# Outline



# Summary


- In response to the blog post by the dYdX Foundation, Steakhouse Financial would like to tender a proposal to create a treasury SubDAO. In this post, we share our views on treasury management and provide our initial financial assessment of dYdX to encourage community discussion on the dYdX Chain treasury.
- As dYdX reaches the next stage of its evolution, we believe dYdX and the community should begin to plan funding the protocol's growth initiatives and OpEx from revenues as much as possible, rather than relying on token issuance from the community treasury.
- Currently, we think dYdX's fees are over-indexed on rewards to staked token holders (i.e. paying for security), which currently constitute 100% of gross trading fees. This means that growth and OpEx spend are financed through token dilution, suppressing dYdX token price.
- In our view, the community can benefit from reviewing capital allocation decisions between growth spend/incentives, security, and operating expenses to ensure sustainable financial resourcing for protocol growth.
- We welcome feedback on our analysis and proposal to create a treasury subDAO to support a more economically sustainable future for the dYdX community. Our intention thereafter is to follow up with a formal proposal including scope and our terms of engagement.


# Steakhouse's General View on Treasury Management

The house view at Steakhouse Financial is that 'treasury management' is a subset of the finance function whose purpose is to collaborate with the operations team in order to achieve an organization's business objectives. Such activities typically include financial planning & analysis (FP&A), financial reporting, and capital allocation in partnership with the leadership team (internal and external). Treasury management falls in the latter capital allocation category (external) and its strategies should be simple, and serve to support the operations of the organization.

We believe that decentralized projects achieve economic success over the long term by improving their sustainable ROI (Return on Investment) on tokens spent. The treasury management function is a crucial part of ensuring that issuance of incremental token is put towards generating the maximum amount of sustainable revenues.

Below, we outline our framework for maximizing ROI for projects at different maturity stages. With protocol-market fit established in the on-chain perps market, dYdX has entered or is entering the expansion and scale-up phase. During this phase, the suitable financial strategy in our view would prioritize funding initiatives organically through protocol fees over token issuance, the latter of which is the most expensive form of financing. While this shift won't happen overnight, the objective of increasing internal funding over token funding guides our capital allocation proposal for dYdX and the treasury SubDAO.

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# Protocol Economics Overview

### A leading decentralized perps exchange

Perpetual futures are a popular derivative useful for traders looking to take directional views on the market as well as hedge other financial exposures more efficiently and on a rolling basis relative to other trading instruments. Traditional centralized exchanges often offer deep liquidity from exposure to many market participants, but at the cost of counterparty risk in having to hold either collateral or margin positions on a centralized venue. dYdX's key value proposition relative to centralized exchanges is its security, guaranteed by a strong distributed network of validators, allowing users to use perps in a self-custodial manner without sacrificing access to liquidity or long-tail trading pairs.

### Competition is intensifying

dYdX is the OG perps protocol and has generally defended market share relatively well in a fragmenting market. The exception has been against Hyperliquid which has been growing rapidly from enabling a smooth user experience and a highly anticipated airdrop.

The Hyperliquid L1 is custom built with emphasis on high performance. Currently the token launch and airdrop may mean users metrics could be inflated. Sustainable level is still TBD after the token launches. As of June 2024, dYdX (v4) has lost its volume leadership position to Hyperliquid: dYdX has ~25% market share of Perps trading volumes vs. Hyperliquid's 36% (Source: Artemis.xyz).

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Perp market volumes and share

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Further, our suspicion is that dYdX is used more by institutional players with higher tickets and volumes vs. Hyperliquid which seems more widely used by retail:

- dYdX has <1000 unique traders, with average trading volume per user at ~$1.5m.
- Hyperliquid has >10,000 unique traders, with average trading volume per user ~$150k.

There are pros and cons to being more institutional-focused. Pros are potentially higher quality of fees (i.e. institutional demand is likely less fickle/cyclical than retail), but higher reliance on a small number of users could make fees more volatile, should key participants decide to trade on another platform.

