**[Manufacturing Business Valuation:](https://www.valuadder.com/blog/2007/09/26/manufacturing-business-valuation-focus-on-business-assets-and-earning-power/%22%20%5Co%20%22Permanent%20Link%20to%20Manufacturing%20business%20valuation%3A%20focus%20on%20business%20assets%20and%20earning%20power)**

**We** can measure the value of a manufacturing firm using a number of well-known methods under the [**market, income and asset approaches**](https://www.valuadder.com/glossary/business-valuation-approaches.html) to [**business valuation**](https://www.valuadder.com/valuationguide/business-valuation-three-approaches.html). However, to get accurate business valuation results you need to focus on two key points.

**1. Identify and include all income-producing assets in your manufacturing company valuation.**

More so than most other business types, manufacturing firms use a large number of assets. Property, plan and equipment typically represent a large portion of the manufacturing company’s investment.

Off-balance sheet assets such as internally developed intellectual property are very common. Product and process technologies can be licensed to generate additional income streams which increase business value.

**2. Base your business valuation on a realistic cash flow forecast and business risk assessment.**

Accurate estimation of the income-producing capacity for a manufacturing business may be challenging. Yet it is essential in defining what the business is worth.

Manufacturing firms invest heavily in developing new products and processes. And all products have a finite life cycle. Without constant innovation, technology obsolescence sets in quickly, reducing the income derived from product sales.

**Recasting historic financial statements for manufacturing business valuation**

To determine the value of a privately owned manufacturing company, you need to construct an accurate picture of the business assets and income. You do this through the [**process of adjusting or normalizing**](https://www.valuadder.com/valuationguide/recasting-financial-statements.html) the historic balance sheet and income statements.

**Balance sheet reconstruction for valuing a manufacturing company**

Here are a few guidelines for recasting your balance sheet:

**Assets:**

* Remove cash levels in excess of operating requirements.
* Remove uncollectible accounts receivable. Check the aging report.
* Adjust all inventory to market value, focusing on the work-in-process and finished goods levels. Remove obsolescent inventory.
* Adjust all long-term assets to their fair market value. In a business sale situation, include only those hard assets that will be included in the transaction.
* Determine the current value of any prepaid expenses.
* Remove shareholder loans.
* Value the business owned real estate separately.

**Liabilities:**

* Ensure that all currently owed amounts are included in the accounts payable.
* Verify all accrued expenses such as payroll and taxes due.
* Determine the customer deposit levels and only include those that can be transferred to the business buyer.
* Remove loans from business owners.
* Remove any real estate loans.
* Identify any contingent liabilities that may not appear on the historic balance sheet. Examples are possible legal expenses, and regulatory compliance costs.

**Recasting the company’s income statements and preparing cash flow forecasts**

Preparing a future cash flow forecast is to show an accurate picture of the business earning potential. The key points to consider are these:

**Sales:**

* Realistic revenue projections from sales of new products and services.
* Can historic levels be sustained in the future? Consider the product life cycle and competition offerings.
* Review the current sales order backlog against historic numbers.
* Check the accrual of customer deposits against actual product delivery.
* If some customers account for a larger percentage of sales, assess the likelihood of this continuing. Adjust your sales projections if sales to some large customers can be lost.

**Cost of Goods Sold:**

* Supplier stability and anticipated cost trends.
* Watch out for changes in inventory costing and direct labor accounting.
* Assess the risk of reliance on “single-source” suppliers.
* What prices and terms will the business buyer receive?

**Expenses:**

* Check and adjust for owner-discretionary spending such as auto, advertising, phone, travel and entertainment expenses.
* Make sure that there is adequate business insurance and account for any premium increases if needed.
* Remove any personal charges from the professional expenses such as legal and accounting fees.
* Identify all compensation components for the principal owner-operator. This is an important part of your seller’s discretionary cash flow estimation.
* Adjust the salaries of all other working owners to market rates. This is also known as the “manager replacement” adjustment.
* Check the rent expense. If the business sells and a new lease needs to be signed, your cash flow forecast should reflect this change.

**Income-based business valuation: Discounted Cash Flow and Multiple of Discretionary Earnings methods**

The [**Discounted Cash Flow**](https://www.valuadder.com/tour/discounted-cash-flow.html) method is a common way to value manufacturing companies. You can obtain very accurate business valuation results based on your business cash flow forecast and the [**discount rate**](https://www.valuadder.com/glossary/discount-rate.html), which captures the business risks. You can determine the discount rate using standard [**cost of capital models**](https://www.valuadder.com/glossary/cost-of-capital-models.html) such as the [**Build-Up**](https://www.valuadder.com/valuationguide/discount-rate-buildup.html) or [**CAPM**](https://www.valuadder.com/glossary/capital-asset-pricing-model.html).