

HOFFMAN, WHITE & KAELBER FINANCIAL SERVICES, LLC  
INVESTMENT MANAGERS & FINANCIAL ADVISORS

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First and foremost, please accept our best wishes for a happy and prosperous New Year! Now on to our letter:

## **Selling A Business**

Either you built it from the ground up, or maybe you bought it. If your business has been a success, you've probably invested significant time, energy, and money into it for what may have seemed like forever. Now, after assessing your reasons for doing so, you feel it's time to sell and move on.

But before proceeding with what could be the most important financial deal you'll ever make, you should carefully assess your reasons. And, when doing so, it may be helpful to consider the following: What are my objectives as an owner of the business? Am I looking to diversify risk, retire or maybe both? What are my objectives as manager of the business? Do you want to continue managing or retire soon? What are your objectives for the business itself? Are you intent on liquidating the business or do you want to afford it potential for continued growth? And, who else will be affected and what will they want? (I.e., other shareholders, managers, key customers and suppliers.)

While you're going through this soul searching process, it's usually wise to keep your plans confidential. If word gets out that you plan to sell, that information can be exploited by competitors and may disrupt relationships with suppliers, customers and employees. The result could adversely affect your ability to continue the business and could certainly have a negative impact on its selling price.

Selling all or part of your business may be the best way to achieve your objectives, but an outright sale may not always be the optimal solution. While most businesses wind up being sold to another business, there's a range of exit routes that may suit your needs better. If you're not ready to retire, seeking investors could provide access to capital to develop your business and make it easier to sell all or part of your stake. Alternatively, you could approach your employees to buy the business. In the latter scenario, an ESOP (employee stock ownership plan) can help you retire, provide tax benefits and enable you to sell the company to people who are most likely to understand it and continue to run it well.

As mentioned in our prior newsletters, we strive to provide articles on various aspects of wealth management to assist your understanding of why planning for the present and for your future has importance. Yes, we also promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

This month's letter will cover some basic information about ESOPs. And, substantial thanks for this month's topic go to my new friend, Ron Gilbert. Ron is President and Co-founder of ESOP Services, Inc. ([www.esopservices.com](http://www.esopservices.com)) and is considered a guru in the ESOP consulting business. And, the significant literature he provided me affords us an informative

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look into his industry. Lastly, and as always, we will finish with an update on our investment activities.

### **What Is An ESOP?**

An ESOP is an employee benefit plan, which qualifies for some very interesting tax saving advantages under the Internal Revenue Code. But, in order to take advantage of these tax benefits, it must comply with various participation, vesting, distribution, reporting and disclosure requirements set forth therein. ESOPs are also subject to regulations set forth in the Employee Retirement and Income Security Act of 1974 (ERISA) and must meet the employee benefit plan requirements of the Department of Labor.

An ESOP functions like a profit sharing plan. The company creates a trust to which it makes contributions. Then, contributions are allocated to individual employee accounts within the trust. The shares of company stock and other plan assets allocated to employees' accounts vest over time, and the employees receive vested portions of their accounts at retirement or termination. Moreover, employees incur only long-term capital gain tax treatment on the appreciation in stock value, rather than ordinary income tax on the appreciation. The company makes discretionary contributions on an annual basis of at least 25%, and up to 50%, of covered payroll. These contributions can be made in either stock or cash.

With a leveraged ESOP, the company obtains a loan from a commercial lender and then lends this money to the ESOP. The proceeds are then used to buy stock from either existing shareholders, or the company itself. Thereafter, the company makes deductible contributions to the ESOP to service the loan. Also, the company can pay tax-deductible dividends to the ESOP to amortize the loan. Consequently, even principal payments on the loan can be tax deductible to the company. As the loan is repaid, the stock held aside as collateral on the loan is released and allocated to participant accounts within the ESOP.

### **What Are Some Advantages To Setting Up An ESOP?**

For private business owners, ESOPs can be used to develop a business succession strategy; implement an estate plan that includes providing for children who are not involved in the business; or, afford an ability to cash out tax-free while continuing to control the company. An ESOP can also allow for retaining an equity interest in a tax-free company; provide a tax advantaged way to sell some or all of a business in order to diversify holdings; deduct principal payments on existing or new loans to finance growth; tie employee compensation to company performance; or, make a tax-free sale of some or all of the business to employees.

As a corporate finance tool, ESOPs can provide businesses a viable means to: deduct the cost of buying out stockholders; increase working capital through significant reduction of tax liability; repay stock acquisition debt with pre-tax dollars; or, provide an ability to outbid competitors on transactions with tax savings from deducting acquisition costs. Even management groups can benefit from an ESOP. This versatile tool can assist a management buy-out for the subsidiary or division that employs them using pre-tax dollars. This list of advantages is not exhaustive.

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From my understanding, and I'm expecting Ron Gilbert to correct me if I'm wrong, the best ESOP candidates seem to be C or S corporations that have profitability and pay taxes or, in the case of S corporation owners, create tax liability for owners. It seems that one of the best reasons to set up an ESOP is the remarkable tax benefit that accrues to owners, the company, and employee-owners. The contributions employees make to the plan are tax deferred, and when they eventually tap the plan for their own retirements, they may be eligible for substantial tax savings. Also, if the company donates stock to the plan, the gift is tax deductible, and when owners sell stock to the plan, they may not have to pay current ordinary income or capital gains tax rates. So, it would seem that, the more profitable the business and the more tax liability thereby created, the better the ESOP benefits.

