DIGITAL ASSET LENDING SNAPSHOT

2019 | Q4 Insights

Matt Ballensweig | Roshun Patel | Leon Marshall

111 Town Square Place, Suite 1203
Jersey City, NJ 07310
Email: lend@genesiscap.co
Call: 917.536.6804

genesiscap.co
twitter.com/gen_capital
linkedin.com/company/genesis-global-capital

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2019 | Q3 Insights

Summary Statistics

- **2019 Total Originations: $3.1B**
- **2019 Q4 Originations: $1.1B**
- **Total Active Loans as of Dec 2019: $545M**

Genesis continued to see sustained growth in its digital asset lending business in the fourth quarter of 2019. Genesis added more than $1B in new originations, breaking our record of $870M set in the previous quarter. As of December 31, 2019, active loans outstanding stood at $545M, up 21% from the previous quarter despite a significant decrease in the price of bitcoin.

Originations increased 34.8% from the prior quarter, marking a seventh consecutive quarter of strong growth and bringing total originations to nearly $4.3B since we launched the lending business in March 2018. Our loan portfolio substantially increased in value through increased cash (USD and stablecoin) loan issuance, partially offset by a decrease in the notional value of crypto loans outstanding.

Figure 1

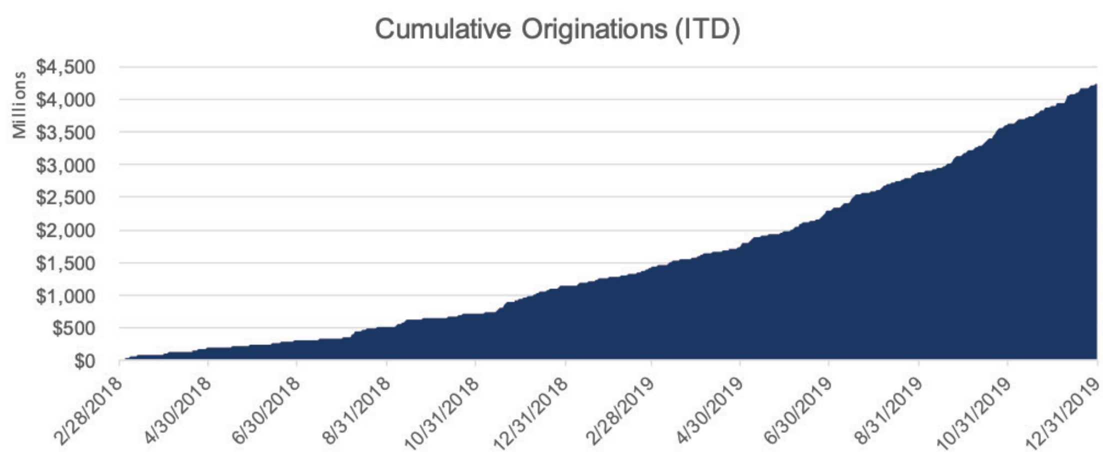

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Figure 2

($ in millions, except BTC Price)	9/30/2019	12/31/2019	QoQ Growth
Cumulative Originations	$3,155	$4,251	34.8%
Cumulative Loans	$2,001	$2,710	35.4%
Cumulative Borrows	$1,154	$1,542	33.6%
Active Loans	$450	$545	21.1%
BTC Price	*$8,284*	*$7,145*	*-13.7%*

Q4 2019 Asset Composition

For a third consecutive quarter, cash loans as the percentage of loans outstanding increased significantly. At year end, cash loans represented 37.2% of our active loan portfolio, up from 31.2% at the end of Q3 and 14.0% at the end of last year. The new USD issuance in Q4 took share away from both active BTC and altcoin loans. BTC and cash lending still dominate the loan portfolio comprising 84.5% of the value. The infrastructure, maturity and general interest in BTC/USD markets relative to altcoin/USD markets is much greater and we don't see that trend redirecting anytime soon.

