

The Valuation School



Cost of Debt (k_d)
(The correct way)

A hand-drawn illustration of a pink pushpin on the left side of a white rectangular box. Two thick purple lines extend horizontally from the left and right sides of the box, passing behind it.

MASTERCLASS
VALUATION
Part - 6/30

Hey! Good morning.

- Till now we have completed calculation of cost of Equity
ie. Risk free rate, ERP & Beta.
- Let's delve into cost of finance
to complete "Cost of capital".



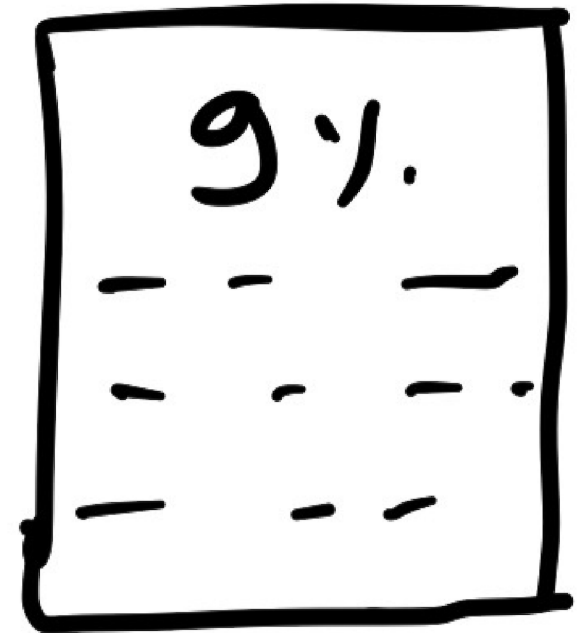
What is Cost of Finance (K_d)?

- It is cost of raising funds for a company "Today"
- The word today is most important here.
- Its not a historical cost but future cost of raising debt.

How not to calculate K_d ?

— MOST of the people assume K_d as Intt paid by the company Over Debenture

This is a 9% debenture
raised by company
5 years ago



9% was a K_d 5 years ago, not Today

How to calculate K_d ?

We will learn calculation of K_d through two methods.

① Traded Debt

② Rated Debt.

Let's begin \rightarrow

Traded debt.

- If debt of a company is Traded in the market, you have got a Jackpot.
- Just assume yield of Traded debt as cost of financing
- why? - Because it reflects current risk perception about the company.

check out current yield on
Traded Bonds of VEDANTA.



Vedanta Resources Plc		₹ 65.75
CPN 9.25% 04/26		Yield 26.13%
Vedanta Resources Finan...		₹ 66
CPN 8.95% 03/25		Yield 34.16%
Vedanta Resources Finan...		₹ 84.35
CPN 13.875% 01/24		Yield 37.66%

It shows that people perceive Vedanta as a risky business and expect higher returns on debt.

Rated Debt:

- In India, most of the debt is not traded but rated.
- Identify the Debt rating of your company.
- use the look up table given in later slides to identify the corporate default spread.

How to identify Debt rating of co.?

① Check Annual reports.

② screener.in.

- open your company.

- go in bottom



screener.in

FEED SCREENS

Adani Enterp. Chart Analysis Peers Quarters

Adani Enterprises Ltd

adani.com [BSE: 512599](https://www.bseindia.com/quote/BSE:512599) [NSE: ADI](https://www.nseindia.com/quote/NSE:ADI)



Credit ratings

Rating update

10 Mar from brickwork

Rating update

8 Mar from care

Rating update

Concalls

Jul 2022

Jul 2022

Nov 2021

check the default spread of your company in this lookup table.

Rating	Spread	Rating	Spread	Rating	Spread
D2/D	20.00%	B1/B+	4.55%	A2/A	1.42%
C2/C	17.50%	Ba2/BB	3.13%	A1/A+	1.23%
Ca2/CC	15.78%	Ba1/BB+	2.42%	Aa2/AA	0.85%
Caa/CCC	11.57%	Baa2/BBB	2.00%	Aaa/AAA	0.69%

→ These are average traded yield of Rated bonds.

Say, your company's debt rating is AAA.

So the default spread would be 0.69%.

Hence Cost of Debt =

Risk free rate + Corp default spread.

$$4.45 + \underline{0.69\%} = \boxed{5.14\%} \rightarrow \text{Real } K_d.$$

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apologies for pathetic handwriting

