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THE FUTURE IS HERE AND NOW

Introduction

There are certain innovations that are born from a flash of a brilliant mind - that "Eureka" moment, as occurs in a comic book. However, most successful innovations come from the conscious, tireless, and repetitive search of a pathfinder. An opportunity detected in an unexplored environment.

Let's take the example of Wolfgang Amadeus Mozart, a figure that British journalist Malcolm Gladwell brilliantly portrays in his most recent book. In *Talking to Strangers*, the author says that although Mozart began composing at the age of six, his first arrangements were not exceptional. Rather, it was only after twenty years of practice that the genius, we all know of today, produced his greatest compositions. Gladwell concludes, then, that the musician's great differential was tireless practice, which eventually led him to professional excellence.

For those who want to dive deeper into the subject, we also recommend the research developed by psychologist Michael Howe, *Genius Explained*, which is the cornerstone of Gladwell's conclusion in his book.

Innovation, for the most part, is conceptual and sensory. The most successful entrepreneurs always start with deep analytical work and then "go into the field" to test hypotheses. In short, experimenting with the behavior of your potential customers is proving increasingly valuable when you have an idea. To be effective, innovation needs to be simple and have a very well-defined purpose, escaping from the cliché "disruption" when used only for the glamour that surrounds it. As Peter Thiel well defines it, "[disruption] has metamorphosed into a self-congratulatory jargon for anything that poses as new and modern."

On the other hand, innovation can also be quite naive yet transformative, as occurred in Japan after the end of occupation by the Allies in World War II, only 14% of its roads were paved, while the rest were laid out for 10th century ox carts. What made the Japanese system work for cars and trucks was the introduction of small reflectors on vehicles that had already been part of cars in the United States since 1930. With this simple advent, everyone could see each other, no matter in which direction they were facing.

*If at first the idea is not absurd,
then there is no hope for it."*

Albert Einstein

In an industry like Venture Capital, which constantly looks at innovative companies and entrepreneurs, it is worth asking: how is our industry reinventing itself? What were the main innovations presented and where is it moving to?

This is precisely the theme we will share with you in our first letter of 2021.

The birth of Venture Capital

The first fund formally recognized as a Venture Capital appeared in the United States in 1946 under the name of American Research and Development Corporation (ARDC). It had distinguished founding partners such as Karl Compton, president of MIT (Massachusetts Institute of Technology), Ralph Flanders, then president of the Federal Reserve Bank of Boston, and George F. Doriot, then a professor at Harvard Business School.

ARDC became the first venture capital fund to receive funding from endowment and mutual funds. Funding that would set the industry standard for years to come.

ARDC's greatest success, however, came from its investment in Digital Equipment Company (DEC) in 1957, when the fund invested \$70,000 for a 77% stake in the company. Over the next fourteen years, the value of the company exceeded \$355 million. ARDC's success story caused several other funds to hop on the train, both on the East and West Coast of the United States.

In the Land of the Rising Sun, the economy after World War II was devastated. Its manufacturing industry had been reduced to dust and the food supply had halved. From a macro point of view the situation was not encouraging either, as the Japanese people suffered from sky high inflation due to an uncontrolled money supply. A number of policies were implemented by the Japanese government to help the country recover. These included an aggressive priority-production initiative, which provided subsidies to the manufacturing industries, in particular coal and steel. As well as very strong price controls to stem the loss of purchasing power. These actions worked well and allowed the country to return to robust economic growth in the years that followed. Even so, for the authors, Japan's technological development lagged behind after World War II, and the country survived by importing machinery and equipment, hiring consultants from the United States, buying inventions, and sending thousands of top engineers around the world.

*"Intelligence is hitting the target that nobody can.
Genius is hitting the target that no one can see."*

Amin Toufani

Many relate ARDC's success to the fact that the world was living in the post-war period, with the argument that World War II would have been a major catalyst for investments in technology. While the correlation is undoubtful, we believe that there are other accelerators that were also relevant to the period in question.

