

Asset tokenization

Towards the unified secondary market: The evolution of distribution channels and evaluation of Asset Tokenization Benefits

September 2023

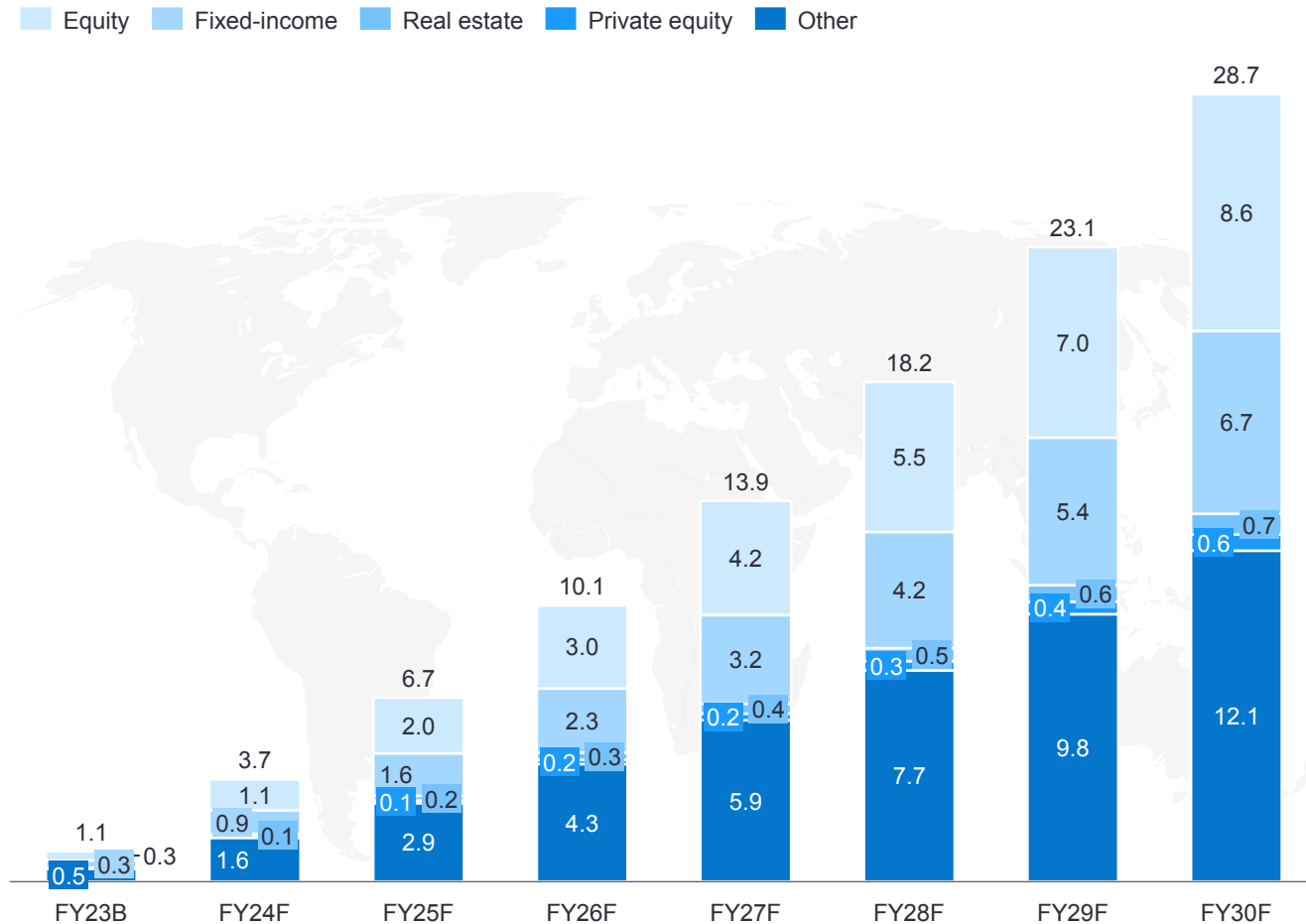
Prepared for _____

External

Tokenization has the potential to bring trillions in value to blockchains (\$28.7tr by FY30F). This is already transforming the way assets are managed and traded

Asset tokenization market

Asset tokenization market forecast (FY23B-FY30F), in \$tr



Asset tokenization – supply and demand

1 Demand – investing in tokenized assets

Investors believe in the long-term value of tokenized assets and plan to invest in tokenized assets this year or the next.

“Based on a EY-Parthenon survey, 57% percent of the institutional investors indicated an interest in investing in tokenized assets, particularly tokenized private funds, equities, fixed-income, and public funds.”

2 Supply – tokenization of (existing) assets

Leading firms in the industry are reassessing their growth and fundraising strategies, taking into account the evolving competitive landscape and the role of individual capital.

Global funds (e.g., from KKR, Hamilton Lane and Franklin Templeton) have experimented with Blockchain-based tokenization and are increasingly moving towards public infrastructure.

“Based on a EY-Parthenon survey, 47% of hedge funds and institutional asset managers are interested in tokenizing their own assets.”

Asset tokenization is the process of converting ownership rights of an asset into a digital token stored on a blockchain, which enhances a.o. accessibility and efficiency

Asset tokenization at a glance

Securities and real-world assets (RWA)

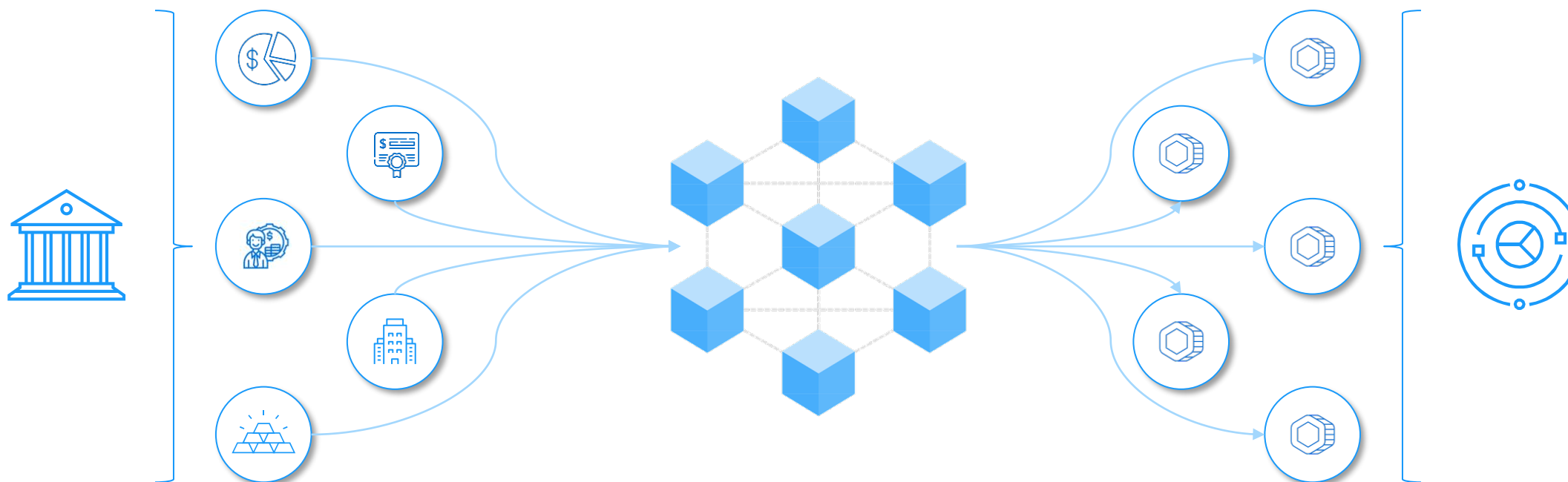
Equities, fixed-income, public/ private funds, real estate, commodities and other assets custodied by financial institutions.

