

THE VALUE OF SWEAT EQUITY

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As a business appraiser, I sometimes hear business owners claim that the value of their company should include their “sweat equity.” Sweat equity, of course, refers to the long hours, dedication and, in many cases, personal hardship, contributed by a business owner to his or her enterprise, especially in the early years, in order to make it successful. It may also include the help of family members and friends who were willing to dedicate their time, effort and expertise to help the owner get his or her new business off the ground. This non-cash investment can often be substantial and it’s not unreasonable to suggest that it may have value when the time comes to sell the business.

An owner typically devotes this time and effort with the expectation of reaping future benefits in the form of increased sales, improved financial stability and higher income. But does it also accrue to the economic value of the business? And what about a business that hasn’t fared particularly well even though the owner has made a valiant effort to be successful?

First of all, it’s important to understand that the value of a going concern is fundamentally a function of the present value of future profits the business is expected to produce for a new owner. In other words, a typical buyer of a business will invest capital only if he believes it will render future earnings at an acceptable rate of return. Therefore, in order for a *seller* to benefit from his investments in his company, both tangible and intangible, the company must demonstrate financial results and operational attributes that enhance the business’s value drivers in the eyes of a prospective acquirer. Value drivers include a history of steady and predictable sales levels, controlled costs, manageable debt loads and the presence of a well-trained and reliable staff, for example. These and other desirable characteristics result in industry-typical profit performance and risk levels, which in turn translate into value.

If the contribution of sweat equity from the owner and his family and friends has had a positive affect on the financial performance of the business and the perception that it is likely to continue providing acceptable levels of cash flow to the owner, then his

efforts will pay off in the form of a higher price. Unfortunately, the value of a business is diminished if it is losing money or only marginally profitable, regardless of one's contribution of time and treasure.

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