Figure 3

Asset	3/31/2019	6/30/2019	9/30/2019	12/31/2019
BTC	68.1%	62.5%	50.2%	47.3%
BCH	0.3%	0.5%	0.3%	3.4%
ETH	3.6%	3.9%	7.5%	5.0%
ETC	2.3%	0.9%	3.0%	2.7%
XRP	6.7%	2.5%	3.6%	2.7%
LTC	3.6%	3.7%	2.0%	0.9%
USD and Equivalents	9.6%	23.5%	31.2%	37.2%
Other	5.9%	2.5%	2.2%	0.9%

This report marks the end of 2019, Genesis Capital's first full operating year. Rather than focus specifically on the fourth quarter, we're going to examine the key trends we saw in 2019 and provide thoughts on what lending markets and infrastructure might look like in 2020.

Cash Rates: Accessibility vs. Demand

2019 Takeaways

- Cash demand is a function of forward curve steepening (arbitrage opportunity) and desire for leverage among hedge funds and miners
- The supply of cash in crypto markets is limited and thus can be very expensive in certain BTC price environments
- The lack of cash access contributes to the sustained premium in futures vs spot markets
- Cash rate increases (on a relative basis) tend to lead BTC price surges

As we highlighted in previous reports, the demand for cash is driven by both arbitrage and leverage. For much of 2019, the near-dated bitcoin future has traded at a rich premium to the BTC spot price. This trend tends to arise in bullish markets as investors and traders believe the future price of bitcoin will be higher than current spot price. As time lapses and the current date becomes closer to the future expiry date, the premium between the future and spot price (basis) declines. In an efficient market, the size of that premium stays relatively consistent. If the premium becomes large enough, traders can borrow cash or utilize excess balance to buy the underlying spot and sell the future, capturing the premium. The sooner that premium collapses, the more lucrative the trade is from a return perspective. Assume a future that expires 90 days from today is trading at a $200 premium to the BTC spot price of $8500 and you wait the full 90 days before realizing that premium. The annualized return on the trade is $200 divided $8500, prorated to account for the 90-day trade capture, which equals roughly 9.5% ann. If the premium collapsed sooner than 90 days, for example, in 30 days, then the return would be far greater, and in this case 28.6%.

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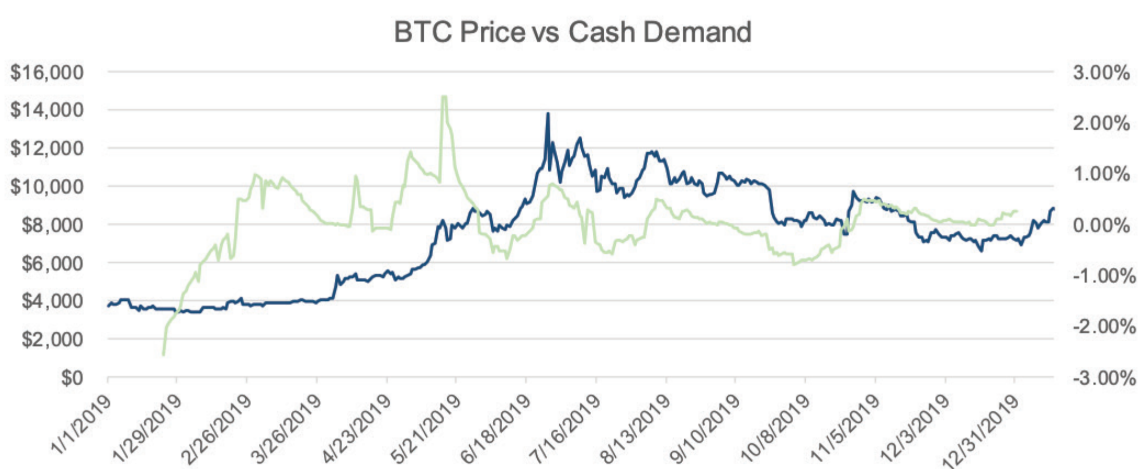
In highly efficient futures markets, such as oil and other commodities, large trading institutions keep the steepening of curves at bay given they have robust access to cash and larger balance sheets to run this trade at relatively low costs of capital. In less efficient markets like bitcoin, the steeper curves might be present for longer as there isn't enough available cash for trading firms to take advantage of this arbitrage. It becomes somewhat of an arms race during periods of steep contango and borrow rates on cash spike.

