

NURTURING SMALL BUSINESS

A NEW ASSET CLASS FUND

FOR PUERTO RICO



THE PANDEMIC & BEYOND: A SOLUTION FOR SMALL BUSINESS

Puerto Rico is a microcosm of macro challenges, suffering from climate change-induced natural disasters, fiscal mismanagement and debt, austerity-driven reductions in public infrastructure and services, and a lack of investment in the productive economy.

The island lost approximately 20% of its small businesses following Hurricane Maria in 2017, itself exacerbating decades of man-made disasters. Now disruptions from COVID-19 are likely to be at least as, if not more, devastating. Add an aging cohort of business owners without succession plans, and we have **an existential threat to small, local businesses**, the engine of national economies and pillar of local communities.

NCG proposes **a new systemic solution** that brings together investors, communities and entrepreneurs, powered by a concept that opens up small and mid-size businesses to outside investors, from large institutional investors to small community investors who wish to sustain their local businesses. The vehicle we created functions like a diversified Community Mutual Fund, where investors invest in a fund and the fund invests in the individual businesses.

The result is a new asset class that empowers communities to bring their small businesses into the global financial economy, that offers investors a way (with full liquidity) to support and profit from the rich variety of smaller local and regional companies that are critical to a healthy economy, and that creates a productive rather than extractive model that works to safeguard the viability and vitality of communities and local economies.

Puerto Rico Economic Benefit Corporation¹

Business Model & Strategy

Objective

National Commonwealth Group² (NCG) plans to establish one or more investment companies in Puerto Rico as part of its unique economic development strategy. The first will acquire small and medium sized enterprises (SMEs) throughout the island.

The below information describes the business plan for this investment company, and how investors will realize both liquidity and profitability. This company will be established as a benefit corporation (see below), formed under the laws of Puerto Rico. It will be named PREBCO (Puerto Rico Economic Benefit Corporation) and it will be managed by PREBCO Management LLC, a Puerto Rico limited liability company formed by NCG.

Background

Puerto Rico is emerging from a decade marked by natural and man-made disasters - recession, a debt crisis, and hurricanes Irma and Maria in 2017.

Post the hurricanes, the number of small and medium sized business enterprises was reduced by almost 20%, from approximately 44,000 to around 36,000, with a commensurate loss of jobs and economic activity. Now the social and economic effects of the coronavirus pandemic threaten another wave of small business closures, both in Puerto Rico and around the world. With current Congressional mit-

igation efforts appearing to be inadequate,³ the scale of additional closures may dwarf those previous losses and we are already beginning to see unprecedented levels of economic collapse.⁴

Puerto Rico urgently needs to create thousands of new jobs and inject more money into the economy through higher wages. .

Unfortunately, there is another trend developing that is likely to dramatically exacerbate all the above.

In Puerto Rico, as in the rest of the world, the majority of small business owners are baby boomers.⁵ Now in their mid 50s to mid 70s, they have begun retiring and want to sell their businesses.⁶ Already, 70 percent of business brokers surveyed said that at least a quarter of their closed sales were related to baby boomers.⁷

According to Forbes,⁸ “Some 4.5 million firms representing more than \$10 trillion in business value will transition over the next decade or so . . . but only about 20 percent to 30 percent of businesses that go to market end up selling . . . many owners probably won’t be able to sell their businesses when they’re ready, because they’re not taking critical steps toward a transition or toward getting the full value of the enterprise.” The coronavirus pandemic is set to significantly impact that already gloomy outlook.

This article⁹ and this article¹⁰ explore reasons why owners normally have difficulty in selling their businesses. The pandemic now adds an extra dimension, as owners are forced to retire or shut down, or perhaps even die, before they can successfully close a deal, with commensurate contraction of local economies in the form of job losses and reduced services.

SME Acquisitions

These problems represent an opportunity for investors that, in turn, will provide many of those small business owners with a solution they might not otherwise find. Here is how.

This fund will focus on the outright acquisition of SMEs from owners wishing to sell their business. There is robust activity in the sale of middle market companies, with competition among corporations, investment funds (private equity and hedge funds) and family offices. However, there are virtually no institutional buyers interested in SMEs and the market is largely left to individual buyers. That creates a significant opportunity for an institutional buyer that can profitably address the M&A market for SMEs.

