

3 week Assignment.

* Cost of Debt:

- General Rule: Debt generally has the following characteristics.

⇒ Fixed payment

⇒ Tax deduction

⇒ Loss of Control.

- As a consequence, debt should include

⇒ Any interest-bearing liability, whether short term or long term.

⇒ Any lease obligation, whether operating or capital.

* Estimating Cost of debt.

Estimating Cost of debt	{	It Rated	—	Cost of debt, Credit rating
		Not Rated	{	Last borrowed
				Synthetic Rating.

Estimating Synthetic ratings:-

\Rightarrow The Rating for a firm can be estimated using the financial characteristics of the firm.

$$\Rightarrow \text{Interest Coverage Ratio} = \text{EBIT} / \text{Interest Expense}$$

Cost of debt Formula:

$$= \text{Risk Free Rate} + \text{Default spread} (1 - t)$$