



CPAs & Business Advisors

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What is your manufacturing company worth?

If you think a business valuation is only for when an owner leaves the company or if the firm is being sold, think again. In fact, valuations are useful in many circumstances, including succession planning, due diligence by a lender, mergers and acquisitions, estate planning, and complying with government regulations.

Even if none of these trigger events are happening now, it still can be beneficial to have a valuation. Understanding what adds value to your firm can help you in future business decisions, such as timing the sale of your business for the maximum selling price.

The benefits of valuation

To make smart business choices, you'll need to know the amount an outside investor would pay to own some or all of your company. But unlike the value of a publicly traded company, the value of a privately held company can't be readily ascertained by the company's stock value.

A valuation assesses how much cash a company generates and might be expected to generate in the future, as well as how much an investor would require as a return on the investment.

But calculating those numbers isn't a science. Valuations rely on numbers and data, but those are only a starting point. After a thorough investigation, the valuator must make some assumptions based on the information at hand.

The price of goodwill

One of the most important assumptions is assigning a dollar value to goodwill. In this case, goodwill doesn't refer to the reputation of the business in relation to its customers; instead it denotes an amount the buyer pays over the company's book value (assets minus liabilities). There are several reasons why a buyer would be willing to pay this premium, such as an established client base or strong employee loyalty.

Goodwill is the excess price a buyer is willing to pay for a company beyond the tangible assets listed on the balance sheet. The intangible assets listed could be reasons why the buyer is willing to pay the premium, and therefore are potential contributing factors to goodwill.

The factors that contribute to goodwill are called intangibles, which include assets such as manufacturing processes, business reputation, patents and innovative marketing strategies. Intangibles differ from tangible assets, which are the company's physical assets, such as buildings, machinery and equipment.

Intangibles add value



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Although both asset types form a company's foundation, it's the intangibles that make a company worth more than the dollar value on its financial statements. Assessing intangibles is a subjective process. For this reason, price can vary depending on the buyer and the circumstances.

The IRS, however, requires a price that reflects fair market value (FMV) — the price a willing buyer would pay a willing seller providing the two parties are fully informed and not pressured to make the sale.

But because valuations are inexact, there is a range of acceptable valuations within the standard of FMV. Not surprisingly, sellers will push for the higher end of the range while buyers advocate for the lower end.

An expert opinion counts

In most cases, businesses choose to hire an independent valuation expert to perform the valuation. It's important that he or she have a solid understanding of the company and the industry it operates in.

An engagement letter at the start of the project should spell out the valuation's scope, list the different approaches and methods that the valuator can apply, and explain those that he or she will employ.

The engagement letter also should outline the responsibilities and roles of all the parties involved, key terms, and the information that will be supplied by others on which the valuator will rely. In addition, the letter should state why the valuation is being conducted and how the final report will be used and by whom.

To gain the insight necessary to make an evaluation, a valuator should address key issues such as the:

- Company's background,
- Economic conditions and forecast of the industry,
- Company's financial and future earnings potential, and
- Company's intangible assets.

As part of the valuation process, the valuator should conduct a site visit and thoroughly review financial statements, tax returns, contracts, leases and marketing materials.



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Once all the information has been gathered, the valuator analyzes it to produce a value estimate, which then appears in the final report. The valuation is the valuator's best estimate of the price and as such doesn't carry any assurances.

On track toward a quality valuation

A business valuation can provide insight into your manufacturing company's strengths and weaknesses as well as provide a road map for increasing its value. To ensure a quality valuation, be sure to hire an independent valuator who knows the ins and outs of your company and industry.

Sidebar: Valuation primer

Here are definitions of some key terms often used in valuations.

Book value. The historical, or original, cost of assets shown on the balance sheet. A company's book value is reflected in the owner's or stockholders' equity (assets minus liabilities).

Market value or adjusted book value. When an asset is adjusted to reflect its current market value. In most cases, the book value shown on financial statements isn't the same amount as the market value.

Revenue multiple. Price determined by multiplying the last 12 months of gross revenue by a number that generally ranges between one-half to four. The multiplier varies by industry and company and is based on several factors, including a company's customer base, ability to produce high-quality goods and key personnel.

Capitalization of earnings. The price is determined by adjusting historical revenues to reflect the buyer's desired return on investment. This method is commonly used for gift and estate tax purposes.