I’m going to make this as simple and straight forward an explanation as I can. Yield Farming via Staking and Liquidity Providing are a core feature of most, if not all Decentralized Finance (DeFi) projects. The principle behind why they are brilliant also applies to other crypto projects , but lets put that aside. But first let me say that this is not investment advice. This is how I see the market and there may be things that I am wrong about or could change by the time you read this. Feel free to add your thoughts in the comments below.

What Business Are They In ?

The first question you have to always ask about any De-Fi is the same question you need to ask about any business you may create a financial relationship with – “What Business Are They In”

Yes, every single DeFI project, is at its core, just another business. They may or may not know what business they are in, but they are just another business that happens to be using a blockchain and smart contracts to host and program their business processes.

Let me give you an example of some DeFi and Blockchain projects I’ve placed some money with and how I view their business:

Polygon/Matic – They are a very simple business that is hard to execute on. Their job is provide tools that enable transactions using their Ethereum/Solidity smart contracts, built primarily by outside parties, to take place as quickly and in-expensively as possible while still being able to bring in more money than they spend. In order to do this, they charge a fee per transaction. That fee is paid for using their Matic token. Much like you buy your Dave & Buster tokens in order to play their games, you must buy Matic Tokens in order to use the features of their network and smart contracts.

But blockchain based businesses diverge quickly from traditional software and the difference is where the brilliance of crypto based businesses like Polygon/Matic and their competitors, from BTC to Eth and even to Doge coin come in.

Every business or financial software service or application business has cloud computing and operating costs that very often grow faster than their revenues. This is not a surprise, it is exactly why software companies raise significant amounts of capital in order for their “software to eat the world “

Companies like Polygon’s capital needs are very different. Why? Because rather than building their business exclusively on a cloud computing platform like AWS, their businesses are decentralized (im not going to argue the definition of decentralization or security, or speed here) . The foundation of decentralization is built upon an independent party, usually called miners in Proof Of Work Networks like BTC or validators in Proof of Stake Networks like Polygon Matic and a few other crpyto descriptive words, putting up their own capital to provide computing resources in order to support the network platform.

B**rilliant**.

Any other business you have to raise a shit load of money in order to host your own servers, or more likely pay for cloud computing costs which can be insanely expensive for compute intensive applications and just as expensive for scaling heavy use applications. Plus you have to hire all the people , have the CapEx to support them, etc.

In the decentralized crypto world these 3rd parties (minors, validators, etc) provide the computing power that effectively run the platform in exchange for rewards in the token of that network.

In the case of Polygon, they have validators. These 3rd parties are willing to make this investment if they believe the network platform can grow the numbers of transactions on the network significantly. If they can, that pushes demand for the Polygon tokens they earn. That allows them to earn revenue from the sale of the tokens they earn or they can hold the token and hope it appreciates if demand exceeds supply.

Even better, platforms like Polygon will allow pretty much anyone to STAKE their Matic tokens with those Validators and share in the earnings of the Validators ! Here is a nice guide from Coinbase on what Staking is. Validators love Stakers for a variety of reasons, but they are willing to share their earnings because the more they have staked the more rewards they can collect. It’s a symbiotic relationship that also helps secure the network.

So why is this brilliant ? **If Polygon, or any of their competitors , took a traditional, centralized business path where they controlled and owned everything, they would have had to raise not just millions but potentially much, much more. Instead, they create a near zero cost token** that they distribute in accordance with the tokenomics they defined to their community (and whose approval is required to make any changes). And it works for all involved.

The crazy part of it all, is that because these businesses are token driven and the costs are distributed and operations are decentralized, it is FAR LESS EXPENSIVE to operate than a traditional centralized business. So where a crypto based business competes with a traditional business, the crypto business may have a significate cost of capital and cost of operations advantage. There are a lot of financial institutions that should be concerned.

So how will Polygon build their transaction volumes and fees ? By having enough widely and heavily used applications. Every platform whether its an exchange or blockchain , is in a race to achieve a network affect. The more users they have the more fees, the more fees, the more they can invest to get users. the more users the more fees it has to share , the more valuable its token, etc.

