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Valuing Ethereum

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Since launching in 2015, Ethereum has garnered significant interest as the second largest blockchain network. But even as the network has matured into a robust settlement layer for billions of dollars of peer-to-peer value transfer, investors often find it difficult to identify the investment case.

It's helpful to take a step back and consider Bitcoin's value proposition: the promise of a global, verifiable accounting system. This accounting system, supported and secured by the most powerful computing network in the world, allows users to track value with a high degree of confidence.

Ethereum similarly facilitates verification, but of a wider set of logic and information. In other words, Ethereum's robust network ensures that applications run according to the logic that is encoded, without the need for third parties or without the possibility of interference. Ethereum creates an environment of trust, which is historically a prerequisite for prosperous trade.

Does this mean that Ethereum is better than Bitcoin? Not necessarily — they specialize along different frontiers and make tradeoffs accordingly. Bitcoin is hardened and relatively inflexible, instilling confidence that its accounting system won't change arbitrarily. Ethereum is adaptive and flexible, cultivating an environment of innovation and iteration. Ethereum and Bitcoin enjoy a symbiotic relationship, drawing liquidity, mindshare, and value from the outside world. Bitcoin is the preferred store of value in the digital ecosystem, whereas Ethereum has emerged as the leading financial infrastructure, settling over $12 billion of daily transactions.[1]

With the growing activity on Ethereum, investors wonder about the investment case and how to value the native asset of the Ethereum network, Ether. In August, we released a report on Valuing Bitcoin to help investors understand the Bitcoin investment case and how they can monitor important

1. Source: Coin Metrics, as of January 25, 2020

underlying metrics.[2] Similarly, the goal of this paper is to outline important considerations for valuing Ether. But while Bitcoin is widely known as digital gold, Ether's designation is less clear. We explore three approaches and relevant metrics associated with each: Ether as money, Ether as a consumable commodity, and Ether as an interest-bearing asset.[3]

Ether as Money

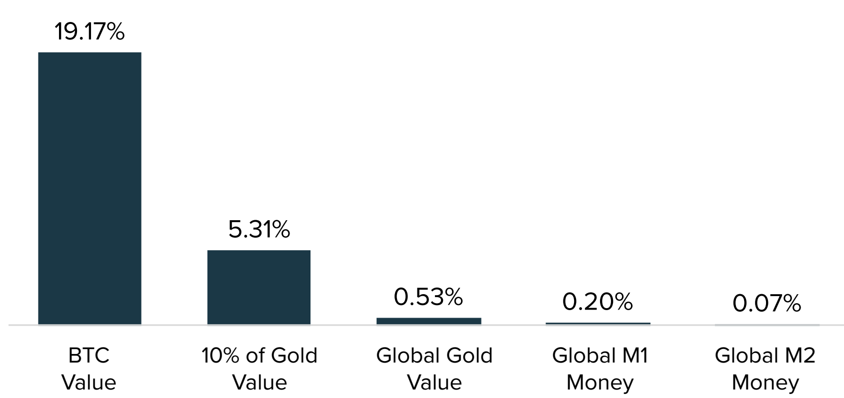
Ether is the native asset underpinning a burgeoning decentralized financial system. It is used as trust-minimized collateral for lending and borrowing, and is the primary capital source for applications built on top of Ethereum. At the time of writing, there are approximately 7 million Ether locked as collateral in decentralized protocols on the Ethereum network, worth over $9 billion at current prices.

In many ways Ether is functioning as new-age digital money on the Ethereum network. Anytime a user deploys a smart contract on the Ethereum network, provides liquidity to an application, or makes a trade on a decentralized exchange, Ether is necessary to pay network fees.

While the Bitcoin community contends that money should be fixed in supply, Ethereum aims to issue the minimum amount necessary to adequately secure the network over time. While the supply serves as the primary focal point for Bitcoin, Ether's use as money is driven by the utility of applications on the Ethereum network. For Ether, this utility drives its use as a monetary good on the Ethereum network.

If investors do consider ETH to be money, it is worth exploring its relative value to other money competitors. At current prices, is its ability to take market share from competitors appropriately priced?

