National Rural Utilities Cooperative Finance Corporation
FY21 First-Quarter Investor Call
October 20, 2020
10:00 AM EDT

Operator: Good day, and welcome to the Fiscal Year 21 First-Quarter Investor Conference Call. Today's conference is being recorded. At this time, I'd like to turn our conference over to Ling Wang. Please go ahead.

Ling Wang: Good morning. This is Ling Wang, Vice President of Capital Markets at National Rural Utilities Cooperative Finance Corporation. Welcome to our fiscal year 2021 first quarter investor call which covers the 3-month period from June 1 to August 31, 2020. Joining our call this morning is Andrew Don, our Chief Financial Officer.

Before we begin, let me remind you that some of the information provided and comments made during today's format include forward-looking statements that are based on certain assumption and describe our future plans, strategies and expectations are generally identified by our use of words such as intend, plan, may, should, will, project, estimate, anticipate, believe, expect, continue, potential, opportunity, and similar expressions, whether in the negative or affirmative.

Those statements about future expectations or projections are forward-looking statements. Although we believe that the expectations reflected in our forward-looking statements are based on reasonable assumptions, actual results and performance may differ materially from our forward-looking statements. Factors that could cause future results to vary from forward-looking statements about our current expectations are included in our 10-K and 10-Q filed with the SEC. All forward-looking statements are made as of today, October 20, 2020 and we undertake no obligations to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the statements are made.

Today's remarks will also include certain non-GAAP measures. Please refer to our Form 10-Q filed on October 15, 2020 with the SEC and also posted on our website for a discussion of why we believe our adjusted measures provide useful information in analyzing CFC's financial performance and the reconciliations to the most comparable GAAP measures.

We will have a Q&A section at the end of this presentation. You can ask questions via phone or submit your questions online if you are participating in this event via webcast. We encourage you to take this opportunity to ask any questions you may have in addition to the material for this event including the presentation slides and financial reports are available on our Investor Relations section of our website at www.nrucfc.coop. A replay and a call transcript will be made available on our website after the event. With that, I'll turn the call over to Andrew.

Andrew Don: Thank you, Ling. And again, good morning, and thank you again for joining us today for National Rural Utilities Cooperative Finance Corporation's call to review our financial performance for our first fiscal quarter of fiscal year 2021, for the three-month period ended August 31, 2020.

Our total assets at quarter ended August 31, 2020, were approximately $28.3 billion, a slight increase of $105 million from the May 31, 2020, fiscal year-end level, primarily due to the growth in our loan portfolio of $227 million, partially offset by a decrease in cash, cash equivalents, and investment securities of $103 million.

During the current quarter, the increase in loans to members was driven by an increase in long-term loans of $385 million, which was partially offset by a decrease in line of credit loans of $159 million. Specifically, on a net basis, loans to distribution members represented the largest increase of $242 million, while loans to RTFC borrowers increased by $11 million. Partially offsetting this growth, loans to NCSC borrowers, statewide and associate organizations, and power supply members decreased on a net basis by $17 million, $8 million, and $2 million, respectively.

We experienced modest loan demand from our members during the current quarter. For the three-month period ended August 31, 2020, CFC's long-term loan advances totaled $807 million. These advances consisted of $750 million or 93% for capital expenditure purposes and $35 million or 4% to refinance other lenders' debt. In comparison, during the same prior-year quarter, long-term loan advances totaled $888 million, with $645 million or 73% for capital expenditure purposes and $166 million or 19% for the refinancing of other lenders debt.

Our members' equity, which excludes cumulative derivative forward value losses and accumulated other comprehensive loss, decreased slightly by $7 million. The decrease was due to CFC's Board of Directors' authorization in the first quarter to retire patronage capital of $60 million, which more than offset the adjusted net income of $57 million reported for the three months ended August 31, 2020. Our adjusted debt-to-equity ratio increased to 5.96 to 1 at August 31, 2020, from 5.85 to 1 at May 31, 2020, due to a slight increase in adjusted liabilities of $158 million, primarily to fund the loan growth and a decrease in adjusted equity of $45 million. The decrease in adjusted equity was primarily attributable to the $7 million decrease in our members' equity mentioned earlier, and the maturity of $41 million of our member subordinated certificate. That said, our adjusted debt-to-equity ratio remained below our targeted threshold of 6 to 1.