The Business of DeFi

One way Polygon tries to create a network effect is via DeFi (Here is a good explanation of Defi) based businesses.

As the name implies, DeFi is built on financial services.

Consider Dave & Busters tokens. When you buy their tokens you can only use them in their arcades. You can’t use them at others. One of the foundational businesses of DeFi is the ability to exchange the tokens of one project to those of another. That is why they call them Exchanges. And if the exchange is Decentralized, they call it a …. DEX

Examples of such exchanges that I use are Zapper.fi, (not a true exchange but great for tracking and swapping and Im an investor, so had to get it in here !) quickswap.exhange, bancor.network , uniswap. T**hey all are basically the same business, they are token exchanges. They make money from fees every**

time someone exchanges one token for another. But that isn't the BRILLIANT part.

In a money exchange business, or even a banking business, you have to have the financial depth to be able to offer the range of needed currencies and services . You need to be able to afford to hedge the risk of pricing volatility between currencies. If you want to do this business with scale, across the world , it can be very expensive and risky.

Not for DeFi Exchanges. ***What makes running a DeFi exchange so much better than a traditional centralized financial business of this and ANY kind is that rather than the owners of the business, investors and their creditors putting up capital for all the transactions to take place, Liquidity Providers (LPs) do it for them.*** (this is an explanation) .

I'm a small LP for QuickSwap. I provide 2 different tokens (DAI/TITAN) that enable QuikSwap to offer swaps between these two tokens. As you can see here, this pair is one of many, and you can also see that based on the .25 pct of volume in this swap that Quickswap pays, my return on my initial $75k investment (based on fees only) as of this writing, is an annualized return of about 206% (Based on the fees earned in the last 24 hours. This return percentage will vary all over the map depending on the activity.) But the cool thing is while I don't get any extra rewards for this pair (you reading this Titan and Quickswap ???), I am currently the only LP in this pool, so I get 100pct of the fees. In every pool, the LPs, get a percentage of the fees based on the percentage of the liquidity they provide.

So in exchange for providing the Liquidity both TITAN and Quickswap need for their businesses, I get .25 of the transaction volume for swaps between these two tokens. As long as I keep making a good return, I will keep my money invested (Volatility can create mark to market losses). If not, I can immediately withdraw it (some platforms have a hold period or penalties) . Have enough LPs and the exchange is far more capital efficient than a similar traditional exchange business and i get to make some money !

In addition, exchanges will often offer LPs additional reward tokens. I provide liquidity on Bancor Network as well and get rewards in their BNT token. They allow LPs to do single or double sided liquidity providing and offer great rewards in their BNT tokens as an incentive to use their platform (FYI, they basically invented DeFi), and to protect against token pricing volatility. Their rewards may not be as high as other platforms, but they are an easier platform to use and do a great job of protecting LPs who keep their Liquidity in place.

One thing to note is that the competition between exchanges is BRUTAL. The rewards have to be high because it is truly a Laissez Faire market. Exchanges compete heavily for LPs. You have to be careful if you choose to be an LP. Unless you are very experienced as an LP make sure to Do Your Own Research. Make sure the platform has a legit business.

Let's look at another DeFi business, AAVE. AAVE, like its competitor Compound, looks like a bank. But it is not. No where close. Aave is a completely automated , permissionless platform where there are no bankers, no buildings, no toasters, no vaults, no cash, no holding your money, no forms to fill out, no credit ratings involved. Everything is controlled by smart contracts. It's fully automated. You don't have to get approval from anyone and it takes minutes to take out a loan. This is called being Permissionless This approach is the future of personal banking.

What business is Aave in ? They are in the business of making it easy for people to loan and borrow. Every time someone deposits tokens, the depositor gets paid an amount of Aave tokens that reflect their share of interest earned by the total pool of depositors , and sometimes tokens like Matic as an incentive to use Aave on Matic as opposed to Ethereum or other networks.

Every time a borrower borrows, they pay the algorithmically set rate. And what is really different, sometimes the borrower gets paid a reward as well. Because Aave and comparable platforms want you to use the platform early and often, particularly when its still a startup and trying to attract depositors, they will reward you for being a user.