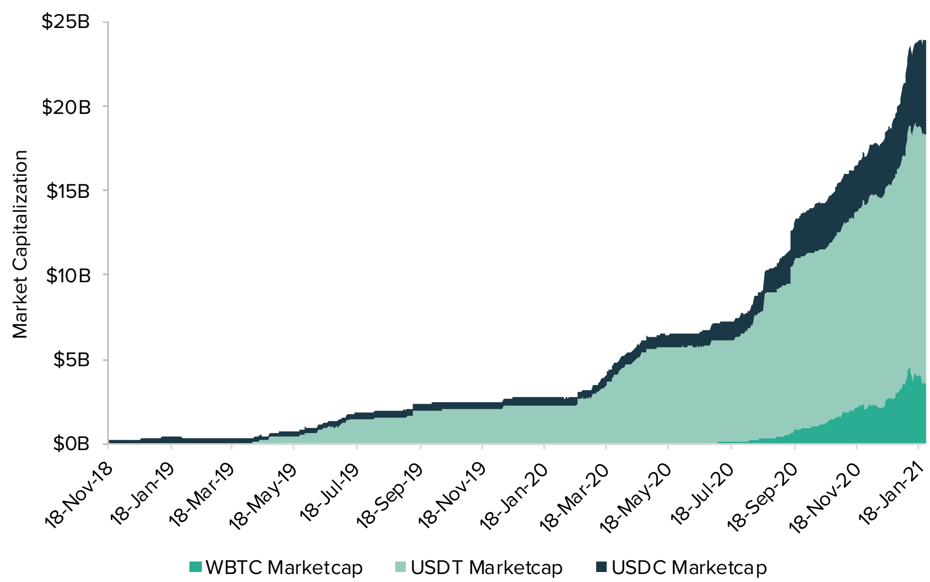
FIGURE 1: **ETH MARKET CAP AS A PROPORTION OF OTHER MONIES**[4]



2. "Valuing Bitcoin", August 2020, https://grayscale.co/insights/valuing-bitcoin/
3. David Hoffman, "Ether: The Triple Point Asset," Bankless (Bankless, October 4, 2019), https://bankless.substack.com/p/ether-a-new-model-for-money.
4. Source: Grayscale, Coin Metrics, Bloomberg

Ether's use as collateral within the decentralized finance ecosystem continues to broaden. However, an uptick in the use of stablecoins (digital currencies pegged primarily to USD) and Bitcoin as collateral on Ethereum, may be challenging Ether's position as the ecosystem's preferred collateral. WBTC is a synthetic version of Bitcoin on Ethereum — it enables Bitcoin to be transfered on the Ethereum network. USDT and USDC are the largest US dollar stablecoins on Ethereum. The chart below shows the growth of WBTC, USDC, and USDT. While the growth of alternative assets on Ethereum could challenge Ether's use as collateral, the increased usage of Ethereum as a settlement network is a positive trend.

FIGURE 2: **BITCOIN AND USD ON ETHEREUM**[5]



Ether as a Consumable Commodity

Ether is integral to the functioning of the Ethereum network. Each transaction on the network incurs a certain cost that is priced in terms of Ether. These transaction fees, or the network's revenue, are then distributed to the miners. Fees increase as demand for the network increases – transactions have to "compete" for space in a given block by increasing their associated fee.

5. Source: Grayscale, Coin Metrics

Some analysis has noted that it may not be necessary to pay fees in Ether, but rather fees could be paid in any digital currency of one's choosing. This is known as economic abstraction, and has been used to challenge the value of Ether. Similarly, some have argued that Ether suffers from a working capital or infinite velocity problem — as simply a medium of exchange asset, investors may look to minimize their holdings to only what is necessary to pay for a service, i.e., Ether would be treated as working capital.[6] Because investors might look to minimize their working capital, the velocity of Ether would increase and its value according to the equation of exchange, M=PQ/V, would decrease.[7] In other words, constant selling would drive down the price of the Ether.

