National Rural Utilities Cooperative Finance Corporation
FY20 First-Quarter Investor Call
October 23, 2019
11 AM EDT

Operator: Good day and welcome to the National Rural Utilities Cooperative Finance Corporation's fiscal year 2020 first quarter investor call. Today's conference is being recorded. At this time, I would like to turn the conference over to this Ms. Ling Wang, Vice President of Capital Markets. Please go ahead, ma'am.

Ling Wang: Hi, good morning. This is Ling Wang, Vice President of Capital Markets at National Rural Utilities Cooperative Finance Corporation. Thank you for joining us today to review our first quarter of fiscal year 2020 financial results. Andrew Don, our Senior Vice President and Chief Financial Officer will discuss our financial results for our first quarter of fiscal year 2020, which ended on August 31st, 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 "intend, plan, 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 our 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 period reports previously filed with the U.S. Securities and Exchange Commission. Except as required by law, we undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in the expectations after the date on which statements are made. We will have a Q & A session at the end of this presentation. You can ask questions via phone or submit your questions online, if you are participating in this event via webcast. We encourage you to take this opportunity to ask any questions you may have. In addition, all the material for this event, including the presentation slides and financial reports, are available on our website, at NRUCFC.coop. A replay and call transcript will be made available on our website after the event. With that, I'll turn the call over to Andrew.

Andrew Don: Thank you, Ling, and again, good morning, and thank you for joining us today for National Rural Utilities Cooperative Finance Corporation's call to review our financial performance for our first quarter of fiscal year 2020 for the three month period ended August 31, 2019.

We report our results based on Generally Accepted Accounting Principles, or GAAP, in our form 10-Q, which we filed on October 10th, 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 include 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 at 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 and our recently filed form 10-Q. Is it 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 are adjusted measures rather than the comparable GAAP measures. We, therefore, believe these adjusted measures are also useful to investors in evaluating our performance.

Our total assets for the quarter ended August 31, 2019, were approximately $27.6 billion, an increase of $455 million, or 2% from the May 31, 2019, fiscal year-end level. This increase was primarily driven by an increase in gross loans to members of $383 million. Specifically, loans to distribution members and power supply members increased by $329 million and $92 million, respectively. We also experienced a very slight increase in our RTFC loans of $6 million. These increases were offset by a decrease in NCSC loans of $45 million.

We experienced healthy loan demand from our members during the current quarter. Our long-term loan advances during the quarter totaled $888 million, with approximately 73% of those advances made for capital expenditure purposes, and 19% for the refinancing of loans made by other lenders. In comparison, our long-term loan advances during the same prior-year period totaled $468 million, with approximately 71% of those advances for capital expenditures and 25% for refinancing other lenders' loans.

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 decreased slightly by $3 million. The decrease was due to CFC's Board of Directors' authorization in the first quarter to retire patronage capital of $63 million, which was partially offset by the adjusted net income of $61 million for the three months ended August 31, 2019.

Our adjusted debt to equity ratio increased to 5.84 to 1 at August 31, 2019, from 5.73 to 1 at May 31, 2019, primarily due to an increase in debt outstanding to fund the loan growth. Based on our current projection, we expect our adjusted debt to equity ratio to remain below our 6 to 1 targeted threshold over the next 12 months.

For the three months ended August 31, 2019, CFC generated adjusted net income of $61 million and an adjusted TIER of 1.27 times, compared with adjusted net income of $28 million and adjusted TIER of 1.13 times the same prior-year quarter. The $33 million increase in adjusted net income for the current quarter from the comparable prior-year quarter was attributable to four primary factors. One, an increase in adjusted net interest income of $11 million. Two, an increase in fee income of $7 million. Three, a gain of $8 million from the sale of a parcel of land that had been purchased as a potential headquarters site but never developed. And fourth, the absence of the loss of a $7 million expense related to an early redemption of debt that was recorded in the prior-year quarter. Our adjusted net interest income during the current quarter of $66 million, an increase of $11 million, or 19% from the comparable prior year quarter. This increase was driven by an increase in the adjusted net interest yield of 12 basis points or 14% to 97 basis points, coupled with the increase in average earning assets of 3%. The increase in the adjusted net interest yield reflected the combined impact of an increase in the average yield on our interest-earning assets of five basis points, to 4.3%, and a reduction in our adjusted average cost of funds of eight basis points, to 3.53%. The reduction in our funding costs was largely due to interest savings from the repayments of the 10.375% collateral trust bonds in fiscal year 2019, and the replacement of this debt with lower-cost funding. We expect that our adjusted net interest income, adjusted TIER, and adjusted net interest yield will increase over the next 12 months compared to prior year periods, largely due to a projected decrease in our average funding costs and an increase in average interest-earning assets.

