

JAIIB



Accounting & Financial Management for Bankers

Module C : Cost of Capital

Understanding the Cost Cost of Capital

Capital represents a firm's long-term funding sources. It sources. It includes both debt and equity capital.

The cost of capital provides a benchmark above which a firm should earn from its business.



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Equity Capital Isn't Free

* Higher Risk

Equity holders take more risk than other investors.

Expected Returns

They expect higher returns than debt investors.

Opportunity Cost

Investors forego other investment opportunities.

Difficult Calculation

Cost depends on investors' risk perception.

Cost of Debt Capital

Term Loans

Interest rate is transparently known. No calculation needed.

Bonds & Debentures

Cost equals Yield to Maturity (YTM) in secondary market.

Investor Expectations

Depends on coupon rate, firm's risk profile, and market conditions.



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Calculating Yield to Maturity

YTM Formula

$$\text{YTM} = \{\text{Annual interest} + (M - P)/n\} / (0.6 \times P + 0.4 \times M)$$

Variables

M = Maturity value, P = Present Present market value, n = Years Years to maturity

Purpose

Provides approximate yield without trial and error calculations



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Question

- A firm's debentures with face value of 100 and coupon of 10% p.a. are having a current market price of 90. The number of years left to maturity are 4 years. What is the cost of debt capital for the firm?

$$\text{YTM} = \{10 + (100 - 90)/4\} / (0.6 \times 90 + 0.4 \times 100) = (10 + 2.5) / (54 + 40) = 12.5 / 94 = 13.30\%$$



Cost of Preference Capital

Similarities to Debt

- Fixed rate of interest (dividend)
- Can use same YTM formula
- Expected to pay dividends yearly

Key Differences

- Higher risk perception
- Lower priority in liquidation
- Interest not tax deductible



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Formula

$$\text{YTM} = \frac{\text{Annual interest payment} + (M - P)/n}{(0.6 \times P + 0.4 \times M)}$$

where M is the Maturity value, P is the present market value and n is the number of years left to maturity. Here the underlying assumption is that the firm will pay the dividends every year and the preference shares will be redeemed on the due date.



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Thank You

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