However, Ethereum plans to implement a proposal known as EIP-1559.[8] Among other things, this proposal would burn (or destroy) Ether that is used to pay for transactions. This is important because it would transform Ether from a medium of exchange asset to a consumable commodity. Ether would become more like combustible gas than money. If this proposal is implemented, it would also ensure that Ether is the native economic unit on Ethereum – protocol rules would dictate that only *Ether* could be burned. This would reduce the possibility of economic abstraction – the ability to pay fees in an asset besides Ether.

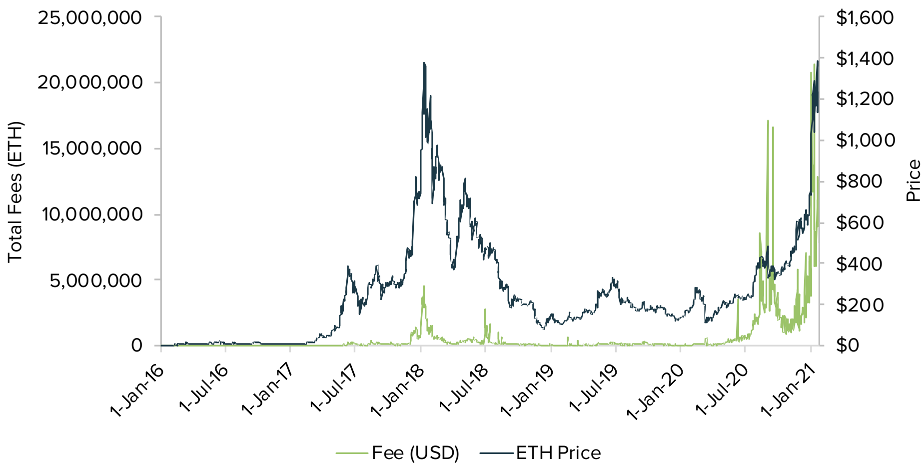
This burning method may also serve as a deflationary mechanism if the Ether consumed as *fuel* outpaces the issuance schedule. If activity increases and the supply of Ether *decreases* due to burning, a supply and demand curve would indicate an increase in the unit price of Ether because each unit would need to satisfy a greater proportion of economic activity. If EIP-1559 is implemented, it would institute a consumption mechanism that should serve as a positive feedback loop for Ether's price.

As a commodity, the price of Ether will fluctuate depending on supply and demand in the market. Luckily, the Ethereum blockchain is transparent and we can analyze user activity to make interpretations about Ether's fair potential market price.

We can examine the total daily transaction fees collected on the Ethereum network as a measure of demand, as shown below. Since Ether is the commodity that pays these fees, high fees drive demand for Ether just as an increase in travel might drive demand for gasoline. Notably, total transaction fees during January 2021 we nearly 5x the peak fees of January 2018. Yet, Ether's price is approximately equal to that of the 2018 peak.

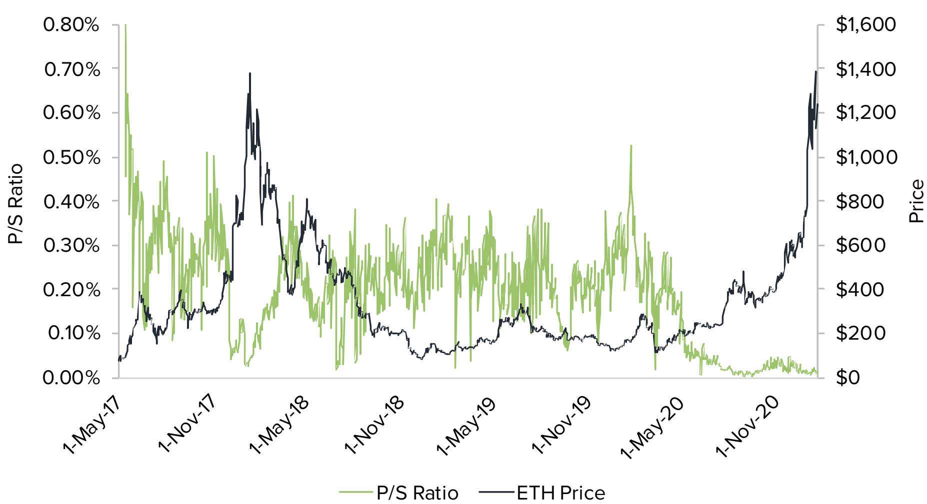
6. "Multicoin Capital: Understanding Token Velocity," December 8, 2017, https://multicoin.capital/2017/12/08/understanding-token-velocity/.
7. "Equation of Exchange," Wikipedia (Wikimedia Foundation, February 8, 2020), https://en.wikipedia.org/wiki/Equation_of_exchange.
8. Ethereum, "Ethereum/EIPs," GitHub, November 6, 2020, https://github.com/ethereum/EIPs/blob/master/EIPS/eip-1559.md.

