

ASSIGNMENT-8.

1) Explain cost of debt and benefits of debt.

Cost of debt:-

* Cost of debt is the total interest expenses accrued on debt, simply the cost of debt is the effective interest rate on the total amount of interest that a company or individual owes on any liabilities, such as bonds and loans.

* This expense can refer to either the before tax or after tax cost of debt. The degree of the cost of debt cost depends entirely on the borrower's creditworthiness. So higher cost mean the borrower is considered riskier.

The cost of debt is the effective rate that a company pays on its debt, such as bonds and loans.

Debt is one part of a company's capital structure with the other being equity.

Calculating the cost of debt involves finding the average interest paid on all debt as a percentage of the total debt.

* You can get it as:-

$$\text{Pre-tax cost of debt} = [\text{Risk free rate} + \text{Credit spread}] \times (1 - \text{Tax rate})$$

Before tax cost of debt:-

$(\text{million}) \times (\text{interest rate}) \times (\text{tax rate})$

1,200,000

calculating by average interest rate and pre tax cost of debt.

Benefits of debt:-

* Tax benefits

Interest expenses on debt are tax-deductible from income.

* Lower cost of capital:-

Debt is generally cheaper than equity especially

For large, stable companies.

* Increased Financial leverage:-

Debt returns on equity enhancing shareholder value.

* Improved cash flow:-

Debt can provide liquidity, helping companies manage cash flow.

* Investment Financing:-

Debt facilitates investments in assets projected on acquisition.

* Risk management:-

Debt can hedge against interest rate or currency fluctuations.

Fluctuations.

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