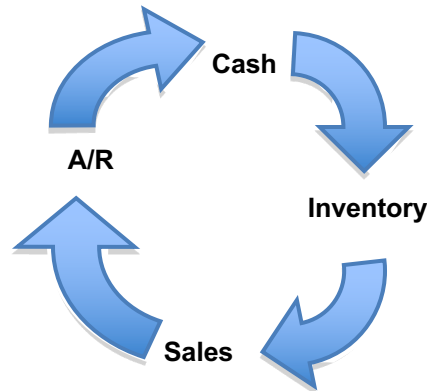




As defined by *The Business Ferret, LLC*, the net trade cycle or trading cycle is:

“Net Trade Cycle is a popular metric that new business clients always want to learn more about. The Net Trade Cycle is sometimes known by the name Cash Conversion Cycle. The whole idea of the Net Trade Cycle or Cash Conversion Cycle is how fast it takes for cash to go from the cash balance through the regular trade cycle of the business.

Cash, along with vendor payables, are used to purchase inventory, which goes through processes to become a service or product for sale, ultimately to be sold and held as an account receivable balance until eventually being paid off by the customer. The Net Trade Cycle shows how long the cash is tied up in the trade cycle before coming back out as cash again.

To calculate the Net Trade Cycle, we start with the number of days, on average; money is held in each of accounts receivable (AR), inventory, and accounts payable (AP). Once the days are tabulated for each, AR days are added to inventory days and AP days subtracted out to come up with a total net trade days. This net number of days can either be positive (usually) or negative. The Net Trade Cycle tells how many days it will take for cash to go through the trade cycle back to cash.

When the net trade days are positive, the company needs to fund those days with net income or a line of credit. **When the net trade cycle is negative**, the firm is being paid for the service or product before the firm pays its vendor AP. While a negative net trade cycle can be very advantageous to a business, it only holds true when a business is increasing the revenues. When revenues start to decline, a negative Net Trade Cycle can be disastrous to cash flow. Basically, a positive Net Trade Cycle uses cash flow as the business grows and a negative Net Trade Cycle produces cash flow as a business grows. The reverse is true of both positive and negative Net Trade Cycles when the business is constricting.

The Net Trade Cycle can tell a company how many cycles it goes through in a year and how many total dollars are tied up in each cycle. This indicates how many dollars are tied up in each day in each category whether accounts receivable, inventory, or accounts payable. **When days increase in accounts**

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Net Trade Cycle

receivable or inventory, the company is decreasing cash flow and cash balances. **When days decline**, the company is increasing cash flow and cash balances.

With accounts payable it is the opposite: when days are increasing in the accounts payable, the cash flow increases. When the AP days decline, the cash flow declines. If the company knows specifically how much each day in the Net Trade Cycle actually represents in dollar amounts, then management is much less likely to ignore problems in the cycle as a whole. This may be one of the reasons it has such appeal or interest to understand; there is a concrete metric to follow to determine success or failure.

There are, however, two more tactical levels of the Net Trade Cycle. Most financial discussions only look at the most basic cycle (explained above). There are two more levels of Net Trade Cycle that should be discussed. Besides accounts payable days, a firm can do the calculation of days for other payables, which could include credit card balances, and unearned income (or, if these amounts are typically substantial, they can be the calculated for days separately). This would be a Level 2 Net Trade Cycle where the first one that was discussed was Level 1.

Additionally, the calculation of days tied up in the line of credit is calculated to determine a Level 3 Net Trade Cycle. Level 2 adds the AR days to the inventory days and subtracts out the AP days and the other payable days. Level 3 now subtracts out the line of credit days.

The faster a company can turn cash back to cash, the faster it can grow without increasing the investment in working capital. Working Capital is the net difference between the drivers in current assets (not counting cash) and those in current liabilities (not counting any accrued tax liability in order to avoid double counting in the cash flow before financing numbers)."