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THE METHODS AND PRACTICES OF FUNDRAISING FOR WEB3 STARTUPS

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МЕТОДИ ТА ПРАКТИКИ ФАНДРЕЙЗИНГУ ДЛЯ WEB3 СТАРТАПІВ

The article presents and compares typical fundraising methods used by Web3 startups. One of the key challenges for startups is attracting the funding needed to develop and scale projects. This article defines Web3 projects and their characteristics, highlights classic fundraising methods for startups and those that became possible only with the advent of blockchain technology and decentralized applications. In addition, an overview of the basic principles of web3, including decentralization, blockchain technologies and smart contracts, which are the foundation for many modern digital projects, is provided. Next, traditional and emerging fundraising methods are explored: angel investors, venture capital firms, family offices, initial coin offerings (ICOs), initial exchange token offerings (IEOs), initial liquidity pools, and other new models that have emerged from development of decentralized finance (DeFi). The article provides characteristics of these fundraising methods, as well as a comparison between them, historical examples of their application. Special attention is paid to the analysis of the advantages and disadvantages of each of the fundraising methods, as well as their applicability in the context of web3 startups. The article also presents practical recommendations for startups on preparing for fundraising campaigns. As a recommendation, the authors developed and described two basic scenarios, depending on the stage of the project and the experience of the founders, which describe the recommended portfolio of project investment sources with the rationale for choosing these methods. In conclusion, the article examines the prospects for the development of fundraising in the web3 ecosystem, emphasizing the importance of an innovative approach and adaptation to rapid market changes. The article contains useful material for founders of Web3 Startups as well as potential investors who may want to evaluate certain assets based on historical data.

У статті представлено та порівняно типові методи збору коштів, які використовують стартапи Web3. Одним з ключових викликів для стартапів є залучення фінансування, необхідного для розвитку та масштабування

проектів. У цій статті наведено визначення Web3 проектам та їх характеристики, виділено класичні методи збору коштів для стартапів і такі, що стали можливими лише з появою технології блокчейн і децентралізованих додатків. Додатково проведено огляд основних принципів web3, включаючи децентралізацію, блокчейн-технології та смарт-контракти, які є фундаментом для багатьох сучасних цифрових проектів. Далі, досліджуються традиційні та новітні методи фандрейзингу: інвестори-ангели, компанії венчурного капіталу, сімейні офіси, первинні пропозиції монет (ICO), первинні пропозиції біржових токенів (IEO), початкові пули ліквідності, а також інші нові моделі, що з'явилися з розвитком децентралізованих фінансів (DeFi). У статті наведено характеристики цих методів фандрайзингу, а також порівняння між ними, історичні приклади їх застосування. Особлива увага приділяється аналізу переваг та недоліків кожного з методів фандрейзингу, а також їх застосовності в контексті web3 стартапів. У статті також представлені практичні рекомендації для стартапів щодо підготовки до фандрейзингових кампаній. Як рекомендацію авторами було розроблено та описано два базових сценарії, в залежності від стадії проекту та досвіду засновників, які описують рекомендований портфель джерел інвестування проектів з аргументацією вибору цих методів. На завершення, стаття розглядає перспективи розвитку фандрейзингу в екосистемі web3, акцентуючи увагу на важливості інноваційного підходу та адаптації до швидкоплинних змін ринку. Стаття містить корисні матеріали для засновників Web3 Startups, а також потенційних інвесторів, які можуть захотіти оцінити певні активи на основі історичних даних.

Keywords: investments, company finances, startup, fundraising, venture capital, decentralized finance.

Ключові слова: інвестиції, фінанси підприємства, стартап, фандрайзинг, венчурний капітал, децентралізоване фінансування.

