Conference Title: FY23 Year-End Investor Conference Call

Date: August 9, 2023

Operator: Good afternoon and welcome to the National Rural Utilities Cooperative Finance Corporation Fiscal Year 2023 Year-End Investor Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Heesun Choi, Vice President, Capital Markets Relations. Please go ahead.

Heesun Choi: Thank you, Operator. Welcome to our Fiscal Year 2023 Investor Conference Call. Joined with me today are Andrew Don, our Chief Executive Officer, and Ling Wang, our Chief Financial Officer. Andrew and Ling will discuss our financial and operating reserves during the fiscal year ended May 31, 2023. Today's presentation slides and financial reports filed with the SEC are available on our investor relations page on our website. This call is being recorded and a replay and call transcript will be made available on our investor relations page after the call.

Our presentation today will include forward-looking statements and certain non-GAAP financial measures. Please review the disclosures on slide two and slide three of the presentation regarding these statements and measures. I would like to remind you that any forward-looking statements that we may make during today's call, as of August 9, 2023, are subject to risk and uncertainties. Factors that may cause actual results to differ materially from expectations are described on slide two of today's presentation, as well as our Form 10-K filed with the SEC on August 2, 2023.

Information about any non-GAAP financial measures referenced, including reconciliations to GAAP measures, can also be found in our Form 10-K, as well as in the appendix of the presentation slides. At the end of the presentation, we will open the call and Andrew and Ling can take your questions. You can ask questions over the phone or submit your questions online. With that, I will turn this call over to Andrew.

Andrew Don: Thank you, Heesun. Thank you for joining our call today to review the results for our fiscal year 2023, which concluded on May 31, 2023. I'll provide comments regarding our fiscal year 2023 results and then turn this call over to Ling to review our financial performance in greater detail. I'll start on slide five.

As you can see on the slide, we had another very strong year with exceptionally robust loan growth as well as solid financial performance. Our results reflect the overall continued financial strength of our members and our focus on strategically managing our balance sheet to fund our members' capital needs. During fiscal year 2023, our loans to members increased by $2.5 billion, or 8%, from $30 billion at May 31, 2022, to $32.5 billion at May 31, 2023. This $2.5 billion loan growth is the largest year-over-year growth since 2002.

As we continue to focus on lending to electric cooperatives, our total loans outstanding represent market share of 25% of the total loans outstanding in the electric cooperative sector as of December 31, 2022, based on financial data submitted to us by our distribution power supply members. We continue to be the largest private lender to electric cooperatives.

The overall quality of our loan portfolio continues to be sound and strong with 99% of our loans to rural electric systems that provide essential electric utility services. Consistent with our historical experience of very limited charge-offs, loan defaults, loan delinquencies and non-performing loans in our electric portfolio, non-performing loans represented 0.27% of our total loans outstanding as of May 31, 2023, and we had only 0.05% net charge-offs during fiscal year 2023.

It is worth noting that this has been the first charge-off in our electric portfolio since fiscal year 2013. The charge-off in fiscal year 2023 was related to the payment default of Brazos Electric Power Cooperative and Brazos Sandy Creek Electric Cooperative, in connection with their previously disclosed bankruptcy filings. I'm also pleased to report that subsequent to May 31, 2023, we received payments in full for all remaining loans to Brazos Electric and Brazos Sandy Creek. Ling will discuss the charge-offs later during her commentary.

Our financial position remains strong as we continue to generate solid financial metrics. During fiscal year 2023, our adjusted TIER was 1.25 times, which was well above our targeted goal of 1.1 times. Our capital position continued to improve during fiscal year 2023. Our members' equity, consisting primarily of our retained earnings, continue to grow and surpass $2.2 billion at fiscal year-end 2023.

By comparison, our members' equity at fiscal year-end 2013 was approximately $1 billion. We have more than doubled our members' equity over the past 10 years by diligently and strategically managing our financial results while steadily accumulating retained earnings. Our liquidity position remains healthy and resilient as we maintain diverse, well-established funding sources to minimize the risk of being dependent on any single source or market.

We're committed to having strong investment grade credit ratings from Fitch, Moody's and S&P. We currently have long-term senior secured ratings of A+, A1 and A- and long-term unsecured ratings of A, A2 and A-, all with stable outlooks. For fiscal year 2024, we instituted an incentive payout contingency for named executive officers. Specifically, incentive payments are tied to the overall performance of the company and will be capped at 50% for the named executive officers in the event that CFC's long-term unsecured credit rating is below an A rating or equivalent for two or more of the credit rating agencies at May 31, 2024.