Asset tokenization

Tokenization converts the ownership rights of an asset – such as real estate or a share in a company – into a digital token that is stored on a blockchain.

Tokenized assets

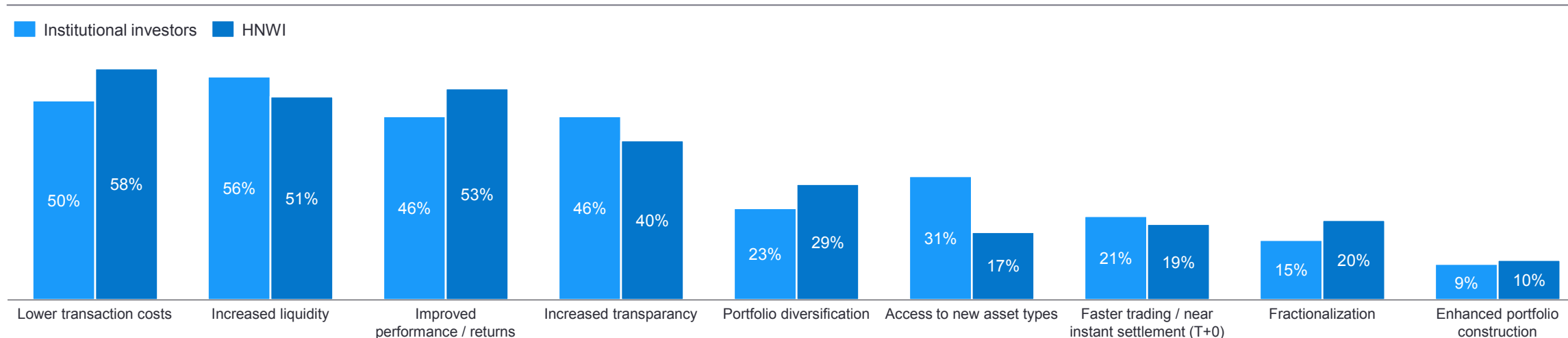
Enhance accessibility, transparency, efficiency and liquidity of traditional assets. These benefits are maximized when trading across decentralized finance (DeFi).



Lower transactions costs, increased liquidity are the main drivers for investors to switch to tokenization. However, uncertainty in regulatory environment holds them back...

1 Demand – investing in tokenized assets

Investor motivations to tokenize assets¹



Investor hurdles

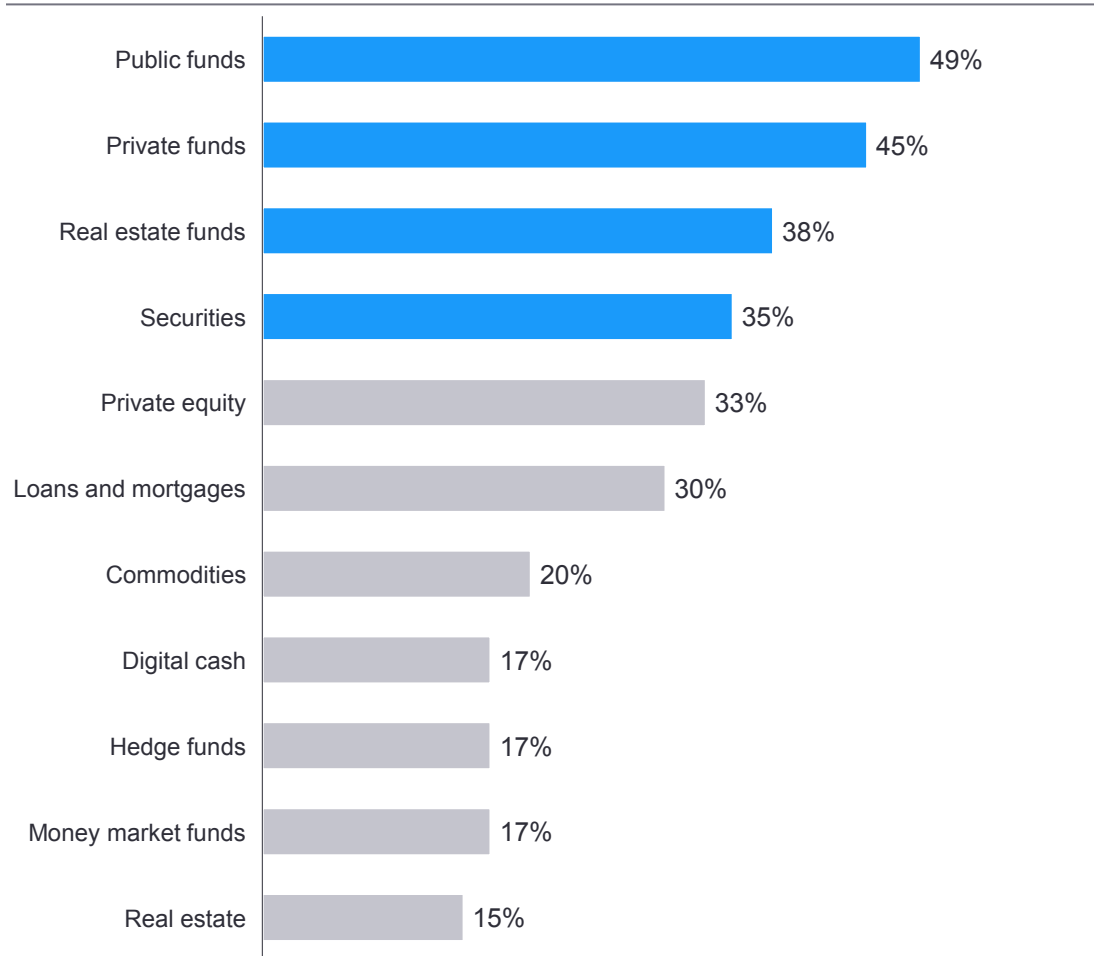
- i Uncertain regulatory environment
- ii Lack of trusted service providers in the market
- iii Lack of internal education about blockchain technology / tokenization
- iv Lack of established marketplaces / ATS
- v Up-front investment required to hold tokenized assets
- vi Unproven technology
- vii Lack of established liquidity / secondary market liquidity
- viii Lack of privacy associated with blockchain

