De-Coding Crypto

Weekly Analysis

Whither Canaan?

December 18, 2019

In this week's issue, we take a deep dive into recently Nasdaq-listed cryptocurrency mining hardware firm Canaan, looking at what's behind its decline in valuation post-IPO and assessing what it means for cryptocurrency prices more broadly.

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Our Market View

May you live in interesting times. A very ugly week overall, with BTC seeing repeatedly sharp downwards movements, and alts tracking historically aggressively to the downside to the tune of generally doubling BTC's losses. What has been interesting, however, is that the pattern has essentially been the inverse of the one that developed across the late end of Q3 and most of Q4 - downward pressure has been concentrated in European and North American trading hours, with some measure of relief then coming from Asia.

It does seem to us that movement has been driven far more than anything else by an extremely belated panic in Western markets in response to explanations of the November bleed (with selling pressure from the proceeds of the PlusToken ponzi being widely blamed); while this drop below $7000 has lasted longer than the matter of hours that the ones in late November did, and may end up going steeper, we still see a move back up and above as more likely than unlikely in the medium-term.

Please direct all queries about this week's research to jedwards@enigma-securities.io.

Major

Ticker	Price	7D	1M	6M	12M	Cap
BTC	6594.01	-9.02%	-19.68%	-38.29%	66.90%	119.4B
ETH	121.85	-16.38%	-31.84%	-60.57%	-6.09%	13.28B
XRP	0.180886	-18.50%	-28.68%	-61.89%	-50.97%	7.83B
BCH	174.451	-15.62%	-29.56%	-63.59%	-10.78%	3.17B
LTC	37.0247	-16.45%	-33.83%	-73.84%	11.83%	2.36B
EOS	2.21248	-15.31%	-30.31%	-70.46%	-21.30%	2.09B

Whither Canaan?

When the first reports came out back in May 2018 that Canaan, the second-biggest global producer of cryptocurrency mining hardware behind Bitmain, was planning an IPO in the near future on a ten-digit valuation, sentiment was euphoric. When the second reports came out in January 2019, sentiment was decidedly more muted. When it finally happened in November, one needed a stethoscope to scope out whether there was any sentiment left.

It has been a long road to IPO and public listing for Canaan. It has still been a shorter road than for most crypto-centric businesses with similar designs; Bitmain, their lead competitor, has been through a similar succession of IPO rumours, with reports surfacing in October of a Deutsche Bank-backed filing with the SEC (though this has yet to materialise into even an official prospectus). Across the industry, while a handful of businesses with crypto at their core have gone public in one way or another, it remains exception far more than rule.

For the few that were paying attention in November, the mood for the most part was cautiously optimistic. This has not, so far, borne out:

Credit: Tradingview.

After IPOing at $9 (and very briefly reaching above that in the first few minutes of trading), Canaan found itself hovering barely above $4.50 at one point on Tuesday. It actually made a slightly recovery on the day, albeit still closing below its position on the previous Friday.

Such a drawdown is of course worrying in isolation, but what makes it stand out in the world of cryptocurrency - a world where every asset seems to undergo a 90% drawdown at some point - is that the IPO price and valuation already represented a significant drawdown. The 2018 rumours posited a $1b raise; by the preliminary IPO filing, this was down to $400m, then $100m after the prospectus update in mid-November, and $90m on the day itself. The drop in the extrapolated valuation was not as drastic (with the $90m-$100m based on a 6-7% offering), but still meant a reduction from the $3b figure being bandied around in 2018 to around $1.5b.

Not a successful launch, and while it’s possible that Tuesday may be the start of at least a limited reversal, that remains far from certain; in any case, not all appears to be well with Canaan, which raises the questions: what should we make of that, and are there any broader implications for crypto?

First, we should look at the Canaan IPO itself. Our stance has leaned more sceptical than the consensus on the Canaan IPO since the prospectus release, as laid out in our November 13th issue. Our major argument at that time was this:

> General consensus has been positive on this news; we are a little more cautious. Revenue was higher than the previous three quarters combined, but still below Q2 2018. While it is above Q3 2018, if we take the listed change in market share (15.3% in 2018 -> 21.9% in 2019) to be roughly accurate, it would imply in the median a small contraction in the total market in the respective quarters - concerning given that between an exploding hash rate and the sheer proportional increase in power and efficiency of 2019's new products (and the implications for older staple rigs finally being pushed out of the market), we would tend to expect a decent overall increase in sales across the market even being further removed from the warmth of the 2017 boom. We are at this point extremely worried about what the details of the Bitmain IPO may show when published.

Speaking more specifically on Canaan itself, the prospectus did not lay out a completely terrible situation for the company, but there were issues. Revenues had grown significantly towards the end of the year, and the company made a reasonable gross profit of $22m across the first three quarters, but still lagged heavily behind both 2017 and 2018, and overall turned a comprehensive loss of $31m after comprehensive profits of $8m in 2018 and $53m in 2017.

