NFTs, Demystified

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NFTs or Non-fungible tokens seem to have emerged out of nowhere in the last year. NFTs based on art, music, cartoons and even random voice or film clips of celebrities have been selling like hot cakes for unimaginably large, even absurd amounts. So are NFTs real or a hype or passing fad? There are staunch believers who aver that NFTs are here to stay and will change the investing paradigm for ever. On the other side, there are others who firmly believe that this is a bubble which is going to burst, or even a con job to defraud gullible investors.

So what is an NFT? In simple terms, an NFT is a unique digital asset that represents ownership of a real world item like a work of art, music, video or audio clip. A fungible item is one that can be exchanged with another easily and for the same value because there is no uniqueness attached to the item. For example, a Rs.100 note can be exchanged for another Rs.100 note without any issues – they have the same value, though they bear different serial numbers, and they are not unique. In contrast, a non-fungible item is unique and not interchangeable. Think of a real world item like a painting by M.F.Hussain. Each painting of the artist is unique and not interchangeable with another. In a similar vein, an NFT is the digital version of this – a unique asset or item which cannot be interchanged with another. To continue with the analogy of the Hussain painting, there may be numerous prints and copies in circulation, but there is only one original with one owner. When this concept is carried over to the digital world, the one original is the NFT.

An NFT can be thought of as a modern day collectible. They are bought and sold online, usually with cryptocurrency like bitcoin or ethereum, and the underlying technology or code is the same as many cryptos. The creator of an NFT is able to generate digital authenticity and scarcity, which is what usually creates a value in the mind of a buyer.

So how does an NFT work ? NFTs are created and stored on a blockchain. In simple terms, a blockchain is a decentralized way to store data without having to trust any single company or entity to keep the data secure and accurate. An NFT is represented as a token on a blockchain. Anyone can review the blockchain but no one person can modify it, so the NFT ownership can be verified and traced easily. At the same time, the owner of the token can remain anonymous if they wish to. Tokens can easily be transferred on the blockchain. Most NFTs are created and stored on the Ethereum network, although a few other blockchains are also used.

The process of creating an NFT is usually referred to as “minting an NFT”. Minting an NFT is the process of transforming a digital file like a picture into a digital asset or crypto collectible on the blockchain. The creator will need to pay a fee to the blockchain in crytocurrency to be able to mint and store the NFT as a token on the blockchain. The creator can add their name, description, signature or other metadata to the token. When the NFT is bought by a person, the ownership changes from the creator to the buyer. As it is a digital file, it is often possible for others to make or download copies of the image, video or digital item owned by the buyer. This is similar to the above example of Hussain prints and the original - the downloaded copies are the prints, and the NFT is the original.

NFTs are often confused with cryptocurrency. The only real common factor is that both NFTs and cryptocurrencies work on the same underlying blockchain technology. Cryptocurrencies like bitcoin aim to act as currencies i.e. as a medium to buy and sell goods or services, or as a store of value. On the other hand NFTs are digital tokens conveying exclusive ownership of the underlying item. Most NFTs can be bought on NFT market places only with cryptocurrency.

The NFT phenomenon is huge – from June 2021 to June 2022, the cumulative NFT sales amounted to a staggering $ 29 billion ! Some of the more prominent transactions include

- An NFT of the first tweet by Twitter CEO Jack Dorsey, which sold for $2.9 million
- “Everydays – the first 5000 days” a work of the digital artist Beeple was sold for $69.3 million through a Christie’s auction
- Sotheby’s sold a CryptoPunk NFT for $1.8 million in their first curated NFT auction. A CryptoPunk NFT is a digital image, usually of punky looking men and women, created algorithmically.
- A 20 second video clip of professional basketball player LeBron James “Cosmic Dunk # 29” was sold for $ 208,000

There have other more incredible instances bordering on the ridiculous. One of the early ones was cryptokitties which were digital representation of cats with unique identification on the ethereum blockchain. Within a few weeks of their launch, cryptokitties were bought and traded for a cumulative value of more than $20 million. Another such instance is the Bored Ape Yacht Club project, where algorithmically generated unique images of apes sold for millions of dollars!

Closer home, several prominent Indian personalities have jumped on to the NFT bandwagon and created or launched their NFTs on market places. These include actors Amitabh Bachchan and Salman Khan, cricketer Dinesh Karthik and designer Manish Malhotra. While some of these NFTs have been traded for small amounts, no blockbuster trade has been reported yet in respect of NFTs of Indian creators.

An NFT can be created and stored and traded on online marketplaces or exchanges. The creator or current owner of an NFT may put it up for sale on the marketplace for a specific price, or may even attempt to auction it. The more popular and larger marketplaces include

- OpenSea – one of the first and largest market places with a wide range of collectibles
- Rarible – Similar to the above with a focus on art
- Foundation – this is a community market place which requires creators to be invited or "upvoted" by existing creators already on the platform. By creating a barrier and cost of entry, Foundation seeks to become a more exclusive purveyor of higher caliber and hence more valuable artwork.

These and other platforms host a large number and wide variety of NFTs. However the verification processes for creators and NFT listings are mostly rudimentary and seldom stringent or foolproof. Similarly there is no real buyer protection being offered by most marketplaces, so it is truly a situation of "caveat emptor" – may the buyer beware. There have been instances of impersonation of creators, creating and listing of fraudulent items and so on, which add to the risks of dealing in NFTs.

In the final analysis, is the phenomenon of NFTs a trend which is here to stay or a bubble or worse, a fraud? The jury is still out on this though the historic performance in this brief period is not encouraging. While transactions have happened for large amounts, an NFT's value is based entirely on what someone else is willing to pay for it. Unlike the prices of other real world assets like stocks or real estate which are mostly driven by fundamental, technical or economic indicators, the prices of NFT are usually solely driven by demand. So whether the value of an NFT will increase over time, or even whether it can actually be resold remains a highly questionable proposition. There have been early attempts to widen the use of NFTs to more tangible use cases in private equity and real estate transactions, primarily as a digital escrow mechanism. Perhaps more such use cases will be identified in the future, which will take NFTs beyond art and collectibles and bring them into the mainstream.