National Rural Utilities Cooperative Finance Corporation
FY2019 Year-End Investor Call
August 7, 2019
11:00 am ET

Operator: Good day and welcome to the National Rural Utilities Cooperative Finance Corporation Fiscal Year 2019 year-end investor call. Today's conference is being recorded. At this time, I would like to turn the conference over to Ling Wang. Please go ahead, ma'am.

Ling Wang: Good morning. This is Ling Wang, Vice President of Capital Markets at the National Rural Utilities Cooperative Finance Corporation. Thank you for joining us today to review our fiscal year 2019 financial results. Andrew Don, our Senior Vice President and Chief Financial Officer, will discuss our financial results for our fiscal year ended May 31, 2019. During today's call, we will make forward-looking statements within the Securities Act of 1933, as amended, and the Exchange Act of 1934, as amended. These forward-looking statements are based on certain assumptions and describe our future plans, strategies, and expectations are generally identified by our use of words such as "intends, plans, may, should, will, project, estimate, anticipate, believe, expect, continue, potential, opportunity" and similar expressions, whether in the negative or affirmative. All 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 are 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 annual and quarterly periodic reports, previously filed with the U.S. Securities and Exchange Commission. Except as required by law, we undertake no obligations to update or publicly release any revision to our looking statements to reflect events, circumstances, or changes in expectations after the date on which the statement is made.

We will have Q&A session at the end of this presentation. You can ask questions via phone or submit your question 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, all of the material for this event, including presentation slides and financial reports, are available on our website at www.NRUCFC.coop. A replay and full 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 for joining us today for National Rural Utilities Cooperative Finance Corporation's call to review our financial performance for our fiscal ended May 31, 2019.

We report our results based on Generally Accepted Accounting Principles, or GAAP, in our fiscal year 2019 Form 10-K, which we filed on July 31st, 2019. In addition to our GAAP results, during parts of this discussion, I will refer to certain financial measures that are calculated based on amounts that are included, adjustments to amounts determined under GAAP, and are therefore referred to as "adjusted." The primary non-GAAP adjusted metrics include adjusted net income, adjusted net interest income, and adjusted net interest yield, adjusted times interest earned ratio or TIER, and adjusted debt-to-equity ratio. We provide a reconciliation of our adjusted measures to the most comparable GAAP measures in our recently filed form 10-K.

It's important to note that we use our adjusted measures to manage our business and evaluate our financial performance. Additionally, the financial covenants in our revolving credit agreements and debt indentures are based on our adjusted measures rather than the comparable GAAP measures. We, therefore, believe these adjusted measures are also useful to investors in evaluating our performance.

Fiscal year 2019 was another successful year for CFC, as we continue to see solid loan demand from our members. That said, our loan growth slowed during fiscal year 2019 compared with recent prior years, primarily due to a reduction in the outstanding amount of borrower debt with other lenders available for refinancing with us on more beneficial terms. During the most recent fiscal year, CFC’s total long-term loan advances total $1.8 billion, which consisted of $1.6 billion or 87% for capital expenditure purposes and $182 million or 10% to refinance other lenders' debt. In comparison, during fiscal year 2018 long-term loan advances totaled $2.2 billion with $1.5 billion or 67% for capital expenditures and $524 million or 24% for refinancing of other lender debt. Going back an additional year to fiscal year 2017, of the $2.3 billion total long-term loan advances during that fiscal year, $1.2 billion or approximately 54%, was for capital expenditures and $900 million or 40% was for refinancing. Over the last five fiscal years, annual long-term loan advances to our members has averaged approximately $2.5 billion.

CFC continued to add new 100% borrowers during fiscal year 2019. CFC had 238 100% borrowers at May 31, 2019, an increase of three from the prior fiscal year-end. CFC 100% borrowers represent those members who have 100% of their long-term funding needs sourced exclusively from CFC. Since most of our electric borrowers are private companies, there is limited public information to determine precisely the actual size of the rural electric lending market. We, therefore, estimate the size of the overall rural electric lending market from annual financial and statistical reports our borrowers provide to us on a calendar year basis. Based on the most current available information, we estimated that our market share in terms of long-term loans outstanding to electric cooperative borrowers was approximately 24.3% at December 31st, 2018, a slight increase from December 31, 2017. We continue to be the single largest private lender to the rural electric cooperative sector.

Turning to our financial results, total assets increased by $434 million or 2% during this fiscal year, primarily due to the growth in our loan portfolio of $738 million, which was partially offset by a decrease in derivative assets of $203 million due to mark to market value changes in our interest derivatives portfolio, which I will discuss later.