1. Rank order determined by % of respondents that ranked each choice 1, 2 or 3
 Source: EY-Parthenon Tokenization Survey (HNWI n=234; Institutional Investors n=78)

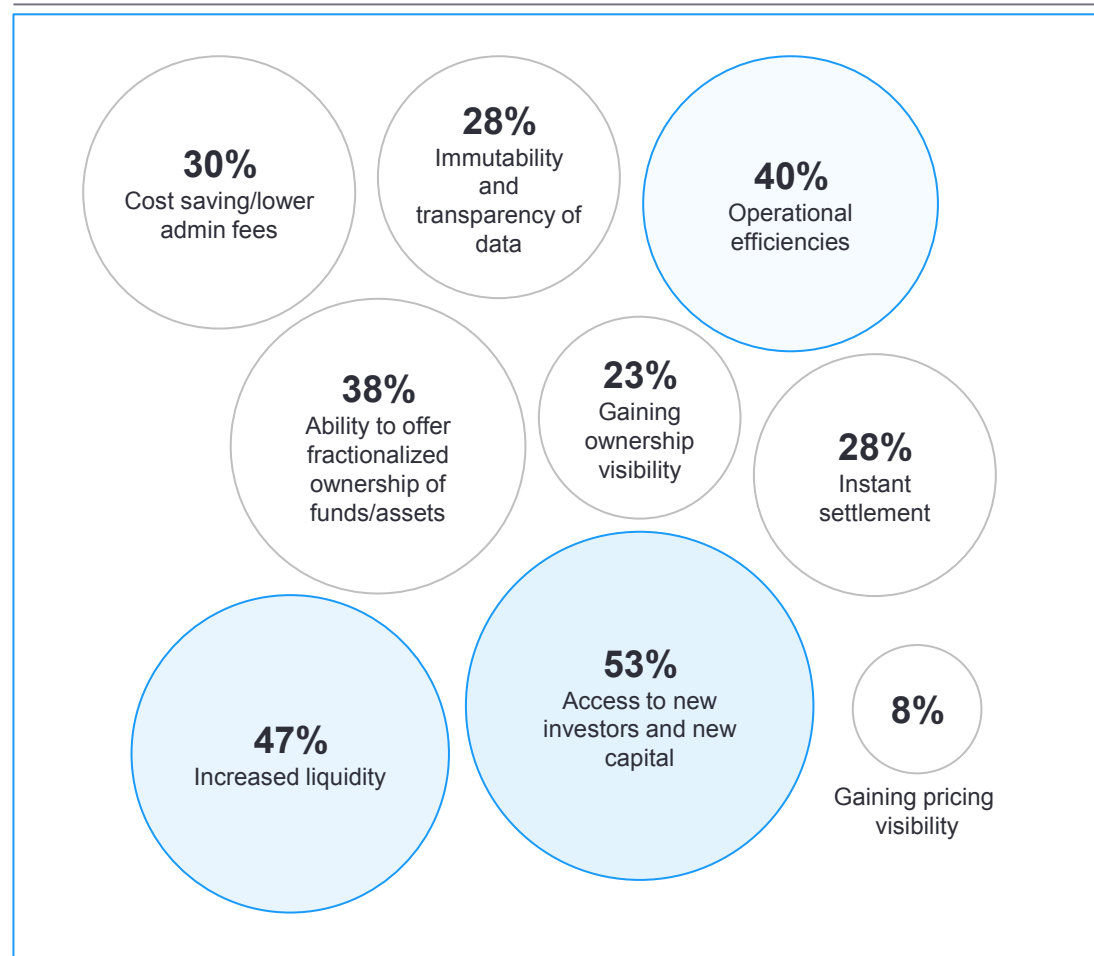
...institutions are most interested to tokenize funds and securities as they see opportunities to access new capital, increase liquidity and enhance operational efficiency

2 Supply – tokenization of (existing) assets

Asset classes that are considered for tokenization¹



Motivation to tokenize assets¹



1. Rank order determined by % of respondents that ranked each choice 1, 2 or 3
 Source: EY Parthenon Tokenization Survey, n = 256

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- ▶ **Evolution of distribution channels**
- ▶ Benefit evaluation per asset class
- ▶ Towards the unified secondary market
- ▶ EY-Parthenon tokenization approach



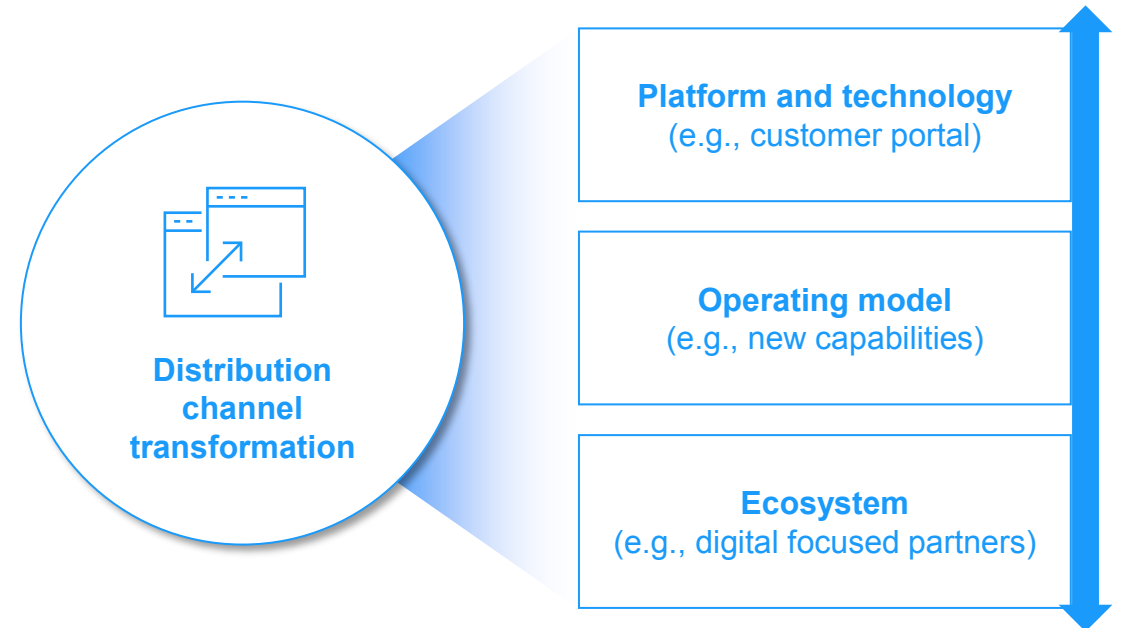
To satisfy investor demand and sustain their competitive advantage, fund managers need to re-evaluate their long-term distribution channel strategy...

