

SmartMoney/Enigma Research Note

August 24th, 2021

SYNTHETIX (\$SNX)

- **TYPE:** Derivatives
- **CHAIN(S):** ETH, Optimism
- **TVL:** \$2.33B
- **FDV:** \$3.11B
- **MARKET CAP:** \$2.28B
- **CONTRACT ADDRESS:**
 - 0xc011a73ee8576fb46f5e1c5751ca3b9fe0af2a6f

PRODUCT OVERVIEW/SUMMARY

Synthetix is a synthetic asset protocol built on Ethereum. The core use case for the Synthetix protocol is to create markets for composable (ERC20) synthetic assets called “synths”. These synths enable investors to get exposure to the returns of various assets without having to hold the actual asset. Synthetic assets are a key product in a derivatives market with trade volume in the hundreds of trillions each year, and particularly important for bootstrapping the DeFi financial system.

Each synthetic asset (Synth) minted on the platform is underwritten by stakers of the native \$SNX token at a ratio of 600%.

With over \$1B in total synths minted and growing volume on their decentralized synth exchange, Kwenta, Synthetix continues solidifying itself as a key “money lego” in the DeFi ecosystem.

HOW IT WORKS

Core to the Synthetix model is an incentive system that encourages \$SNX stakers to lock up capital, creating a collateral pool against which synthetic assets (called synths) can be minted.

All debt underwritten by staked \$SNX is denominated in sUSD, which can then be traded via Synthetix' Kwenta exchange to any other token. Synth markets include currencies (\$sYen, \$sJPY), commodities (\$sXAU) and securities (\$sAMZN, \$sTSLA, \$sNFLX). Chainlink (\$LINK) oracles are used for maintaining the prices of these synthetic assets. \$sETH, \$sUSD and \$sBTC account for 78% of the synth market currently.

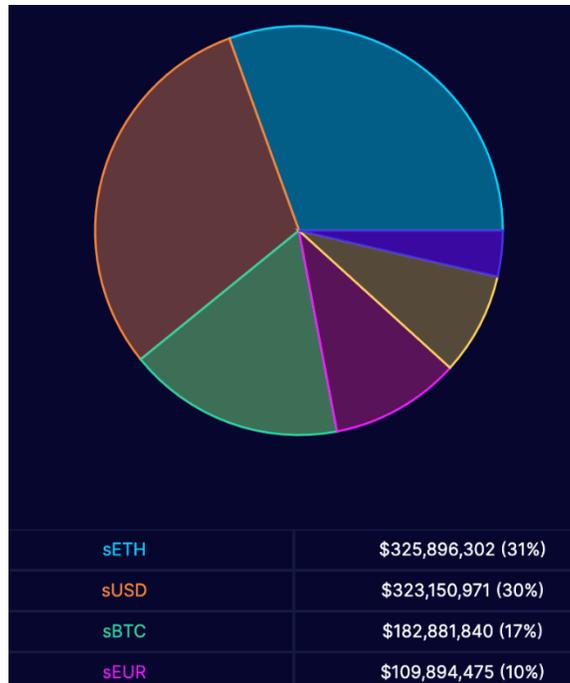


Chart: stats.synthetix.io

\$SNX stakers manage their positions via Synthetix's dapp, Mintr, and stakers must manually manage their collateralization ratio on Mintr by minting or burning \$sUSD. The amount of debt taken on by a user may not be constant, as a user's debt position can increase or decrease with the supply of Synths and their relative exchange rates.

While a 600% collateralization ratio may appear overly cautious, it's set to be capital inefficient for a reason. By underwriting the the liquidity for an entire ecosystem of synths, it allows users to trade with low slippage in a currently thinly traded market without a counterparty.

This pooled collateralization model is the key to bootstrapping the ecosystem.

TOKENOMICS AND MONETARY POLICY

To encourage the locking up of \$SNX to secure the platform, stakers are compensated with exchange fees from Synth trading revenue as well as governance token rewards to subsidize lower volume in the early years.

SNX stakers are entitled to a pro-rata distribution of weekly \$SNX staking rewards pool and the \$sUSD fee pool. The #SNX rewards are currently generating 16.92% APY in the native governance token, while the exchange fee pool contributes another 2.36% in \$sUSD yield, for a blended 19.29 APY for \$SNX stakers. Users must maintain their 600% collateralization ratio or they will not be able to claim periodic rewards. Synthetix' inflation model has a weekly decay rate of 1.25% until September 2023 at which point the inflation rate will stay permanently at 2.5% annually.

For all trades on the Kwenta exchange, transaction fees that range between 10-100 bps are sent to the fee pool, which SNX stakers can claim weekly on a pro-rata basis relative to their outstanding Synthetix debt.

As the chart of Kwenta’s trade volume shows, there is steady long term growth that suggests exchange trading fee pool could become more substantial and thus a more lucrative aspect of returns to stakers over time.

