different approaches and methods for today's deal-makers to make the most of the existing opportunities. Deloitte has identified five critical success factors for M&A transactions in the digital asset space:

1. Build the strategy and skills your company needs to embrace digital assets

The first key step is to gain a basic understanding of the digital asset market and its ecosystem. It is particularly vital for buyers to identify potential use cases for these assets within your own core business. Before even starting to pursue (M&A) activities in this space, it needs to be determined what expertise there is in-house – as well as where there are gaps – and come up with a broad-based digital asset strategy for your business. Making the business case for or against entering the digital asset market is clearly crucial but assessing the own market readiness and taking an informed decision about "build or buy" strategies are equally if not more important.

2. Make sure your approach to digital asset M&As is consistent

Change happens fast in the digital asset market and related business models, often faster than many traditional companies or financial institutions can acquire the requisite technical and business expertise.

We can expect deal-making to become even more attractive as a result, with both the speed and the frequency of the deals on the rise, and buyers facing a lot more competition. The digital asset market is extremely dynamic, and for the most part there is only limited information available on target companies, competitors, the relevant market and the overall environment. That means buyers not only need new approaches in terms of assessing the potential and the risk of a deal; they also need to take a different approach to the decision-makers involved – after all, in digital asset M&As the classic scenario, where one CFO talks to another across the table, is quite rare. Instead, you are more likely to find tech founders, coders and crypto enthusiasts at the negotiation table. It is important to have a consistent M&A strategy in place that aligns with your overall digital asset strategy to make fast, informed decisions.

3. Build expertise in international regulatory framework for digital assets

Most of these young, fast-growing digital asset FinTechs have only ever operated in a global, "borderless" decentralized digital asset universe, where the regulatory framework is often ill-defined. In our experience, deals in this market are more likely to be cross-border M&As than in other sectors. That means rapid and constant change in the market environment. Having an international, multi-disciplinary and "crypto market savvy" M&A team with the right expertise and network will add value for both your company and your consulting partners.

4. Develop a Web 3.0 communication strategy to support your M&A activity

It may come as a surprise, but it should definitely be considered how sensitive many digital asset businesses are to statements made by certain opinion leaders in the so-called Web 3.0 community. One should not underestimate how important it is – for buyers as well as sellers in digital asset deals – to have an extremely comprehensive communication strategy. This strategy should take into account the many idiosyncrasies of the Web 3.0 community. The language you use, the target group for your messaging, the medium used and the speed with which you issue statements and respond to events are the key issues here. The risk associated with negative reporting on the acquisition target, on the underlying technology or even on the overall digital asset market is not to be underestimated. It is also true that the market players and above all their customers are accustomed to much faster and more direct messaging.

5. Make the team and the technology your top value drivers

In contrast to traditional M&A deals where hard financial indicators are the main drivers, the team and the technology are the key value drivers in digital asset M&As – even more so than for most FinTechs. Whether the technology is reliable and scalable is just as important as how innovative and adaptable the leadership team is with its specific expertise – plus whether both are a good fit for the buyer's corporate structure. It is vital for buyers to take these issues into account when they assess the potential and risk of a particular deal (i.e., during the due diligence process), identify the decision parameters, determine the target valuation and design the terms of the deal.

Make the most of this volatile market

In some ways, M&A deals in the digital asset space play by their own rules. Dealing with the particular complexity of these businesses and the dynamics of this market can be extremely challenging. That said, we can tell from the sheer volume of investment and the number of transactions that M&As in the digital asset space continue to have considerable appeal and considerable potential. With such a broad range of applications with these digital assets, there is virtually no end to the potential for use cases.

The enormous opportunity emerging technologies offer come with an equally enormous risk of a total loss for investors. All the more reason to take extreme care when making these kinds of investments. The success factors outlined above provide helpful guardrails for identifying the most promising targets and making your digital asset M&A deals a success.

In the future, (acquired) digital asset innovations will play a significant role in setting your company apart from the competition. Novel products based on blockchain technology can make companies stand out in a competitive environment. Likewise, these high-tech solutions can also help improve the customer experience or optimize your in-house workflows. Blockchain technology offers companies an opportunity to reshape specific areas of your business – but also the chance to completely transform the way you do business. With the massive potential of digital assets, it is definitely worth your while as a market player to keep your eyes open for targeted M&A opportunities.

[1]The term "digital assets" describes blockchain-based business models designed to create value through:

- Issuance and tokenization

- Trading

- Custody

The products within the value chain include, for example, security tokens (e.g., ETFs, mutual funds, etc.), asset-referenced tokens (NFTs as collectibles, but also stablecoins or real estate tokens (promissory notes, etc.)), utility tokens (renewable energy tokens for PV installations, etc.) or currency tokens (e.g., Bitcoin).

[2]CBInsights – State of Blockchain Q1 2022

[3]Prices from Coinmarketcap.com

[4]G+J Medien GmbH: "Crash eines Stablecoins: Was die Terra-Krise für die Kryptoszene bedeutet" ("A stablecoin crashes: What the Terra crisis means for the crypto world"), https://www.capital.de/geld-versicherungen/stablecoin-terra-crasht--was-das-fuer-die-kryptoszene-bedeutet-31856016.html (accessed on Aug. 16, 2022)

[5]Block-Builders GmbH: "Bankrott von Three Arrows Capital (3AC): 3,5 Milliarden US-Dollar Schulden" ("Three Arrows Capital (3AC) declares bankruptcy: USD 3.5 billion in debt"), https://block-builders.de/bankrott-von-three-arrows-capital-3ac-35-milliarden-us-dollar-schulden/ (accessed on Aug. 16, 2022)

[6]Tagesschau: "Das Ende einer Start-up-Hoffnung?" ("The End of a promising start-up?"), https://www.tagesschau.de/wirtschaft/finanzen/nuri-bank-fintech-insolvenz-101.html (accessed on Aug. 16, 2022)

[7]NFTs refer to non-fungible tokens. As uniquely identifiable digital assets, each NFT is a one-off asset that cannot be replicated.

[8]Cointelegraph: "DeFi-Startup Unstoppable Finance holt sich 12,5 Millionen Euro frisches Kapital" ("DeFi start-up Unstoppable Finance raises EUR 12.5 million in fresh capital"), https://de.cointelegraph.com/news/german-defi-startup-unstoppable-finance-gets-investment-from-lightspeed (accessed on Aug. 16, 2022)

[9]Blockworks: „FTX Reaches Deal to Acquire BlockFi for up to $240M", https://blockworks.co/ftx-reaches-deal-to-acquire-blockfi-for-up-to-240m/ (accessed on Aug. 16, 2022)

Contact
Nils-Alexander Berent
Partner | Financial Advisory, Financial Services
nberent@deloitte.de
+49 69 756956929