Conference Title: FY24 First-Quarter Investor Conference Call

Date: October 16, 2023

Operator: Good afternoon and welcome to the National Rural Utilities Cooperative Finance Corporation fiscal year 2024, first quarter investor call. Today's conference is being recorded. At this time, I let the conference over to Ms. Heesun Choi, Vice President of Capital Market Relations. Please go ahead, ma'am.

Heesun Choi: Thank you, Operator. Welcome to our investor conference call for the first quarter of fiscal year 2024. Joining 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 results during the three months ended August 31, 2023. Today's presentation slides and financial reports, filed with the SEC, are available on our website, www.nrucfc.coop, under investor relations. This call is being recorded and a replay and call transcript will be made available under investor relations.

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 October 16th, 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 in our annual and quarterly report filed with the SEC. Information about any non-GAAP financial measures referenced today during the presentation, including reconciliations to GAAP measures, can also be found in our Form 10-Q filed with the SEC on October 12th, 2023, 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 will take your questions. You can ask questions over the phone or submit your questions online. With that, I'll now turn this call over to Andrew.

Andrew Don: Thank you, Heesun. Good afternoon. Thank you for joining our call today to review the financial operating results during the three months ended August 31, 2023, which is our first fiscal quarter of 2024. I'm moving to slide five to discuss CFC's financial highlights during the quarter. Our financial position remains strong as we generated solid financial results during our first fiscal quarter. Our loans to members continue to increase and we recorded a level of $33.1 billion, which represents an increase of $565 million, or 2%, during the three months ended August 31, 2023. During the quarter, our adjusted TIER was 1.23 times, which is well above our goal of 1.1 times. Our members' equity has surpassed $2.2 billion at August 31, 2023, as we've been increasing member equity through retained earnings accumulation.

Our liquidity position remains strong as we maintain diverse, well-established funding sources to minimize the risk of being dependent on any single source or market. Our diverse liquidity sources consist of cash investments, committed bank lines, the guaranteed underwriter program, the Farmer Mac note purchase agreement and repo facilities. We are committed to maintaining strong investment credit ratings from Fitch, Moody's and S&P. We have long-term senior secured ratings of A+, A1, A-, and long-term unsecured credit ratings of A, A2, A-, all with a stable outlook. In September 2023, Fitch affirmed all of CFC credit ratings with a stable outlook.

Now, I'm turning to slide six to discuss our loan portfolio. As I mentioned, our loans to members was at a level of $33.1 billion in August 31, 2023, compared to $32.5 billion at May 31, 2023, reflecting a $565 million increase. 91%, or $515 million, of the net loan increase was driven by increases in loans to distribution and power supply borrowers. At August 31, 2023, our loans to distribution members totaled $25.8 billion and our loans to power supply members total $5.6 billion, accounting for 95% of total loans to members. Looking at the increases by business segment, our distribution loan portfolio increased by $381 million and our power supply loan portfolio increased by $134 million. We also experienced increases in RTFC loans of $51 million and CFC statewide and associate loans of $32 million and a decrease in NCSC loans of $33 million during the quarter. In terms of the loan type, long-term loans increased by $326 million to $29.7 billion, and line of credit loans increased by $239 million to $3.4 billion at August 31, 2023. The $239 million increase in line of credit loans was primarily attributed to funding for our members' higher operating costs and working capital needs, as well as bridge loan financing for U.S. borrowers.

During the quarter, we made long-term loan advances for a total of $711 million. Approximately $616 million, or 87%, of those advances were for capital expenditure purposes, with the remaining balance being for other purposes, primarily asset acquisitions. Additionally, of the $711 million total long-term loan advances during the quarter, $659 million were fixed-rate loan advances with a weighted average fixed-rate term of 14 years. In comparison, of the $815 million total long-term loans advanced during the same prior-year fiscal quarter, $747 million were fixed-rate loan advances with the weighted average fixed-rate term of 21 years.

Some of our members have shown a preference for slightly shorter fixed-rate term loans during the quarter given the prevailing higher interest rate environment. We estimate that there are over 200 electric cooperatives engaged in rural broadband projects at various stages of development. Generally speaking, these projects are financed through a mix of grants and debt funding. At August 31, 2023, CFC's total outstanding loans associated with these broadband projects was approximately $2.6 billion, an increase of $203 million compared to the May 31, 2023, level of $2.4 billion.

With that, I would now like to turn this call over to Ling, who will review our financial results in more detail. Thank you.