Distribution channel evolution

Factors driving the evolution of distribution channels...

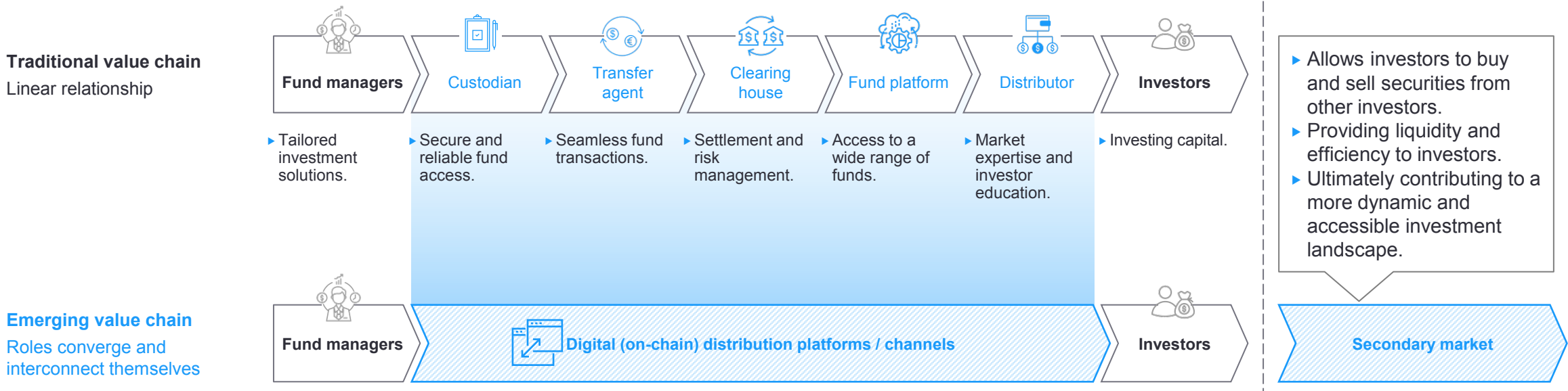


...leading to changes in how to distribute funds and ecosystem structure



...in particular, fund managers are actively seeking digital (on-chain) distribution channels that can integrate multiple capabilities in the value chain

Fund value chain transformation

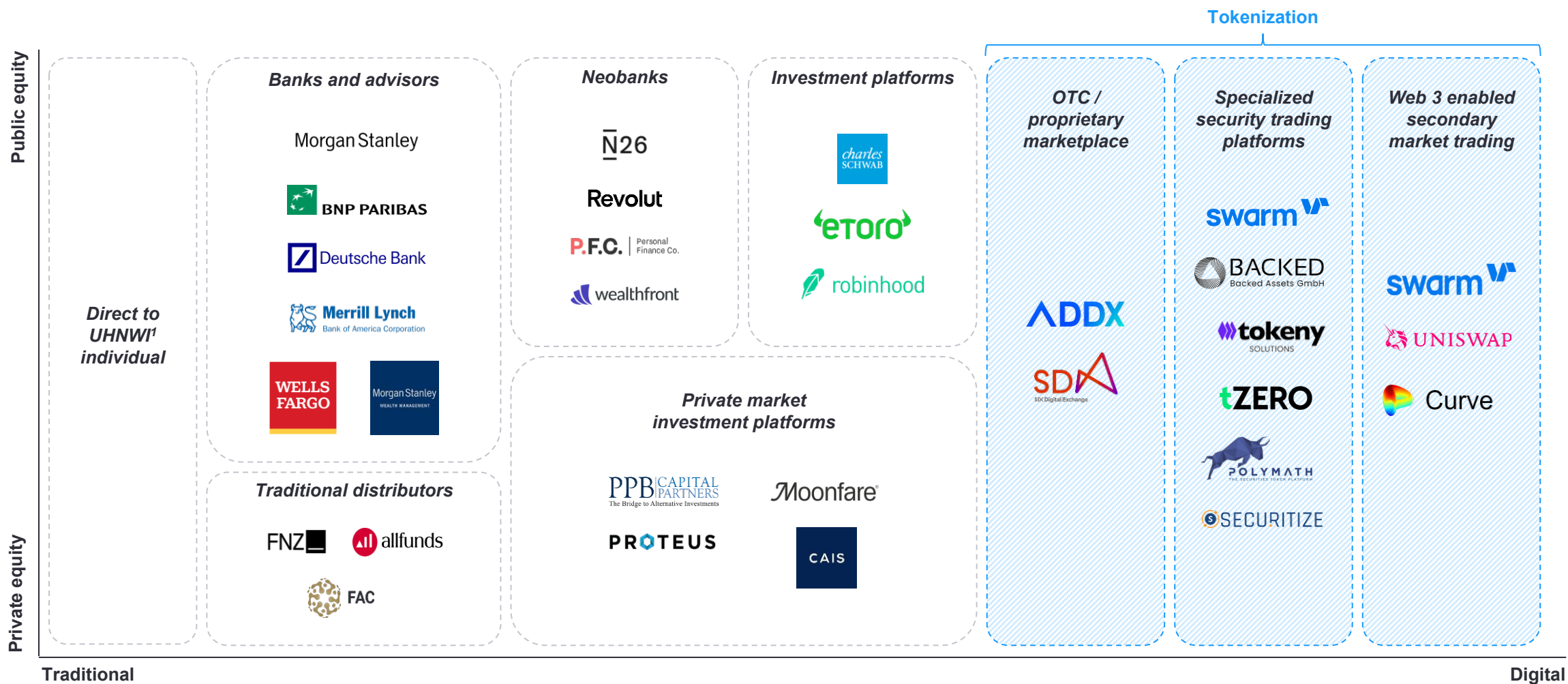


- 1 ▶ The industry is undergoing a value proposition transformation, prompting traditional channels to adjust to new participants and roles.
- 2 ▶ Fund managers are relying on multiple intermediaries and collaborating with digital investment platforms.
- 3 ▶ Distribution channels need to embrace one-stop shop platform capabilities, including efficient fund feeder structures/services and robust compliance measures.
- 4 ▶ This adaptation enables players in the value chain to stay competitive, streamline processes, and reduce operating costs for a better experience.