### dYdX's P&L Construction

dYdX earns gross trading fees from taker volumes, and reimburses market makers as a reward for providing liquidity to the order book. The net figure, 'gross trading fees', are essentially the protocol's revenues.

Expenses wise, there is a growth spend to reward LPs and traders, usually paid out in DYDX tokens (i.e. source of token dilution). It is worth noting that this figure has been gradually declining following various governance proposals (e.g. proposal to reduce LP rewards in favor of paying out maker fee reimbursements).

As a sovereign L1 chain, dYdX also pays its validators (staked token holders) for security. This expense has been the single largest cost item for the protocol, currently equating to 100% of gross trading fees. As such, gross margin, which we define as net trading fees after payment for security, has been running consistently negative, with operating expenses needing to be financed through token sales.

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dYdX P&L Schema

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dYdX Monthly P&L Estimate

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In the above illustrative P&L, we make simplifying assumptions to facilitate the discussion points:

- Neglecting DYDX rewards for stakers (minimal)
- Excludes investor unlocks, while grants to Operations subDAO / Foundation and team unlocks are ‘operating expenses’
- Assuming LP incentives and trading incentives are ‘growth’, for historical view we rolled the dollar amounts for simplicity
- Trading fees and security rewards taken from mintscan

Following our schema for dYdX’s business model, a few insights emerge:

- Gross trading fee generation is healthy despite market share losses
- Investments should be capable of offsetting DYDX dilution to cover for growth and protocol development
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- Excluding investor unlocks, there is a significant degree of overhang from team allocations that we are accounting for as ‘operating expenses’ on the premise that they are there to reward long-term contributions
- There has been significant investment in growth through trading & LP incentives but these have not been able to stymie market share losses to new entrants
- It is worth calibrating stable market share once token generation events for competitors come and go to avoid overspending if there is a whiplash effect, once the TGE-anticipatory demand wears off
- We need to understand the sensitivity of taker fees to incentives before making any business model recommendations
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- Pure protocol OpEx for development and maintenance is within reasonable ARR ranges for peer DeFi protocols (Aave at 20-30% ARR, Maker DAO at ±40% ARR)
- Security is over-indexed and is currently soaking up 100% of gross trading fees (i.e. 200% of net trading fees after accounting for above-the-line growth investments)
- We need to understand the sensitivity that must be possible to incentivize ‘enough’ security while reducing the amount of trading fees that go to validators
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The important business model adjustment to make, in our view, is to find a sustainable level of cost of revenue (growth) and cost of goods (security) such that in the steady state, the protocol can grow at a healthy gross margin and accrue a positive cash surplus.

The below comparison is an illustrative (fake numbers) schema. Conceptually, the protocol can justify going through a phase of negative gross margin to subsidize user acquisition. However, if its cost of goods equivalent (security) is too high, when growth investments eventually taper off, the protocol reaches a long-term unsustainable end-point. There is another confounding factor, in that the growth investments are all dilutive to token holders, so if they generate a lower rate of return over surplus relative to the dilution, it is technically value dilutive to all token holders.

The goal should be to calibrate the cost of goods today, such that in a future when growth investments taper off and a steady state is found, the protocol can generate a sustainable gross margin surplus.

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On the tokenomics side, between investor & team unlocks (which began in December 2023) and the growth spend that is financed by the DYDX token, circulating supply has increased meaningfully. It is worth noting that as of August 1, 2024, 73.3% (366,666,667) of investor and team tokens have been unlocked and 91.6M DYDX (i.e. 9.16% of max supply) will unlock in the next 12 months. In terms of community spending, the community treasury currently contains 102.0M vested DYDX that can be spent through a dYdX Chain governance proposal and 64.4M DYDX (i.e. 6.44% of max supply) will vest in the community treasury over the next 12 months.