### **Some Disadvantages And Potential Problem Areas**

**Valuation, consulting and administration costs.** Depending on your purposes, an ESOP's structure can range from simple to very complex. Yet, in any event, the stock must be valued annually in order to establish its value for purposes of purchasing shares, allocating shares, and/or distributing shares. As such, to ensure tax deductibility compliance with the Internal Revenue Service regulations and to meet the employee benefit plan requirements of the Department of Labor, it would be well advised to retain or employ competent consultants, lawyers, accountants and administrators for help.

**Stock valuation and liquidity issues.** If the value of the stock appreciates substantially, the ESOP and/or the company may not have sufficient funds to repurchase stock, upon employees' retirement. And, if the stock appreciates dramatically, it's certain that your company's liquidity needs will increase correspondingly. Whereas, if the value of the company does not increase, the employees may feel that the ESOP is less attractive than a traditional profit sharing plan. Also, if the company fails, the employees will lose their benefits to the extent that the ESOP is not diversified in other investments.

**Dilution and disclosure issues.** If the ESOP is used to finance the company's growth, the cash flow benefits must be weighed against the rate of dilution to shareholders. During their participation in the ESOP, plan participants are not entitled to receive annual reports or attend annual shareholders' meetings. However, owners or participants of privately held companies may be less sensitive to these concerns.

**Pro-rata offers and fiduciary responsibility.** Offers to purchase stock on behalf of an ESOP must be made on a pro rata basis to all shareholders. Therefore, unless remaining shareholders agree, a retiring shareholder, may not be able to sell his or her stock without offering other shareholders the same opportunity to sell stock on a pro rata basis. This same requirement applies to corporate stock redemptions. Additionally, committee members who administer the plan are deemed to be fiduciaries and can be held liable if they knowingly participate in improper transactions.

### **Some Concluding Thoughts**

As you may have already guessed, an ESOP isn't created without some careful consideration. There are so many options that doing it right can take significant analysis and planning. And, even after the ESOP is in place, it will require continual strategy and record keeping. Yet, in the right situation, the benefits are very compelling.

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If this sounds like something you'd like to explore further, I recommend you contact Ron Gilbert at ESOP Services, Inc. ([www.esopservices.com](http://www.esopservices.com)). Ron's been at this for more than 25 years and has written and spoken extensively on the subject.

## **We're At Your Service**

At Hoffman, White & Kaelber Financial Services, our focus is to help our clients achieve a more certain future. As such, our wealth management clients gain comfort in knowing that they've hired disciplined decision makers whose objective favors consistency of returns and capital preservation rather than magnitude of returns. And, this type of investing makes a lot of sense for ESOP sponsors and exiting shareholders seeking to keep what they've earned!

## **Hoffman, White & Kaelber Financial Services Investment Performance Update**

It's a risky business to predict a decline of the US financial markets these days. Especially, with large and small cap stocks achieving new highs in the fourth quarter of 2004. Yet the economic signposts, at the end of this year, are ominous. The bulls who have been driving up share prices and anticipating another year of growth and corporate prosperity are really betting that any adverse impact from underlying economic problems will be postponed long enough to be addressed. They also may be betting the impact of financial market ups and downs on the real economy will be limited. Whereas, we who are worried about what we perceive as growing risks to the economy, are betting the adverse impact could come sooner. Particularly as foreign investors in US equities appear to already be changing their behavior. Foreign purchases of US equities have reportedly been declining for months. For us, the risk of "running with the bulls" is too great for our appetite.

For the month ended December 31, 2004, our one-month performance is up 1.59%, our three-month return is up 1.92%, our one-year return is up 0.31%, and our average annualized return since inception is up 9.99%. While volatility (risk) steadily continues to increase, our (since inception) risk profile has crept downward further to +/- 6.42%. This conservatively low risk level remains consistent with our strategy. With our expectation that this statistic gains increasing importance, our Sharpe Ratio remains a very respectable 1.37.

## **About Measuring Risk and Sharpe Ratios**

Investment pros borrow a tool from the statisticians—standard deviation—to measure investment risk. It shows the *range* of returns that investments are likely to earn over a given period of time and it has two sides, the out-performance and the under-performance of an average rate of return.

The Sharpe Ratio is a commonly used measure of portfolio earnings quality. In short, the Sharpe Ratio is a measure of return achieved per risk taken. Sharpe ratios can be better than just looking at performance because it incorporates the issue of risk. Some would say it is a measure of a manager's ability to perform consistently. The number by itself, however, is hard for many to understand without comparing it to something.

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Let's take a look at the S&P 500 Index for a quick comparison. The Standard & Poor's 500 Index is usually considered the benchmark for US equity performance. As the name suggests, the S&P 500 consists of 500 companies from a diverse range of industries. Contrary to popular belief, the S&P 500 is not a simple list of the largest 500 companies by market capitalization or by revenues. Rather, it is 500 of the most widely held US-based common stocks, chosen by the S&P Index Committee for market size, liquidity, and sector representation. For the last ten years, the Sharpe Ratio for the S&P 500 is less than 0.40 and it doesn't look much better when looking over the past thirty years.

Are you familiar with Morningstar, Inc.? They are a Chicago-based, global investment research firm, providing information, data, and analysis on the mutual fund industry. They say that a Sharpe Ratio of over 1.0 is "pretty good" and outstanding funds achieve something over 2.0. Using this "yardstick", we are more than pleased with our accomplishment to date.

For most investors, the Sharpe makes good intuitive sense because they not only hate to lose money but they often compare the returns to risk free investing. You owe it to yourself to understand and consider this measure when making investment decisions.

**Is a comfortable retirement or preservation of wealth important to you?  
Want better long-term results from your investments?  
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