The distribution landscape primarily comprises traditional segments, but innovative players are introducing digital and tokenized solutions in public and private markets

Distribution channel landscape

ILLUSTRATIVE



1. UHNWI: Ultra High Net Worth individual
Source: EY-Parthenon analysis

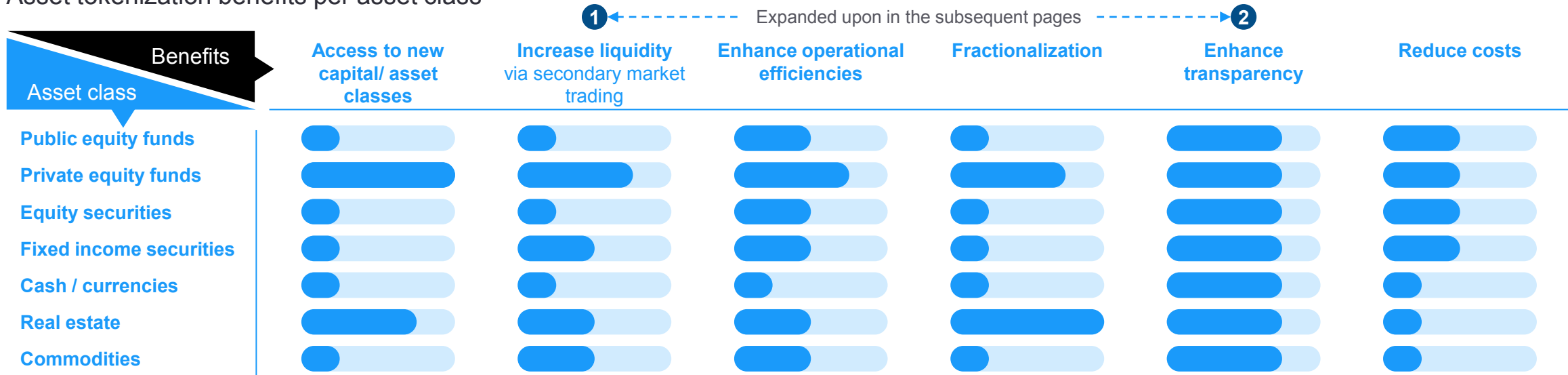
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Tokenization is better suited for inefficient and illiquid assets that are easy to authenticate, such as real estate, which are currently inaccessible to most investors

Asset tokenization benefits per asset class



▶ **Access to new capital/ types of assets:** Tokenization can lower the minimum investment required to access certain assets, making them more accessible to a wider range of investors, particularly in private capital markets.



▶ **Increase liquidity:** Tokenization can increase liquidity in traditionally illiquid markets by allowing investors to buy and sell tokens on secondary markets, but regulatory uncertainties currently pose obstacles to the liquidity of secondary markets. A forward-looking approach to token design is required to unlock the liquidity potential of tokenized assets.



▶ **Enhance operational efficiency:** Tokenization can automate various tasks through smart contracts, including administrative processes, reconciliation, auditing, and transaction execution.



▶ **Fractionalization:** Asset tokenization enables fractional ownership of assets, such as real estate properties, which improves liquidity and allows for broader participation in the investment process.



▶ **Enhance transparency:** Blockchain technology, which underlies tokenization, provides a transparent and immutable record of transactions on-chain, which can help build trust among investors and increase confidence in the market. However, it's important to note that the internal operations of the security or fund may not be included in the transparency.



▶ **Reduced costs:** By using smart contracts, transactions can be automated, reducing the need for intermediaries and potentially lowering operational costs, which can be passed on to investors in the form of lower fees.

 Extent of benefit derived from asset tokenization.

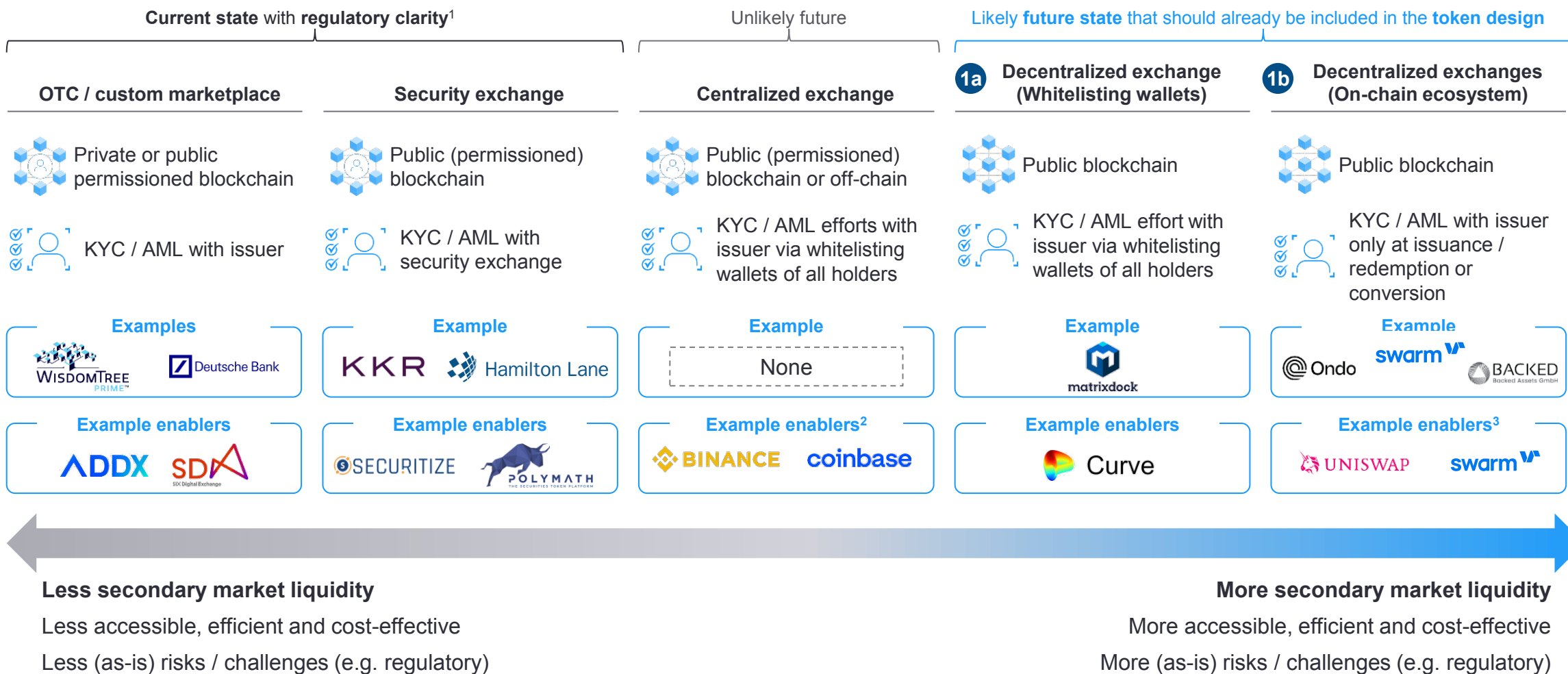
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Tokens should be designed with the intention of being traded on an open decentralized market, thereby enabling the liquidity potential of tokenized assets...