Statement of the problem in a general form and its connection with important scientific or practical tasks. In the second half 2010's, the blockchain industry started attracting the attention of institutional investors. From the very start it became apparent that Web3 startups require a new approach to investments. Few factors contributed to them: some investors were averted by highly volatile assets with questionable predictability of performance; some could not directly invest in these assets due to lack of regulations. But Web3 startups had its own appeal. First of all, they developed several unique ways for investors to invest directly into them, or via other DeFi (Decentralized Finance) such as DEX-es (Decentralized Exchanges) and Launchpads. These methods has not only allowed Web3 startups to effectively raise funds when more traditional fundraising mechanisms are out of reach, but has also democratized the investment market. While historically only professional investors had access to private equity, while most retail investors only could invest in stocks, bonds and commodities via brokers and on exchanges, these new methods of fundraising that we are going to explore make the market of Web3 investments accessible to anyone, albeit the investment risks are high.

Analysis of the latest studies and publications. Theoretical and applied aspects of investment methods have been reflected in the scientific works of renowned scholars such as Edwin G. Dolan, David Morrison, K. John McConnell, Steve Blank, Maria Tepluk, Leighann Neilson, François Brouard, and Xue Yang. However, conceptual questions regarding the specifics, guidelines, and barriers of fundraising activities among Web3 enterprises require further investigation. The relevance and significance of these issues, as outlined above, informed the choice of topic and determined the purpose and logic of this study.

The goal of this article is to identify specifics regarding investments in the Web3 sphere and analyze their benefits and risks for enterprises at different lifecycle stages.

Outline of the main material of the study. We know a startup as an innovative and scalable project that may or may not be seeking for investments for further development. Web3 startups, however, exist in the Web3 environment that influence the ways how these startups are appreciated by their stakeholders.

But first, let us define what is Web3 starting with the evolution of the internet and Web1 environment. Labeled as the “read-only web”, it is characterized by static content, limited interaction, and simple visuals. With Web1 the internet consisted of static information linked to each, often located on the websites. Users could primarily share the information using URLs. [1]

After it in the early 2000-s Web2 took its place. Where the user experience web revolves around social interactions, connecting users. Platforms like Instagram and Twitter curate algorithm-driven data feeds. Users actively engage by sharing, liking, reposting, and commenting within these ecosystems. Even with this example, we can surely tell that Web2 keeps all the features of Web1 and builds on top of them. With Web3 this sequence continues. [2]

With the development of blockchain technology and the so-called DApps (short for Decentralized Apps) Web3 emerged. Web3 represents an environment where users not only create content, like it was with Web2, but they can own it and have more tools monetize it or handle the right of ownership. It represents a decentralized web where information is linked through a public ledger (often a blockchain). Unlike Web2, where tech companies control data, Web3 empowers users by removing intermediaries and emphasizing transparency. [3]

Henceforth it requires to take these things into account when appraising the Web3 Startups at a certain stage of their development because traditional startup fundraising models often fall short in capturing the nuances of this novel environment. Potential investors that assess the project should know that Web3 projects operate within a distinct ecosystem characterized by decentralized networks, smart contracts, and token economies. Also as we will demonstrate further, Web3 introduced new fundraising methods that are currently only limited

to this industry. Alongside these new methods they emphasize the concepts of decentralization, transparency, and trustlessness that should be account for in the appraisal process. Fundraising practices must align with these principles. [3; 4]

Methods of fundraising for web3 startups

In this section we are not setting ourselves a goal of mentioning all exiting forms of fundraising for startups, but instead focus on several methods that are dominating the Web3 fundraising climate. We will provide several classical startup funding methods followed by the methods unique only to the Web3 industry. [7]

