PATHWAY ADVISORS LLC
WORKOUT & SELL-SIDE PROFESSIONALS

Getting it Done

Management & Financial Insights for Business Professionals

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Dear Friend,

On countless occasions over the years, people have made comments to me that have a common theme along the lines of: "Gee – the economy isn't very good right now – you must really be busy." While that's often true, the thought itself is actually somewhat off base. In fact, ***with regards to the CEO/owner led operating companies that are the focus of Pathway's work***, my general response about the impact of economy is "it's not really just the economy that keeps me busy, more often it's stupidity." Pardon my being blunt - but I love that line. Putting that aside, the simple fact is that weak management often leads it's company into an undercapitalized position. At that point, their company is vulnerable and, far more often than not, economic headwinds are really just the straw that broke the camel's back.

Today I'll be sharing both published research and my own experiences regarding failed companies. My hope is that this newsletter can help broaden your perspective on why companies fail. Further, my goal is to help you have productive conversations with your clients, peers or employees about the central importance of building a company's financial strength - *and how often it's just remarkably overlooked.*

As always, your comments and questions are both invited and appreciated.

Best Regards,
Gerry

The Weakest Link

THE REMARKABLE CONSISTENCY OF OPERATING BUSINESS'S FAILURE RATES

It's well known that the failure rate for start-ups is, not surprisingly, quite high. Per The US Bureau of Labor Statistics, 40% to 50% of start-ups fail within 4 years. There are reported variations in these statistics based on industry type and a variety of other factors. Regardless, overall, 40% to 50% is a constant.

What's really interesting, though, are the reported failure rates for companies that get beyond the 4-year mark. Again, citing The US Bureau of Labor Statistics, the annual failure rate of these older companies, on an industry-wide basis, runs between 4% and 6% ***regardless of economy cycles.*** While this might sound surprising at first, I ask that you step back and think about your own observations. With the exception of extraordinary circumstances like COVID, or certain industries like restaurants, I think you'd agree that even in "bad times," you don't see a high percentage of companies that fail. You just don't.

THE REMARKABLE CONSISTENCY OF WHY OPERATING BUSINESSES FAIL

Early in my career, I identified what I've come to call a "cluster" of strikingly common management issues that have proven to correlate, for me, with both undercapitalization and a heightened likelihood of failure.

This cluster includes:

1. A flawed owner/CEO who largely focuses on one or two aspects of their company's activities and is either unskilled or unappreciative of the broader range of management tasks they are ultimately responsible for
2. A lack of focus on building and maintaining financial strength
3. A lack of planning
4. A lack of efficient organizational structures
5. A lack of clearly articulated and closely observed policies and procedures
6. A lack of consistent communications: both top-down and bottom-up
7. A lack of effective financial controls
8. A lack of accountability company-wide
9. A lack of formalized training from top to bottom

All of these issues are both impactful and interrelated. Further, my experience is that collectively, they often lead a company into chronic undercapitalization. In turn, this leaves a company ***vulnerable*** to the full range of business challenges that can lead to failure. ***Yes, the economy is certainly a very significant factor. At the same time, it should really be viewed more as the force that breaks what's often the weakest link in the internal chain that supports a***

company's longevity - <u>undercapitalization</u>, This may seem trivial, but I can assure it's not. Human nature is powerful and it's just easier – as well as more energizing - to think about building sales rather than it is to think about building a Balance Sheet.

A SIMPLE APPROACH TO ADDRESSING UNDERCAPITALIZATION

Intuitively and experientially, many business owners and senior executives know when their company is undercapitalized. Regardless, it's crucial to concretize the issue. And that task is actually pretty straightforward. Industry specific financial ratios are generally available and can be used as a benchmark for measuring a company's financial strength. Furthermore, these benchmarks can be used as a target for a company to attain.

I know this sounds simple and conceptually, it is. At the same time, you'd be amazed by how much difficulty many business owners have both grasping and acting on the need to build financial strength. It takes discipline, foresight and a willingness to look at cold, hard facts. Unfortunately, these are three traits that some business owners flat out don't have.

FINAL COMMENT

Economic cycles and the difficulties they create are a basic fact of business life. The challenge every CEO/owner of an operating company must meet is to be ***truly smart*** and understand that undercapitalization is often the weak link that really breaks the chain.

<u>Pathway Advisors LLC</u> is a specialized business advisory firm focused on helping our clients effectively resolve their most significant profitability, cash flow, banking, operational, and organizational challenges. Most often, the solution we help execute is a sale transaction, a refinancing 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.

Gerry Sherman 617-699-2756
gsherman@pathway-advisors.com

Richard Katzman 617-935-3581
rkatzman@pathway-advisors.com