In addition to forward curve steepening, desire for leverage is another large driver of cash demand as holders of crypto want to add to their position, speculating the price will go higher. This demand generally comes from hedge funds and family offices.

What's interesting about forward curve steepening and leverage is how they impact price. Though we have a limited dataset to work with, below we've graphed the demand for cash borrow through Genesis Capital against the price of BTC since January of 2019. We show this by highlighting the % +/- annualized cash borrow rate per day relative to the 30-day moving average cash rate since January 2019.

Figure 4



There are a few interesting takeaways from Figure 4. First, though there are times when cash rates move swiftly away from the average, the total range of where cash has been extended has been within a 5% absolute band. This is likely because holders of cash have a floor where they'd lend regardless of the market dynamic in digital currencies. Cash can be deployed and invested in many ways, and thus even when cash demand isn't high in crypto capital markets, lenders won't drop rates to meet that demand because of the opportunities in other markets. Second, the periods where cash rates increase greatest relative to the 2019 average rate seem to come before large moves in the BTC price. This is only one year worth of data, but in both early June of 2019 and most recently, December of 2019, cash demand spikes have preceded moves in BTC price. This will be an interesting dynamic to track over time.

2020 Outlook

- Above-average forward curve premiums will likely still exist over the course of 2020 keeping average cash borrow rates much higher than most digital asset borrow rates
- This phenomenon will slowly normalize due to:
    - Increased cash supply in crypto markets
    - Operational efficiencies across exchanges and service providers making it less burdensome to capture arbitrage
    - Increase in the number of trusted exchanges reducing overall counterparty risk
- We expect more institutional fiat lenders to enter the space and partner with crypto native exchanges and trading desks to provide financing

Basis-capture opportunities will likely persist in the first half of 2020 but as market infrastructure matures, and more cash lenders enter the space we think that futures vs spot markets will become more efficient. In our Q3 Report we discussed the possibility of traditional lenders entering the space to earn outsized yields on cash relative to other forms of lending. Particularly, we think institutional asset-based lenders will closely examine BTC-based lending as a form of revenue generation in 2020.

Some of the largest financiers in the world currently lend against things like accounts receivable, inventory, and real assets like equipment and property. The returns on these structures can be as low as a few percentage points above LIBOR, so if there are greater opportunities lending against bitcoin, they'll be captured over time. If a traditional lender can get comfortable holding and liquidating bitcoin using trusted partners, they're more likely to explore this lending market.

The accessibility of this new capital might come in various forms. We expect to see crypto native exchanges and service providers partner with traditional capital pools to make financing easily accessible for traders. The Silvergate and Bitstamp partnership is a good example of this. Silvergate will use its balance sheet to provide cash funding to traders on Bitstamp. Traders get access to margin financing and Bitstamp will manage all the logistics that go along with these (i.e. collateral calls, forced liquidations etc.). We think these types of partnerships will continue to unfold and act as a key bridge between capital supply and demand among traders.

