

FTX's Token Death Spiral: When Junk Equity Financing Goes Wrong

Behind the scenes of one of the most shocking collapses in the history of crypto is a very familiar story of excessive leverage and poor capital structure management



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When Icarus flew too close to the sun, at least he didn't have to face the fallout and consequences of his actions. Sam Bankman Fried (SBF) may have his [~\\$1bn fortune](#) to cushion his fall but he must now answer to the public and government having fallen into the very trap he minimized the adverse consequences of: leverage.

Investors need to be wary of the hidden leverage created by token-based *junk-equity* financing models. We addressed this topic in [a piece we wrote](#) a couple months ago: on predicting the FTX fiasco, we wrote:

"However, companies pursuing this method of junk equity (token) financing should be very wary of Double Leverage. Your token is capitalized on your balance sheet as equity and an asset, it's super sensitive to mark to markets. Borrowing against this "asset" which is actually a financing liability provides scope for other market participants to manipulate your asset side of the balance sheet, and force your equity negative. Lesson being, if you're asset levered to a market traded asset, DON'T BORROW or someone external can put you under."

As shocked as we are, FTX died in a bank run: the most common source of death for financial institutions. But how did nobody see it coming, and why did Alameda's [balance sheet](#) being leaked change that? Alameda is SBF's proprietary trading shop, and historically very connected with FTX: investors can use one to infer the health of the other.

We [previously argued](#) that many tokens in the crypto ecosystem function only as *junk equity*: a claim over the option value of a future token-based network. Acolytes will insist tokens represent limited value today, but in that future world where the issuing company decentralizes, could be worth a ton. Traditionally, tokens begin accruing value as they create utility or underly governance of a decentralized network. But what of networks with valuable tokens day-1, that don't necessarily fit this *junk-equity* criteria?

Many networks can structure as DAOs day-1 (ie. Uniswap), providing a clear path to token value accrual or as utility tokens (ie. Helium), backing a claim to a resource like bandwidth – in these cases, the value of the token is clear. Others like FTX's token FTT doesn't really offer much utility or governance value other than a slight fee discount on FTX trades – the value to the token is the option value that the company may eventually become a DAO or underpin utility for a network. Projects using a token only as *junk equity* are the most susceptible to runs against their token, as there

often isn't organic customer demand, and a company must use its real revenue to defend the token's price.

In bear markets, when liquidity dries up and optimism vanishes, investors wake up to the lack of fundamental value in these *junk equity* tokens besides their belief in the founder and project. The company is increasingly put in a bind as they drain their cash flows to defend their token. Token defense drain flow: pushed to an extreme companies must borrow debt to maintain liquidity to defend their token. When this goes wrong, it's likely what happened here. We break out this classic death spiral below.

Assets = Liabilities + Equity is one of the first foundational principles for professional investors, and surely half the industry didn't jump on the entire industry overnight... However, investors have never asked the question of junk equity before. Below is Alameda's leaked balance sheet from 2022. Note the price of FTX at that time was ~\$25 vs. \$3 with



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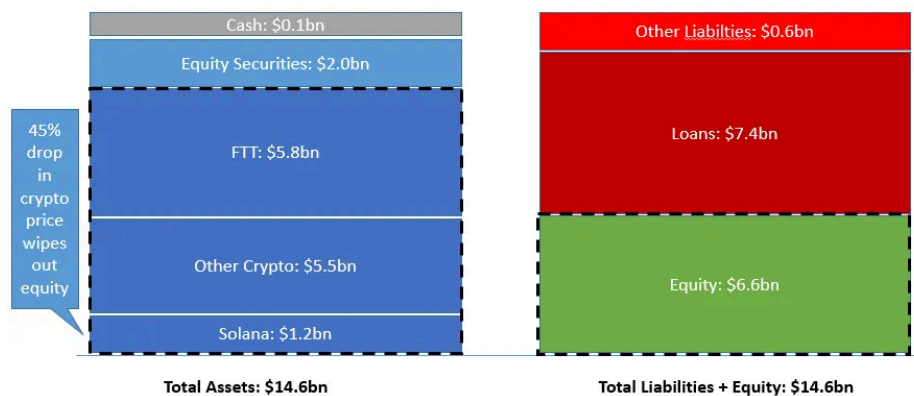
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Alameda Balance Sheet – 6/30/22