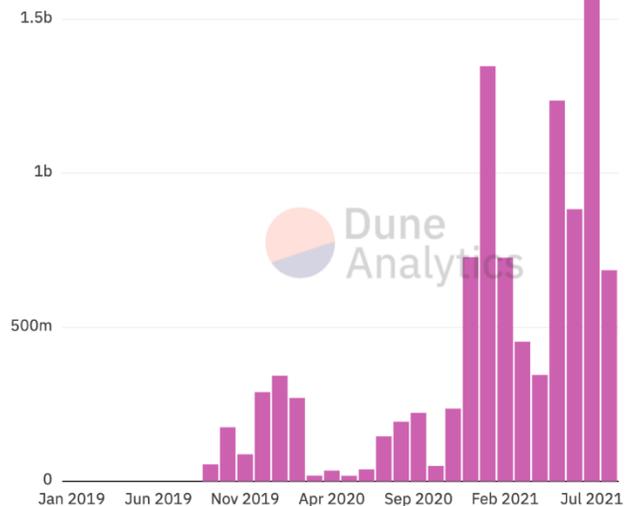


Chart via Dune Analytics.

WHY IT’S INTERESTING

Synthetix is a legitimate pioneer in crypto-economic systems, and the Synthetix ecosystem is a tribute to a long term vision to enable ERC20 synthetic assets. But Synthetix didn’t start as a synthetic asset protocol, and endured a significant pivot from their origins as a stablecoin project called Haven.

Ironically, while Synthetix has made substantial progress towards the tall task of creating a viable decentralized synthetic asset protocol, the supply of \$sUSD may be Synthetix’ most tangible traction to date.

With \$300M in market capitalization, \$sUSD is one of the largest truly decentralized stablecoins in existence, with each \$sUSD fully collateralized by \$SNX. While \$DAI remains decentralized in design, a substantial percentage of its issuance is backed by \$USDC, which is a centralized, fiat-backed stablecoin. Having truly decentralized stablecoins remains critical to the stability of the DeFi ecosystem during the coming regulatory uncertainty.

#	ASSET <input type="text"/>	PRICE (USD)	REPORTED MARKETCAP	REAL VOLUME (24H)
1	Tether · USDT	\$1.00	\$64.30B	\$23.29B
2	USD Coin · USDC	\$1.00	\$27.33B	\$1.12B
3	Binance USD · BUSD	\$1.00	\$12.02B	\$4.06B
4	Dai · DAI	\$1.00	\$5.92B	\$179M
5	TerraUSD · UST	\$1.01	\$2.21B	\$10.09M
6	Fei Protocol · FEI	\$0.997	\$2.05B	\$28.50M
7	TrueUSD · TUSD	\$1.00	\$1.36B	\$21.08M
8	Paxos Standard Token · PAX	\$1.00	\$952M	\$23.19M
9	HUSD · HUSD	\$1.00	\$490M	\$25.27M
10	Neutrino Dollar · USDN	\$0.995	\$468M	\$918.83
11	Synthetix USD · SUSD	\$1.00	\$300M	\$2.84M
12	FRAX · FRAX	\$1.00	\$279M	\$4.88M
13	Gemini Dollar · GUSD	\$0.998	\$196M	\$0.65M

Chart via Messari.

SNX CONTINUES TO BE A TRUE PIONEER IN DeFi

As mentioned above, Synthetix' innovative pooled liquidity model was a true innovation in crypto-economics. But Synthetix boasts many innovations which reinforce their reputation as an innovator and ability to execute.

L2 and Options

Synthetix was one of the earliest integrations of Optimism for layer 2, something that became a priority as gas fees made claiming staking rewards unprofitable for retail investors. Synthetix Optimism exchange initially supported synthetic \$ETH (\$sETH), synthetic Bitcoin (\$sBTC), and synthetic \$LINK (\$sLINK), with naturally occurring shorts.

Synthetix also launched one of the earliest decentralized binary options markets, although that product has not gotten notable adoption to date.

Layered liquidity mining rewards

Because Synthetix and Curve were both incentivizing liquidity for stable asset pools, a natural strategic alliance emerged to incentivize Curve pools that included \$sUSD, \$sETH and \$sBTC. Liquidity providers received liquidity mining rewards in both \$SNX and \$CRV, and resulted in deep liquidity for Synthetix' most important synths.

Staking rewards contracts

Many of the early implementations of DeFi liquidity mining programs were based on Synthetix' incentive design. In fact, the actual Synthetix liquidity mining and rewards distribution contracts have been forked and re-used to bootstrap many prominent DeFi projects. Thus, Synthetix' code exists all over DeFi, and most investors who have participated in liquidity mining programs have unknowingly used forked Synthetix code.

COMPETITION

Although the open source nature of DeFi often lends itself to countless copycats and competitors alike, Synthetix has a much smaller competitor set, likely a result of the difficulty of bootstrapping a liquid synthetic asset protocol.

