Investing in a Better Job

Michael Sack Elmaleh
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by Michael Sack Elmaleh, MS, CPA, CVA

It is often remarked that in many equity transfers involving small “Main Street” businesses, the new owner is simply buying a job. For many in the valuation community, the idea that anyone would be foolish enough to simply buy themselves a job is met with derision. Because the standard model of valuation holds that equity value is driven exclusively by the anticipation of free cash flow, rather than compensation, investors who do not act according to the standard theory of value are seen as irrational. However, if we view a small business equity transfer as the acquisition of a better job, as opposed to just a job, the supposed irrationality disappears.

In this article, I will demonstrate that investing in a better job is a widespread phenomenon that is not confined to equity transfers involving small, closely held businesses. The attainment of college degrees and professional and technical certifications operates on the same economic principles as an investor acquiring a small, closely held business. The economic principles are (a) marginal benefit and (b) delayed gratification. The economic actors invest time and money in the present, in anticipation of realizing higher compensation in the future.

The primary anticipated marginal benefit for these activities is increased cash compensation. This increased compensation is not profit or free cash flow, because in order to receive it, the investor must continue to provide personal labor. Furthermore, the incremental benefit that people seek from a college education, special professional certifications, or the acquisition of small businesses is not limited to additional cash. Other incremental benefits include improved status, autonomy, and more stimulating and challenging employment.

Investment in Education

According to the 2000 census, almost 46 percent of the population between the ages of 18 and 24 has attended some college and obtained an associate degree or higher.¹ While the percentage of the overall population with a bachelor’s degree or higher is closer to 30 percent, college attendance in some form continues to be widespread, despite steeply increasing tuition costs. The U.S. Department of Education estimated the average yearly cost in tuition, room, and board at 54 institutions to be over $17,000 for the 2005-06 academic year. The average cost for two-year institutions was over $7,000 per year.² Therefore, an investment in a bachelor’s degree now costs on average nearly $70,000, while an associate degree costs about $14,000. These figures represent out-of-pocket costs, but do not reflect the full opportunity costs of obtaining a post-secondary education, because they do not include the wages foregone while attending school full-time. When foregone wages are included in the calculation, the average cost of attaining a bachelor’s degree is now well over $100,000.

The recent steep increase in educational costs has led some to question the economic wisdom of investing in education beyond high school. Nonetheless, 2005 Census Bureau data,

¹ U.S. Census Bureau, 2000 Census.
summarized in Table 1, indicates that such investments are economically rational. The census also provides a breakdown of expected lifetime earnings by level of educational attainment, shown in Table 2.\footnote{U.S. Census Bureau, Annual Social and Economic Supplement to the Current Population Survey, 2005.}

### Table 1: Average Annual Full-time Earnings by Educational Attainment, 2005

<table>
<thead>
<tr>
<th>Education</th>
<th>Earnings ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>No high school diploma</td>
<td>19,200</td>
</tr>
<tr>
<td>High school diploma</td>
<td>28,600</td>
</tr>
<tr>
<td>Bachelor’s degree</td>
<td>51,600</td>
</tr>
<tr>
<td>Advanced degree</td>
<td>78,100</td>
</tr>
</tbody>
</table>

### Table 2: Expected Lifetime Earnings by Educational Attainment

<table>
<thead>
<tr>
<th>Education</th>
<th>Earnings ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>No high school diploma</td>
<td>1,000,000</td>
</tr>
<tr>
<td>High school diploma</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Some college</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Associate’s degree</td>
<td>1,600,000</td>
</tr>
<tr>
<td>Bachelor’s degree</td>
<td>2,100,000</td>
</tr>
<tr>
<td>Master’s degree</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Doctoral degree</td>
<td>3,400,000</td>
</tr>
<tr>
<td>Professional degree</td>
<td>4,400,000</td>
</tr>
</tbody>
</table>

Clearly, there is a significant economic payback for individuals willing to invest in college education. Although higher compensation represents a major marginal benefit of an investment in higher education, there are other benefits as well. The attainment of a college degree opens up a greater range of employment choices and flexibility, increased status, and often more stimulating and enjoyable work.

There are other less tangible, marginal benefits to attaining a college degree. First, there is a sense of achievement that individuals feel upon completion. College education often results in close friendships, associations, and lasting connections. Alumni usually develop and maintain significant emotional loyalty to their educational institutions, which benefit both institutions and graduates. Finally, graduates may actually retain what they learned in college, and develop a desire for more lifelong learning.

