Moody's Investors Service

Credit Opinion: National Rural Utilities Coop. Finance Corp.

Global Credit Research - 30 Nov 2009

Herndon, Virginia, United States

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Secured	A1
Senior Unsecured	A2
Subordinate	A3
Commercial Paper	P-1
Other Short Term	P-1

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Key Indicators

National Rural Utilities Coop. Finance Corp.

	2009	2008	2007	2006	2005	2004	2003
Loans ($billions) [1]	20.19	19.03	18.13	18.36	18.97	20.49	19.48
Adjusted Capital Funds ($billions) [1][2]	2.36	2.03	1.97	2.00	2.03	2.17	2.16
Adjusted TIER (x) [1][3]	1.10	1.16	1.12	1.11	1.14	1.12	1.17
Adjusted Debt / Adj. Capital Funds (NIC) x [1][2][4]	8.14	8.27	8.14	8.26	8.53	8.55	8.21
Loan Loss Reserve ($millions) [1][5]	623	515	562	611	590	574	511
Loan Loss Reserve / Loans (%) [1][5]	3.09	2.71	3.10	3.33	3.11	2.80	2.62

[1] Fiscal year ends May 31st [2] Members' Equity is adjusted for derivative forward value and foreign currency adjustments. [3] Net margin adjusted to exclude derivative forward value and foreign currency adjustments. Cost of funds adjusted to include derivative cash settlements. [4] Members capital securities receive 50% equity credit [5] Excludes loss reserves for guarantee portfolio of $12, $10, $13,$15, $16, $19, and $53 million for 2009, 2008, 2007, 2006, 2005, 2004, and 2003.

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Unique franchise provides strong competitive position

- Loan pricing flexibility enables NRUC to maintain targeted coverage ratios

- Loan and guarantee portfolio heavily weighted towards RECs

- Outstanding credit quality of loan portfolio

- Strong track record in managing difficult credit restructurings

- Dependence on wholesale funding continues

- Leverage remains high and must be managed

Corporate Profile

Based in Herndon, Virginia, National Rural Utilities Cooperative Finance Corporation (NRUC) is a non-bank financial institution exclusively serving rural electric, service, and telecommunication utilities. NRUC was organized in 1969 by rural electric cooperatives (RECs) as a not-for-profit, tax exempt association that provides a source of financing to supplement the loan programs of the Rural Utilities Service (RUS) of the U.S. Department of Agriculture.

Loans to telecommunication members are made through Rural Telephone Finance Cooperative (RTFC), a private taxable cooperative association formed to provide financing to its for-profit and non-profit rural telecommunications members and affiliates. Loans are also made through National Cooperative Services Corporation (NCSC), which provides specialized financing and services to entities owned, operated and controlled by RECs.

NRUC's goal as a not-for-profit cooperatively-owned finance company is to set rates at levels that will provide its members a wide range of flexible, low-cost financing programs while earning a minimum profit or margin consistent with defined financial targets to support its overall credit position and maintain access to capital markets. Loans and guarantees supplied to members are priced to cover its funding costs, general and administrative expenses, the loan loss provision, and a modest profit in order to maintain an adjusted times interest earned ratio (TIER) of at least 1.10 times. NRUC's adjusted TIER averaged 1.12 times over the past three fiscal years, and its adjusted TIER was 1.10 in FY 2009.

Recent Developments

On November 24, 2009, Moody's affirmed the long-term and short-term ratings of NRUC with a stable outlook, including its A1 senior secured rating, its A2 senior unsecured rating and its Prime-1 short-term rating.

On September 16, 2009, NRUC issued $500 million in collateral trust bonds (CTBs), including $250 million of 2.625% CTBs due 2012 and $250 million of 3.875% CTBs due 2015.

SUMMARY RATING RATIONALE

The A2 senior unsecured debt rating of NRUC is based on its high quality asset portfolio; an excellent competitive position that includes an ability to raise margins on member loans; a strong track record in managing credit restructurings; an improved risk management program and a declining exposure to the more volatile telecommunications sector. The rating also takes into account NRUC management's attempts in recent years to reduce the degree of single obligor exposure within the loan portfolio; the company's reliance on capital markets to fund its lending business, continuing high leverage and the challenges associated with managing certain problem loans.