FIGURE 3: **TOTAL DAILY TRANSACTIONS FEES**[9]



Transaction fees are the total amount paid for transactions on the Ethereum network. Another way to consider Ether's value is to compare Ether's historical price to the sales (fees) on the network. The chart below illustrates this relationship with a "Price to Sales" ratio — a lower ratio indicates that the network is generating high revenue relative to Ether's historical market capitalization, and thus may be undervalued.[10]

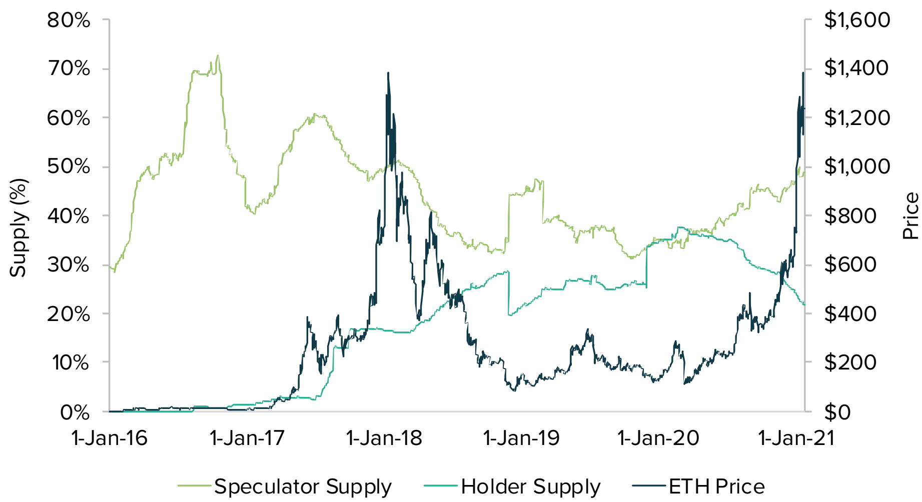
FIGURE 4: **ETHER PRICE TO SALES RATIO**[11]



9. Source: Grayscale, Coin Metrics
10. Token Terminal, "The Price to Sales Ratio (P/S)," Token Terminal (Token Terminal, December 11, 2020), https://tokenterminal.substack.com/p/the-price-to-sales-ratio-ps.
11. Source: Grayscale, Coin Metrics

To inform the supply side of the equation we can examine holding patterns on Ethereum. We previously introduced the Holder vs Speculator Index in our Valuing Bitcoin report, which specifies assets that belong to holders as those that *have not* moved in 1-3 years and those that belong to speculators as those that *have* moved in the last 90 days. The pattern is less clear on Ether because the network is so young, but we can nonetheless see Holders' assets peaking prior to Ether's 300% performance in 2020. In addition to traditional investment analysis tools, looking at supply patterns may be a useful too for investors.