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The engine for driving protocol revenues to the protocol are trading fees that users pay to enter into positions. These gross revenues must then be balanced between capital allocation decisions. The overarching categories of allocation are:

1. Reinvesting for growth
2. Returning capital to token holders
3. Accumulating surplus

As part of these, the decision space that dYdX has includes:

1. Growth of the protocol
2. Grow the top of funnel for generating more trading fees
3. Grow the top of funnel for generating more trading fees
4. Cost-of-goods for the network
5. Find the optimal rate for compensating validators (staked token holders) without compromising decentralization
6. Find the optimal rate for compensating validators (staked token holders) without compromising decentralization
7. Operating expenses
8. Fund development, maintenance and operating expenditures for innovation
9. Fund development, maintenance and operating expenditures for innovation

Today, this capital allocation decision is currently being allocated as follows.

1. Growth initiatives are typically invested through DYDX dilution
2. This is a reasonable investment if the return to excess profits is greater than the dilution incurred (accretive), otherwise it is net dilutive to existing DYDX holders
3. This is a reasonable investment if the return to excess profits is greater than the dilution incurred (accretive), otherwise it is net dilutive to existing DYDX holders

4. Security is likely over-indexed
5. 100% of protocol fees are redirected to DYDX stakers in exchange for 'security' writ large
6. Any Treasury subDAO should lead research to determine what the optimal level of security is and find a suitable level of compensation
7. Roughly speaking, we can consider this an indirect 'COGS' rather than below-the-line interest expense, as security is paramount for dYdX to generate trading fees, i.e. each $1 of trading fees is generated because there is some amount of security behind it
8. 100% of protocol fees are redirected to DYDX stakers in exchange for 'security' writ large
9. Any Treasury subDAO should lead research to determine what the optimal level of security is and find a suitable level of compensation
10. Roughly speaking, we can consider this an indirect 'COGS' rather than below-the-line interest expense, as security is paramount for dYdX to generate trading fees, i.e. each $1 of trading fees is generated because there is some amount of security behind it
11. Operating expenses are similarly dilutive
12. For the purpose of simplicity, we consider three major constituents as community treasury funding recipients that provide stewardship, infrastructure, maintenance, growth and innovation:
13. dYdX Foundation
14. Operations subDAO
15. Grants
16. dYdX Foundation
17. Operations subDAO
18. Grants
19. For the purpose of simplicity, we consider three major constituents as community treasury funding recipients that provide stewardship, infrastructure, maintenance, growth and innovation:
20. dYdX Foundation
21. Operations subDAO
22. Grants
23. dYdX Foundation
24. Operations subDAO
25. Grants

### Can and should dYdX seed an endowment to cover for operating costs going forward?

The theory of the endowment model is that in the long-run, operating expenses could be funded indefinitely from a Treasury that can pay for operating expenses out of the endowment return. The ideal end-state would be that the endowment could cover the spending needs of the DAO at around 4-5% of the endowment's size. Currently, dYdX's annualized operating expenses are approximately $30m, including grants, subDAOs and the Foundation.

A reasonable target return for endowments is 7-8%, 4-5% to cover operational expenses, 2-3% for inflation, and 0.5-1% for administrative expenses. We look to Angle's stUSD as an illustrative example for 30D trailing APR of 8.24%, as it transparently and efficiently offers the larger of DeFi lending rates or SOFR, with strong liquidity guarantees enforced by programmatic asset-liability management modules. Full disclosure, Steakhouse Financial advises Angle on the asset-liability management of USDA.

This means that the endowment target size should be approximately $30m / 8.24% = $364m. Needless to say, this is an extremely ambitious target for endowment size.

We believe that the solution here should be to find a source for seeding the endowment without causing undue pressure on token holder dilution, while feeding in gross profit into the endowment that grantees can draw from. Structurally, you could enact this with optimistic governance-type contracts, such as the Lido EasyTrack model, to allow grantees to pull from pre-approved budget limits while allowing protocol gross margin to flow into the Treasury contract continuously after paying for security.

The structure of this endowment could be wrapped in a Cayman Foundation, based on the recommendation from the dYdX Foundation, with estimated setup costs in the $50k range at a maximum, after accounting for director fees. We have experience navigating and setting up structures of this kind for various protocols, with external directors and a line of accountability to DAO token holders through the Foundation's articles of association.

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No management fee is necessary for a minimalist setup of this nature that follows the benchmark.