It is worth remembering a great paper published by the Oxford University Press, in which the authors Hiroyuki Odagiri and Akira Goto study Japan's situation in the post-war period. The title of the paper is Postwar Technological Progress and Government Policies in Japan and we recommend it if anyone wants to delve deeper into the topic.

Back to the subject of the letter, some legal and structural aspects were also very relevant for the maturity of the industry in a global scenario. A very clear example was the creation of the Limited Liability Company in 1811. To put everyone on the same page, the LLC, as it is known, is a type of company incorporated as a limited liability company in the United States. It is formed by partners who can be U.S. residents, and as a major “innovation” brought the fact that the owners of the organization do not bear personal liability for potential liabilities. This limited risk, in addition to a high-risk industry, has obviously unlocked a lot of investment.

Another innovation, which only emerged in the 1960s, was the segmentation of the roles of each specific agent in this industry. Specially the good relationship between the general partner (GP), which in our parallel in Brazil would be the fund manager, and the limited partner (LP), which in Brazil has the mirror image of the investor. And what governs this good relationship between the GP and the LP are clear governance practices and guidelines.

With successful examples such as the ARDC, with the loss limit established by the LLC rule and a clear guideline on the segmentation of the main players (GP and LP), the last advent of innovation in this industry that needs to be mentioned came after 1879, with the regulation of the banking system that brought much more transparency and access to information. If our readers would like to know more about the beginning of this regulation of the US banking system, we recommend a didactic article written by Lynne Doti, Chapman University, and Richard Runyon, University of Cambridge, under the title *The Effect of Regulation on Banks: California 1879-1929*.

The Surge of Venture Debt

In recent years, in emerging countries alone, debt-related product options for innovative companies have increased by more than \$80 billion in the past three years. In 2019 alone, according to Pitchbook data, the Venture Debt market reached a record \$28.2 billion across 3,000 deals. A level that remained quite high even with the COVID-19 pandemic.

In the last decade, Venture Debt has emerged as a great financing alternative for high growth companies. Given the accelerated access in the past three years, Venture Debt has shown an even more robust growth than the Venture Capital market itself. Interestingly, this progress has been across all sectors and in all rounds.

*“We truly are living
in the most exciting
time to be alive.”*

Peter Diamandis

If before an innovative company that had non-convertible debt on its balance sheet was viewed negatively by the Venture Capital industry, today the cases are much more common and understood. After all, in an exponential company, the most expensive currency that the entrepreneur can sell are its own shares, a reality that the market has finally understood.

In recent years, debt product options for exponential growth companies have also expanded. Corporate credit cards specifically targeted at startups, small business banking and capital solutions such as those launched by Square and Brex, and, most importantly, the development of recurring revenue-based financing options have channeled a huge flow of previously pent-up capital.

Recurring revenue financing, also known as MRR Financing (Monthly Recurring Revenue), has been gaining a prominent role both in Brazil and the United States. In the US market, the most emblematic case was Pipe, a company launched in June 2020 already valued at \$2 billion.

Pipe's goal is to give SaaS companies a way to receive their revenue upfront. According to its founder and co-CEO Harry Hurst, they were already expanding the scope of their platform beyond SaaS companies to "any company with a recurring revenue stream." This would include subscription companies, streaming services and even telecom organizations. According to him, when they started their business, they really only thought of the SaaS startup as a target customer, however "over three thousand companies have already signed up to use our platform. And companies ranging from early stage to publicly traded.

Pipe's system evaluates a customer's key metrics by integrating with the customer's accounting and payment processing and banking systems. It then instantly evaluates the business' performance and qualifies it for a pre-set credit limit. The limits currently range from \$50,000 for early-stage companies to more than \$100 million for later-stage, publicly traded ones. Unofficial data point to an ARR (Annual Recurring Revenue) of \$1 billion traded on the platform today.