And of course, with every transaction Aave gets paid a very tiny fee and they make money on the spread on loan interest that is not distributed to depositors . I should add that the underlying network, whether its Ethereum, Polygon/Matic or any other, earn a fee on every transaction as well. (Which is why they often contribute to the user rewards.).

Now its time to put this in context. As an automated depositor to borrower, matchmaking service, there are no buildings, no huge departments, no branches, no paperwork, no approvals, no confirmation calls to make. All that matters to Aave and their competitors is volume. They can make a FORTUNE for their depositors and token holders because their overhead vs their revenue is miniscule. Automated Financial Market Makers are so much more capital and operationally efficient than similar traditional companies. Banks should be scared.

So lets review.

Basically, traditional, centralized businesses raise capital first. Start a business and then hope they make enough revenue to return enough capital to their investors and/or founders to make them happy.

In the crypto/DeFi world, organizations don't require near as much capital to start and operate. Rather than raising money in a traditional sense, they can sell tokens to raise capital , they can reward Liquidity Providers instead of having to raise liquidity for financial transactions, they can reward stakers who support Validators, they can operate on a blockchain where most of the CapEx/Infrastructure and much of the critical security is provided by Miners or Validators. They can build communities that replace layers and layers of bureaucracy. And what I'm about to say is what makes the crypto world so dramatically different and why it's a model for future technology businesses and possibly all businesses.

Profits are of no use. There is no company I have mentioned that thinks they have to make profits to put in their owners pockets. There is no reason to financial engineer and manipulate EPS. This isn't to say that they don't have to cover the costs they have. They do. But their mission is not to maximize profits because in almost every crypto based organization, they are decentralized. Every token is created equal. No matter who owns it. And every token owner gets to participate in the community. Yes bigger owners get more votes, but there are not multiple classes of tokens. There aren't VCs or Founders who's tokens get priority treatment as with stocks. (at least that i know of), decentralized and automated completely changes the game.

That is not to say that every crypto blockchain or DeFi project will work. They won't. These facts are not a secret in the crypto world. There is an incredible amount of competition. So much in fact , many, if not most will not work. They will not get enough users or generate enough fees to succeed. (This is a great site to track the fees being generated by different projects (https://cryptofees.info/), Crypto is brutally competitive. But in crypto vs traditional, centralized businesses, all other things being equal, I'm taking crypto every time.

So how do you value a blockchain or DeFi project ? It's the revenues stupid. Not all that much different than valuing a software business, I look for current revenues, growth rates, defensibility, the strength of the community, If i think the platform can continue to grow as fast or faster than the crypto industry as a whole, It has my attention. If they are vapor ware, talking about what they are going to do , but years in and have still done nothing, and have no revenues, i get concerned. When I buy a token as an investment as I have with Ethereum, BTC and others mentioned above I know there is going to be pricing volatility, but like the early days of the internet, sales cured all. Have happy customers who are willing to pay for the goods and services an application offers and a community that will grow and be supportive and you have me as a long time holder who will stake and possibly LP those tokens

One More Topic

One place that these organizations are VERY DIFFERENT is that they are not based in the USA and they are not corporations. They are foundations. They are Decentralized in their governance. NO ONE owns majority control (although the founders certainly have significant influence). This is not only because of the ethos of Decentralized Autonomous Organizations (DAOS), but also because of the ABSOLUTE STUPIDITY of our regulators forcing some of the most impactful and innovative entrepreneurs of this generation to foreign countries to run their businesses.

During the pandemic I gave zoom speech after zoom speech talking about when we look back at the pandemic in 10-20 years we would see world changing companies had been created in 2020 and 2021. Among those companies, its already a certainty that De-Fi and other crypto organizations will be at or near the top of the list. Unlike the early days of the internet where we fostered and supported innovation and entrepreneurs, we are already seeing our politicians shitting on the innovations crypto is fostering. Hopefully this changes quickly or we will lose the next great growth engine that this country needs.

As always tell me what you think in the comments below. I'm still learning so all comments are welcome