For the three months ended August 31, 2020, CFC generated adjusted net income of $57 million and an adjusted TIER of 1.28 times, compared with adjusted net income of $61 million and adjusted tier of 1.27 times for the same prior-year quarter.

The $4 million decrease in adjusted net income for the current quarter from the comparable prior-year quarter was mainly due to a reduction in prepayment fee income of $7 million and the absence of the gain of $8 million from the sale of land in the same prior-year quarter, partially offset by an increase in our current quarter adjusted net interest income of $7 million. Our adjusted net interest income during the current quarter was $73 million, an increase of $7 million, or 11% from the comparable prior-year quarter. This increase was driven by an increase in the adjusted net interest yield of 7 basis points or 7% to 104 basis points, coupled with an increase in average interest-earning assets of $947 million or 4%. The increase in the adjusted net interest yield reflected the favorable impact of a reduction in our adjusted average cost of funds of 37 basis points to 3.16%, partially offset by a decrease in the average yield on interest-earning assets of 31 basis points to 3.99%.

We continue to actively monitor the COVID-19 pandemic impact on our borrowers' financial conditions and analyze key credit metrics of our borrowers' to facilitate the timely identification of loans with potential credit weaknesses and any notable shifts in the quality of our loan portfolio. We currently believe the pandemic has had very little impact on CFC's financial condition and operating results as well as our members' financial conditions. Assuming no material adverse change in the overall credit quality of our borrowers, we expect that our financial performance for fiscal year 2021 will be better than our financial performance for fiscal year 2020, excluding the one-time impairment charges we had in fiscal 2020.

As a reminder, our prior fiscal year results included two one-time non-cash charges, consisting of a $31 million software project impairment charge and a $34 million loan impairment charge. The overall composition of our loan portfolio at quarter-end August 31, 2020, remained largely unchanged from the composition of the prior fiscal year-end of May 31, 2020, with $26.5 billion or 99% of our loan portfolio, consisting of loans to rural electric systems and $396 million or 1% to the telecommunications sector.

The percentage of CFC's long-term fixed-rate loans was at 92% as of August 31, 2020, unchanged from the May 31, 2020 level. We typically lend to our members on a senior secured basis, with 94% of our loans being senior secured at both August 31, 2020, and May 31, 2020. We did not have any loan delinquencies, loan defaults, or charge-offs during the current quarter and during the last three fiscal years.

In addition, we have not had any loan defaults in our electric utility loan portfolio since fiscal year 2013. On June 1, 2020, we adopted the current expected credit loss model, also known as CECL, which requires immediate recognition of expected credit losses over the remaining contractual term of the loans in our portfolio. CECL replaced the incurred loss model we used previously for determining the allowance, which was based on an estimate of probable incurred losses inherent in our loan portfolio as of each balance sheet date.

Our allowance for credit losses increased to $57 million as of August 31, 2020, from $53 million as of May 31, 2020, primarily due to the $4 million additional allowance for credit losses recorded with the adoption of CECL on June 1, 2020. The $4 million additional allowance was a result of our CECL model using the remaining life of our outstanding loans versus the prior incurred loss model, having used a five-year loss emergence period. The average life of our loan portfolio is significantly greater than the five-year loss emergence period, which required the $4 million increase in the loan loss allowance upon the implementation of CECL.

I'd like to emphasize that this increase is not in any way a change in the view of the credit quality of our loan portfolio. The credit quality of our loan portfolio remains strong with our members continuing to demonstrate solid financial and operational performance. This is especially true for our electric utility portfolio as we now have a sustained period of 29 consecutive fiscal quarters for which we have had no credit losses in our electric utility portfolio.

Our total debt outstanding was $26 billion as of August 31, 2020; a very nominal increase of $20 million from May 31, 2020. CFC continues to maintain diverse funding sources to minimize the risk of being dependent on any single source or market. As of August 31, 2020, $5.6 billion of CFC's funding came from our members in the form of short-term and long-term investments; an increase of $195 million from $5.4 billion at May 31, 2020.