Every year, a substantial number of small businesses are put up for sale. The articles [Sold! Sales of Small Businesses Continue to Rise](#)¹¹ and [26 Percent More Small Businesses Were Sold in 2017](#)¹² identify a growing trend. As noted, retiring baby boomers are driving up those statistics, but more and more of those businesses won't be able to be sold and will just be shut down.

Given that SMEs are the economic backbone of communities everywhere, the loss of those businesses represents a tangible loss of not only jobs, but of the financial activity they represent. While many of those businesses are not good candidates to take over (especially if the business is too tied to the knowledge and relationships of the existing owner), others are perfectly viable acquisition candidates that not only can be acquired, but grown with the proper contribution of money, knowledge and other resources (see below).

Where a small business can be acquired and not only kept operating but improved, that represents the foundation for a potentially very profitable business model. How is explored in this article [Retiring Business Owners Flood Market](#),¹³ where we detail how a community investment fund can provide a solution for everyone. How it does that is described in greater detail below. In general, our fund will be in a strong position financially to compete for any business, and in particular those that can't find a buyer even though they are perfectly solid companies.

Not only will it have cash to arrange such purchases, but it will also have publicly traded securities to use as part of a negotiated sale. Public companies frequently used their own stock as a tool in the M&A transactions of middle market companies, a benefit unavailable to individual buyers. We will utilize a similar solution to acquire SMEs.

The Liquidity Problem

When creating investment funds, historically limited partnerships (LPs) have been the investment vehicle of choice for investors and fund managers. There is one fundamental flaw in that model — the means by which investors can get out of their investment, ideally with a profit.

A limited partnership interest is considered a very illiquid form of investment, as are the investments in the private companies that funds invest in. Normally a limited partner can only get money out when an individual company in the fund is sold or goes public and the proceeds from that transaction are distributed to the limited partners. Otherwise, the investors normally only get out of their investment when the entire LP is liquidated and the proceeds distributed to the investor partners.

However, one model invented by the venture capital industry in 1980 introduced a way for investors to realize liquidity without the need to liquidate the whole fund or its individual investments. Known as a Business Development Company¹⁴ (BDC), this model entails establishing a fund as a publicly traded corporation rather than a limited partnership.

That way investors can buy and sell their interests in the public BDC at any time, without concern about the liquidity of the underlying assets. However, BDCs moved away from being primarily investors and are today primarily lenders and thus no longer a viable vehicle as a public

venture capital company. But because it fits our needs, we adapted the original concept for our Puerto Rico economic development company to utilize a generic holding company as a publicly traded venture capital entity. The article How to Increase the Flow of Capital to Small Businesses While Enhancing Liquidity for Investors,¹⁵ explores this concept.

There we explain how a public holding company¹⁶ similar to Berkshire Hathaway can be used for our purposes. But whereas Berkshire pursues very large companies, our company will pursue SMEs. As a consequence, we call it a Small Business Holding Company¹⁷ (SBHC). Although we call this SBHC an investment fund, like Berkshire Hathaway, it will avoid being designated an investment company under the Investment Companies Act¹⁸ because it will take an active role in the oversight and management of its subsidiaries. How an SBHC works and can be used is explored in this video.¹⁹

One of the key benefits of SBHCs is that they solve the liquidity problem of limited partnership venture capital firms. They do so by providing investors with the freedom to get in and out of their investment at any time (publicly traded securities), without the fund ever having to liquidate its underlying holdings or especially having to liquidate the whole fund. This can benefit existing small business owners who want to take advantage of this liquidity. See the end section below.

An Alternative Way to Go Public

This brings us to the topic of how an SBHC can become a public company. The vast majority of public companies list their shares on a stock exchange, but recent developments in financial markets have introduced new forms of ownership and new trading platforms. Our SBHC will take advantage of those advancements.