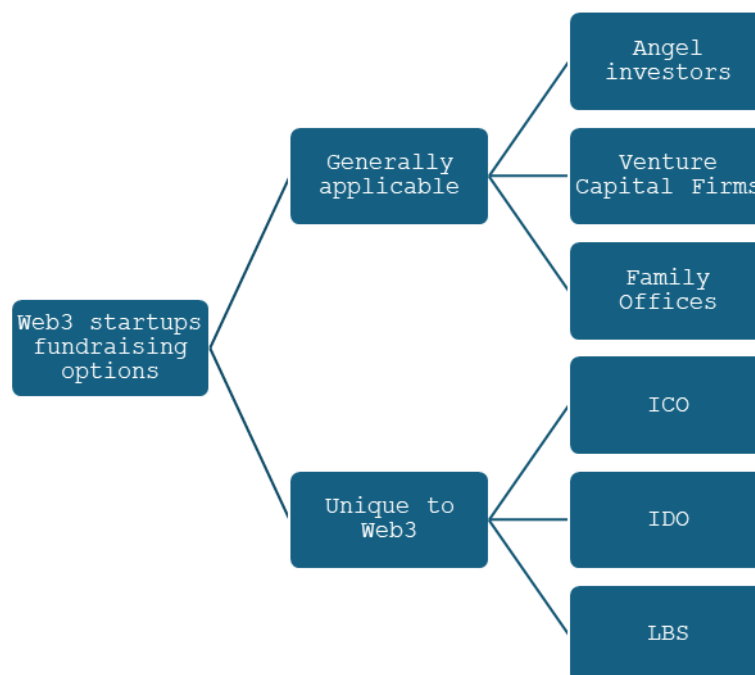


Image 1: Typical Fundraising options selected for Web3 Startups

Source: Systematized, summarized and grouped according to data [1-3].

Angel Investors – these are high net worth individuals who invest in the business with their own money. Usually, they are professional investors with vast experience in Venture investing, however, they are not necessarily considered institutional investors, and hence they offer a range of benefits such as offering additional advisory, mentorship, or joining the non-executive board, and also can take quicker decisions than typical institutional investors. [6; 9]

Among the advantages typical to fundraising from Angel investors we can list the Due Diligence and Assessment because Angel investors rigorously assess potential investments. This includes evaluating the founding team's track record, technical expertise, financials, market opportunity, and ROI potential. Also the founders can expect additional expert guidance beyond capital injections from Angel investors. Angels often assist with equity allocation, open-source community building, and networking. But one of the key benefits when dealing with Angels is that they are flexible and willing to take on higher risk. And this aligns well with innovative and unproven technologies typical of Web3 startups. [8; 9]

But with every fundraising method specific concerns arise. With Angels in particular we may derive such as problem with valuation as startups often lack a proven track record or historical performance, including market validation, product-market fit, and scalability. Misaligned expectations can lead to conflicts down the line. This may cause problems with the ability to adequately value the company or justify given valuation. Some Angel investors try to use this period to get hold of a greater share of the business or other perks that may significantly reduce the investment potential of later rounds. Also, a Startup early on is very much dependent on alignment of interests between founders and angel investors is crucial, while misaligned expectations can lead to conflicts down the line. Founders should also be aware that Angels seek returns through exits and Startups must have a clear exit plan to provide liquidity to investors. And it should not be ignored that while guidance from Angels with an expertise in Web3 industry is often appreciated, the overreliance on an angel's involvement can impact decision-making autonomy. [10; 11; 12]

Notable examples of Angel funding in Web3 projects:

1. Ryan Selkis – an entrepreneur from New York, Founder and Chief Executive Officer of Messari. He was the Managing Director CoinDesk before that. After discovering bitcoin, Ryan became obsessed with the technology's social

and economic potential. Ryan's portfolio highlights include investing in such Web3 startups as Agora, StripChain and Bitlayer. [21]

2. Balaji Srinivasan, he Co-Founder and Board Member of Coin Center. He was the CTO of Coinbase and cofounder of Counsyl, Earn, Teleport, and Coin Center. He was previously CEO at Earn.com, which was sold to Coinbase. His portfolio highlights include investing in Ord.io, Agora (just as Ryan Selkis) and Sending Network. [21]

Venture Capital funds – the typical institutionalized investors, typically join the later rounds, and only a few of them specialize investing in Pre-seed and Seed rounds. In Web3 space in particular institutional investors appeared quite recently. Several years ago only the most pioneering of funds actually dared penetrating this new industry. Unlike traditional VC, where investment cycles can span eight to ten years, Web3 VC investments can yield returns within two to four years due to the scalable nature of Web3 offerings. Venture Capital firms provide lots of benefits when they lead or join the investment rounds. Similarly to Angel investors, VC firms bring industry expertise and insights to the table. They understand the nuances of blockchain, decentralized technologies, and crypto markets. Startups benefit from mentorship, strategic advice, and connections provided by VCs. This guidance can be crucial for navigating the complex Web3 ecosystem. VCs have extensive networks that extend beyond capital. They introduce startups to potential customers, partners, and other investors. VCs have extensive networks that extend beyond capital. They introduce startups to potential customers, partners, and other investors. [9; 16]

What is often considered one of the strongest reasons of going for VC funding is, of course, that VC funding serves as a validation of a startup's potential. It signals confidence to other investors and reduces perceived risk. Furthermore having a reputable VC on board can make it easier to raise additional rounds of funding.