Lastly, a strategic initiative that we've engaged in for over the past year has been to consolidate the Rural Telephone Finance Cooperative (RTFC) portfolio with the National Cooperative Services Corporation (NCSC) portfolio. In April and June 2023, RTFC and NCSC's members, respectively, approved the sale of the RTFC portfolio to NCSC.

We intend to complete the consolidation of RTFC and NCSC over the next 12 months, which is subject to meeting certain closing conditions. We believe that the consolidation of these two portfolios will further enhance our operating efficiency. Now I'm turning to slide six to further discuss our loan portfolio.

As I mentioned earlier, we recorded a $2.5 billion increase in net loan growth during fiscal year 2023. The $2.5 billion increase in loans to members during fiscal year 2023 reflected net increases in long-term and line of credit loans of $1.6 billion and $845 million, respectively. The $845 million increase in line of credit loans was primarily attributable to funding for higher operating costs that our members experienced, bridge loans due to delays in our U.S. financing as well as broadband bridge loan financing.

At May 31, 2023, our loans to distribution members totalled $25.4 billion and our loans to power supply members totalled $5.4 billion. During fiscal year 2023, we experienced increases in all of our business segments. Specifically, our distribution loan portfolio increased by $1.6 billion and our power supply loan portfolio increased by $535 million. We also experienced increases in CFC statewide and associate loans and NCSC and RTFC loans of $74 million, $246 million and $20 million, respectively.

Loans to our electric borrowers accounted for 99% and 98% of total loans to members as of May 31, 2023, and May 31, 2022, respectively. During fiscal year 2023, we made long-term loan advances totalling $3.3 billion, of which $2.8 billion, or 86%, were fixed-rate loans. Additionally, approximately $3.1 billion, or 95%, of long-term loan advances were for capital expenditure purposes, compared to 80% during fiscal year 2022, with the remaining balance being for the refinancing of other lenders debt or other corporate purposes. As the Federal Reserve increased the federal funds rate over the past year, leading to a higher interest rate environment, our members have shown a preference for relatively shorter fixed rate term loans in fiscal year 2023, compared to fiscal year in 2022. The weighted average fixed-rate term was 18 years for the new $2.8 billion fixed-rate term loan advances during fiscal year 2023, where it was 23 years during fiscal year 2022.

We serve a geographically diverse group of electric and telecommunications borrowers throughout the U.S. The consolidated number of borrowers with loans outstanding total 884 at May 31, 2023. Our borrowers are located in 49 states and the District of Columbia. The top five states with the largest loan growth for fiscal year 2023 were Texas, Arkansas, Florida, Kentucky and Georgia. You can see the increases in loans in those five states on the map presented on the right side of the slide. For Texas, Arkansas and Georgia, the growth was primarily driven by our members funding needs for electric CapEx or broadband projects. For Florida and Kentucky, the majority of the growth was driven by bridge financing for capital expenditures and/or weather related emergency funding needs.

Separately, we experienced a decrease in loan growth in Louisiana. Some of the outstanding balances on emergency of credit loans were repaid using reimbursement funds from FEMA, the Federal Emergency Management Agency.

We continue to see an increase in members needs for bridge financing for broadband projects. At May 31, 2023, outstanding loans to CFC distribution members for their broadband projects increased to approximately $2.4 billion, which is a $708 million, or 43%, increase compared to the May 31, 2022, level of $1.6 billion. The three states with the largest CFC loans outstanding for broadband projects were Indiana, with $300 million, Arkansas, with $273 million, and Oklahoma, with $253 million, in loans outstanding for broadband infrastructure investment at May 31, 2023.

As you may be aware, we issued our second sustainability collateral trust bond in August 2022, with proceeds of the bond to fund our broadband loans. We're planning to publish our sustainability bond report for the bond issuance in the near future, and the report will be available on our website.

Moving on to slide seven, we recently published our annual preliminary key ratio trend analysis for results for 801 electric distribution cooperatives for the year ended December 31, 2022.

Our key ratio trend analysis (KRTA) is an annual assessment of financial trends amongst electric distribution cooperatives nationwide. Based on the preliminary KRTA results for 2022, electric cooperatives continue to experience growth across many metrics—including number of consumers, sales and utility plan investment—and have maintained strong financial metrics.

Consumer growth nearly surpassed 1% after exceeding 1% last year for the first time in more than 10 years, with approximately 95% of the cooperatives reporting showing increases in consumers served. Notable states with greater than 2% consumer growth were Texas, Florida, Idaho and Utah. Investment in utility plants also sustained its five-year growth trends, as demonstrated by an increase in the total utility plant ratio, which grew by 4.48% in 2022, as compared to 3.95% in 2021.