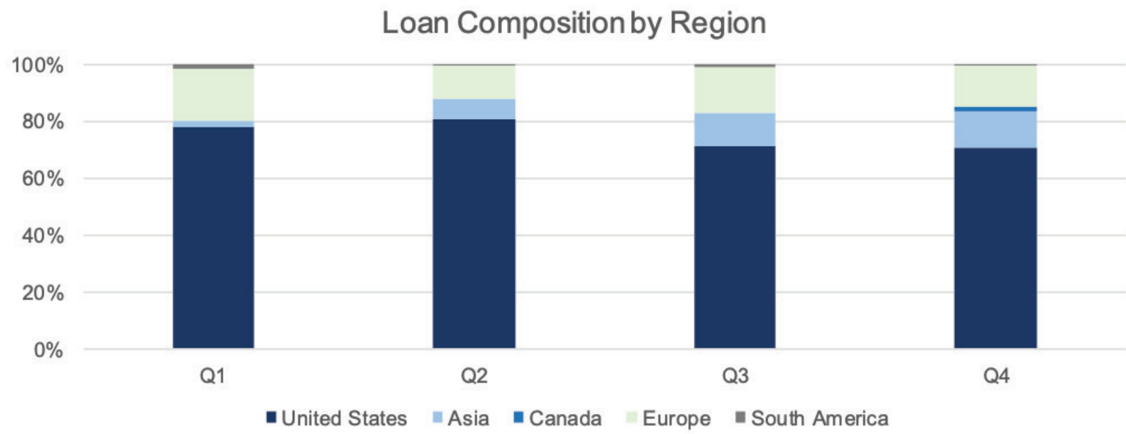
International Growth and Development

2019 Takeaways

- We've seen substantial growth in international lending participation specifically in Asia and Europe since the beginning of January
- In China, the restriction on capital flows out of the local currency into the dollar along with the growth of the mining segment has led to a strong cash need
- Activity in Europe remains robust as the UK and Switzerland lead the region in overall financing activity, particularly on the yield-seeking side
- Asia and Europe make up over 25% of our loan portfolio and have been growing consistently quarter over quarter

The loan portfolio composition by region can be seen in Figure 5 below:

Figure 5



Though both regions have contributed significantly to our overall portfolio growth, the new issuance has come on separate sides. In Europe, we see more holders of digital currencies and stablecoins looking to earn outsized returns on their assets by lending to Genesis. In Asia – specifically China, Hong Kong, Singapore and Japan – we've seen much more borrowing than lending. In China we've noticed miners looking to leverage their businesses and generate additional cash to either upgrade their facilities or use for working capital.

Outside of institutional demand, we also have seen the retail platforms for crypto-backed loans in Asia and Europe gain momentum. Given Genesis only lends to institutions, we've developed key strategic partnerships with lenders that can service the retail segments of their respective regions while using Genesis as its wholesale lender of cash and stablecoin. These partnerships allow Genesis to finance global crypto markets, while allowing local lenders to establish their footprint and service the bespoke needs of their counterparties.

In other Asian countries, such as Hong Kong and Singapore, the activity has been much more trading-centric. Many of the crypto-native trading firms and delta-neutral desks operate here and have been growing rapidly. They have some of the best understanding of credit markets and tend to be cyclical borrowers of Genesis, depending on forward curves and cost of capital.

2020 Outlook

- Cash demand among miners will increase significantly as new-generation equipment comes on the market, providing immediate efficiency gains going into the halvening
- "Crypto-Friendly" regulation has the potential to drive more capital into the lending space in both Europe and China

We think there will be a few key drivers of new capital into the lending space in 2020 and expect international composition of our portfolio to increase. As we approach the halving this year, we're expecting a handful of the largest miners to upgrade their facilities to become more efficient as they'll be compensated less per block mined. The price might adjust as we get closer to the spring of 2020, but if it doesn't, having best-in-class mining equipment will be important in order to stay profitable. We will likely see miners leverage their existing balance sheet and treasury to source the cash necessary to invest in their operation. The need for cash will likely be shared among the largest miners, who will globally be looking to take advantage of the new machines on the market. Those unable to source cash will be stuck mining on old generation machines and might face serious profitability issues if the price of bitcoin doesn't rise substantially to offset the reward reduction.