### Continuing Education for the Employed

According to 2006 Department of Education statistics, of the nearly 17.5 million students enrolled in college, about 6.7 million or 38 percent were part-time.\footnote{U.S. Department of Education, National Center for Educational Statistics, Digest of Educational Statistics (2006).} Fifty-six percent of all colleges offered some form of distance learning geared to employed students. Based on 2003 surveys, 46 percent of all employed people participated in some form of career- or job-related course work. Based on 2004-2005 academic year data, fully 4 percent of the adult population were enrolled in part-time college degree programs, 1 percent were involved in part-time vocational course work, and 1 percent were enrolled in part-time apprenticeship programs. According to this survey data, 5 percent of adults employed full-time were enrolled in part-time college degree programs, while 8 percent of professional or managerial employees were enrolled in such programs.\footnote{Ibid.}

The popularity of these programs suggests that currently employed individuals are willing to invest time and money to improve their career prospects. The commitment to part-time and vocational degree programs by those already fully employed is remarkable, because the sacrifices made by those students may be quite significant. They are willing to give up free time to advance their job prospects. Although part or all of the tuition is often paid by employers under educational assistance programs, reimbursement generally depends on maintaining minimum academic performance.

### Professional Certifications

Most of the thousands of trade and professional associations in the United States offer certification and training programs. In our profession, the CVA and ABV designations are examples. Usually these programs are designed for employees, professionals, or tradespeople who have already established the minimum level of experience or educational attainment to enter their chosen field. The basic idea behind such certifications is to demonstrate additional expertise beyond the minimum standard for entry in the relevant trade or profession.

The cost in time and money to obtain these certificates varies, but generally it is less than part-time, post-secondary degree programs. Nonetheless, the cost usually is measurable in the low four figures. Most of these programs do not qualify as tax-free employer educational benefits, so these costs are probably less subsidized than weekend and evening degree programs. Obtaining these certificates may require additional training and passing an exam or exams. Often practitioners and tradespeople are required to have a certain minimum of experience as well. The economic rationale for attaining additional credentials and certifications is identical to the rationale for obtaining a college degree: The holders of degrees and certificates expect marginal benefits in the form of higher wages or fees.
Investing in a Small Business

Many, if not most, small businesses require the active, full-time presence of an owner-manager. These businesses are not large enough to generate sufficient revenue to pay for the internal and external audit functions that are needed to overcome the agency conflicts between owners and employees that can threaten the continued survival of a business. Even if agency problems could be overcome with non-owner employees, the cost entailed would leave little or no cash available to the owners.

In these small businesses the owner-manager must invest not merely capital but full-time labor to ensure that the business survives. Owner-managers who invest in these businesses have made a decision that the material and psychological rewards of ownership and full-time management of a small business are greater than the comparable benefits of full-time, non-owner employment.

When an investor purchases an equity interest in a small, closely held business that requires their full-time participation, the underlying economics are not comparable to acquiring an equity interest in a publicly traded corporation. In the latter case, there is no expectation that the equity acquirer will provide any services to the acquired company. All returns from the investment in a publicly traded company are free cash flow. In most small, closely held businesses the return on investment primarily represents compensation for services.

The rationale for buying an equity interest in a small closely held business is that the owner’s compensation, net of the cost of the investment, will be higher than if the investor remains a non-owner employee. Therefore, the underlying economics of a small company equity purchase more closely resembles an investment in education than an investment in a publicly traded security. In both educational and small business equity investment, the investor exchanges time and money now for greater future compensation. The expected return on the investment of tuition and classroom hours is a higher future wage than would be available without the educational investment. The expected return for an equity investment in a small, closely held business is a higher future wage to the investor than would be available if that investment had been foregone. It is just that simple.

In educational, vocational, and small business equity investments, there are no expectations of receiving any cash return from the investment if the investor withdraws from the job market or from active participation in the business (although it is sometimes possible to grow a small business that currently generates little or no free cash flow into a bigger business that does). The common feature of these investments is that the economic benefits cannot be sustained without continued investment in work. In contrast, investments in publicly traded securities provide returns independent of investor exertions.

Investing in Business vs. Education

While the fundamental goal of these improved-compensation investments is the same, there are notable differences. One difference involves the degree to which the investor attempts to precisely compute the estimated future benefit associated with the investment. The decision to invest in attaining a two-year or four-year college degree is not likely to be accompanied by a specific future compensation analysis. This may be the case because the anticipated wage increase is assumed to be very high, relative to the cost of tuition and wages foregone, negating the need for the computation.