They evolved out of the introduction of cryptocurrencies, which have been sold to the public as initial coin offerings²⁰ (ICOs), which in turn were often listed on public trading platforms called cryptocurrency exchanges.²¹

When cryptocurrencies were first introduced to investors in 2009 with the initial release of Bitcoin, growth was slow. But in 2017 and 2018, the industry experienced an explosion of ICOs and raised more money than the sum total of venture capital investments worldwide in that same timeframe.

However, instead of just a currency offering, many of those ICOs were sold by companies to raise money in lieu of selling stock. That triggered a response from regulators like the U.S. Securities and Exchange Commission (SEC), which declared that those ICOs were in reality offerings of securities and therefore subject to securities regulations.

For those willing to abide by and take advantage of those regulations, organizations like our SBHC can use those rules to improve on the old stock/stock exchange paradigm.

How it Works

Cryptocurrencies are based on a digital technology called blockchain.²² Blockchain provides the means to record ownership, with each unit often described as a “token.” However, blockchain enables the prospects of tokenizing not just money but almost any kind of asset (see Tokenization of Everything: How Tokens Will Create a More Liquid World),²³ something our SBHC will take advantage of.

If tokens represent ownership in a corporation, they are classified as a security and labeled “securitized tokens” (see Classification of Cryptocurrency: Coins, Tokens & Securitized Tokens).²⁴ A significant portion of the cryptocurrency world has evolved over to security tokens (see Security tokens could be the next big thing in cryptoassets).²⁵

A public offering of a securitized token to investors is called a “Security Token Offering”²⁶ (STO). However, private placements under Regulation D would also qualify as STOs, and the resale of those Reg D tokens are restricted just like any other Reg D stock offering. If those tokens are subsequently registered with the SEC, they may then be freely traded just like any registered shares of stock.

One of the attractive elements of the blockchain ecosystem is the disintermediation of middlemen, allowing buyers and sellers to directly interact with each other and conduct near instantaneous transactions. Investors in our SBHC funds will, once we register the tokens with the SEC, be able to freely buy and sell those tokens on one or more platforms arranged by NCG.

How SBHCs Make Profit for Investors

One of the more common forms of profit for stock market investors is the increase in the value of a stock they hold, i.e., capital appreciation. If those shares are freely tradeable, then a stockholder can sell appreciated stock and receive a profit on their investment. Dividends are another way that companies can share profit with their shareholders.

Capital appreciation will be the primary mechanism by which our SBHC fund will reward our investors.

We do not anticipate issuing dividends to shareholders and we intend to plow all profits back into the funds and their subsidiaries and grow their value.

How will those funds increase in value to the benefit of the token holders? The key driver will be the increase in value of the underlying investments. This will occur as a result of two chief mechanisms.

First Mechanism Driving Capital Appreciation

This is driven by the differing valuations of private companies versus public companies. On average, a public company in the same industry as a private one and of comparable scale (i.e., roughly the same annual profit) will usually trade at a substantially higher value than its private counterpart (see [Valuation of Private vs. Public Firms](#)).²⁷ That can easily be as much as a multiple of private company share price (two to three times). More than any other factor, it appears that the liquidity of publicly traded securities is what drives this price differential.

And although private companies are usually valued based on a different set of metrics than public companies (private companies seek mostly to minimize taxes, public companies seek to maximize earnings for shareholder reporting purposes), they are comparable for calculation purposes.

The key is that when a private company is invested in or acquired by a public company, the price paid is usually based on a private company valuation (typically a multiple of EBITDA).²⁸ However, once that private company has been made a partially or wholly owned subsidiary of the public company, it is revalued on the books of public company at the public company multiple, typically a multiple of net income after taxes (price earnings ratio).²⁹ More often than not, this results in an immediate increase in the value of the public company based on the differential between the investment/purchase price versus the value it is booked at post investment/purchase.

A further dynamic that impacts this process relates to the variation in the multiples of private companies. In general, the larger a company and the greater its annual earnings, the higher the valuation multiple. Thus,

we find that typical Main Street companies are valued around five times EBITDA, whereas larger middle market companies are often valued at ten times EBITDA or more. Public companies often trade at 15 times earnings and more.

