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**Banker to Entrepreneur: Your Product May Be "Aces," But "Cash Is King"**

"Cash is king." This age-old adage is never truer than with young companies that are not yet cash-flow positive. As a banker, I also rely on its corollary cousin, "Collateral doesn't repay loans, cash does." Both of these axioms are critical considerations for lenders and therefore important to understand as a borrower.

When I first discuss a potential loan with a budding company that is still developing or has just begun to commercialize its product, the applicant will invariably present (and rightfully so) a thorough description of the product, the current competition and alternatives. And to be sure, there will be a business plan that is as optimistic as a Cubs fan on Opening Day of the baseball season. I have yet to, and don't ever expect to, see a business plan that states "and then in the second year we run out of money."

But even the best business plans often leave me asking more questions about cash. How much has been invested so far? By whom? In what form was the cash invested? How much more do the owners and investors have available? (Such funds are commonly referred to as "dry powder" or "money around the table.") It's the classic push/pull of capitalizing a business; the equity investors generally want as much debt as possible, and the lender wants as much equity as possible!

Bankers are generally not great at picking winning and losing new products, especially if those products are highly technical or specialized. We like to think we can recognize the obvious great and bad ideas on the margin, but in the big bell curve of business ideas, most fall in that large area in the middle. It would be nice to think that your average banker saw the potential of Facebook and MySpace, but could they pick which one would raise $16 billion in an IPO and which one would fade away? Probably not with enough certainty to lend depositors money and be able to sleep at night.

**Follow the Money**

So what are lenders to do? I heed the advice of that infamous parking lot informant from All the President's Men, Deep Throat, and "follow the money" – preferably what I believe to be, and hope is, "smart" money. We bankers are likely to ask a lot of "what ifs" about both invested and working capital as well as downside cash-flow scenarios.

Put another way, a lender doesn't want to be the only player anteing into a poker game. Lenders would prefer to ante in last (and less!) than the other players. Lenders want to have less risk than the other players, and in exchange for that are willing to cap their winnings at just their interest rate. And, if the pot grows or shrinks, all they want is to be repaid first, and leave however much remains in the pot, large or small, to be divided among the others.

## One Way a Banker May View Your Cash Flow

But how do bankers determine the right amount of cash on hand for a particular business? Well, we use the concepts of "cash burn" and "cash runway." Lenders use these concepts to calculate the amount of cash a not-yet-cash-flow-positive company currently has and how long it can live off that cash, all else remaining constant. These terms are often mistakenly used interchangeably, but in reality they represent different, albeit highly correlated, concepts.

Cash burn is usually calculated by ascertaining how much cash was actually expended during the most recently completed three-month period. This is normally reported on a quarterly basis. (Be sure not to equate cash burn with your income statement profit or loss – that is, your "bottom line." They can be, and usually are, very different, especially over short periods of time.) This quarterly cash burn number is then divided by three to create the "average monthly cash burn." I have seen, though rarely, cash burn determined after each month, but doing it quarterly is the standard, as it smoothes out month-to-month volatility. Conversely, bankers will sometimes average the burn over the preceding rolling six months, but the number is still calculated every 90 days.

Once the average monthly cash-burn number is established, a lender will simply divide that amount into the company's cash on hand at quarter end to get how many months of cash are on hand. To illustrate this concept:

Imagine that Startup LLC used $150,000 of cash in its most recent quarter.  Dividing by three gets us to $50,000 of average monthly cash burn. If Startup LLC had $200,000 of cash on hand at quarter end, its "cash runway" would be four months ($200,000/$50,000). Note that "cash burn" is expressed in dollars, whereas "cash runway" is expressed in months.

A lender will thus set the cash covenant in terms of "cash runway" covenant to capture the changing cash-flow dynamics of the borrower. The number of months of the runway is usually a highly negotiated item between lender and borrower, and an astute lender will build in enough cushion so that it can react to a covenant breach proactively without a sense of impending doom that might require more drastic actions. Remember also that borrowers usually have up to 30 days to report financial results and covenant compliance, so by that time the cash runway is another month lower. I typically use the "acceptable cushion plus one more month" approach to setting the covenant level in order to have sufficient time to work toward a mutually agreeable remedy if necessary.

After agreeing on the math and the minimum cash runway to be maintained, both lender and borrower understand the rules of the game. In a follow-on article to be published shortly, we will explore what a borrower should do in the unfortunate event of a broken covenant.

**About the Author**

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