Our member investments represented 21% of our total debt outstanding at both August 31 and May 31, 2020. Over the last 12 quarters, our member investments have averaged approximately $4.8 billion at each quarter-end. At August 31, 2020, our funding under the Guaranteed Underwriter Program and notes payable with Farmer Mac totaled $9.3 billion, or 36% of our total debt outstanding; a decrease of $53 million from May 31, 2020, due to regularly scheduled principal amortization.

Our capital markets-related funding sources totaled $11 billion at August 31, 2020, a decrease of $121 million from the prior fiscal year-end. The decrease was primarily due to a reduction of $400 million in collateral trust bonds outstanding, which matured in June, partially offset by an increase of $300 million dealer commercial paper outstanding. At both August 31 and May 31, 2020, capital markets-related funding sources accounted for 43% of our total funding. At August 31, 2020, 62% of our total debt was secured and 38% was unsecured compared with 64% secured and 36% unsecured at May 31, 2020.

Our short-term borrowings totaled $4.6 billion and accounted for 17% of our total debt outstanding at August 31, 2020 compared with $4 billion or 15% of total debt outstanding at May 31, 2020. The majority, or 88%, of our short-term borrowings came from member investments at August 31, 2020, compared with 94% at the prior fiscal year-end. As we have consistently stated, investments from our members are a very reliable funding source, with little reinvestment risk as our members consistently invest a large portion of their excess funds with CFC.

In September, we issued our first sustainability bond in the form of a collateral trust bond. The net proceeds of the $400 million ten-year CTB will be used to fund eligible projects as defined in our Sustainability Bond Framework published on our website. Generally speaking, loans we have made to our members to develop broadband infrastructure for either unserved or underserved rural areas and loans to members and nonmembers for renewable energy projects are considered eligible use of proceeds. We expect to fully allocate the net proceeds within a one-year period from the date of issuance. We will publish a sustainability bond report within the next 12 months to include proceed allocation and other relevant information pertaining to certain broadband and renewable energy projects. We will continue to assess the need to issue additional sustainability bonds in the future.

This slide presents CFC's long-term debt maturities and amortization over the next 12 months from October 2020. On October 1, 2020, we redeemed at par our $350 million, 2.3% collateral trust bonds due November 1, 2020. Excluding our member medium-term note maturities, our refinancing needs over the next 12 months to fund upcoming maturities are very modest at $1.6 billion, which largely consist of two dealer medium-term note maturities totaling $750 million and several Farmer Mac note maturities totaling $470 million. We believe we have ample sources of liquidity to meet each of the maturities as is highlighted in the next slide.

This slide depicts the various noncapital market sources of liquidity that CFC had in place at August 31, 2020 compared with the prior fiscal year-end. As indicated in the graph, we had an aggregate of approximately $6.5 billion of member and nonmember debt maturities over the next 12 months as of August 31, 2020 compared with $6 billion as of May 31, 2020. At August 31, 2020, we had access to $8.4 billion of liquidity, which is 1.3 times the combined member and nonmember debt maturities of $1.9 billion or $1.9 billion greater than the combined member and nonmember debt maturities.

Approximately 64% or $4.2 billion in debt maturities over the next 12 months are short-term investments that our members have with CFC. We consider our member investments to be very stable and a reliable source of funding for CFC. If we excluded the $4.2 billion debt maturities related to our member short-term investments, we would have total liquidity equal to 3.5 times or $6 billion of liquidity in excess of dealer commercial paper and the current portion of nonmember long-term debt maturities during the next 12 months; subsequent to August 31, 2020.

In addition, in September, we received an approval for an additional $375 million commitment under the Guaranteed Underwriter Program, which is not included in the chart on this slide. We expect to close the new GUP series by the end of this calendar year.

This slide presents CFC's projected long-term debt issuance needs over the next 18 months subsequent to August 31, 2020. Our cash needs are derived from two primary areas; refinancing existing debt maturities and funding loan growth, partially offset by the amortization and repayments of loans from our members. We expect our net long-term loan growth over the next 18 months to be manageable at approximately $700 million. As indicated in the last column, our expected long-term debt issuances over this time period are approximately $3.2 billion; mainly to refinance existing long-term debt maturities.