Thus, the lower the investment/purchase price multiple for the private company, the greater the percentage of value bump for the public company. For example, a middle market company with \$1 million annual earnings purchased for \$10 million (10X) and then booked at \$15 million (15X). Thus, that company is now worth 150% of its purchase price. That would result in a \$5 million increase in the value of the public company. A smaller business with annual earnings of \$200,000 purchased for \$1 million (5X) and booked at a \$3 million valuation (15X) would result in a 300% increase over the purchase price. That would yield a bump of \$2 million for the

public company valuation, a smaller amount per transaction, but a much larger percentage increase. If that same \$10 million that was used to purchase one middle market company were applied to smaller SMEs, 10 such companies could be acquired. And whereas the public company would increase in value by \$5 million in the first case, it would increase by \$20 million in the second!

Thus, if a public company can invest in and purchase smaller companies (partial or wholly owned subsidiaries) at a lower multiple than middle market companies, then the booking value will result in a larger jump than if the public company purchased larger businesses. When Berkshire Hathaway buys a company, it typically pays a much higher price for those companies as a percentage of its market value than would an SBHC fund.

Second Mechanism Driving Capital Appreciation

Since the value to the public company post the transaction is tied to the earnings of the private company it invested in or purchased, it makes sense that if those new additions to the public company portfolio can realize an increase in their earnings, that in turn will increase the overall value of the public company.

Example

A private company with pre-acquisition earnings of \$200,000 per year is purchased for \$1 million (5 times \$200K) and then booked at

\$3 million (15 times \$200K). If its earnings can be grown to \$400,000 per year, the value of the company would grow to \$6 million (15 times \$400,000) for a company that cost \$1 million to purchase, i.e., a six-fold jump in value!

Getting a smaller company to double its earnings is normally a lot easier than doubling the earnings of a middle market company. Most small businesses have been founded and run by individual entrepreneur/owners who often lack the resources and ex-



expertise to optimize their business, leaving a great deal of room for improvement. In contrast, middle market companies usually have sufficient financial resources to acquire the expertise they need to optimize their business.

How can SMEs improve their overall operations, sales and profitability? The answer lies with the management of this fund. The fund managers will

be responsible not only for acquisitions, but for active oversight of those companies. This will be fundamental to their improved health and profitability and therefore value to the fund. National Commonwealth Group, through its subsidiary PREBCO Management, will also provide a variety of services internally and via third parties as explained below.

The Role of The Fund Managers

Previously we introduced the concept of Business Development Companies. Congress authorized the organizers of those corporations to choose between being internally managed (like most corporations) or externally managed (like most limited partnership investment funds such as VCs, hedge funds, etc.).³⁰ Having used the original BDC paradigm as the model for our SBHC concept, we have likewise adopted those management options and have elected to establish this fund as an externally managed SBHC.

Therein lies the framework for helping acquired SMEs become more successful, profitable and therefore valuable to the fund, its investors and all others concerned with the health of local businesses. An externally managed fund³¹ is structured so that a separate group manages the investment and acquisition activities, along with the subsequent oversight and management of those acquisitions. For those services, the fund managers receive a management fee³² and a performance fee³³ (a form of profit sharing often called “carried interest”).³⁴

Both the management fee and the performance fee vary, often based on how much work the fund managers have to perform (active versus passive management). The more the work, the higher the fee that can be justified. Such is the case for an M&A firm like this one that is focused on the acquisition and management of SMEs. SMEs require more work than larger firms. To understand how, we need to examine the role of fund managers in other M&A funds and compare them to managing one for SMEs.

It begins with a system that resembles most M&A funds, wherein the investment managers frequently oversee the senior management of the firms being acquired, ensuring that they are fit for the job and have access to the tools and resources needed to run that enterprise effectively, efficiently and profitably. However, since most M&A funds focus on middle market sized companies and larger, those enterprises normally are already being run by professional management and the fund managers typically can hire experts as needed to optimize the performance of those professional managers.