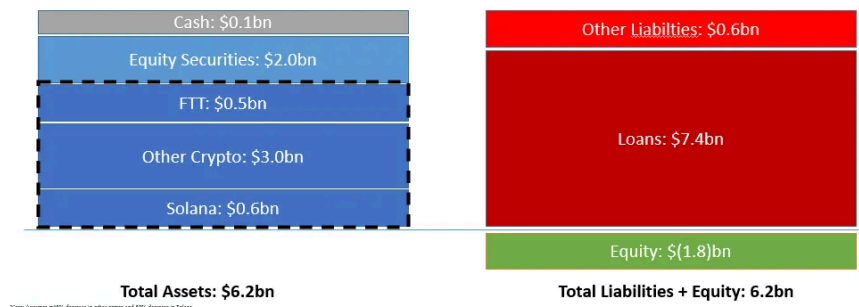


So where did the debt even come from? Alameda/Sam was able to convince some lender to accept the FTT token as collateral for a loan. The sheer size of the loan has led many to speculate it came from FTX itself: after all, who else would let a lender with no financial track record borrow billions of dollars with no real collateral?

The implications here are monstrous: Alameda's net worth is majority comprised of FTT, a junk equity token controlled by FTX. In other words, those \$7.4bn of loans were back by Sam's good faith – probably worth something in bull markets, but worthless in a liquidity-drained bear market.

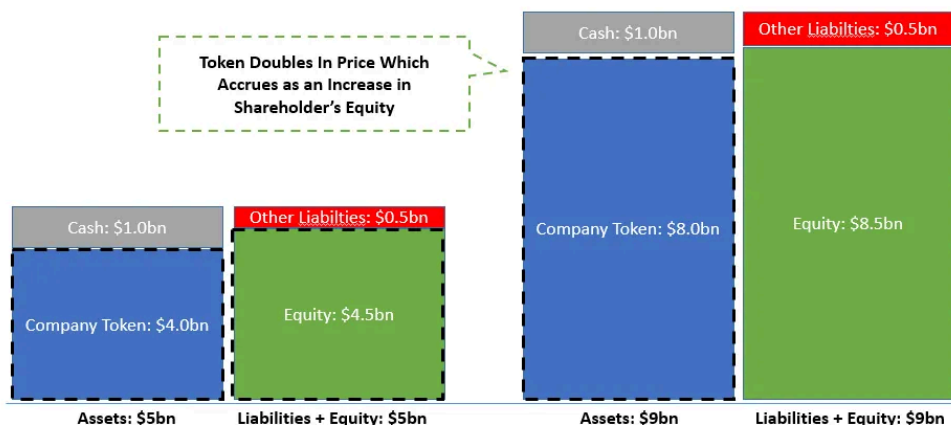
The sovereign individual remain but a dream. Other market participants (read: CZ) jumped at the opportunity to bankrupt Alameda, and did so quite effectively by driving the FTT token's value down significantly, and shrinking the asset side of the balance sheet. In doing so, he set off a classic crypto death spiral. This is an estimation of what Alameda's balance sheet would look like today.