DETAILED RATING CONSIDERATIONS

- Unique franchise provides strong competitive position

NRUC's primary mission, as a low-cost provider of capital to its member cooperatives, provides it with unique franchise value. NRUC enjoys strong support from its member cooperatives as it provides them with attractive and customized financing alternatives. As such, given NRUC's status as a not-for-profit cooperative association and its operating objective to provide interest rates to its members at the lowest reasonable cost, operating margin and earnings profitability metrics have limited value from a ratings driver perspective. To that end, profitability comparisons and market share comparisons to other financial institutions also have limited value, particularly given NRUC's narrowly defined market and unique franchise position.

- Loan pricing flexibility enables NRUC to maintain targeted coverage ratios

NRUC's credit quality benefits from its ability to reset margins sufficiently to maintain its targeted adjusted TIER of 1.10x. NRUC manages this policy by having terms and conditions in virtually all of its customers' loan documents that allow for a variety of re-pricing mechanisms. NRUC's dominant position in the market place coupled with the flexibility of its electric borrowers to set rates as necessary to cover their expenses and maintain required covenants helps to effectively carry out this strategy.

-Loan Portfolio Remains Heavily Weighted Towards RECs

As of Aug 31, 2009, of the more than 90% of NRUC's loan portfolio with RECs, 68% or $13.6 billion of loans were with rural electric distribution cooperatives. The majority of the remaining loans are to generation and transmission cooperatives. Moody's views the electric distribution segment, NRUC's principal lending market, to be among the least volatile across the electric sector given the generally steady capital requirements, the relatively low risk nature of operating these businesses, and the ability of NRUC's members to pass through cost increases to its customers.

Since FY 2003, NRUC has taken a proactive role in reducing its exposure to the telecommunications portfolio. Total outstanding loans in the portfolio have declined by $3.2 billion to $1.7 billion at Aug 31, 2009, representing less than 9% of NRUC's total outstanding loan portfolio.

Moody's views the shift away from the rural telecommunications sector as being supportive to NRUC's overall credit quality and to the quality of the loan portfolio. Over the next few years, Moody's expects moderate growth from NRUC's loan portfolio with all the growth coming from the REC portfolio over this timeframe.

-Outstanding Credit Quality of NRUC's Asset Portfolio

Overall, NRUC has an excellent loan loss experience. Since the cooperative's inception in 1969, only $183 million in cumulative net losses have been taken. The low write-off loan history demonstrates the historically high credit quality of NRUC's portfolio, the strength of the collateral typically pledged to NRUC, and the ability of the NRUC to take a long-term view concerning debt restructuring due to its unique relationship with its customer base and the fact that NRUC is a not-for-profit organization.

At August 31, 2009, nearly 87% of NRUC's total loan portfolio is secured. Loans are typically secured on parity with other secured lenders (primarily RUS), if any, by a mortgage lien on the borrower's total assets and a pledge of future revenues with certain exceptions typical for utility mortgages. This strong collateral position has helped to provide high recovery values for NRUC in past problem loan/debt restructurings and often enables NRUC to receive the payment of interest and principal while a borrower is operating in bankruptcy. The majority of NRUC's unsecured loans reflect primarily short-term lines of credit with RECs.

Since FY 2000, NRUC has materially increased its loan loss reserve. At Aug 31, 2009, the loan loss reserve stood at $607 million, representing 3.02% of total loans. Moody's observes that since 2003, incremental loan loss allowances have been based upon management's application of a more objective loan loss methodology that takes into account the internal risk ratings of each loan, the maturity of each loan, the business segment of each loan, expected defaults based upon historical default rates, and expected recovery rates.

-Strong track record in managing difficult credit restructurings

NRUC has a demonstrated track record of being able to effectively manage difficult credit situations. As discussed above, some of this track record can be attributed to the strong security position associated with the vast majority of NRUC's loans. Additionally, its status as a not-for-profit cooperative entity allows management to take a longer-term view towards restructuring difficult credit situations although Moody's notes that this also has the potential to delay the final resolution of problems, relative to other financial institutions.