Improving Management of Candidate Companies

When it comes to small and medium sized enterprises (typically no larger than small middle market companies), we often find that the business is run by an owner who frequently lacks professional management skills and experience. That leaves a great deal of room for improvement simply by applying modern management tools and techniques, including simple steps like new technologies that allow small businesses to substantially improve on their marketing and resultant sales volume (see below). Updated and more interactive websites and various social media marketing options (near zero cost e-newsletters, promotions and the like) can dramatically improve on the marketing tools of even just a few years ago (e.g., costly direct mail and printed advertising). Even a modest introduction of some of those tools can dramatically improve profitability.

All of these steps can have a dramatic positive impact on earnings for those SMEs. That drives up their individual value, which in combination drives up the value of the fund to the benefit of investors.

However, if the success of the business is dependent on the exclusive and non-transferable knowledge of the current owner/manager, then that business cannot be acquired no matter how attractive the terms. A lesser but still significant consideration is the role of personal relationships between the customers

and the current owner. For example, clients of an investment and personal financial management advisory service trust the existing owner and that trust might not be easily transferrable.

If it is determined that the current owner/manager can be replaced, the next critical go/no go decision addresses recruitment, training and ongoing oversight of the replacement management. Each business will be evaluated on its own merits and a determination made by PREBCO Management whether it is a viable acquisition.

If there are more candidate companies available than the resources needed to successfully acquire and integrate them into the fund, the fund managers will need to prioritize those that can more easily be obtained.

For example, in the case of an “absentee owner,”³⁵ some form of management is likely already in place and the focus can be on improving management performance. If the owner is onsite but most of the day to day operations are performed by employees, those employees can be evaluated as potential managers. In both cases, these conditions might make it easier for the fund to acquire the ongoing business and begin to improve on its success.

If there is a need for replacement management to be recruited, trained and supervised, one source that PREBCO Management might turn to are business school graduates who have considered running their own business but see the value in taking over

an existing business. They start with knowledge of business fundamentals and need only learn the particulars of that SME from the existing owner. They should also be receptive to the introduction of business improvement systems, tools and resources. Thus, the business can be more easily groomed to convert into a more professionally managed enterprise. Management retirees from both the profit and non-profit worlds, as well as military veterans who have managed and run teams, can also make very good SME managers.

PREBCO Management will assemble, both internally and externally, a full spectrum of individuals and or-

ganizations capable of providing the expertise, services and resources needed by most SMEs.³⁶ There is an existing robust network of such organizations throughout the island and they represent a substantial resource for PREBCO Management. Group plans like insurance and employee benefits packages will also be made available.

In combination, these can have a dramatic and positive impact on those SMEs resulting in substantial increases in their earnings. That in turn will drive up their individual value which in combination will drive up the value of the public company funds to the benefit of their investors.

Benefit Corporation

Puerto Rico, along with approximately two thirds of U.S. states, has adopted a new form of corporation called a “benefit corporation”.³⁷

“...A benefit corporation’s directors and officers operate the business with the same authority and behavior as in a traditional corporation, but are required to consider the impact of their decisions not only on shareholders but also on employees, customers, the community, and local and global environment...”

Benefit corporations fit well with a global movement towards socially responsible investing (SRI) ³⁸and impact investing.³⁹ By their very design, SBHCs can be classified as SRI/impact type funds and formally incorporating them as benefit corporations embodies those values.

SRI/impact investors have a broader definition of value than is reflected in the common metrics by which corporations are valued today. Alternative valuation mechanisms reflecting this broader definition of value are still in their infancy, yet to properly ascribe a value to our SBHC funds, we will need to work towards incorporating other metrics.

Valuation

Once this fund has registered tokens that are being traded on an open market, NCG intends to provide quarterly reports in a fashion similar to the reports required of BDCs and as such, will provide a valuation estimation on the fund. Over time that valuation will incorporate those alternative metrics. And even though investors will be free to set the price of their tokens, this quarterly report should provide them and future buyers with a basis upon which to set the price.