As far as the Brazilian market is concerned, the company that stands out the most in this niche is the São Paulo-based fintech, a55. Founded in 2017 by Hugo Mathecowitsch and André Wetter, it has a robust operation in both Brazil and Mexico. Here, specifically, there are more than ten thousand registered businesses. Unlike Pipe, a55 operates mostly in anticipating recurring revenue, but focused on SaaS. [It is worth mentioning that a55 is a partner of Fuse for Venture Debt transactions directed at Fuse Capital Fund I.](#)

Venture Capital's New Frontier

Our perception is that there's this fragment in the Venture Capital spectrum with very little progress so far, but that needs to move quickly. Wearing our entrepreneur hat, we perceive that, in the same way that there were structural changes inside and outside the Venture Capital industry, we are living a unique moment in which it is necessary to innovate both in the offering of products and also the access to them. What we are witnessing with Pipe is the new relationship between investor and illiquid assets. As the process becomes less bureaucratic and more personalized, the investor will be closer and closer to the asset. However, today, the products we find on the shelves of the Venture Capital industry are long term, undemocratic, and with many intermediaries, given its aim at qualified investors.

Since the beginning of the pandemic, the world has changed completely. As we said in our previous letters, we are living a new goal plan, the new "50 years in 5", but this time in the way we socialize, consume, work, and even invest. In this period, trends have been driven and implemented in record time.

The innovation that we believe will severely impact the funds industry is blockchain and the implications that this technology brings to the Venture Capital industry.

Blockchain allows two ends, with no trust in each other, to exchange digital data without having a third party or an intermediary. It is worth noting that when we mention "data" in the previous sentence, we mean money, insurance, contracts, property titles, medical records, educational records, marriage certificates and certificates of sale and purchase of goods and services, and any transaction or asset that can be translated into a digital form. Do you realize how many industries and sectors blockchain can impact?

This is why its potential in industry and society is being explored by several sectors and several organizations. It is important to emphasize that our intention in this letter is not to address the topic of cryptocurrency itself, but rather the technological innovation behind it, which has been impacting the investment market in a very clear way.

A key feature of blockchain innovation is the degree of transactional trust, which is removed from a third-party intermediary, and which would normally function as an authenticator of a transaction. By way of illustration, a very transparent authenticator in our Brazilian day-to-day lives are public notaries, whose days are numbered. In the case of blockchain, authentication is achieved in an encrypted way, with all participants having access to the “version of the truth” without any user being able to control or change it.

The blockchain that currently guarantees the greatest flexibility when it comes to the kind of innovation, we mentioned is Ethereum, as it allows the use of smart contracts so that prearranged rights are executed automatically. For example, issuers and

today and interact digitally with any decentralized app. These apps are where the interesting steps happen for those who would like to participate in the market.

As an example of these decentralized apps we can cite some relevant ones, such as Compound, an algorithmic and autonomous peer-to-peer lending protocol that generates liquidity for those who need it and earns interest on it; Nexus Mutual, which sells insurance against smart contracts in case of unintentional use of the code; and Decentralized Exchanges (DEXs), which offers margin trading, derivatives, and synthetics. The list is long and the possibilities are even greater.

When we looked at the Venture Capital industry as it is today, we were faced with illiquid long-term funds, little democracy in their access, and an antiquated onboarding process, which led us to study how blockchain could be used to solve specific bottlenecks. We concluded that the best way to address these problems goes by the name of Securitized Token Offerings (STO).

“Tokenized securities have the potential to bring liquidity and access to asset classes that were previously out of reach for most investors.”

Joachim Godet, of 01 Capital

investors agree on the terms of a sale and an offer by acting as programmable variables in the smart contract, which is then cryptographically signed by all participants, or ledgers. On the closing date, the smart contract protocol initiates the exchange of money and the transfer of securities, each of which is permanently recorded on the blockchain.