Also note that the other sources and uses of cash column in the middle of the slide reflects net increases or decreases to our dealer commercial paper outstanding, short-term member investments and investment portfolio. For future potential funding needs, we will continue to look to balance capital market and noncapital market secured and unsecured financings while always looking to access the most attractive cost of funds for our member borrowers.

To conclude our call, I'd like to leave you with a few key takeaways when you consider CFC as an investment opportunity. These items are areas that CFC is consistently focused on and represent key credit strengths when viewing CFC as an investment. As indicated, CFC's ratings remain strong and stable. Fitch recently reaffirmed CFC's ratings and outlook on September 18, 2020, and published a full rating report on CFC in October. CFC has a long-term incentive compensation plan, which is tied to our credit ratings. Specifically, we must maintain an A, A2, issuer credit rating with a stable outlook in order to receive a payout under our long-term incentive plan.

Our primary corporate goal is to maintain strong long-term credit fundamentals for our members and investors. The overall quality of our loan portfolio continues to be very strong with 99% of our loans to rural electric systems and 94% of our loans being on a senior secured basis. We have not had any loan defaults in our electric utility loan portfolio since fiscal year 2013. We had no charge-offs during the current quarter and during the last three fiscal years.

The coverage ratio of our allowance for credit losses remain low at 21 basis points of our total loan portfolio at August 31, 2020. In CFC's 51-year history, we have experienced very limited charge-offs, loan defaults, loan delinquencies and nonperforming loans in our electric portfolio.

While there continues to be uncertainty about the duration and severity of the COVID-19 pandemic and the extent of its future economic impact, our borrowers operate in an industry sector that historically has been resilient to economic downturns. Our electric utility cooperative members, which have a strong track record in preparing for and responding to emergencies, thus far has been able to manage the challenges and pressures presented by the pandemic. As a result, through today's date, we have not experienced any delinquencies in our scheduled loan repayments from our borrowers and we have not received any requests from our borrowers for payment deferrals.

CFC continues to receive strong support from our members, both in terms of new lending business and as a valuable funding source. Our members' investments continued to grow and stood at $5.6 billion at August 31, 2020, representing 21% of our total funding compared with $4.2 billion or 18% at our fiscal year-end 2016.

As a member-owned cooperative organization, CFC cannot issue common or preferred equity. However, we are committed to grow our equity through retained earnings. Our members' equity has grown by 31% to $1.7 billion from $1.3 billion since our fiscal year-end 2016. We continue to maintain diversified funding sources and demonstrate a strong liquidity profile. Our funding sources are very well-established and have remained stable. From a liquidity perspective, at August 31, 2020, we had $876 million of cash, cash equivalents and short to intermediate-term fixed income investment securities; $2.7 billion committed revolving credit facilities from our relationship banks, $900 million committed availability in the Guaranteed Underwriter Program and $2.5 billion revolving credit capacity by the Farmer Mac secured note purchase agreements.

These sources, together with the scheduled loan amortization and other repayments from our members resulted in CFC having $8.4 billion of liquidity available at August 31, 2020 to meet the $6.5 billion in debt maturities over the next 12 months, a 1.3 times liquidity coverage ratio. Excluding debt maturities related to our member investments, which have historically had a high reinvestment rate, our liquidity coverage ratio would be 3.5 times.

Thank you once again for joining us today to review our results for our fiscal quarter ended August 31, 2020. We appreciate your interest in CFC and look forward to discussing our financial performance and funding plans in the future. I would like to ask the operator to open the lines for questions and also suggest that you submit other questions via the web service so we may respond to those as well. Thank you.

Operator: Thank you, if you would like to ask a question on the phone lines today, you can press Star 1 on your telephone keypad. If you are on a speakerphone, please make sure your mute option is turned off to allow your signal to reach our equipment. Once again, everyone, that is Star 1 to ask a question on the phones. And we'll pause for a moment.

Again, that is Star 1 on the telephone. All right, there are no phone questions at this time.

Andrew Don: Okay. Thanks, operator. It doesn't appear that we have any questions submitted on the web service. So with that, we will conclude the call. And thank you once again for joining us today, and we look forward to talking with you in the near future. Have a good day.

Operator: And that does conclude today's presentation. Thank you for your participation. You may now disconnect.