1 Increased liquidity via secondary market trading



1. In the future, the traditional value chain enabled by blockchain technology is expected to continue existing because many traditional investors are unlikely to participate in a fully decentralized ecosystem.

2. Parties that could enable it, in practice no centralized exchanges support security trading currently

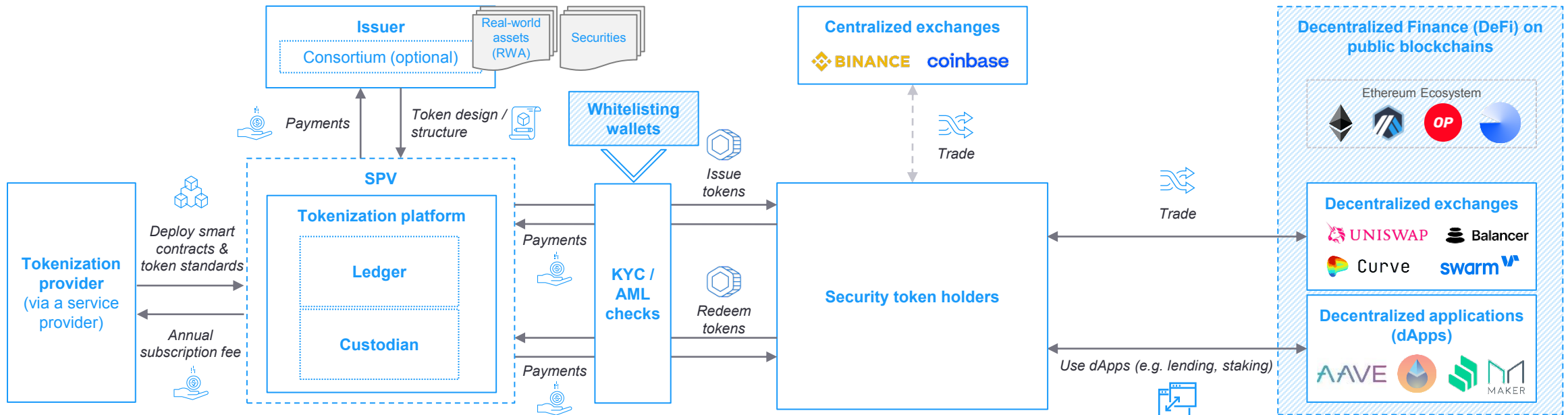
3. Secondary market liquidity is currently very low due to regulatory uncertainties around security trading on decentralized exchanges, liquidity pools exist but not supported on the platform front-end

Source: EY-Parthenon analysis

...however, the lack of clear regulations hinders secondary market liquidity. One interim solution is to "whitelist" wallets in close cooperation with regulators to operate in DeFi...

1a Interim solution – Whitelisting wallets

ILLUSTRATIVE



Design tokens on a (permissioned) public blockchain network where peer-to-peer trading is possible, while taking into account investor protection regulations.



KYC and AML has to be performed at issuance and redemption, but also on everyone who acquires tokens on the secondary market. Engagement with regulators is required to determine the rules and guidelines for these checks.

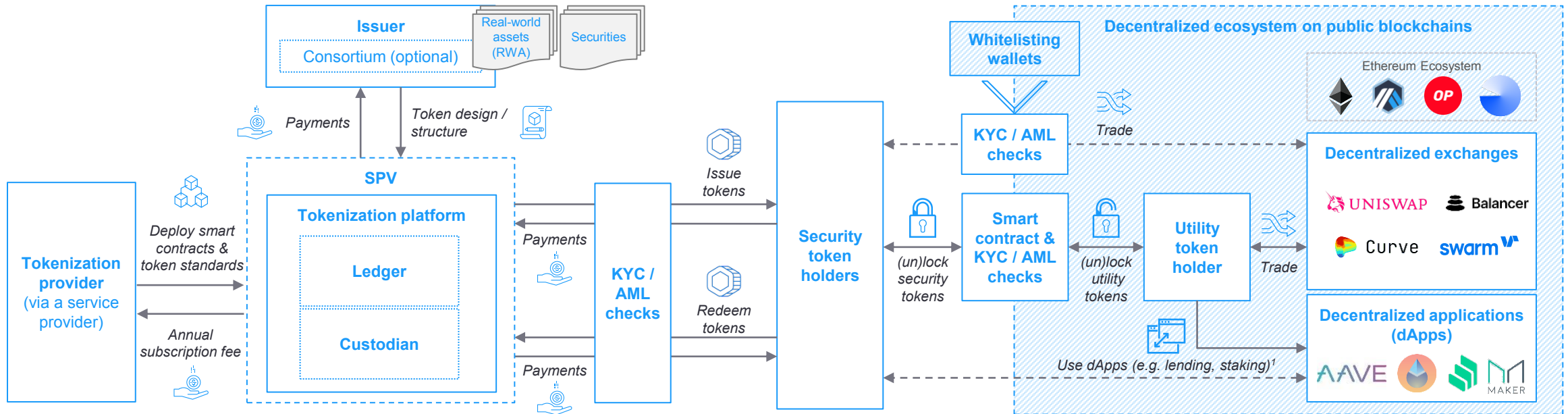


To take the burden away from exchanges, issuers can perform KYC / AML checks and whitelist all wallets that are allowed to trade securities on every platform. **This unlocks secondary market trading potential.**

...in the long term, free trading could occur by proactively steering regulations towards the concept of locking security tokens in a smart contract and unlocking a utility version

1b On-chain ecosystem (with KYC / AML at conversion)

ILLUSTRATIVE



Highlight the distinctions between utility tokens and security tokens, emphasizing that security tokens require KYC and AML verifications before they can be transferred. Additionally, clarify the characteristics that classify a token as a security.