Inflationary pressures, especially rising power costs, are affecting operating expenses. Power costs have increased by more than 9% compared to 2021, and continue to be a distribution cooperative’s single largest expense, representing more than 60% of revenue. It’s worth noting that a majority of our distribution members also faced material and supply cost increases, along with wage hikes, during the calendar year 2022.

Rising operating expenses over time are effectively passed through to consumers through power cost adjustments. Furthermore, both accounts receivable over 60 days and write-offs continue their pre-pandemic declines, falling to historic lows. Accounts receivable over 60 days fell to 0.08% of operating revenue, from 0.09% in 2021, and write-offs fell to 0.06% of operating revenue from 0.07% in 2021. We believe that the 2022 KRTA results demonstrate that our member cooperative’s financial condition continues to be resilient, sound and stable.

As I conclude my remarks, I'd like to extend my gratitude and appreciate our employees for their exceptional efforts and contributions and meeting our members' financing needs during a period of remarkable loan demand, when we grew our balance sheet by nearly $6 billion, from $26 billion to $34 billion, over the last three fiscal years. With that, I'll turn the call over to Ling.

Ling Wang: Thank you Andrew, and good afternoon everyone. I'm going to turn to slide nine to delve into our fiscal year 2023 financial results. Unless specified otherwise, I will be primarily focused on year-over-year comparisons while discussing our fiscal year 2023 outcomes. Slide nine shows our balance sheet information. Our total assets at the fiscal year ended May 31, 2023, were approximately $34 billion, an increase of $2.8 billion, or 9%, from the prior fiscal year. The primary driver of the growth was a $2.5 billion increase in loans to members, which Andrew mentioned earlier.

Our total liabilities increased by $2.3 billion, or 8%, to $31 billion at May 31, 2023, as we issued debt to fund the loan growth. Our members' equity, which excludes cumulative derivative forward value gains and accumulated other comprehensive income, increased by $191 million, or 9%, to $2.2 billion. The $191 million increase was a result of an adjusted net income of $249 million during fiscal year 2023, which was partially offset by $59 million retirement of the patronage capital in September 2022.

As a cooperative, CFC allocates a portion of our net earnings to our members on an annual basis. Our current policy, which is approved by our board of directors, is to allocate a portion of the fiscal year 2023 net earnings to CFC's members in the form of patronage capital. Subsequently, we retire 50% of this allocation while holding the remaining 50% for 25 years. The specific retirement amount and the schedule are subject to yearly approval by the CFC Board of Directors.

In July 2023, the CFC Board of Directors authorized the retirement of patronage capital of $72 million, consisting of $55 million, representing 50% of the patronage capital allocation for fiscal year

2023, and $17 million, representing the allocation from fiscal year 1998 net earnings that had been held for 25 years pursuant to CFC's Board of Director policy. We expect to return this amount to our members in cash in the second quarter of fiscal year 2024.

Our adjusted debt-to-equity ratio was 6.04-to-1 in May 31, 2023, a decrease from 6.24-to-1 at May 31, 2022. The decrease was primarily due to the issuance of $300 million subordinated deferral debt in May 2023. That said, in June 2023, we redeemed $100 million of an existing $400 million subordinated deferral debt due 2043.

While our goal is to maintain an adjusted debt-to-equity ratio of approximately 6-to-1, we expect that our adjusted debt-to-equity ratio is likely to remain elevated from the current level, primarily due to the early redemption of the $100 million of the subordinated deferral debt mentioned earlier, the anticipated loan growth and the expected retirement of discounted patronage capital as part of the RTFC's consolidation with NCSC, which Andrew mentioned in his remarks.

Moving on to slide 10 for our income statement. Both our adjusted net interest income and adjusted net income increased during fiscal year 2023. Our adjusted net interest income was $349 million, a $14 million, or 4%, increase, and our adjusted net income was $249 million, an $8 million, or 4%, increase. Our adjusted net interest income increased by 4% as our average interest earning assets increased by $2.4 billion, or 8%, due to the grossing average loans outstanding, while our adjusted net interest yield decreased by four basis points, or 4%, to 1.08%.

Our adjusted net interest yield decreased by 4 basis points as our adjusted average cost of borrowing increased by 44 basis points to 3.33%. While our average yield on the interest earning assets increased by 37 basis points to 4.19%, and additionally we were able to save 3 basis points in our cost of funds from utilizing our non-interest bearing funding, which is essentially our equity.

Our adjusted net income increased by $8 million, primarily due to a $14 million increase in adjusted net interest income and a $25 million reduction in losses recorded on our investment securities, partially offset by a $19 million unfavorable shift in the provision of credit losses, and a $12 million increase in other expenses, which is primarily operating expense.