In the same time, being the institutional investors, VC firms experience the tug of regulatory framework, hence Web3 founders should consider the such concerns when considering VC funding as legal uncertainties, that happen because Web3 projects operate in a dynamic regulatory environment where legal technicalities around Web3 fundraising can be complex and unclear and where Government regulations related to Web3 products and services may not provide clear guidelines, leading to uncertainty for founders. In the same time VC funds, unlike Angel investors, have to answer before their Limited Partners. Therefore VC funding involves external investors who seek returns on their investment. Founders worry about balancing investor interests with their vision for the project.

o Ensuring transparency, accountability, and fair treatment of investors is crucial. Sometimes Tokenomics and Timing become additional concerns and some VC firms may pressure startups to launch tokens prematurely. Striking the right balance between token issuance timing and project development may be very challenging even for seasoned founders and advisors as too many factors are at play. Also, such concerns as potential problems with vision alignment between VC and the founder and reputational risks remain. VC firms may influence a startup's roadmap, potentially altering the project's direction. And VC firms are much more sensitive to the reputation of the founders as well as the projects with which they partnered. Some historical scandals can break the deal.

Notable examples of Venture investments in Web3 projects:

1. On July 16, 2021 a large Venture firm a16z / Andreessen Horowitz led the Series B financing round in OpenSea - the world's first and largest digital marketplace for NFTs. \$100M was raised at a valuation of \$1.5B [14]

2. On February 9, 2022 one of the largest Venture firms Sequoia Capital led \$450M investment in the Polygon blockchain network. At the time the Polygon's Market Capitalization exceeded \$13B [15]

Family Offices – another type of institutional investors that are private wealth management entities that oversee and invest the assets of high-net-worth families or individuals. Over the past few years Family offices are becoming more interested in Web3 industry, that is a clear indication that the industry is becoming more mature.

Many advantages and concerns of Family offices are similar to the ones presented for Venture Capital firms, but there are a few differences: For example, Family offices use their own money and don't have to answer to external investors (Limited Partners). Because of that they can make investment decisions more swiftly and are closer to Angel Investors in that regard.

At the same time typically they may not offer the same extensive network as VCs as they often do not specialize on researching industries in which they invest, especially with alternative assets like cryptocurrencies, and just seek to diversify their portfolio.

Notable examples of Family offices investments in Web3 projects:

1. Winklevoss Capital, the crypto-focused family office, joined a \$52M pre-ICO investment round in Filecoin in August 2017 [17]
2. Accretion Capital, a Miami based family office, joined the investment round in Metaverse startup “Somnium Space” in 2022 that totalled in \$2.27M investment. [18]

Initial Coin Offerings – a method of gathering resources for cryptocurrency-related projects that involves the distribution of new cryptocurrency tokens to participants. A project that aims to gather funding initiates an ICO so that anyone can join the fundraising event directly and receive tokens of the project. ICOs were popular during the 2016-2017 period, also known as ICO boom. Large amount of frauds and poorly audited projects made this method of fundraising highly unpopular and over the past few years the preferred alternative for this fundraising method is Initial DEX Offering that we will explore next. ICOs have they own perks, among which are global accessibility as anyone can buy ICO tokens. Unlike