Because contracts have the ability to be modified depending on the objective of both ends, the disruption that the technology presents in each sector is relevant. In our environment, what has gained traction in recent months is the “niche” of Decentralized Finance (DeFi), with the purpose of decentralizing everything that the big financial services offer. Using DeFi protocols, you can hold your own cus-

An STO is an offering of equity or debt securities of a private company on a Global Exchange. Unlike an Initial Public Offering (IPO), an STO allows the exchange of a company’s securities for tokens without the need for any intermediary fees. In this way, the STO offers an investment contract that is legally binding on the company’s capital. In the case of the investment industry, the contract would be linked to the fund’s share or NAV (Net Asset Value) in the US fund market.

Because the token is 100% digital and is backed by fund assets (share or NAV), it could be issued on an exchange in Europe, Asia, and in the near future even in Latin America. The exchanges that tokenize and list digital assets offer access to a secondary

market for the first time. With this, an investor in an illiquid asset can exchange his or her stake very quickly and with minimal transaction costs. One of our partners through this study on the topic, Joachim Godet of 01 Capital rightly said, “tokenized securities have the potential to bring liquidity and access to asset classes that were previously out of reach for most investors. Venture Capital is one such asset class of growing importance to the economy.”

In turn, certain exchanges, such as Fusang and Archax, implement the processes required to list the token. From structuring the token of the asset to Know Your Client/Anti-Money Laundering compliance in accordance with the securities laws that each jurisdiction establishes, all 100% digital and registered on the blockchain.

Note the number of steps and intermediaries that tokenization eliminates. As Henry Chong, founder and CEO of Fusang, says, securities can provide secondary liquidity to investors through tradable tokens. Digital securities also allow for widespread automation of the process, eliminating most of the paperwork and inefficiencies in the traditional investment market. This means that investors can bet on digital securities frictionlessly, regardless of their location or citizenship, and with a lower investment. It is worth noting that Fusang, the first and only fully regulated digital stock exchange open to retail investors, provides an end-to-end service to its clients to create regulated digital securities.

We are witnessing a unique moment in this industry, and we believe that the new frontier of innovation will be this STO revolution in the fund industry. Throughout this study, we had the chance to talk to global players ranging from tokenized funds to fund of funds that only invest in tokenized assets.

We believe that the four pillars of a successful manager are: access, capital, analytical capabilities, and people. As the investor gets closer to the assets, as Pipe and Robinhood have shown, the pillars of access and capital become less of a determinant for the Venture Capital allocator/investor. In turn, analytical capability and people remain extremely relevant and will continue to show a strong correlation with manager success. We are very confident that the technology and solution that STO offers will come to optimize processes and focus on the core business.

Conclusion

In the 1960s, Gordon Moore wrote the article Cramming more components onto integrated circuits, with some predictions that would later end up changing the world we live in. In the 1965 study published in Electronics Magazine, Moore noted that the number of components on an integrated circuit on a computer chip doubled every year.

Although quite bold for its time, his prediction was not only confirmed, but still holds true today. In short, Moore's famous law states that every eighteen months the number of transistors on an integrated circuit doubles. This means that every eighteen months computers become twice as fast for the same price. Even excluding the exchange rate effect from the bill, you can clearly see this effect in the iPhone, for example.

"If you tell your idea to ten people and nine of them say you're crazy, you're probably doing something innovative."

Nolan Bushnell

We believe that in recent years the Venture Capital industry has seen a number of innovations that, if not at the same pace as Moore's law, are very close. The advent of Venture Debt, as mentioned before, has configured a paradigm shift for the industry. Not only for its dynamics, but also for including new investors in this world of startups.

However, nothing seems to us as transformative and disruptive as the advent of STO. The democratization of this asset class out of a small and select group seems, to Fuse, closer to reality. The frontier of turning illiquidity into liquidity, or of turning attrition into access, is there. [The future is here and now.](#)

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"From entrepreneurs to entrepreneurs"