The $738 million increase in our loan portfolio in fiscal year 2019 was driven by an increase in CFC distribution loans of $603 million and an increase in CFC power supply loans of underneath $182 million partially offset by decreases in NCSC loans of $43

million and RTFC loans of $18 million. Our total debt outstanding increased modestly by $528 million or 2% in fiscal year 2019 to fund growth in our loan portfolio. Our member's equity, which excludes the non-cash impact of derivative forward value gains and losses, accumulated other comprehensive income, and non-controlling interests, increased by $129 million due to adjusted net income of $169 million which was partially offset by the [patronage capital] retirement of $48 million. Our adjusted debt to equity ratio decreased to 5.73 to one at May 31st, 2019, compared to 6.18 to 1 at May 31, 2018.

In light of the favorable interest rate environment and market conditions in May 2019, we issued $250 million, 45-year, fixed-for-life subordinated deferrable debt, which we classify as equity on our adjusted debt to equity calculation to reduce our adjusted debt to equity ratio below our targeted threshold of six to one. Based on our current projection, we expect our adjusted debt to equity ratio to remain below our six to one targeted threshold over the next 12 months.

In July of 2019, subsequent to our May 31, 2019, fiscal year-end, our board of directors authorized the retirement of patronage capital totaling approximately $63 million. We expect to return this amount to our members in cash in September 2019. As a reminder, our current patronage capital policy, which was adopted by our board of directors in 2009, is to allocate a portion of our annual adjusted net income to our members in the form of patronage capital each year. Of the allocated patronage capital amount 50% is paid out to our members in the form of cash in the following fiscal year and the remaining 50% is retained by us for 25 years to fund operations.

For fiscal year 2019, CFC generated adjusted net income of $169 million and an adjusted tier of 1.19 times, compared with adjusted net income of $151 million and adjusted tier 1.17 times for fiscal year 2018. The $18 million increase in adjusted net income for the current fiscal year from the prior fiscal year was attributable to an increase in adjusted net interest income of $46 million, which was partially offset by a reduction in the benefit for loan losses of $17 million and the loss in the early extinguishment of debt of $7 million.

During fiscal year 2019, we recorded a benefit for loan losses of $1 million, compared with a benefit for loan losses of $18 million in fiscal year 2018. The benefit of $18 million for loan losses in fiscal year 2018 was attributable to increases and the recovery rate assumptions used in determining the allowance for our electric loan portfolios.

Our overall provision for loan losses was $18 million at May 31, 2019, which remained relatively unchanged from $19 million at May 31, 2018. Our adjusted net interest income of $256 million in fiscal year 2019 increased by $46 million, or 22%, from our adjusted net interest income of $210 million in fiscal year 2018. The increase in adjusted net interest income was driven by an increase in the adjusted net interest yield of 14 basis points or 17%, to 97 basis points, coupled with the increased in average interest-earning assets of 4%. The increase in our adjusted net interest yield reflected the combined impact of an increase in the average yield on interest-earning assets of 7 basis points and a reduction in our average cost of funds of 7 basis points. The reduction in our overall funding costs was largely due to the interest savings from the repayment of the 10 3/8% $1 billion collateral trust bonds. We refinanced this debt with lower-cost funding during the second quarter of fiscal year 2019. We expect that the benefit from the payoff of the 10 3/8% coupon debt will continue to have a favorable impact on our adjusted net interest yield, adjusted net interest income, and adjusted TIER in fiscal year 2020.

We recorded $320 million of derivative forward value losses during fiscal year 2019 compared with $306 million of gains in the prior fiscal year. The derivative forward value losses in fiscal year 2019 were due to decreases in the fair value of our pay fixed interest rate swaps, as intermediate and long-term interest rates declined during the fiscal

year after reaching a peak in November 2018. As we have regularly disclosed, the derivative forward value gains or losses represent the changes and the estimated fair value of our interest rate swaps at the end of each reporting period based on the projected movement and interest rates due to the maturity the swap transactions in place at the end of each period. These amounts do not represent the current period realized cash gains or losses. Therefore, as previously noted, we exclude derivative forward value gains and losses from our adjusted net income and adjusted equity calculations in managing and evaluating our operating performance. These amounts are also excluded from financial debt covenant measures.

The overall composition of our loan portfolio at fiscal year-end May 31, 2019, remained largely unchanged from the composition of the prior fiscal year-end with, $26 billion or 99% of our portfolio, consisting of loans to rural electric systems and $345 million or 1%, to the telecommunication sector.