### Can dYdX seed a smaller, tactical, endowment with 2-3 years of operating expenses?

The problem is more solvable, though all of the considerations regarding dYdX's revenue distribution model remain urgent to solve. Assuming a revised revenue distribution model, dYdX can likely continue to fund operations with minimal dYdX token dilution, assuming a larger portion of the unstaked DYDX tokens in the community treasury are staked.

The exact amount of DYDX tokens to diversify the treasury will be dependent on the timing of the operating expenses, revenue forecast, and risk appetite of the dYdX community. Given the significant cash flow distributed to dYdX stakers, staking the dYdX remains an attractive albeit risky strategy from a principle perspective.

Ultimately, the treasury strategy will be highly dependent on whether dYdX seeks to build an endowment or an operating organization. The former would have higher risk and returns, targeting 7-8%+, while the latter would take minimal risk and target yield to match SOFR (currently 5.35% and anticipated to fall) with a high degree of liquidity to support operational flexibility.

Regardless of the amount of DYDX tokens to be diversified, we would recommend reaching out to token holders unlocking in the coming months to persuade them to remain committed to the project through growth and innovation and participate in future upside.

### How should dYdX align its tokenomics for growth?

We are of the opinion that fundamentals ought to be strong for any tokenomics changes to be long-term beneficial to a project. We approach the projects that we are involved in with the overarching objective of helping drive attractive long-term token performance via sustainable ROI improvements.

At the high level for tokenomics, this means instituting a ROI orientation on incentive spending, conservative treasury management that provides multi-year runway, and finally (should there be surplus capital), evaluating various value accrual strategies that are suitable for the protocol and its jurisdictions.

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# About Steakhouse Financial

### A short introduction to the entity or individual who is interested in becoming a member of the subDAO

Steakhouse Financial is a boutique advisory firm that provides financial consulting services to a variety of DAOs, Stablecoins, and other crypto projects. Steakhouse helps organizations harness the power of public blockchains by designing on-chain financial infrastructure, creating blockchain-based financial reporting, and providing strategic advisory services tailored to the needs of the client. We are leaders in financial advisory and are known for creating some of the first widely used blockchain-based financial statements and financial reports dating back to early 2021.

### Key information regarding previous experience in overseeing financial assets (especially in DeFi) and/or managing other DAOs' treasury

We actively report on and monitor MakerDAO's >$2.5bn RWA portfolio and protocol financials,ENS's >$100mm endowment, as well as Arbitrum's RWA portfolio. We are currently organizing thelargest ever RFP for tokenized public securities products which will seek to allocate up to $1bn of these assets as collateral for MakerDAO's Dai. We also perform comprehensive commercial risk and legal assessments for private credit transactions.

## Proposed key results, performance reporting, and its cadence

We helped drive Maker's average earnings assets from ~30% in Q4 2022 to >90% in mid 2023, and soon to be 100% (target Q3/Q4), driving >$100mm in incremental revenue for MakerDAO: https://dune.com/steakhouse/makerdao. We also helped rationalize Lido DAO's LDO curve LP incentive program, saving >$100mm in annualized LDO expenses while maintaining in excess of $150m in order book depth at less than 1%.

We are happy to partner and collaborate with the dYdX Foundation and Operations SubDAO to develop KPIs, discuss operating results, and build out financial & KPI reporting to aid the community in making capital allocation decisions.

Further relevant contributions:

- We lead the Finance workstream for Lido DAO and developed and lead the Lido Treasury Management Committee as a way of fencing treasury activities to nothing / a bare minimum and future-proofing through automation
- We contribute as independent reporting agents to the ENS enDAOment in collaboration with Karpatkey
- We sat as a council member on Arbitrum's STEP program for selecting RWA allocations
- We contribute extensively to MakerDAO through asset-liability management research and RWA structuring
- We co-authored "Benchmark and Performance Attribution for DAOs" in collaboration with Dialectic, a leading DeFi hedge fund, as a way of proposing minimalist benchmarking and performance measurement tools for decentralized communities