Our adjusted TIER declined by 0.05 to 1.25 for fiscal year 2023, primarily due to the increase in adjusting interest expense. Despite a slight decreasing in our adjusted TIER, the 1.25 adjusted TIER for fiscal year 2023 was well above our target of 1.1. We expect our adjusted net income will increase over the next 12 months, primarily driven by the projected increase in adjusted net interest income. However, we believe our adjusted TIER will decrease slightly over the same period, primarily due to projected increasing adjusted interest expense caused by the current elevated interest rate environment.

Looking at slide 11, our loan portfolio consists of mainly of long-term fixed rate secure loans to electric cooperatives. The overall composition of our loan portfolio at May 31, 2023, remains similar to the composition at May 31, 2022, with $32 billion, or 99%, of our portfolio consisting of loans to rural electric systems, and $488 million, or 1%, to the telecommunication sector. Long-term fixed rate loans were 87% of total long-term loans outstanding at May 31, 2023, compared to 90% at May 31, 2022, primarily due to the increase in line of credit loans.

We typically lend to our members on a senior secured basis, with 92% of our loans being senior secured at May 31, 2023, compared to 93% at May 31, 2022. We generally offer long-term amortized loans to our members for up to 35 years. The average remaining maturity of our long-term loans, which accounted for 90% of total loans outstanding, at May 31, 2023, was 19 years.

Our credit metrics are presented on slide 12. During the last fiscal year, the quality of our loan portfolio continued to demonstrate strength and we observed positive trends in our credit metrics. Our non-performing loans outstanding declined by $139 million to $89 million, or 2.7%, of total loans outstanding at May 31, 2023. The $139 million decrease in non-performing loans during fiscal year 2023 was due to the receipt of loan principle payment on one of the non-performing loans, the partial charge-offs related to the Brazos and Brazos Sandy Creek non-performing loans and the reclassification of Brazos non-performing loans to non-performing trouble debt restructured loans during our third fiscal quarter of 2023.

As Andrew mentioned earlier, subsequent to May 31, 2023, we received $23 million for Brazos and $4 million for Brazos Sandy Creek in loan payment and loans to these borrowers have been fully paid off. Our allowance for credit losses decreased by $15 million to $53 million at May 31, 2023, compared to $68 million at May 31, 2022. The allowance coverage ratio decrease to 16 basis points at May 31, 2023, from 22 basis points at May 31, 2022. The $15 million decrease in allowance for credit losses reflected a $13 million reduction in the asset specific allowance and $2 million reduction in collective allowance.

We recorded $15 million in charge-offs related Brazos and Brazos Sandy Creek during fiscal year 2023. The net charge-off rate was 5 basis points during fiscal year 2023. Prior to this charge-off, we had not experienced any default or charge-off in our electric portfolio since fiscal year 2013. We continue to believe that the overall credit quality of our loan portfolio remains strong at May 31, 2023. This is evidenced by the limited default and losses in our electric loan portfolio since the inception of CFC.

Specifically, in our 54-year history, we have experienced only 18 defaults in our electric utility portfolio. Of the 18 defaults, one remained unresolved, nine resulted in no losses and eight resulted in cumulative net charge-offs of merely $101 million. Our total debt outstanding was $31 billion at May 31, 2023, an increase of $2.3 billion, or 8%, from May 31, 2022, levels, primarily to fund the growth in our loan portfolio.

We continue to maintain diverse funding sources, including funding from our members, as well as capital markets and non-capital markets funding to minimize the risk of being dependent on any single source or market. In May 31, 2023, $4.8 billion of CFC's funding came from our members in the form of short-term and long-term investment. That is a decrease of $600 million, or 11%, from May 31, 2022, as some of our members used the excess cash to fund their operating or CapEx needs.

Our member investments represented 16% of our total debt outstanding at May 31, 2023, compared to 19% at May 31, 2022. At May 31, 2023, our funding under the guaranteed underwriter program and notes payable with Farmer Mac totalled $9.9 billion, or 32%, of our total debt outstanding. This is a $667 million increase, or 7%, increase from May 31, 2022, level due to the net increases of $615 million in borrowing under the guarantee underwriter program and $55 million in borrowing on the Farmer Mac note purchase program.

Our capital markets related funding sources totalled $16.3 billion at May 31, 2023, a $2.2 billion, or 15%, increase from the prior fiscal year end level. The increase was primarily due to a net increase of $890 million in dealer median-term notes outstanding, a net increase of $729 million in collateral trust bonds, a net increase of $296 million insubordinate deferral debt and a net increase of $268 million in dealer commercial paper.