The percentage of CFC's long-term fixed-rate loans was at 89% as of May 31, 2019, compared with 90% at May 31, 2018. We typically lend to our members on a senior secured basis, with 92% of our loans being senior secured at May 31, 2019, compared with 93% at May 31, 2018.

This slide depicts CFC's consolidated loans outstanding by state and the states with the largest overall loan outstanding increases during fiscal year 2019. We experienced loan demand for both term loans and revolving line of credit loans during fiscal 2019. Of the $738 million total increase in our loan portfolios, $425 million or 58% came from increases in long-term loans and $313 million or 42% from increases in line of credit loans.

As mentioned earlier, approximately 87% of our new, long-term loan advances during fiscal year 2019 were made for capital expenditure purposes.

We continue to have our largest concentration of outstanding loans and borrowers in Texas, which accounted for approximately 15% of total loans outstanding and consisted of 70 borrowers at May 31, 2019. Texas represented the second-highest loan growth state during fiscal year 2019. All of our loan growth in Texas came from increases in long-term loans. We continued to experience robust capital expenditure loan demand from borrowers in Texas due to strong economic growth in that state.

Florida accounted for the largest increase in total loans outstanding during fiscal year 2019. That said, approximately 67% of the loan growth in Florida was driven by borrower advances from their emergency line of credit facilities to repair damages from Hurricane Michael, which hit the Florida Panhandle in October 2018. We expect a large portion of these line of credit borrowings will be repaid with funding from the Federal Emergency Management Agency or FEMA.

Overall, Florida and Texas together accounted for 47% of our net loan growth during fiscal year 2019. In terms of single borrower concentration our largest exposure to a single borrower represented approximately 2% of total loans outstanding as of May 31, 2019, while our net loan exposure of our top 20 borrowers, which excludes loans guaranteed by the Federal Agricultural Mortgage Corporation, was 21% of loans outstanding or $5.3 billion. Our top 20 borrowers consisted of 10 distribution systems, nine power supply systems, and one NCSC associate member, which is an electric utility company owned by several distribution systems. These borrower concentration statistics were relatively unchanged from the end of fiscal year 2018. We have not had any delinquent or nonperforming loans in our portfolio since June 1, 2016. We had no charge

offs or loan defaults during fiscal years 2019 and 2018. 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 six consecutive fiscal years for which we've had no credit losses in our electric utility portfolio.

Total debt outstanding increased by $529 million during fiscal year 2019 to fund the loan growth during the year. CFC continues to maintain diverse funding sources to minimize the risk of being dependent on any single source or market. Our overall funding mix has been very stable over the past several years. As of May 31st, 2019, $4.4 billion or 18% of CFC's funding came from our members in the form of short-term and long-term investments. Over the last three fiscal years, member investments have averaged approximately $4.4 billion at each quarter-end. At May 31, 2019, our total outstanding balance under the Guaranteed Underwriter Program increased by $554 million from the prior fiscal year-end and our outstanding balance under the notes payable with Farmer Mac increased by $163 million. Both increases were attributable to our need to fund our loan growth. Our capital markets related funding sources which accounted for 49% of our funding at May 31, 2019, decreased by $192 million from the prior fiscal year-end primarily due to reductions in short term debt outstanding, mainly dealer commercial paper. At May 31, 2019, 63% of our total debt was secured and 37% was unsecured, unchanged from May 31, 2018.

This slide presents CFC's, long-term debt maturities and amortization over the next 12 months. Our total long-term debt maturities over this period are very modest, at $2.3 billion, with collateral trust bonds accounting for approximately $1.1 billion or 48% of the scheduled debt maturities. Our other significant debt maturities during this period include a $300 million dealer medium-term note maturing in November 2019, and a $100 million note maturing with Farmer Mac, maturing in February 2020.

We have three months over the next 12 months that have large debt maturities. $656 million debt maturities in November 2019, $450 million in January 2020, and $445 million in June 2020. With respect to the $462 million of member medium-term notes due over this period, historically our members have chosen to roll over their investments at maturity. 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 non-capital market sources of liquidity that CFC had in place on May 31, 2019, compared with the prior fiscal year-end. The amount and type of sources of liquidity we had at May 31, 2019, remained relatively unchanged from May 31, 2018. As indicated in the graph, we have an aggregate of approximately $5.3 billion of member and non-member debt maturities over the next 12 months as of May 31, 2019, compared with $6.6 billion as of May 31, 2018. At May 31, 2019, we had access to $9.3 billion of liquidity, which is 1.8 times the combined member and non-member debt maturities or $4 billion greater than the combined member and non-Member debt maturities. Over half, or $2.9 billion of the $5.3 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 a stable and reliable source of funding for CFC.