Alameda Balance Sheet – Today Estimated

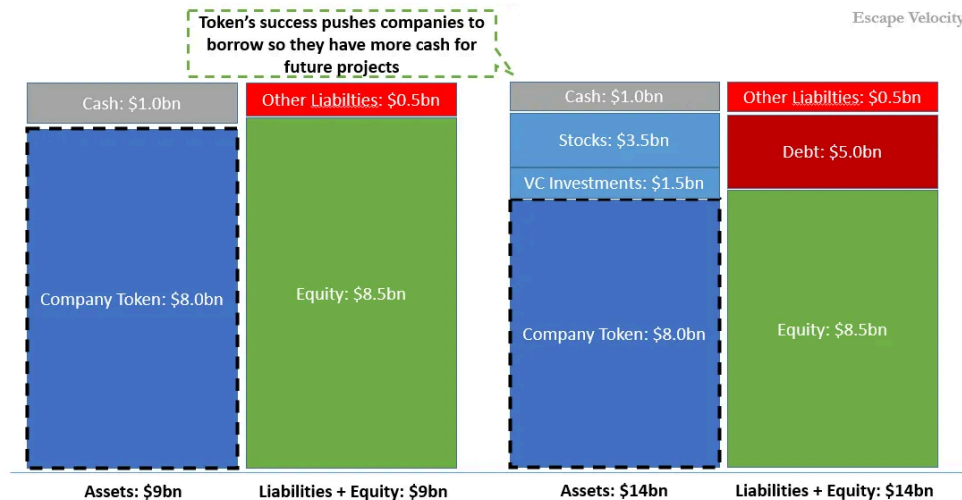


The equity in Alameda has been wiped out completely due to the collapse of FTT's and Solana's price. This collapse would then lead Alameda to fire sale assets to repay the \$7.4bn of loans, which given the illiquid markets they're selling into, would further accelerate the asset side decline. I suspect the ~20% fall in Robinhood's price yesterday was panic sellers, getting ahead of FTX/Alameda having to fire sale equity securities.

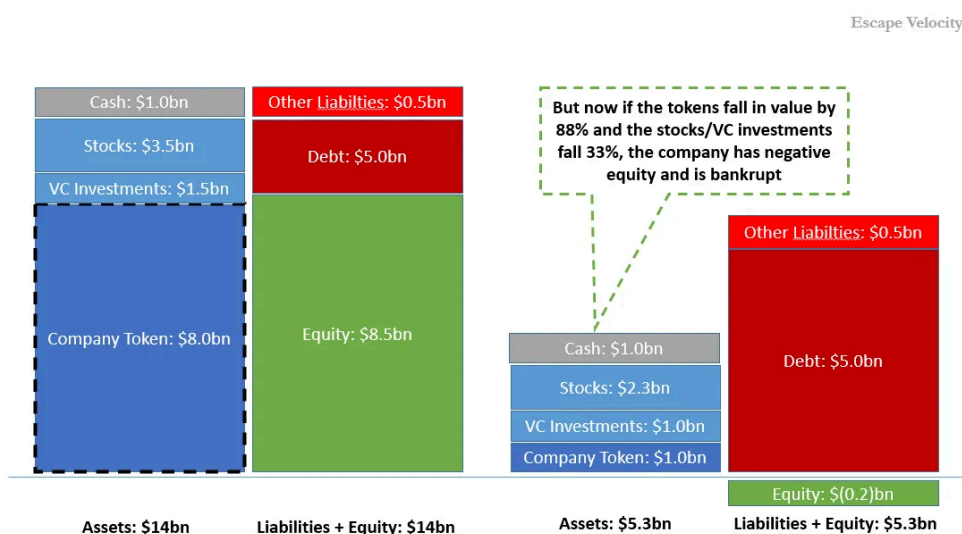
So what of double leverage, and the concept of *junk-equity*? Well, it proved to be just that: *junk* when misused: *junk-equity* relies on the full faith of the issuer to be paid back, with no real recourse for value destructive action. Traditionally when a company issues equity, both sides of the balance sheet increase. Tokens are a form of company equity, held as an asset for the company to utilize as needed, and don't fit squarely into any *accounting* box. In effect, the company controls its entire junk equity financing source up front. However, that financing source is held as an asset without a corresponding liability, so changes in the mark to market of the asset have drastic effects on the company's true shareholder's equity. In good times, this can be a lot of fun. In essence, the token amplifies the equity risk of the company, like debt normally does by adding leverage.