Furthermore, this was actually the first time in five quarters that the company had turned any sort of quarterly profit; sales were solid until the very end of 2018, but margins were thin and other expenses wiped out profits:

All figures in mil. RMB

ER 18/12/19: $1 = 7.00 RMB

Quarter	Net revenue	Gross profit/loss	Total comp. P/L
Q317	391	202	165
Q417	534	244	139
Q118	1069	786	649
Q218	878	-338	-470
Q318	481	49	-96
Q418	278	12	-25
Q119	47	0	-49
Q219	242	11	-266
Q319	671	146	91

Data: Canaan IPO filing

Of course, loss-making IPOs have become more common than not; a Goldman Sachs report in September had the proportion of profit-making IPOs at just 24% in 2019, and the comprehensive loss this year can primarily be attributed to a near-tripling of "general and administrative expenses" from $16m to $41m. Of that loss, a full $30m was because of an one-off of 'share-based compensation expenses' in Q2; without that, the company would have essentially broken even with Q4 still to come. Put simply, this was a company that had already proven it could turn a profit, it had maintained market share in what most still expect to be a growth sector growing forward, and therefore could be reasonably expected to return to profitability in the future.

This did, however, leave a few major issues, and above all else, there is the aforementioned question of the doubts over whether crypto mining is really a growth sector. Yes, interest in cryptocurrency in 2019 in general did not reach the peaks of 2018; but negative sector-wide growth on primary sales is of significant concern given the respective technology in both cases (2018 being a relatively quiet year for gains in hardware efficiency, reducing demand from existing miners but also aiding secondary markets, and 2019 marking the release of the first generation of 8nm-based cards and therefore the approaching forced obsolence of 2016/2017's 16nm-based cards).

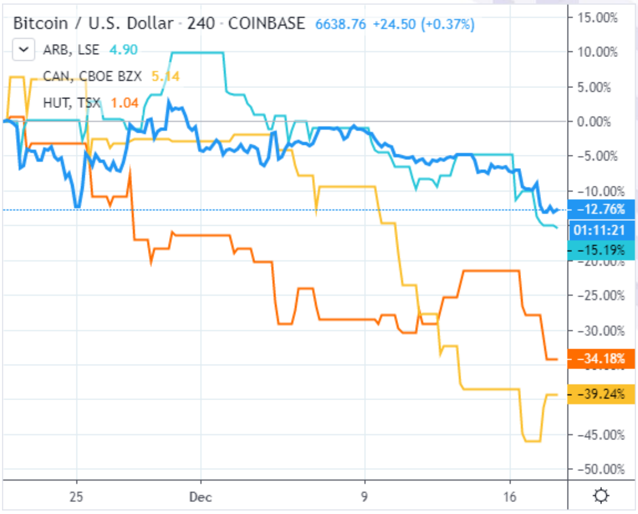
The full-year figures may still see some sector growth. The aforementioned first lines of 8nm cards shipped in August and September, for revenues of approximately $91m (as opposed to $38m, $7m, and $34m respectively in the three preceding quarters), and future sales projections depend on what priority miners put on acquiring said cards as early as possible; with a large number of mining operations both inside and outside of China still dependent on singular electricity sources (typically hydroelectric), and said sources mostly having lower yields and higher prices during the winter, it's possible that more orders than expected are being delayed until Q4 2019 (or Q1 2020). However, in any case, the current evidence is not particularly promising; the data currently available does not paint a picture of explosive potential growth.

Bringing it back around, what does Canaan's decline mean? In the first place, for Canaan itself, our feeling was that the IPO perhaps represented an overvaluation, though we are somewhat surprised to see it fall as far as it has; even at the implied valuation of $1.5b, a P/E of 15 or below would require a profit of $100m a year, which doesn't seem outside the realm of possibility going forward short-term looking back to performance in Q3/Q4 2017 for instance. Nevertheless, it is not difficult to make the case for the Canaan collapse almost purely on the overvaluation and merits (or lack thereof) of Canaan itself.

The bigger question, of course, is what it augurs for cryptocurrency more generally. The natural - and generally correct, in our experience - tendency is to draw a close linkage between the fortunes and sentiments of miners and mining firms, and the health of cryptocurrency as a whole. Prior to Canaan, the biggest listed firm in the crypto mining sector was Hut 8 on the TSX, and the long-term relationship between itself and the BTC price is fairly visible; this is the picture for 2019 as a whole, for instance:

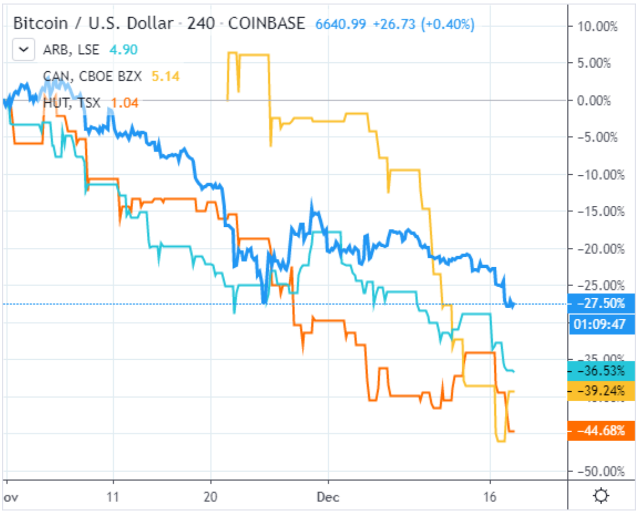
Credit: Tradingview.