If we excluded the $2.9 billion debt maturities related to our member short-term investments, we would have total liquidity equal to 3.9 times or $6.9 billion of liquidity in excess of dealer commercial paper and the current portion of non-member long-term debt maturities during the next 12 months, subsequent to May 31, 2019.

This slide presents CFC’s projected sources and uses of cash over the next 18 months, subsequent to May 31, 2019. As indicated, our total projected cash needs over this time period are approximately $5.3 billion, with 55% to meet maturities of long-term debt and 45% of this amount expected to satisfy projected new loan advances. We project our long-term loan growth for the next 18 months to be modest, at $315 million. For our future potential funding needs, we will continue to look balance capital market and non-capital market secured and unsecured financings, while always looking to access the most attractive cost of funds for our member borrowers.

We completed a variety of financing transactions during fiscal year 2019. Most of these transactions were mentioned in our prior investor calls. From the liquidity perspective, we extended the maturity dates for our bank revolving credit facilities and the Farmer Mac revolving facility and expanded our borrowing capacity under the Guaranteed Underwriter Program. During this fiscal year, we issued $1.6 billion of collateral trust bonds, $300 million of dealer medium-term notes, and $250 million of 5.5% 45-year fixed-for-life subordinated deferrable debt to refinance the $1.8 billion in collateral trust bonds and $350 million in dealer medium-term note maturities. As mentioned earlier, we classify the $250 million of subordinated variable debt that we issued in May 2019, as equity in our adjusted debt to equity calculation.

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 has consistently focused on and represent key credit strengths when viewing CFC as an investment. As indicated, CFC's ratings remain strong and stable. CFC has a long-term incentive compensation plan which is tied to our credit ratings. Our goal is to maintain strong long-term credit fundamentals. The overall quality of our loan portfolios continues to be strong with 99% of our loans to rural electric systems and 92% of our loans being on a senior secured basis. We have not had any delinquent or nonperforming loans in our portfolio for over two years. That is since June 1, 2016, and we have not had any loan charge offs during the past 11 quarters. At May 31, 2019, the coverage ratio of our allowance for loan losses, which is an estimate of probable losses inherent in our loan portfolio was 0.07%, or seven basis points of our total loan portfolio, the same allowance coverage ratio as at May 31, 2018. CFC continues to receive strong support from our members, both in terms of new lending business and as a valuable funding source. Our member investments stood at $4.4 billion at May 31, 2019, representing 18% of our total funding.

As a member-owned cooperative organization, CFC cannot issue common or preferred equity. However, we are committed to growing our equity through retained earnings. Our members' equity has grown by 63% to $1.6 billion from $998 million, since 2013. 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 May 31, 2019, we had $3 billion committed revolving credit facilities from our relationship banks, $1.4 billion committed availability in the Guaranteed Underwriter Program, and $2.4 billion revolving credit capacity via the Farmer Mac secured notes purchase agreements.

In addition, as a supplemental source of liquidity, at May 31, 2019, we had $565 million of held-to-maturity investment securities, consisting primarily of high-quality, liquid, short to intermediate-term corporate bonds. These sources, together with cash and scheduled loan amortization and other repayments from our members, resulted in CFC having $9.3 billion of liquidity available at May 31, 2019, to meet the $5.3 billion in debt maturities over the next 12 months, a 1.8 times liquidity coverage ratio. Excluding debt maturities related to our member investments, which historically have had a high reinvestment rate, our liquidity coverage ratio would be 3.9 times.

Thank you once again for joining us today to review our results for our fiscal year ended May 31, 2019. We appreciate your interest in CFC and look forward to discussing our financial performance and funding plans in the future.

I'd like to ask the operator to open the lines for questions and also suggest that you submit other questions via the web service that we may respond to those as well. Thank you.

Operator: Thank you. At this time, if you would like to ask a question, please signal by pressing 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. We'll pause for just a moment to allow everyone an opportunity to signal for questions. Again, that's star one if you would like to ask a question via the audio portion. I'm showing there are no questions in the queue at this time.

Andrew Don: Okay, thank you operator, and thank you to all you for joining us today and we look forward to talking in the future. Have a good day.

Operator: Okay, thank you, ladies and gentlemen, this concludes today's teleconference. You may now disconnect.