-Problem Loans at $524 Million Represent A Rating Constraint

NRUC's loan exposure to Innovative Communications Corporation (ICC), which is operating in bankruptcy, represents all of NRUC's current non-performing loans ($524 million). Progress has been made to resolve this matter during calendar year 2009, including the bankruptcy court's interim approval of the sale of the ICC Group 1 assets to NRUC as well as the approval of NRUC's application to acquire BVI Cable Ltd from the Minister of Communications and Works and the Telecommunications Regulatory Commission of the British Virgin Islands. Additional regulatory approval of NRUC's purchase of the ICC Group 1 assets is required, and if attained, final bankruptcy court approval is necessary prior to transfer. It is possible that the asset transfer could occur sometime during calendar year 2010. A substantial portion of NRUC's existing $607 million loan loss reserve is earmarked for a potential ICC loan loss.

- Dependence on the Capital Markets

As with many finance companies, NRUC is dependent upon access to the long-term and short-term capital markets for financing its business and for refunding debt maturities. In addition to annual operating cash flow, member loan repayments have averaged about $1 billion for the last several years and are expected to average about $1 billion annually from FY 2011 through 2013. For the remaining three quarters of FY 2010, scheduled loan repayments are estimated at $1.107 billion; however, NRUC expects to receive an additional $585 million of long-term loan prepayments primarily from the repayment of power supply bridge loans with RUS funding.

At August 31, 2009, NRUC members invested about $4.41 billion which represent about 21.4% of total assets (less derivatives) as of that date. Of the $4.41 billion, $1.383 billion represented short-term debt funding through $1.053 billion in members' commercial paper and $330 million in members' contributions to the daily liquidity fund. NRUC's uses the dealer commercial paper market to supplement any short-term funding requirements.

Since FY2006, longer-term funding sources have been supplemented through two separate private programs. Under the Rural Economic Development Loan and Grant (REDLG) program, NRUC has been able to secure $3 billion of twenty year funding from the Federal Financing Bank (FFB) of the US Treasury. In addition, starting in FY 2007, NRUC established a relationship with Federal Agricultural Mortgage Corporation (Farmer Mac), where Farmer Mac can provide funding to NRUC through the purchase of NRUC loans or through an investment in their securities. At August 31, 2009, Farmer Mac had provided $1.825 billion of funding to NRUC under various arrangements. Also, at August 31, 2009, NRUC had the ability to borrow an additional $575 million under a seven-year $1.0 billion revolving note purchase agreement between NRUC and Farmer Mac that expires in 2016.

Notwithstanding NRUC's relationship with its members, Farmer Mac, and its access to FFB funding, NRUC still remains significantly dependent upon wholesale short-term and long-term funding. NRUC's primary sources of long-term capital market funding includes secured collateral trust bonds (CTB), unsecured medium term notes (MTNs), and subordinated deferrable debt.

For more information on capital market access, see liquidity section below.

-Leverage Remains High and Must Be Managed

Due to the nature of its composition, NRUC does not have common stock in its capital structure. In its place, Moody's views the deeply subordinated capital term certificates as equity.

Since FY 2004, NRUC's leverage has been on a slow declining trend. At August 31, 2009, the ratio of adjusted funded debt to adjusted member's equity, as calculated by Moody's, was 8.0x, compared to 8.3x at May 31, 2008. A primary reason for the decline is NRUC's decision to offer member capital securities to its cooperative members. Since their introduction in November 2008, NRUC has raised $337 million in member capital securities as of August 31, 2009.

In June 2009, as a means of increasing its equity retention, NRUC revised its guidelines related to the timing and amount of patronage capital to be distributed. Under the new guidelines, NRUC will retire 50% of prior year's allocated net earnings and hold the remaining 50% for 25 years. Moody's views the decisions to offer member capital securities and to alter the patronage capital cycle as credit supportive actions by NRUC. Moody's believes these two initiatives will enable leverage, as calculated by Moody's, to continue a downward trend.

Liquidity

NRUC's has a short-term rating of Prime-1 for its commercial paper, for the guaranteed commercial paper issued by NCSC, variable rate tax-exempt demand bonds, and extendible commercial notes. While NRUC has alternative funding sources from its members and from private sources, NRUC remains dependent on the capital markets as a primary funding source. Aside from FY 2010, where NRUC's internal sources could exceed $1.7 billion, NRUC's internal sources are expected to approximate $1 billion annually, principally in the form of loan amortization payments.

During FY 2009, NRUC raised $2.3 billion of CTBs in the capital markets, $900 million of 5.5% CTBs due 2013, $400 million of floating rate notes due 2010, and $1 billion of 10.375% CTB due 2018 (in October 2008). Moody's observes that as a cost-plus lender, NRUC has incorporated the higher cost funding experienced from the October 2008 financing in the loan pricing available to members.