Dealer commercial paper outstanding was $1.3 billion at May 31, 2023, and we intend to maintain the dealer commercial paper balance at each quarter end within a range of $1 billion to $1.5 billion. At May 31, 2023, capital markets related funding sources accounted for about 52% of our total funding, compared to 49% at May 31, 2022. At May 31, 2023, 56% of our total debt was secured and 44% was unsecured. This is unchanged from the May 31, 2022, level. Our short-term borrowings decreased by $435 million to $4.5 billion, accounting for 15% of our total debt outstanding at May 31, 2023, compared to $5 billion, or 17%, of total debt outstanding at May 31, 2022.

The decrease in short-term borrowings was driven primarily by a decrease in short-term member investment, partially offset by increases in outstanding dealer commercial paper. A total of $3.3 billion, or 72%, of our short-term borrowing came from our members' short-term investments at May 31, 2023, compared to $4 billion, or 79%, at May 31, 2022. The weighted average cost of our outstanding short-term borrowing increased to 496 basis points at May 31, 2023, from 97 basis points at May 31, 2022.

The weighted average maturity of our short-term borrowings increased to 44 days at May 31, 2023, from 42 days at May 31, 2022. As we have consistently stated, the investment from our members are a very reliable funding source with little reinvestment risk, as our members continue to invest a large portion of their excess funds with us. Our member short-term investments have averaged $3.6 billion over the last fiscal quarter end reporting period.

Slide 14 shows various sources of liquidity that CFC had in place at May 31, 2023. Our available liquidity from various sources include cash, investments, committed bank lines, guarantee underwriter program and the Farmer Mac revolving note purchase agreement, which totalled $7.1 billion at May 31, 2023. Our total liquidity amount does not include the $1.5 billion scheduled repayments and amortization on long-term loans that we expect to receive from our members over the next 12 months.

As indicated in the table on the right side, at May 31, 2023, short-term investment from our members totalled $3.3 billion. Because our members have traditionally rolled over a large portion of their short-term investments with us at maturity, we consider our member investments to be a very stable and reliable founding source for CFC. Excluding our member's short-term debt maturities, we had approximately $3.7 billion of debt maturities over the next 12 months at May 31, 2023. These debt maturities consistent of $1.3 billion in dealer commercial paper and $2.4 billion in long-term and subordinated debt obligations. Excluding the $3.3 billion debt maturities related to our member short-term investments, we have a total liquidity equal to 1.9 times, or $3.5 billion, of liquidity in excess of our debt maturity during the next 12 months subsequent to May 31, 2023.

Slide 15 summarizes CFC’s projected long-term debt issuance needs over the next 18 months subsequent to May 31, 2023. Our cash needs are derived from two primary areas—refinancing existing debt maturities and funding loan advances to our members, partially offset by the amortization and repayment of loans from our members. Our funding needs are also driven by our member investment levels.

During fiscal year 2023, we accessed the capital markets and raised a total of $3 billion, consisting of $1 billion collateral trust bonds, $1.7 billion dealer medium-term notes and $300 million subordinated deferral debt. We also borrowed $550 million under the Farmer Mac note purchase agreement, of which we repaid $500 million in April. We borrowed $800 million under the guaranteed underwriter program.

In addition, subsequent to May 31, 2023, we issued $400 million dealer median-term notes, redeemed $100 million of our $400 million subordinated deferral debt due 2043 and reborrowed $500 million in short-term notes payable under the note purchase agreement with Farmer Mac. We expect a total of $3.8 billion of long-term debt maturities and amortization over the next 18 months from June 2023 through November 2024, consisting of $2.7 billion in capital markets debt and $1 billion in non-capital markets debt.

We expect our net loan growth over the next 18-month period to be approximately $2.3 billion. As indicated in the last column, we expect to issue approximately $4.7 billion in long-term debt over this time period to refinance existing long-term debt maturities and to fund expected loan growth. Thank you once again for joining us today to review our results for our fiscal year ending May 31, 2023. 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 line for questions and also suggest that you submit your questions via the web service so we may respond to those as well. Thank you.

Operator: And thank you. If you would like to ask a question, please press star one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star one to ask a question. And we'll pause for just a moment to allow everyone the opportunity to signal for questions. And I have no questions in the queue at this time.

Ling Wang: And it also looks like we do not have any questions from the website either, so thank you very much. With that, we'll just conclude the call today and if you have any questions, please feel to contact either myself or Heesun Choi and we look forward to talking to you.

Operator: And this concludes today's call. Thank you for your participation. You may now disconnect.