FIGURE 5: **HOLDERS VS SPECULATORS**[12]



Ether as an Interest Bearing Asset

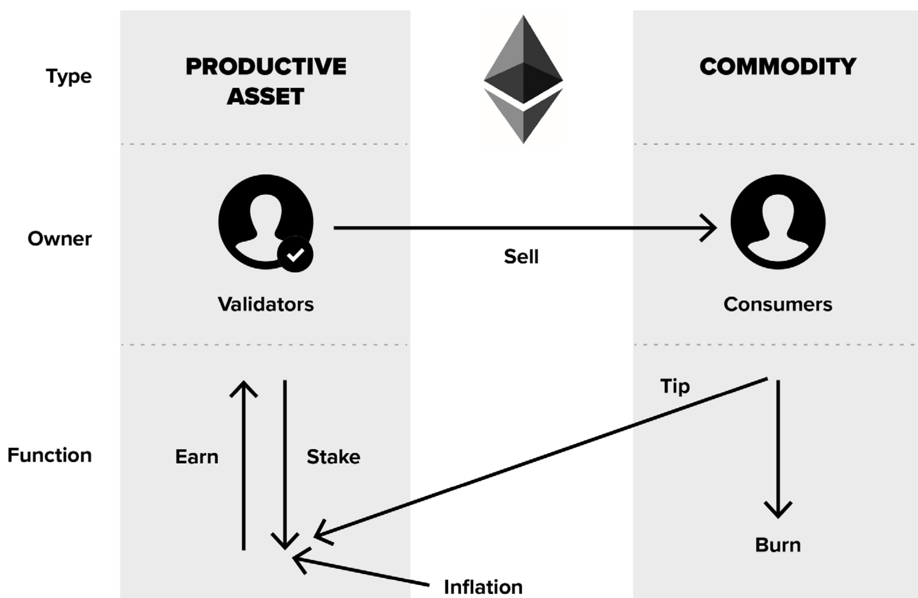
Ethereum has begun its journey to the next phase of the protocol's development, known as Ethereum 2.0.[13] Ethereum 2.0 is intended to be a scalable proof-of-stake blockchain. This means that instead of miners expending energy through specialized computers, holders can stake their Ether tokens as collateral to become validators on the network. In return, validators will receive a subset of transaction fees (fees may be burned under EIP-1559) and their respective proportion of the network's inflation.

This is another key transformation in thinking about Ether's value. Ethereum 2.0 will transform Ether from a commodity to what we might describe as a productive commodity — holders will be able to generate interest by staking Ether. This asset structure is unlike anything else in the physical world. Commodities are consumed. Equities provide rights to cash flows. Under Ethereum 2.0, Ether can be consumed as a commodity or staked as a claim on cash flows, similar to equity.

12. Source: Grayscale, Coin Metrics
13. "The Eth2 Upgrades," https://ethereum.org/en/eth2/

Its initial value is derived from its commodity use and the supply and demand dynamics in the market. Those that are confident in Ether's future price prospects can bolster their allocation by staking the asset to earn a yield on their collateral. This staking may further reduce Ether's floating supply. If a large portion of Ether is staked, this would reduce the supply available for consumption, potentially acting as a positive feedback loop for Ether's price. Refer to the chart below for how value will flow through the Ethereum 2.0 network. Keep in mind, the launch date for a fully functioning Ethereum 2.0 network has not yet been determined.

FIGURE 6: **THE ETHER ECONOMY**[14]