Comparing the post-IPO Canaan movement to the two biggest listed miners (Hut 8, as mentioned, and Argo Blockchain, a London-listed firm), as well as BTC, we see this from the date of the Canaan IPO:



Credit: Tradingview. Canaan in yellow, Hut 8 in orange, Argo Blockchain in turquoise.

This from the start of November:



Credit: Tradingview. Canaan in yellow, Hut 8 in orange, Argo Blockchain in turquoise.

Is Canaan tracking down isolated? Clearly not entirely; it has tracked far more aggressively than BTC or other mining firms to the downside, though it should be noted that this came starting from an IPO price that was not necessarily reflective of the true state of the market even at its heavily reduced level. However, we can see that all three mining firms have themselves outrode BTC on the way down.

This raises the next question: should we be worried about the state of the crypto mining industry in the short term, and especially insofar as it could relate to more general price implications for crypto? On the former point, we think a lot remains to be seen. It does make perfect sense for mining firms to be disproportionately affected by moves like seen in Q4; the baseline cost of production is high enough even for large-scale producers that downwards movements of relatively small magnitude (by historical standards) have an outsized effect on profitability.

Speaking more generally, our tendency is to think that Q1 2020 will provide much more clarity to this, but there are certainly early warning signs now flashing of reduced confidence in the mining industry – while a 2018-style decline in hash rate has in the end been avoided, Thursday's difficulty update is likely to be just about flat, and expectations are going to skew to needing to see significant positive action in that regard as we go into the new year. Any signifiers of weaker-than-expected uptake of new model could very quickly ripple out into panic coming in the halving.

What we're reading

HTC to Increase Focus on Blockchain Phones, AI After New Staff Cuts (Coindesk): A surprising little note of sunshine in contrast to our Canaan/mining negativity. HTC has not had a good time of it over the last couple of years, and find themselves in an industry and a region (consumer electronics/East Asia) where the top of the cycle has already come and gone; their forays into blockchain are an existential bet rather than mere fancy. Given HTC's past track record on making the right call on when to go all-in on an emerging market, it's a nice sign if nothing else.

Chinese Court Freezes $676K in Assets of Bitmain Manufacturing Subsidiary (Cointelegraph): Worth remembering this: the biggest threat to Bitmain isn't its internal problems (as myriad as they're rumoured to be), it's the possibility that it might lose the favour of the party and of the authorities. This doesn't exactly signal a sea change in itself, but like with the Binance/Huobi/OKCoin situations, important to keep an eye on.

Kraken OTC Acquires Circle Trade (Kraken): Will be very interesting to see what comes out of this, particularly in terms of valuation. Circle had lost a lot of OTC staff over the last year or so anyway, so whatever price comes out at this point has to be based on the technology and the reputation more than anything else.

PlusToken Scammers Didn't Just Steal $2+ Billion Worth of Cryptocurrency. They May Also Be Driving Down the Price of Bitcoin. (Chainalysis): Some critiques can be made, but overall, the Chainalysis piece on the PlusToken scam gives a good overview of the circumstances regarding the PlusToken dump (and ensuing downwards pressure on the markets at points in Q3 and Q4). Very important point to note: "As of now, at least 20,000 Bitcoin — nearly $150,000,000 USD worth — has yet to be cashed out." - by most accounts, movement of coins slowed dramatically in early December, a week or two after the PlusToken issue began to be widely brought to attention among the crypto community. This is why we still tend to think that the sell-offs of the last week aren't quite of the same character as seemingly similar ones across the latter half of the year.

UK's Oldest Crypto Exchange to Delist Ethereum and Focus Solely on Bitcoin (Coindesk): Expect to see a surprising amount of moves like this from small exchanges in 2020. Volumes and liquidity on non-BTC products tend to be low enough proportionally as to make said exchanges of very little utility even for pure retail customers, and the staking trend will only serve to further push such customers exclusively towards the Binances and Coinbases of the world.

OKEx Debuts Dai Stablecoin Staking Bonus as Tether Dwarfs Volumes (Cointelegraph): Speaking of staking, worth remembering that stablecoin staking is also a trend to watch. Even if it can't carry the same promises as the XTZs of the world, it's another tool for exchanges to wield in a consolidating market.

Happy holidays to all, and until next time – thank you for reading.

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