Why Startups Need To Keep Their Burn Rate In Check

Starting a business is no mean feat. It takes luck, determination, and no small measure of chutzpah to take on the marketplace and compete for consumers' hard-won dollars.

But while conventional wisdom tells us starting is the hardest part of any enterprise, it's keeping your business afloat on the high seas of commerce, and not launching it from the dock, that's truly challenging for most business owners.

You'll need to use resources effectively and leverage every opportunity for maximum return on investment. And in order to do so successfully, you need to track a metric known as *burn rate*.

What is Burn Rate?

Like the furnace of an old-time steamship, your start-up company needs fuel to drive progress. But instead of coal or wood, you're burning *money*.

Cash flow dictates everything a start-up does. New businesses aspire to do a lot of things, but the vast majority of them lose, rather than make, money in the early stages of their existence.

Your company's burn rate is the rate at which it spends available cash while operating with negative cash flow.

Burn rate is a critically important metric for start-ups because it not only tells you how much you're feeding the furnace, but how likely venture capitalists or seed investors are to contribute fuel for the fire.

Businesses that generate revenue and have a tight lid on the amount of cash consumed by their burn rate will attract more interest, and investment, than those hemorrhaging money without potential profits and growth to show for their expenditures.

High burn rates can create major stress on all parties by creating the need for shorter deadlines to hit revenue targets and/or requiring larger and more frequent infusions of cash from venture capital sources to help the company achieve a positive cash flow and, eventually, a net profit.

Burn rate, much like fire itself, must be managed effectively, or your start-up—like the nearly 30% of all small businesses who fold due to cash flow problems—will burn too hot before sinking below the waves.

> *In most contexts, compliance is simply meeting pre-established expectations. For procurement teams, bringing together the compliance function with the procurement function means treating the latter as the executor of the former.*

Calculating Burn Rate

You'll monitor two different types of burn rate as a total measure of negative cash flow:

- ## Gross burn rate

  Gross burn rate is your available cash, divided by your total monthly operating expenses, e.g. rent, utilities, and staff wages. You can also glean some useful insights about your company's overall efficiency and areas of potential cost reduction with this metric.

- ### Net burn rate

  Net burn rate is your available cash, divided by monthly operating losses (i.e., revenue minus operating expenses). This metric will tell you how much cash your company requires to keep on running over a given amount of time (usually a month). Note that changes in revenue can have a precipitous effect on this metric; a drop in earnings without a comparable drop in expenses will inevitably create a high burn rate.

Let's take a look at a sample cash flow statement. Suppose your start-up company, WidgetCo, has a monthly revenue of **$25,000**.

Operating expenses are **$30,000 a month**, which gives you a negative cash flow of **$5,000 every month**. You have **$300,000** cash on hand.

Based on these amounts, your company's gross burn rate would be:

$300,000 ÷ $30,000/month = 10 months

Using these same values, we can calculate a net burn rate thusly:

$300,000 ÷ ($5,000) = 60 months

Assuming revenue doesn't increase (heaven forbid), your company's net burn rate indicates 60 months of operation before it can no longer support necessary operations.

Keep in mind this isn't necessarily an absolute end goal, but rather an informed place to start your financial planning to ensure you can obtain more cash as necessary to keep things running whether you're flush with revenue or struggling to meet your targets.

Controlling Burn Rate Effectively

Once you know your burn rate, the next step is to lower it. You can dampen the roar of the flames in a variety of ways, including:

Trimming the Fat (and Maybe Some of the Meat)

If you’re relying on investor cash to keep your business going and growing, you may be required as part of the terms of your agreement to slash pay or staff when your burn rate hits a certain level.

Cutting pay and employees will certainly reduce overhead, but it also requires you to know which employees are truly essential to the growth and success of your business, and how much work can be shared among them without bringing the whole works crashing down when things get lean.

Building a Better Budget

Are your financial statements more like financial questions? Trying to get by with Excel spreadsheets and a pocket calculator might be a thrifty solution for the aspiring small business owner, but the added work and stress, as well as the potential for miscalculation, make it a risky choice.

Your new business might operate on a monthly basis, but you need effective planning to secure the kind of long-term funding required to succeed.

Investing in centralized and comprehensive software package will make it much easier to create and manage your company’s budget, create accurate financial statements, and track your cash balance, burn rate and other key metrics.

More data means more insights, so you can continue to refine and reduce expenses while presenting your investors with clear, concise information they can rely on to invest with confidence.

Another side effect? Data-driven growth. Armed with complete and accurate financial information and easy data analytics, you can take advantage of smarter forecasting to (for example) identify opportunities for deeper market penetration, find new verticals to pursue, and leverage economies of scale through detailed expansion forecasts.

These opportunities may be new sources of direct revenue or provide enticement to investors keen to reap additional profits down the road. Both will cut your burn rate significantly with fresh infusions of cash.

Making the Most of Marketing

More customers buying your goods or using your services means more revenue—and to get those customers, you need smart, targeted, and effective marketing.

But early-stage start-ups often don’t have much cash for direct marketing, and so rely on a variety of guerilla techniques, leveraging the power of social media to increase engagement through platform-specific promotions, viral campaigns, and conversion of existing users to brand evangelists.

In the modern connected marketplace, you don’t need to spend a lot to generate heavy buzz that attracts eyeballs and the dollars that will lower your cash burn rate.

Tame the Flames for Start-Up Success

For start-ups, every line item in the budget can seem like the spark that’ll light a business-torching conflagration of cash flow catastrophe.

But once you understand burn rate and how to keep it in check, you can shift your focus away from keeping your head above water and toward smooth (and profitable) sailing on the small-business seas.f

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