Industry Risks and Risk Management Philosophy

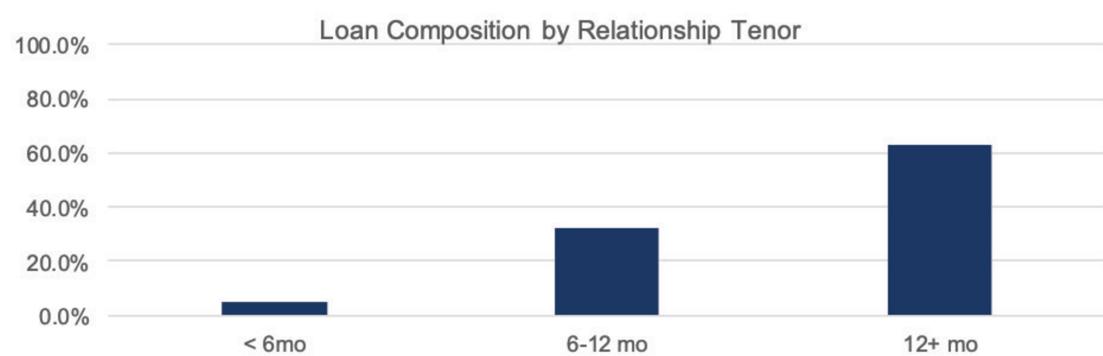
2019 Takeaways

- Having a robust and comprehensive understanding of risk is imperative when assessing opportunity in credit markets
- There are multiple layers to counterparty risk that present an inherent systemic risk to crypto markets

In the previous sections, we've highlighted the incredible growth in lending over the past year. An expanding lending market naturally comes with risk and in this section, we'd like to explore the key areas driving risk and how...

Genesis approaches risk management. The first point of risk is lending directly to borrower. As we've mentioned in previous reports, this risk is mitigated by underwriting borrower credit via balance sheet analysis and financial due diligence, loan collateralization levels, and loan interest rates. Assessing borrower creditworthiness, collateralization, and interest rate as inputs, we can decide whether making a loan is worth it from a risk-adjusted return perspective. One important aspect of our model is that due diligence and collateral supersede interest rate; in other words, if the first two inputs are driving the interest rate too high, the loan might not be worthwhile for us. Another important aspect of our assessment model is relationship and settlement history – the longer counterparties have operated smoothly with Genesis, the more comfortable we become with their credit.

Figure 6



As seen in Figure 6 above, 60% of Genesis' borrowing relationships have existed for more than a year, and 95% are longer than 6 months. Given that Genesis Capital has only been operating for 22 months, counterparties having 12+ months of history is significant to us.

2020 Outlook

- There might be a looming risk as it relates to the open derivative positions on futures exchanges
- Liquidity and duration management will be increasingly important as lending desks and brokerages need to effectively manage their treasury across venues

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One material risk we see on the exchange side is related to open derivatives positions. Trading firms place many derivatives trades, mainly futures and options, in order to hedge spot inventory for various reasons. For example, traders converting BTC borrow to cash might be short the spot market and long futures. If for some reason an exchange is abruptly halted and all derivatives positions are nulled, it could be devastating for many firms, even well-capitalized ones with massive balance sheets.

An additional risk to the market is liquidity and duration management by lending desks. Though liquidity and duration can be viewed independently, we will discuss them together as a single risk point since they are intertwined. As varying lending structures are offered with different tenors, it's possible for a desk to be mismatched on expiring loan and/or collateral flows. There is nothing necessarily wrong with taking duration risk willingly – it's taking duration risk unknowingly which is problematic. As a lending desks grows, the complexity of duration and liquidity management increases and staying ahead of potential stress points grows more challenging. At Genesis we spent a lot of time thinking about modeling our own internal liquidity and managing the web of loans across time, so that we are never caught off guard when a liquidity event might arise.

In Q4 we saw continued demand for cash, strong international growth out of Asian borrowers, and increased derivatives trading. We're excited to see how all these themes play out in 2020 and look forward to another year of operating at the epicenter of the bitcoin and blockchain industry.