Investment Alternatives

Normally an investor would invest cash in an entity like our SBHC. However, NCG will make provision for investors to acquire interest in our SBHC with assets other than cash. NCG will allow those alternative investments provided that they serve NCG's purposes for our SBHC. For example:

- NCG will allow cryptocurrency owners to directly purchase the tokens in our SBHC by simply transferring an agreed amount of those currencies to NCG in exchange for SBHC tokens. There has to be an active market in those currencies so that NCG can both establish a value on them as of the day of the exchange and be free to sell them for U.S. dollars. NCG will determine which currencies it will accept as a valid investment.
- A further asset category that NCG would accept as a valid form of investment is whole or partial ownership in small and medium sized businesses (SMEs) that fit our SBHC's acquisition criteria. The

IRS provides for certain business reorganizations, in particular mergers and acquisitions under IRS Code Section 368, to be done as tax-free transactions. Here is how that benefits both the SBHC and prospective investors.

NCG, and the SBHC it manages, will benefit by being able to directly acquire interest in the kind of SMEs being sought by the SBHC. Normally the process of investment and/or acquisition would first entail:

- Taking in cash investments
- Looking for SMEs to invest in and/or acquire,
- Negotiating the terms of the investment,
- Completing the transaction and adding that SME to the portfolio of subsidiaries. In this scenario, the SBHC will go straight to the ownership interest in the SME, subject to a determination by NCG that the SME fits its investment criteria and that the valuation negotiated is acceptable. That is a more efficient, cost effective and faster way to reach the end goal of the SBHC.

However, the benefit to the prospective investor can be game changing, especially if they are trying to sell their company.

SMEs that are not public companies, are notoriously illiquid. Anyone who has an ownership interest in a SME will find it quite difficult to sell. Likewise, such investments have the flavor of "all eggs in one

basket,” i.e., the failure of that one business can represent a complete loss of the investor’s entire investment. Given the high failure rate of SMEs, that represents a substantially risky investment.

Exchanging one’s ownership position in such SMEs for tokens in our SBHC can provide a solution to both of those problems.

Once the tokens are registered with the SEC and are freely tradable on our targeted trading platforms, they should be quite liquid and the investor will be able to exit their investment whenever they want.⁴⁰

With respect to the risk factor, in many ways an SBHC is like a mutual fund for small businesses. One of the key benefits of a mutual fund is that it owns an interest in many companies and therefore spreads the risk such that the failure of any one or more business does not represent a catastrophic loss of one’s investment.

Finally, this type of investors comes to the table with a fundamentally different perspective than a cash investor. Whereas a cash investor is looking to invest in an SBHC with the idea of making a future profit, an investor that swaps an ownership position in an existing SME has already made that investment decision and is now looking for a way to exit. There is no other similar mechanism in place that will help those investors achieve that objective, other than trying to find an individual buyer.

Anyone in such a position is encourage to contact us to see if their current holdings would satisfy our criteria and a viable swap arranged.■

Endnotes

1. Although we use the label “investment companies” for these companies, they will not be considered investment companies subject to the Investment Company Act of 1940. They will operate as public holding companies that take an active role in the oversight and management of the subsidiary companies and properties they invest in, and therefore will avoid designation by the SEC as investment companies and the need to register them under the Investment Company Act of 1940.
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35. en.wikipedia.org/wiki/Absentee_business_owner
36. Services include web development; sales training; general marketing and public relations specialists including social media marketing experts; product design and manufacturing; lawyers; accountants; insurance experts; employment and hiring experts and more.
37. en.wikipedia.org/wiki/Benefit_corporation
38. https://en.wikipedia.org/wiki/Socially_responsible_investing

39. en.wikipedia.org/wiki/Impact_investing
40. The terms of the exchange may require the investor to limit the amount of tokens they are allowed to sell over certain periods of time, a condition usually called a “lockup period”.

Forward Looking Statements: This document may contain forward-looking statements (en.wikipedia.org/wiki/Forward-looking_statement). Although any such forward-looking statements are based upon what management of National Commonwealth Group believes are reasonable assumptions, there can be no assurance that those forward-looking statements will prove to be accurate, as actual results and future events could differ materially from those anticipated in such statements. National Commonwealth Group undertakes no obligation to update forward-looking statements if circumstances or management’s estimates or opinions should change except as required by applicable securities laws. The reader is cautioned not to place undue reliance on forward-looking statements.

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