traditional investment methods that may have geographical restrictions, ICOs are open to a global audience. And this accessibility democratizes investment opportunities and allows a diverse range of participants to get involved. Also since ICO tokens can be sold globally, they provide liquidity to investors. Once acquired, these tokens can be traded on various cryptocurrency exchanges. This flexibility allows investors to manage their portfolios more actively and respond to market dynamics. ICO tokens often come with a high liquidity premium. As projects gain traction and tokens become more widely used, their value can appreciate. Probably one of the greatest perk is that unlike traditional stock markets or venture capital, ICOs have less barrier to entry. Investors can participate with relatively small amounts of capital. This inclusivity encourages broader participation and fosters innovation in the crypto space. But ICOs are also associated with the riskiest of all methods described and lots of fraud scandals. Many ICOs are based on early-stage concepts without fully developed businesses or operational plans. That is derived from the lack of Regulation and Investor Protection. ICOs operate in a relatively unregulated environment. Unlike traditional securities offerings, ICOs do not have strict disclosure requirements or investor protections. While the lack of mandatory disclosures and standardization makes ICOs susceptible to fraudulent schemes. Some projects may exaggerate their potential or misrepresent their intentions. Another major concern when dealing with ICOs is that tokens can experience significant price volatility shortly after listing. Investors may face sudden price swings, affecting their investment value. Additionally, liquidity in the secondary market may be limited, making it challenging to exit positions quickly.

And ICOs are also susceptible to Cybersecurity risks because ICOs involve digital assets and smart contracts. Security vulnerabilities in these contracts can lead to hacks, theft, or loss of funds. [13]

Notable examples of successful ICO campaigns:

1. EOS blockchain: Block.one – a company behind the blockchain called EOS raised \$4.1B dollars in its ICO campaign, that was held for almost a year, from June 26, 2017 and until June 1, 2018.

2. Filecoin: it is worth mentioning that soon after the pre-ICO funding round that we brought as an example of Family office investments above, Filecoin launched a successful ICO campaign and raised over \$257M in 2017.

Initial DEX Offerings – an event that is similar to the IPO (Initial Public Offerings) that happens on the stock exchanges, but in this case the offering of tokens is happening on decentralized exchanges (DEX-es). IDO's combine the perks of traditional IPOs with the flexibility of ICOs. In some sense, the startup and investors get “the best of both worlds”, which probably became one of the reasons that IDOs have almost removed ICOs from the public agenda.

Indeed IDOs mitigate lots of risks that are usually associated with ICOs, while preserving almost all benefits, such as leveraging the decentralized nature of blockchain technology, and providing greater accessibility, transparency, and decentralization compared to traditional fundraising methods. Unlike traditional IPOs, IDOs do not require companies to meet stringent regulatory requirements, making them more accessible to small projects and startups. Also, IDOs offer better and immediate liquidity at every price level due to their mechanics when Startups can launch tokens and access funds without waiting for exchange approvals or paying hefty listing fees. What is also valued about IDOs is fairness and community involvement. IDOs are generally considered a fair way to launch a new cryptocurrency project. They avoid pre-mines, which favor project founders over community members, ensuring a more equitable distribution.

While IDOs considered to be much more robust with regards to risks compared to ICOs, they are still susceptible to similar risks and criticism. Among the major concerns about IDOs we can list cybersecurity risks that can be mitigated by robust smart contracts and security audits to protect participants.

Also, there are regulatory uncertainties as the regulatory landscape for IDOs is still evolving, and compliance with local regulations remains a challenge. [20]

Notable examples of successful IDO campaigns:

1. BENQI, a decentralized liquidity protocol built on the Avalanche blockchain, did IDO on Tokensoft launchpad in April 2021 and raised \$3.88M [19]
2. MakiSwap, a decentralized exchange on Binance Smart Chain had a successful IDO campaign on Maker DAO launchpad in May 2021 raising \$1.69M [19]

Liquidity bootstrapping pools – another fundraising strategy unique only to the web3 environment. It involves generating tokens that would take part in a liquidity pool with the goal of decreasing the initial volatility and reducing the effect of large investors (also known as “whales”) from influencing the project with their large stakes.

The main difference to Initial Coin Offerings and Initial DEX Offerings is that while the former focus on raising capital through fixed token prices, liquidity bootstrapping pools prioritize dynamic liquidity pools and transparent token distribution.

