

Getting it Done

Management & Financial Insights for Business Professionals

FEBRUARY 2025



Dear Gerry,

As a rule, the owner/CEO of a lower middle-market privately held, or family-controlled company plays many roles. For the most part, however, their most significant role is as the final decision maker on major issues. And what's often their most important and most difficult decision? *Whether or not to sell their company and when.* Sometimes the decision is pretty black and white. Either the company is in position for a significant pay day or, conversely, the outlook is so bleak that there is no choice but to sell - as a whole or in pieces. Often, though, the decision can be gut-wrenching because the company's outlook is uncertain.

I always want to ensure that our clients make fully informed decisions about if and when to sell. With this in mind, I've come to use a structured analytical process which focuses on four key areas of consideration.

Today I'll be discussing these four areas, the ten reference points they encompass, and how this analytical approach can help a business owner make the soundest decisions possible about selling their company.

As always, I invite your questions or comments.

Best wishes,

Gerry

My Company's Future is Uncertain. Is Now The Right Time to Sell?



OVERVIEW

For a substantial percentage of owner-led and family-controlled companies, the process for considering a sale is often somewhat haphazard – at best.

Why is that?

There are a range of reasons but for starters, the baseline fact is that most owners have never sold a company before and are simply inexperienced with the process. Further, the potential sale of a privately held or family-controlled company is emotionally challenging by definition. Finally, many business owners, albeit to differing degrees, tend to shoot from the hip. They're just not used to rigorously examining all of the important facts when they make major decisions. Among my jobs is to make sure that they do. To accomplish this, we look at ten reference points which I've grouped into four fundamental areas: 1) Financial Considerations, 2) Industry Considerations, 3) Company Specific Considerations and, 4) Personal Considerations.

Financial Considerations

As a credit trained commercial lender during the first part of my career, I have tremendous respect for the wisdom that financial ratios offer. What I've found is that these ratios offer clear facts about how a company's financials compare to their peer group. In turn, these comparisons provide a meaningful indicator about a company's future prospects.

The reference points I generally look at are as follows:

- **As a rule, does the company meet or exceed industry profitability norms?**

With regards to industry profitability norms, key measures include Gross Margin, Operating Profit and Profit Before Taxes. And often more granular measures such as labor cost as a percentage sales have great significance as well. Regardless, when a company is below any of the industry midpoints for several years running or more, usually something is fundamentally wrong. It may be weak pricing practices, too many employees or too many substandard ones, poor cost control, inefficient distribution practices, or outdated equipment that's simply incapable of producing products at a competitive cost. Most importantly, however, chronically sub-standard operating ratios virtually always reflect management shortcomings of some sort. Simply put, for whatever the reasons may be, management just hasn't been able to operate effectively.

- **Is the company's leverage consistently above industry norms?**

The challenge of high leverage is often under-appreciated. Most particularly, many owners/CEO's don't recognize that highly leveraged companies are at a substantial competitive disadvantage. Essential investments in technology or hard assets may be out of reach, well-priced financing may be unattainable, and extended trade payables may be creating havoc, etc. Furthermore, over-leveraged companies tend to stay that way. Organic de-leveraging is a long, arduous, often unsuccessful task and outside equity financing for financially challenged, privately owned companies is hard to find.

As a practical matter, the implications of these two financial reference points provide a clear context for the remaining areas I'll be discussing.

Industry Considerations

- Is industry transformation, either looming or largely solidified, creating major hurdles for the company's future success?
- Is the company's competitiveness driven by the ability to invest in new technologies or equipment?
- Is industry competitiveness driven by company sales volumes or distinctive product offerings?
- Does the company have any intangible assets that might be of great value to some, or all, of the most likely buyers?

Clearly, these four considerations raise the question of a smaller company's ability to compete effectively in the long term. And it's obvious that for companies situated on the weaker end of the financial spectrum, these reference points are all the more meaningful.

In the context of industry considerations, it's particularly important to take a close look at a company's intangibles. As just one example, beginning during the height of COVID, Pathway began a long-term engagement with a specialized construction supply distributor with ten locations throughout New England. From the outset, our overriding goal was to sell out to a similar, but much larger company based in the mid-Atlantic. After regaining profitability in the second year of our work together and four years of effort in total, our client was sold to the target buyer for \$5.5 million. This price was *about \$1.5 million more than several EBITDA based valuations indicated*. Clearly, the opportunity for the buyer to gain a strong position in New England drove the deal. Similarly, in 2023, we sold a consumer products manufacturer that had been losing about \$2 million annually for several years. At the same time, the company had one strong product line with a solid customer base. **The company sold for about \$2.25 million over straight liquidation value.**

There's a huge range of intangible assets that offer substantial value to the right buyer. Technologies, trade names, market reach, critical human capital, size related efficiencies, and significant new customers are just a few.

Company Specific Considerations

- *Does the company have essential human capital - or can it be attracted?*
- *Does the company have the capabilities needed to deliver their products and/or services efficiently?*
- *Does the company have a clear and realistic go-forward strategy backed by the entire management team?*

These reference points are all about helping ownership look at some basic, difficult truths. The hardest part though is when these factors are not encouraging – but the company has a level of staying power. When that's the case, selling may very well be the right decision – but it's usually much more difficult for ownership to pull the trigger. At the same time, standing pat might lead to tough times – or worse. I've seen this too many times.

Personal Considerations

- *Does selling their company, in the near term, allow ownership to meet their personal goals?*

This consideration is multi-faceted. Sometimes, it's all about being at a stage of life where a comfortable retirement is both financially possible and desirable. On the flipside, the goal may be as basic as coming out of the business with a good job or avoiding personal guarantee exposures. Needless to say, there can be countless other personal considerations as well.

FINAL COMMENT

Certainly, there are many situations when selling out, or even liquidating, is the only sound decision that a business owner can make. In many other instances though, the right decision just isn't as clear. Regardless, by taking a structured approach which takes a look at these ten reference points, a sound, fact-based decision is far more likely.

Pathway Advisors LLC is a specialized business advisory firm focused on helping our clients effectively resolve their most significant profitability, cash flow, banking, operational, and organizational challenges. Often, the right solution is a sale transaction or a full or partial wind down. We pride ourselves on the ability to analyze issues quickly, develop plans to solve them efficiently, and leverage our deep relationships in the financial and business communities to do so. Pathway has helped over 450 companies throughout the eastern half of the US.

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