Initiate dialogue with regulatory authorities and educate them about the concept of securing security tokens within a smart contract to access utility tokens without security features. It's essential to emphasize that this step entails the mandatory KYC and AML checks.

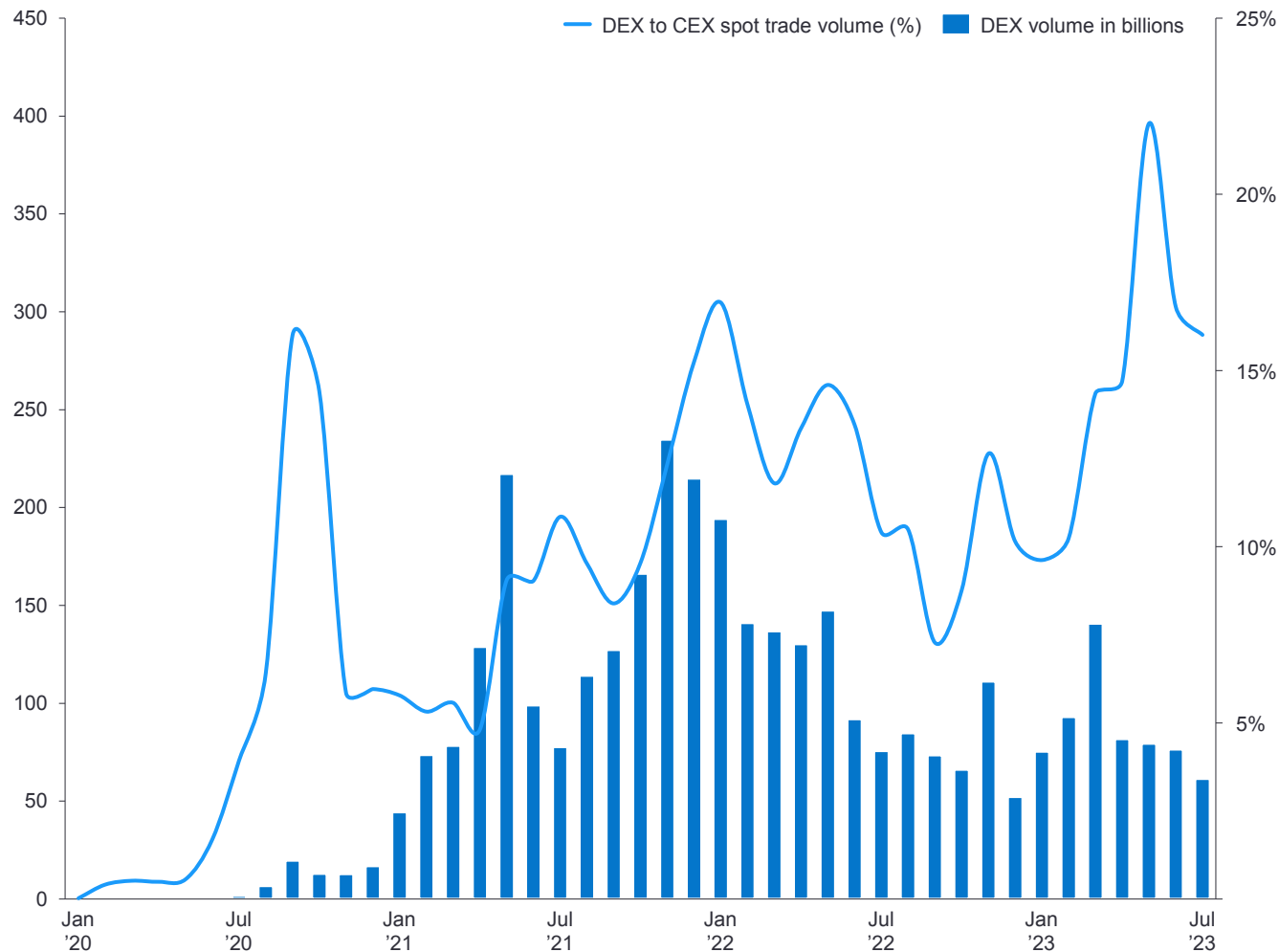


The decentralized ecosystem's true value lies in the ability to trade tokenized real-world assets (RWA) without barriers, which **results in maximum secondary market liquidity.**

1. Security token holders can only use decentralized applications (dApps) without additional KYC / AML checks if they do not transfer ownership of the token. Source: EY-Parthenon analysis

DEXs are gaining more market share compared to CEXs due to a.o. self-custody, easier entry for issuers, fewer regulatory obligations, and additional investor access

1 Increased liquidity via secondary market trading



► **Self-custody of funds:** Centralized exchanges (CEXs) require users to trust the exchange with their assets before trading, while decentralized exchanges (DEXs) let users hold their crypto in their own wallet for greater control (self-custody).



► **Lower barrier for entry for issuers:** DEXs have lower market cap requirements and lower / no listing fees making it a more suitable platform for security trading.



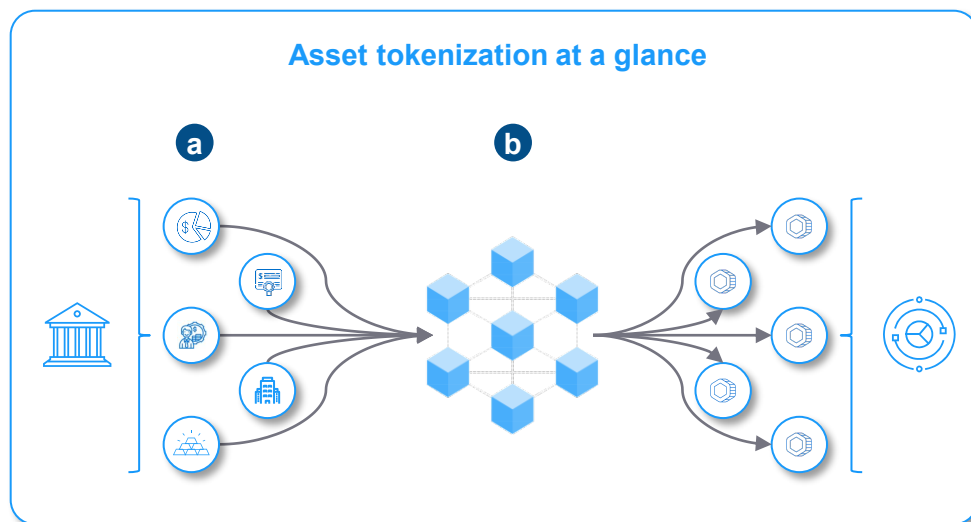
► **Regulations:** DEXs are not (strictly) regulated, which provides more room for innovation compared to CEXs.