Ling Wang: Thank you, Andrew, and good afternoon everybody. I'm going to turn to slide eight to discuss our first fiscal quarter end results, which covers the three-month period from June 1, 2023, to August 31, 2023. Slide eight shows our balance sheet information at August 31, 2023, compared to May 31, 2023. Our total assets at the fiscal quarter end, August 31, 2023, were approximately $34.7 billion, an increase of $682 million, or 2%, from the year-end level. The primary driver of the growth was a $565 million increase in loans to members, which Andrew mentioned earlier. Our total liabilities increased by $523 million, or 2%, to $32 billion at August 31, 2023, as we issued debt to fund loan growth.

Our members' equity, which excludes cumulative derivative forward value against and accumulated other comprehensive income, decreased slightly by $6 million to $2.2 billion from the prior fiscal year-end due to the board-authorized patronage capital retirement of $72 million, partially offset by the adjusted net income of $66 million during the quarter. As a cooperative, we return a portion of our net earnings to CFC's members on a regular basis. In July 2023, CFC's board of directors approved a patronage capital retirement of $72 million, and we returned this amount to our members in cash in September 2023.

Our adjusted debt-to-equity ratio was 6.31-to-1 at August 31, 2023, an increase from 6.04-to-1 at May 31, 2023. The increase was primarily due to a $100 million early redemption of an existing $400 million subordinated deferrable debt in June 2023. 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 projected increasing debt outstanding to fund the anticipated loan growth and the expected retirement of discounted patronage capital as part of the RTFC's consolidation with NCSC.

In August 2023, in connection with the NCSC and RTFC consolidation transaction, the board of directors approved the early retirement of allocated unretired patronage capital at a discounted amount of $52 million, which may be subject to adjustment at the closing of the consolidation transaction. In addition, both CFC's and RTFC's board approved the early redemption of $12 million of members' subordinated certificates, which is expected to occur prior to the closing of the consolidation transaction. We expect the consolidation of RTFC with NCSC to occur in the second half of this fiscal year.

Looking at slide nine for our loan portfolio. Our loan portfolio consists mainly of long-term fixed-rate secure loans to rural electric cooperatives. Our long-term loans are typically secured by substantially all assets of the borrowers. The overall composition of our loan portfolio at August 31, 2023, remains similar to the composition of May 31, 2023, with $32.5 billion, or 98%, of our portfolio consisting of loans to rural electric systems and $539 million, or 2%, to the telecommunication sector. Long-term fixed-rate loans were 87% of total loans outstanding at August 31, 2023, unchanged from the May 31, 2023, level. We typically lend to our members on a senior secured basis, with 92% of our loans being senior secured at August 31, 2023, which is unchanged from the May 31, 2023, level. 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 our total loans outstanding at August 31, 2023, was 19 years.

Our credit quality metrics are presented on slide 10. The quality of our loan portfolio continues to demonstrate strength and we observe positive trends in our credit metrics. We had only one non-performing loan outstanding at August 31, 2023, totalling $85 million. This loan was made to an electric power supply borrower. In comparison, we had two loans to CFC electric power supply borrowers totaling $89 million classified as non-performing as of May 31, 2023. Our non-performing loans outstanding declined by $4 million to $85 million, or 0.26%, of total loans outstanding at August 31, 2023. The $4 million reduction in non-performing loans during the quarter was due to the receipt of loan principal payments from Brazos Sandy Creek for its non-performing loan. During the quarter, we received a total of $28 million in loan payments from Brazos and Brazos Sandy Creek to repay their $27 million total loans outstanding in full. The additional payment of $1 million was recorded as loan recovery for those loans.

Our allowance for credit losses increased by $2 million to $55 million at August 31, 2023, compared to $53 million in May 31, 2023. The allowance coverage ratio increased to 17 basis points at August 31, 2023, from 16 basis points at May 31, 2023. The $2 million increase in the allowance for credit losses reflected a $3 million increase in the collective allowance due to loan growth, partially offset by a $1 million reduction in the asset-specific allowance. We had no charge-offs during the quarter. We had an annualized net recovery rate of 0.01% due to the $1 million loan recovery on the Brazos and Brazos Sandy Creek loans, as I mentioned earlier. We continue to believe that the overall credit quality of our loan portfolio remains strong at August 31, 2023, evidenced by the limited default and losses in our electric utility loan portfolio since the inception of CFC. In our 54-year history, we have experienced only 18 defaults in our electric utility portfolio. Of the 18 defaults, nine resulted in no loss and nine resulted in a cumulative net charge-off of merely a $100 million.

Moving on to slide 11 for our income statement. Both our adjusted net interest income and adjusted net income increased during the quarter ended August 31, 2023. Our adjusted net interest income was $93 million, a $6 million, or 7%, increase, and our adjusted net income was $66 million, an $8 million, or 14%, increase. Our adjusted net interest income increased by $6 million as our average interest-earning assets increased by $2.3 billion, or 8%, due to the growth in average loans outstanding, while our adjusted net interest yield remained unchanged at 1.1%. Our adjusted net interest yield remained unchanged as our average yield on interest-earning assets increased by 62 basis points to 4.52%, and additionally, we were able to save 4 basis points in our cost of funds by utilizing our non-interest-bearing funding, which is essentially our equity, while our average cost of volume increased by 66 basis points to 3.66%.