It may be the case that more specific attention to future wage levels is considered in the choice of an academic major. For example, the choice of a business major versus a history major may be based on a general idea that the job market compensates the former more highly than the latter.

Similarly, the decision to invest in the attainment of a new professional or vocational certification is not likely to be based on a very detailed marginal compensation analysis. One reason is that the cost of obtaining the advanced certification is not nearly as great as the cost of obtaining a college degree or investing in a closely held small business. Another reason for not seeking a more refined marginal benefit analysis may stem from the fact that precise information on the increased expected wages or fees from a certification is not easily obtained.

When, on the other hand, an individual contemplates investing in a small, closely held business as a means of increasing compensation, usually the expected marginal benefits are carefully analyzed, because the investor is putting all of his or her eggs in one basket. The risk that the investment will not pay off is much greater than the risk involved in investing in post-secondary education or attaining advanced professional certifications. In these latter cases, there is an understanding that there are many possible jobs available that will provide greater compensation, not just one job. There is some risk of unemployment to be sure, but this risk is certainly more diffuse than the risk associated with investing in a closely held business. For this reason alone, much more attention is paid to the precise expected increased compensation of investing in a small business.

Although it is fairly clear that the risk of not obtaining the desired higher compensation is much more pronounced with a small business investment, there is one sense in which the risk may be somewhat less. Specifically, an owner of a small firm faces no risk of being terminated if the business
survives. There is, however, always this risk in the case of employment without an ownership interest. It should also be noted that when small business equity interests are exchanged, a variety of risk-mitigating sales terms are often used. These include continued seller involvement during a transition period, non-compete agreements, and sales price being contingent on retained customers and clients.6

Furthermore, to a great extent an owner-employee’s compensation will be more closely tied to job performance than employment without ownership, particularly if that employment is in a large, highly bureaucratic setting. The rewards for excellent performance may be much greater as an owner-employee, compared with a non-owner employee. This closer connection between compensation and job performance represents both a risk and a possible reward for choosing self-employment.

The more pronounced risk associated with small business equity investment raises an interesting question. Do investors in small, closely held businesses demand more compensation than comparable investors in college degrees and professional and vocational certification programs? This would be the analogue of the risk-versus-return relationship that is widely believed to prevail in traditional investments in publicly traded securities. In theory, you would think that small business equity investors would demand higher compensation, because of the extra risk associated with such investments.

In a recent article, I argued that the additional responsibilities associated with owning and actively managing a small, closely held business necessitates the payment of a responsibility premium.7 It is possible that the additional risk of self-employment might be a component of this responsibility premium. The need for such a premium may, however, be offset by the additional benefits of the autonomy associated with self-employment. Unfortunately, I am not aware of any accessible data that relates the size of compensation to the risk of unemployment.

Summary

Investing time and money to attain “something” that allows a person to earn more in future wages is economically rational, if the present value of the additional future wages exceeds the present value of the investment cost in time and money to attain that “something.” In our market economy, these attained “somethings” include college degrees, vocational and professional certifications, and equity ownership in small, closely held businesses.

The underlying economics of a small company equity purchase more closely resembles an investment in education than an investment in a publicly traded security.

Most small, closely held businesses require the full-time active management of the owner. Little or no free cash flow would be available to the investor if they chose to hire a non-owner manager. The return to such owner-managers is compensation. These additional returns are available only if the investor remains an active, full-time manager of the business. These investors believe that the combination of cash and intangible benefits associated with self-employment, net of the investment cost, will exceed the combination of benefits available as a non-owner employee. Such investors are not simply buying a job; they are buying a better job. VE

Michael Sack Elmaleh, MS, CPA, CVA, has served as a principal and partner in CPA firms in Madison, WI, for nearly 20 years. He has been retained as an expert witness in valuation cases in Wisconsin and Maryland. He has served as a past chair of the Wisconsin Institute of Certified Public Accountants Federal Taxation Committee. As an adjunct instructor in colleges in Maryland and Wisconsin, Elmaleh has taught mathematics, statistics, economics, corporate finance, and accounting. He has written several articles for The Value Examiner. (e-Mail: mmsdodger@aol.com)

6 For further discussion, see my article “The Effect of Sales Terms on Goodwill, Risk and Return in Transfers of Closely Held Accounting Practices,” Journal of Business Valuation and Economic Loss Analysis, Volume 3 (2008).