► **Additional investor access:** Anyone can create a wallet and trade on DEXs. Furthermore, DEXs are used and supported by a tech-savvy community that are constantly looking for innovation and expansion of the web3 offering.

Investors desire greater asset transparency, but tokenizing assets often results in on-chain transparency instead of asset transparency, which can potentially cause confusion

2 Enhanced transparency






a Asset transparency

Information relating to the digitalized assets

- ▶ Asset transparency refers to **clear and accessible information related to assets represented by digital tokens** on a blockchain.
- ▶ Investors benefit more from understanding the underlying assets' characteristics, risks, returns, and how they are managed within the tokenized ecosystem compared to the visibility on the blockchain.

Illustrative metrics

-  Asset / fund composition
-  Asset / fund performance
-  Compliance

b On-chain transparency

Blockchain exploration and transaction tracking

- ▶ Due to the nature of blockchain (decentralized and immutable), **stakeholders can verify and trace platform actions**. On-chain transparency contributes to the trustworthiness of the network.
- ▶ This level of visibility extends to tokenized assets, providing access to transaction histories, ownership records, and other pertinent data directly on the blockchain.

Illustrative metrics

-  Price
-  Market cap
-  Transactions

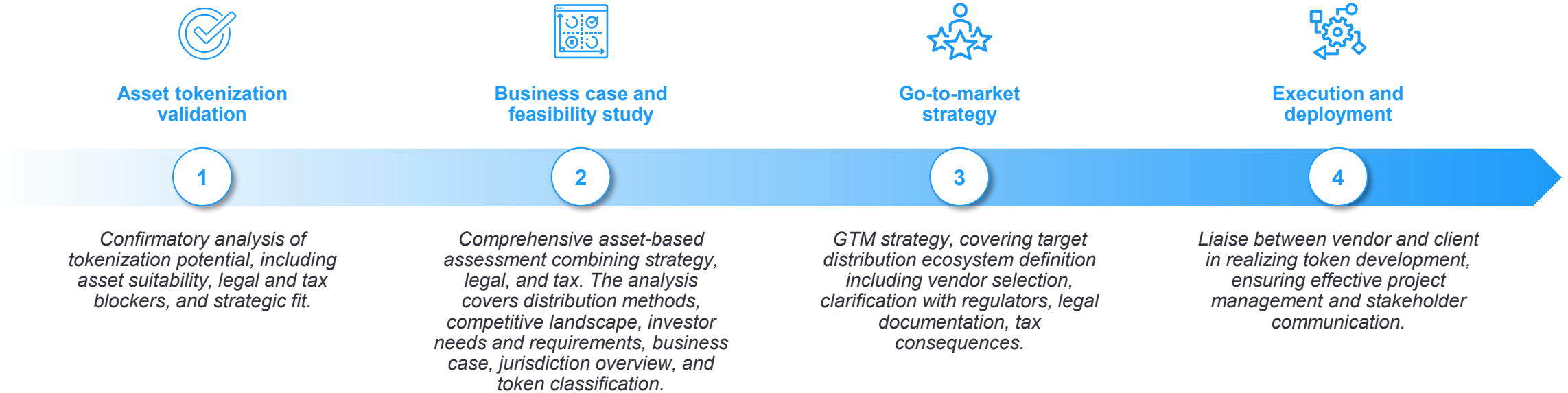
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- ▶ **EY-Parthenon tokenization approach**



Our comprehensive approach encompasses the breadth of EY services, thoroughly validating the tokenization concept, before entering the market

EY-Parthenon's tokenization approach

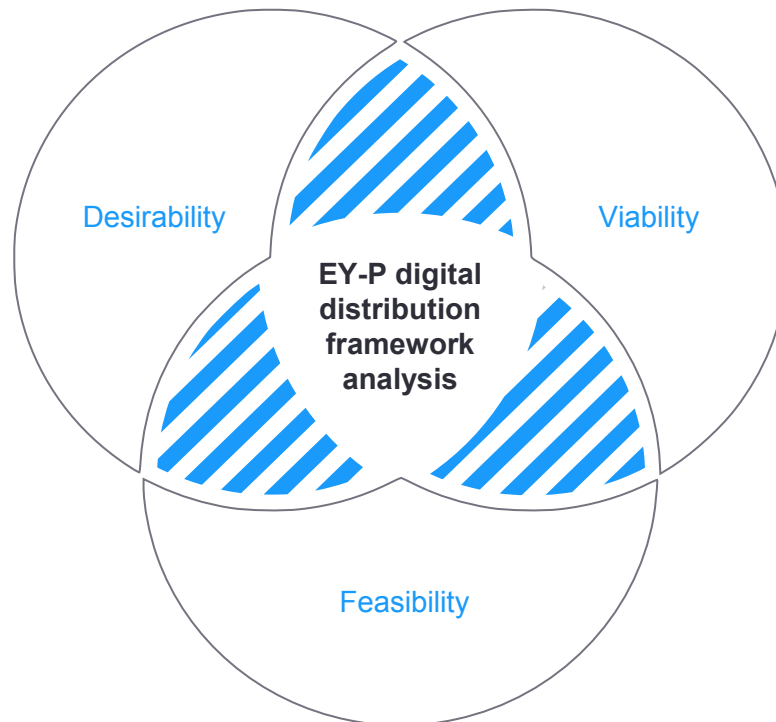


The EY-Parthenon strategy framework ensures that the tokenization concept aligns with market needs, is financially viable, and can be realistically executed

The EY-P digital distribution analysis framework

Assess strategic rationale and market attractiveness

- ▶ Review strategic plans and objectives
- ▶ Assess current market dynamics
- ▶ Analyze fund capabilities
- ▶ Identify first follower advantages
- ▶ Determine potential (cost) pressure headwinds



Determine top -and bottom-line implications

- ▶ Model potential decreases in operational cost
- ▶ Assess secondary market opportunities
- ▶ Sensitivity analysis
- ▶ Assess the upside potential

Examine the practical aspects of each distribution option

- ▶ Assess risk appetite, effort, costs, and legal implications
- ▶ Assess the target ecosystem

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