Because bootstrapping a liquid synthetic asset protocol is so difficult, Synthetix has fewer direct competitors. The largest and most relevant competitor, Mirror Protocol, focuses on US equities markets using a 150% collateral ratio model. Mirror is built on the Terra blockchain, and partners with BAND for price oracles and partners with Injective Protocol for the derivatives exchange.



Chart via DeFiLlama.com.



Chart via DeFiLlama.com.

The key difference between the two projects is that \$SNX is the core collateral on Synthetix, while Mirror uses \$tUSD, the native stablecoin of the Terra blockchain, among other tAssets. Because \$SNX is subject to more volatility than stablecoins and most other tAssets, Synthetix requires the 600% collateral ratio versus a more capital efficient 150% collateral ratio on Mirror.

As the above charts show, Mirror is competitive on total value locked (TVL), but doesn't show the same growth curve that you'd like to see for an early stage project.

Synthetix has an early, but not material, lead in TVL, and ranks as the 18th largest protocol by TVL.

15	 Uniswap v3 (UNI)		-	+12.45%	\$2.7b
16	 Anchor (ANC)		-5.05%	+46.48%	\$2.5b
17	 Liquity (LQTY)		-0.23%	+0.72%	\$2.31b
18	 Synthetix (SNX)		+5.14%	+3.52%	\$2.28b
19	 hBTC (hBTC)		+0.71%	+5.03%	\$1.96b
20	 MDEX (MDX)		-0.21%	-	\$1.88b
21	 Alpaca Finance ...		+3.12%	+13.20%	\$1.75b
22	 Mirror (MIR)		-1.16%	+3.87%	\$1.73b
23	 Bancor (BNT)		-0.14%	+0.98%	\$1.65b

Chart via DeFiLlama.com.

The lack of competition, relative to other areas of DeFi, is a reflection of the difficulty in creating a decentralized and liquidity synthetic asset market.

RECOMMENDATIONS

\$SNX is an interesting asset that has traded sideways after a period of rapid growth during the DeFi summer of 2020.

Synthetix has tremendous potential at scale, and thus gives the token value as a speculative instrument, a market leader at this formative stage. However, it's too early to know for sure whether Synthetix or Mirror has the approach that will end up winning the market, and whether network effects will dictate that this is a winner take all market.

All evidence so far suggests that DeFi does not trend towards winner-take-all dynamics, so we expect Synthetix to remain a leading platform for synthetic assets regardless, but we can't accurately forecast when the fundamentals of the token model will be sustainable beyond inflationary token incentives. If the exchange volume trading doesn't scale before the inflationary rewards decrease to a certain point, how would that impact \$SNX price?

As the chart below shows, revenue growth has been sporadic, although annualized protocol revenue is now up to \$50M.

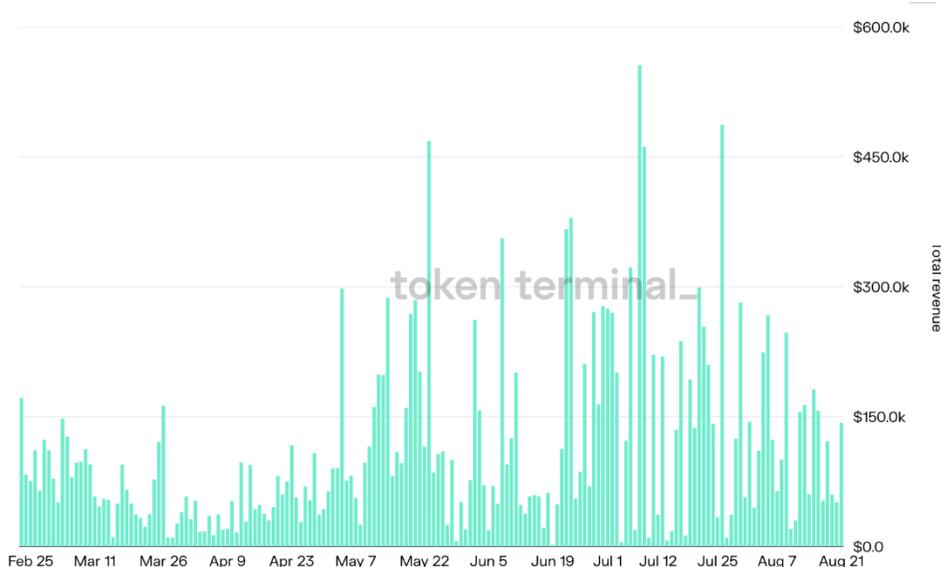


Chart via TokenTerminal.com.

For those reasons, and confidence in one of the best teams and communities in DeFi, we're bullish on Synthetix in the long term. However, the immediate fundamentals are less certain, and we expect \$SNX will trade along with a DeFi index in the short term.

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