Our adjusted net income increased by $8 million, primarily due to a $6 million increase in adjusted net interest income, a $7 million favorable shift from losses to gains recorded on our investment securities and a $2 million reduction in provision for credit losses, partially offset by $6 million increase in operating expenses. Our adjusted TIER declined by 0.03 to 1.23 for the quarter, primarily due to an increasing adjusted interest expense. Despite a slight decrease in our adjusted TIER, the 1.23 times adjusted TIER for the quarter was well above our target of 1.1.

We expect our adjusted net income will increase over the next 12 months, mainly driven by the projected increase in adjusted net interest income. However, we believe that our adjusted TIER will decrease slightly over the same period, primarily due to the projected increase in adjusted interest expense resulting from the current elevated interest rate environment. Our total debt outstanding was $31 billion at August 31, 2023, an increase of $405 million, or 1%, from May 31, 2023, level, 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. At August 31, 2023, $5.1 billion of CFC's funding came from our members in the form of short-term and long-term investment, an increase of $289 million, or 6%, from the year-end level. Our member investments represented 16% of our total debt outstanding at August 31, 2023, unchanged from the year-end level. At August 31, 2023, our funding under the guaranteed underwriter program and notes payable with Farmer Mac totaled $10 billion, or 33%, of our total debt outstanding, a $422 million, or 4%, increase from the May 31, 2023, level, primarily due to a net increase of $476 million in borrowings under the Farmer Mac no purchase program, offset by a net decrease of $50 million under the guaranteed underwriter program.

Our capital markets-related founding sources totaled $16 billion on August 31, 2023, a $309 million, or 2%, decrease from the year-end level. The decrease was primarily due to a net decrease of $205 million in dealer commercial paper outstanding, a net decrease of $99 million in subordinated deferral debt and a combined net decrease of $13 million of dealer medium-term notes and collateral trust bonds. Dealer commercial paper outstanding was $1 billion at August 31, 2023, and was within our quarter-end target range of $1 to $1.5 billion for dealer commercial paper balance.

At August 31, 2023, capital markets-related funding sources accounted for 51% of our total funding compared to 52% at May 31, 2023. At August 31, 2023, 57% of our total debt was secured and 43% was unsecured, compared to 56% was secured debt and 44% for unsecured debt at May 31, 2023. Our short-term borrowings increased by $578 million to $5.1 billion, accounting for 16% of our total debt outstanding at August 31, 2023, compared to $4.5 billion, or 15%, of our total debt outstanding at May 31, 2023.

The increase in short-term borrowings was driven primarily by a $283 million increase in short-term member investments and a $500 million short-term borrowing from Farmer Mac, partially offset by a $205 million decrease in outstanding dealer commercial paper. A total of $3.5 billion, or 69%, of our short-term borrowing came from our members at August 31, 2023, compared to $3.3 billion, or 72%, at May 31, 2023. As we have consistently stated, the investments 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 12 fiscal quarter end reporting periods.

Slide 13 shows the various sources of liquidity that CFC had in place at August 31, 2023. Our available liquidity from various sources included cash, investment, committed bank lines, guaranteed underwriter program and Farmer Mac revolving note purchase agreements, totaling $6.6 billion at August 31, 2023. Our total liquidity amount does not include a $1.5 billion scheduled repayment 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 August 31, 2023, we had a total of $7 billion in debt maturities over the next 12 months, 50%, or $3.5 billion, of these debt maturities are short-term investments from our members. 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 funding source for CFC. These remaining $3.5 billion in debt maturities consist of $1.1 billion dealer commercial paper, $500 million of short-term notes payable to Farmer Mac and $1.9 billion long-term and subordinated debt obligations. At August 31, 2023, excluding debt maturities related to our member short-term investments, we had a total liquidity buffer of $3.1 billion, equivalent to 1.9 times for our 12-month debt maturities. In addition, in September, we received an additional $450 million commitment from the RUS under the guaranteed underwriter program.

Slide 14 summarizes CFC's projected long-term debt issuance needs over the next 18 months subsequent to August 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 the quarter, we issued $400 million dealer medium-term notes and borrowed $500 million in short-term notes payable under the Farmer Mac note purchase agreement. In addition, we redeemed a $100 million of our $400 million subordinated deferrable debt that was due in 2043 at par and paid off $400 million of medium-term notes, which matured in August 2023. We also borrowed $275 million under the guaranteed underwriter program in September 2023 after our fiscal quarter end. We expect a total of $4.4 billion of long-term debt maturities and amortization over the next 18 months from September 2023 through February 2025. That's consisting of $3.3 billion in capital market debt and $1.1 billion in non-capital market debt. We expect our loan growth over the next 18-month period to be approximately $2.7 billion. As indicated in the last chart, we projected issuing approximately $6 billion in long-term debt over this period to refinance existing debt to fund expected loan growth.