Once the token has increased in value, the founder now has a lot more freedom to create liquidity: she can sell her token for cash which is rare, as it depresses price and reduces the value of her assets. More likely, she will borrow to give herself some optionality for future building and buffer to defend her token. She gets the cash, and knowing she isn't spending all of it today, will invest some of it.

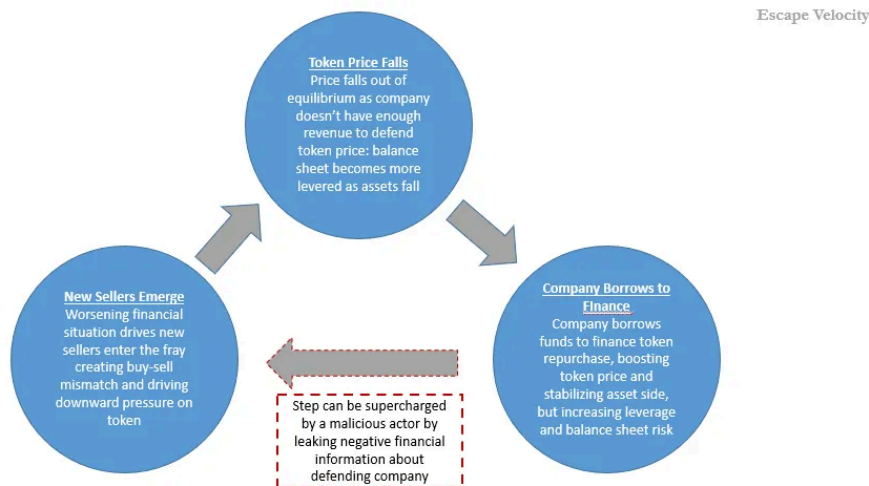


This company already has amplified equity risk through the issuance of junk equity (a token). Adding debt, increases that equity risk even more, but more importantly gives competitors and ill-wishers a kill shot. As the diagram above shows, wipeout of the token can put this company near bankruptcy. These tokens tend to trade in illiquid markets and are susceptible to price manipulation due to poor price discovery. In FTX's case, a \$600m sale of tokens on the open market by CZ provided just that impetus: the token price collapsed ~90%, driving the company into default on its loans.



The death spiral has come full circle. Because junk equity fills no utility, it relies on company generated demand to support price in bear markets when liquidity

disappears. With significant downward market pressure, the company doesn't have enough revenue to defend its token – it turns to capital markets to finance the deficit. The borrowing then sets into motion a self-fulfilling prophecy as leverage increases the volatility of the company's equity. Finally, with enough sell impetus at this point, a bad actor can cause the token price to collapse, putting the company into bankruptcy given their debt leverage. When investors believe in the long-term decentralized model, you have enough market buy pressure to maintain price organically, but as soon as that disappears, malicious actors can thrive if the token doesn't underlie a productive system with utility.



FTX failed where most great financial institutions before it has: a leverage spiral amplified by changes in the asset side of its balance sheet. The kicker here was that it did all this with an asset that it created in the first place – a junk equity asset with limited fundamental value beyond speculation. We're not going to say FTX was a ponzi, because it wasn't – there was an extremely strong operating business and consumer brand here. FTX was mismanaged badly partially driven by one of the biggest changes in market context in history, and partially by the need to stay big and strong to fight off the perception of a bank run.

But it does raise a big question around how companies should account for their own tokens. In equity markets, company shares would never be listed on the asset side of the balance sheet – repurchased or issued shares are either sold or in the treasury reserve account. This raises an important question that we will save for another piece: should a company be able to hold its own token as an asset on its balance sheet?

Businesses that own their own token need the same accountability, and should realize they are already implicitly leveraged. Adding debt leverage to token leverage is hopefully a mistake CZ won't make.

The King is dead, long live the king!