Subsequent to first quarter end, NRUC raised $500 million in September 2009 issuing $250 million of 2.625% of CTBs due 2012 and $250 million of 3.875% of CTBs due 2015.

During FY 2009 and during the first quarter period ending August 31, 2009, NRUC's private funding sources provided $1.925 billion of incremental funding with the REDLG program providing $500 million of funding and Farmer Mac providing $1.425 million. At August 31, 2009, NRUC had $575 million of availability under the $1 billion seven year Farmer Mac note facility.

Also, during calendar year 2009, Moody's understands that NRUC issued nearly $900 million of senior unsecured medium-term retail inter notes.

NRUC has established a goal of maintaining its dealer commercial paper and bank bid notes at no more than 15% of total debt. At Aug 31, 2009, dealer commercial paper and bank bid notes totaled approximately 8% of total debt outstanding. NRUC expects outstanding dealer commercial paper and bank bid notes to remain below 15% during FY 2010.

NRUC's committed bank facilities currently aggregate $3.016 billion (adjusted for the previous commitment from Lehman Brothers Bank) and represent NRUC's principal form of liquidity support. Of the $3.016 billion in committed bank facilities, nearly 67% of the credit facilities have a multi-year maturity. Approximately $1.049 billion of the facilities expire on March 16, 2012, and $967 million of the facilities expire on March 22, 2011. The remaining $1.0 billion of these commitments expire by March 12, 2010. A failure to maintain access to a similar amount of multi-year credit facilities could weaken credit quality.

These credit facilities do not contain a MAC clause but have financial covenants which are set at levels that provide substantial cushion. The agreements require an adjusted TIER average of 1.025 for the last six quarters (excluding any non-cash adjustments for derivatives and foreign currency adjustments) and a maximum senior debt to equity ratio, as defined in the bank agreements, to not be more than 10x (excluding any non-cash adjustments for derivatives and foreign currency adjustments). NRUC was comfortably in compliance with this covenant at August 31, 2009 with an adjusted TIER of 1.15x and a senior debt to equity ratio of 6.75x.

Refinancing needs for FY 2010 have been largely addressed with the repayment of $1.495 billion of medium term notes in the first quarter of FY 2010 and with the cooperative's September 2009 issuance of $500 million of CTBs. Prospectively, for the one year period from September 1, 2009 through August 31, 2010, NRUC has $1.482 billion of notes and bonds maturing, of which $411 million are owed to member cooperatives, leaving $1.071 billion of maturing notes and bonds. Approximately $188 million of the remaining $1.071 billion is due to FarmerMac, which Moody's believes will be extended at its maturity day. Of the remaining $897 million, $200 million and $400 million of CTBs mature in January 2010 and July 2010, respectively. Beyond the July 2010 maturity, NRUC has $500 million of CTBs due in October 2010 with the next sizeable maturity occurring in March 2012 when $1.5 billion of senior unsecured notes mature. Moody's expects NRUC to meet these financing requirements though internal sources, loan repayments, capital market offerings, and access to various private financing programs.

Rating Outlook

The stable rating outlook incorporates our view that modest loan growth among rural electric cooperatives will help maintain strong asset quality within the loan portfolio. To that end, we believe that the telecom portfolio, a source of loan portfolio weakness, will continue to represent less than 10% of the total loan portfolio. The stable outlook factors in NRUC's plans to lower leverage through the offering of member capital securities and through the change in NRUC's patronage retention cycle, and incorporates an expectation that NRUC will maintain sufficient liquidity as well as access to private sources of funding to mitigate the firm's reliance on wholesale funding.

What Could Change the Rating - Up

In light of the still uncertain outcome with respect to NRUC's sizable exposure to a bankrupt telecommunications borrower and the relatively high leverage, the prospect of a higher rating is limited within the next twelve months.

What Could Change the Rating - Down

The rating could be downgraded if a new meaningful problem loan surfaced within NRUC's portfolio, if recently implemented capital raising and capital retention efforts do not reduce NRUC's leverage over the next twelve to eighteen months, if NRUC fails to maintain an adequate liquidity profile, including ample access to multi-year bank credit facilities, or if the size of the telecom loan portfolio were to increase above 10% of the portfolio.