Thank you again for joining us today to review our results for the first fiscal quarter ended August 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 may submit your questions via the web service, so we may respond to those as well. Thank you.

Operator: And if you would like to ask a question over the telephone, you may signal by pressing star one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow our signal to reach your equipment. Once again, that is star one if you would like to ask a question over the telephone. And we'll pause for just a moment. It appears there are no telephone questions. Oh, actually we did have someone just signal. We'll take a question from Raymond Leung with Scotiabank.

Raymond Leung: Hey, Andrew. Hey everybody there. Just a quick question on broadband. You know, it seems to be steady over there about 2.5 billion. Could you talk about what the size that could be down the road and is it going to stay below roughly 5% of the overall loans?

Andrew Don: Sure. Yeah, good to hear from you, Ray. And in terms of the broadband, as we indicated there's about slightly over 200 electric cooperatives that are involved in some form of investment where they're doing a project in their service territory. I think if they're fully built out for all 200 and again, we're financing about 60% so that dollar represents about 60% of the total funding by cooperatives. So we're doing about a 100, I think it's about 120 or so of the 200 plus. I think if they're fully funded all 200, it would equate to about $9 billion, so if you look at 60% of that that would be the number.

Now we'll note that there are other projects that are becoming available to cooperatives. I don't know if you're familiar with the BEAD program, but there are as part of this some of the infrastructure programs that have gone out there have been some significant dollars that are available, grant dollars as well as low-cost loans that are available to electric cooperatives. So potentially some of that funding could come from the government versus debt, which is what we were initially projecting, but that gives you a bit of the lay of the land, if you will.

Just to be clear all that lending that we're doing for broadband is to electric cooperatives. We're not taking technology risk or lending to a subsidiary. It's typically lent to the electric cooperative that either has a subsidiary or something like that and then they make the investment. So that's the number. So yes, as I said, the total build-out about nine and we're looking at 60% of that. Those are approximations.

Raymond Leung: Okay. Thank you, Andrew and one last question. You guys mentioned just you took action on you guys or any latest updates from S&P and Moody's or Moody's?

Andrew Don: We have had our update meeting with S&P, but I think the question's about an update with S&P and Moody's. So we've had our update meetings, but their commentary should be coming out shortly.

Ling Wang: Yeah. So we had annual meeting update with S&P and Fitch, and I think Fitch already published their updated credit report in September. From S&P's perspective, I think they say they're going to publish it soon. We don't have a timing, but I would expect it will be the next couple of months. I think Moody last published their report, I think it was February or March. Yeah, February or March so in their view their reports is somewhat fresh. We do have a scheduled annual update meeting with Moody's that's coming up, but I don't think Moody's going to publish anything anytime soon. Probably it's going to be closer to either year-end or next year.

Raymond Leung: Okay. Thank you, Ling. Thanks Andrew.

Ling Wang: So we do have another question. The question is what are you seeing in terms of credit quality of all borrowers given the state of the economy?

Andrew Don: Sure. I mean, we're not really seeing any significant change to be frank about it. It's an essential service in a basically monopoly business, they don't have competition per se, and we've seen pretty consistently in past recessions people tend to pay their electric bill, their utility bill before they'll make others. It's because of obviously the ability to change service. So we have not seen any deterioration in credit quality at all as a practical matter, cash flows are very, very strong. If anything we're seeing kilowatt. We do what's called a key ratio trend analysis, report that comes out every June. And again, very strong metrics. We saw an increase in kilowatt-hour sales on a year-over-year basis of 3.6%. Continued strong investment in plant and consumer growth on a median basis, about 1%. So we're continuing to very, very strong growth in service area as well as kilowatt-hour sales and cash flow as well. Debt service capabilities are strong.

Ling Wang: And so keeping in mind most of our members their rates are not regulated by the state commission so to the extent that there's increasing cost, that it's easier for them to pass it through.

Andrew Don: You don't have the regulatory lag that you would with a utility that does have regulatory oversight.

Operator: And as a final reminder, that is star one if you would like to ask a question over the telephone. And we'll pause once more. It appears there are no further telephone questions.

Andrew Don: Okay. Thank you very much for joining us. We look forward to talking to you in the future. Have a nice day.

Operator: And once again, that does conclude today's conference. We thank you all for your participation. You may now disconnect.