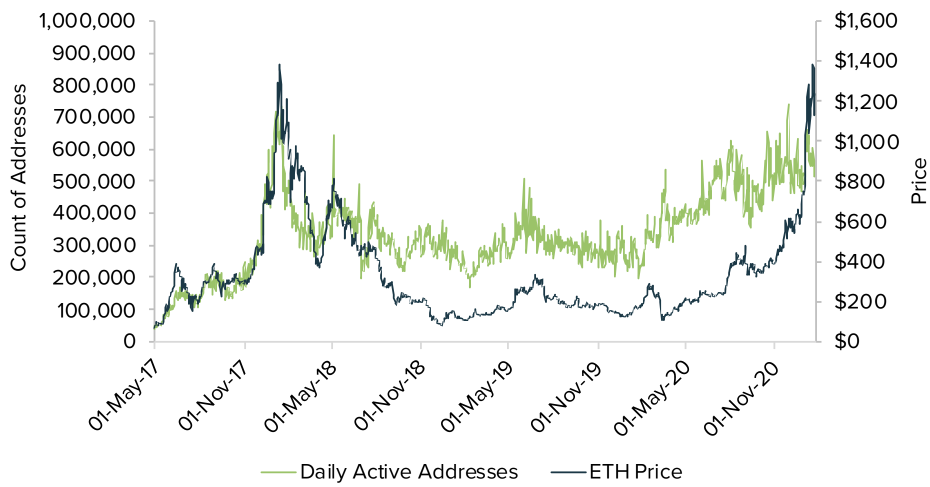


Other Relevant Metrics

Daily active addresses are a useful proxy for network growth. Metcalfe's law, which states that the value of a network is proportional to the square of the number of users, was famously used to value Facebook.[15] Currently, there are nearly 700k daily active addresses on Ethereum.

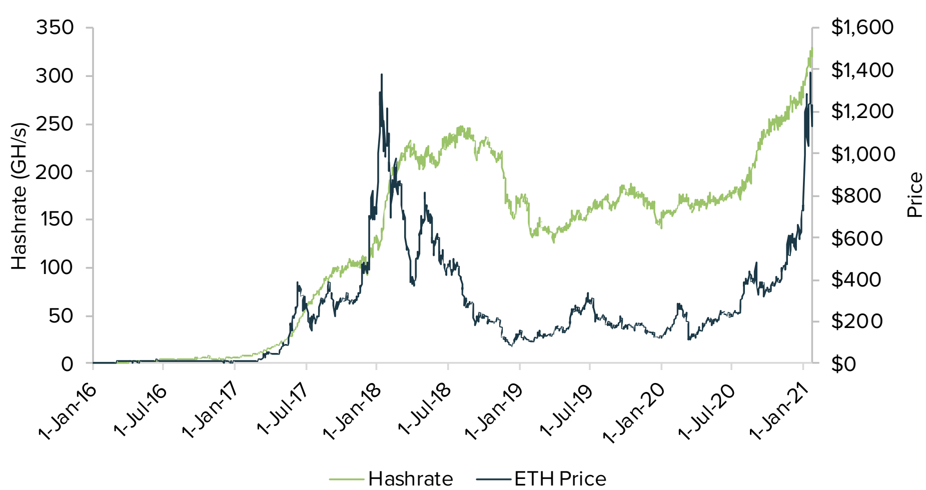
14. Grayscale
15. B. Metcalfe, "Metcalfe's Law after 40 Years of Ethernet" in Computer, vol. 46, no. 12, pp. 26-31, 2013

FIGURE 7: **ETHEREUM ACTIVE ADDRESSES**[16]



In a similar vein, hashrate on Ethereum, which measures the amount of computer power miners are using to validate transactions, is reaching new highs. Because it takes time for miners to recoup their initial investment, this is a sign that miners are confident that Ethereum will continue to generate high transaction fees. If miners felt that transaction fees would decline, they would be less willing to allocate resources to mining.

FIGURE 8: **ETHEREUM HASHRATE**[17]



16. Source: Grayscale, Coin Metrics
17. Source: Grayscale, Coin Metrics

Conclusion

Ethereum is younger than Bitcoin and the protocol continues to undergo significant transformations. As such, the methodology for valuing the underlying asset, Ether, is opaque and changing. Considering Ether as money, as a consumable commodity, or as an interest bearing asset allows investors to account for a range of possible outcomes when assigning a fair value to the asset.

Improvements to Ether's asset structure (EIP-1559), namely converting it into a consumable commodity through token burning, could serve as a catalyst for Ether's value. The proposal also supports Ether as the native asset of the protocol, reducing the validity of prior analyses that posit Ether could be removed from the ecosystem. Finally, if the protocol successfully moves to Ethereum 2.0, investors will have the ability to use Ether as a yield-generating asset by staking their holdings.

Between the enormous amount of activity on Ethereum, the economic improvements to Ether, and the promise of increased scalability with Ethereum 2.0, there is a lot for the Ethereum community to be excited about. We can observe from the data that the price of Ether tends to move with underlying activity on the network. As noted throughout this report, multiple metrics are reaching new highs, including active addresses, hashrate, and network fees – a positive sign for investors.

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