Founders who going for this fundraising methods may do so benefit form the equitable token distribution because by distributing tokens to liquidity providers, the project ensures a more equitable distribution. Participants receive tokens in proportion to their contribution, promoting fairness. Unlike centralized token sales (such as initial coin offerings or ICOs), where early whales or large players can dominate, liquidity pool-based issuance spreads ownership across a broader base. Also, what may be very important at an early stage, liquidity pools allow for organic price discovery. As users trade against the pool, the token’s price adjusts based on supply and demand. This process occurs without undue speculation, as the price reflects real trading activity rather than speculative buying or selling. At the same time, the founders who are setting up LBPs should keep in

mind that LBPs involve dynamic token pricing based on supply and demand within the liquidity pool. That causes rapid fluctuations in token prices during the initial phase and can lead to volatility, affecting investor sentiment and project stability.

Also one of the key goals of LBPs is to incentivize the community to engage, but there's a risk that potential investors may not actively engage or participate. Ensuring widespread community involvement remains a challenge, especially when bots dominate the process. And when setting up the LBP managing the liquidity can be a difficult task given limited financial resources or a small team

Examples of Web3 projects that employed LBP launches:

1. Uniswap – one of the first and the largest decentralized exchanges [22]
2. Balancer – an automated portfolio manager and a decentralized exchange that introduced LBP to the world How web3 startups select the optimal funding methods [23]

The selection of funding methods depends on many factors, including the market cycles, regional tendencies and the type of the product developed by the Web3 startup.

Most of these factors are outside of the scope of this paper. However, we will provide two theoretical examples to demonstrate general tendencies.

Case A: first-time Web3 founder, B2B market

Imagine you are a first-time founder, who started a Web3 project developing a tool for developers of other DApps (B2B market). You bootstrapped for your pre-seed round and need to secure some funding to raise a seed round to gain enough financial resources to complete the MVP. What fundraising methods you should aim for?

The optimal solution would be aiming for Venture capital firm to lead the seed round and hopefully have a few other investors, either other VC firms or

family offices, to join the round. The Web3-focused family office would be able to provide the needed guidance and do valuable introductions to other professionals in the industry.

If your product is too groundbreaking, that there is no VC interested to fill in your niche, you may have to seek for an interested Angel investor with experience or personal vision in that niche.

But you should try to avoid Family offices that do not specialize on Web3 in general to lead the investment round, because more often than not family offices are trying to diversify their portfolio with volatile assets when investing in crypto and they are rarely able to provide necessary value or even conduct the proper audit on every particular asset.

You should not go for ICO or IDO at this stage because having little to no exposure to retail market, combined with your still weak reputation in the space a first-time founder may turn out to be a fiasco.

Case B: serial Web3 founder, retail market

Now imagine that you have already successfully conducted an exit with one or even more Web3 startup, you have favorable reputation in Web3 space and your product is a DeFi protocol aimed for the community use. Similarly to Case A, you have successfully bootstrapped funds for the initial development and now planning to start another fundraising campaign. Given the market conditions are favorable, you may go for IDO. Preferably with a reputable launchpad. The some additional promo campaigns you will be able to deliver a strong message to the public that would incentivize them in backing your product. The IDO campaign will ensure that the tokens of the project are well spread among the backers, not giving too big of a share to any single whale, what could be a major concern during some auditing processes in the future. Or alternatively you could just as well go with a reputable Venture Firm that would more easily work with a celebrated founder and probably on better conditions than we saw with Case A, however here you have more choice and more opportunities for maneuver. For instance, as we described in

the examples above, historically some projects go for ICOs or IDOs soon after the private investment rounds with institutional or Angel investors.

Conclusions. Fundraising for startups is as much art as is science. There is never a sure way to succeed and a lot depend on success and personal connections. However, just by following certain patterns, founders increase their chances for success. In Web3 the major principles of fundraising remain the same, however the additional fundraising methods further complicate the decision making process allowing for greater functionality but also greater potential for doing mistakes when choosing the right method or a combination of them. While the volatility of typical assets in the Web3 market complicate the timing even further. Hence it is paramount for the first-time founders of Web3 projects to realistically estimate their opportunities and go for those fundraising options that correspond to the understanding of investors in question. Otherwise there are huge risks of the asset being undervalued and the investor getting inadequate share that not only thwarts the control over the company and reducing the stake of the founders, but also messes up the further fundraising potential of the startup forever.

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