We recorded $385 million of derivative forward value losses during the current quarter, compared with $20 million of gains in the same prior-year period. The derivative forward value losses in the current period were due to decreases in the fair value of our pay-fixed interest rate swaps as interest rates across the swap curve have declined from May 31, 2019, to August 31, 2019. As we have regularly disclosed, the derivative forward value gains or losses represent the changes in the estimated fair value of our interest rate swaps at the end of each reporting period, based on the projected movement in interest rates through the maturity of the swap transactions in place at the end of each period. These amounts did 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 quarter-end August 31, 2019, remained largely unchanged from the composition of the fiscal yearend date of May 31, 2019, with $26 billion or 99% of our portfolio, consisting of loans to rural electric systems and $351 million or 1%, to the telecommunications sector. The percentage of CFC's long-term fixed rate loans was at 90% as of August 31, 2019, compared with 89% at May 31, 2019. We typically lend to our members on a senior secured basis, with 93% of our loans being senior secured at August 31, 2019, compared with 92% at May 31, 2019.

We did not have any payment defaults or charge offs during the current quarter and during the last two fiscal years. We have not had any delinquent or non-performing loans in our portfolio since June 1, 2016. The credit quality of our loan portfolio remains strong, with our members continuing to demonstrate solid financial and operational performance. This is especially true of our electric utility portfolios. We now have a sustained period of six consecutive fiscal years for which we have had no credit losses in our electric utility portfolio.

Our total debt outstanding increased by $302 million, or 1%, during the current quarter to fund the loan growth. Our overall funding mix has been very stable over the past several years. During our first fiscal quarter, we initiated a marketing effort to raise awareness of the investment products we offer our members as investment options for their excess cash. As a result, at August 31, 2019, our member investments reached a total of nearly $5 billion and accounted for 20% of our total debt outstanding, compared with $4.4 billion or 18% of total debt outstanding as of May 31, 2019. The overall increase was driven by increases in select notes, daily liquidity funds, and member commercial paper. Over the last three years, our member investments have averaged approximately $4.5 billion at each quarter-end. Our funding under the guaranteed underwriter program and notes payable with Farmer Mac decreased $116 million due to regular amortization and scheduled maturity. Our capital markets related funding sources, which accounted for 47% of our funding at August 31, 2019, decreased by $137 million from the prior fiscal year and primarily due to a $150 million reduction in short term debt outstanding mainly dealer commercial paper.

This slide presents CFC's long-term debt maturities and amortization over the next 12 months. In September, we provided a notice to investors to redeem at par on October 15th, 2019, our $300 million, 2.3% collateral trust bonds due November 15th, 2019. As this amount has been repaid as of today's date, our refinancing needs over the next 12 months to fund upcoming maturities of collateral trust bonds, and dealer medium-term notes are very modest, at $1.1 billion. We believe we have ample sources of liquidity to meet each of the maturities, is highlighted in the next slide.

This slide depicts the various non-capital market sources of liquidity that CFC had in place at August 31, 2019, compared with the prior fiscal year-end. The amount and type of sources of liquidity we had at August 31, 2019, did not change materially from May 31, 2019. As indicated in the graph, we had an aggregate of approximately $6.3 billion of member and non-member debt maturities over the next 12 months as of August 31, 2019, compared with $5.3 billion as of May 31, 2019. At August 31, 2019, we had access to $9.2 billion in liquidity, which is 1.5 times or $3 billion the combined member and non-member debt maturities. Furthermore, 58% or $3.7 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 a very stable and reliable source of funding for CFC. If we excluded the $3.7 billion debt maturities related to our member's short term investments, we would have total liquidity equal to 3.6 times or $6.6 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 August 31, 2019.

This slide presents CFCs projected long-term debt issuance needs over the next 18 months subsequent to August 31, 2019. Our cash needs are derived from two primary areas, refinancing existing debt maturities and funding loan growth, partially offset by the amortization and repayment of loans from our members as well as investments by our members. Our projected long-term debt issuances over this time period are approximately $2.4 billion, as indicated in the last column. As indicated, we have approximately $3 billion in long-term debt maturities over this time period, but we only expect to issue $2.4 billion in long-term debt are projected. Our projected funding need is a result of flat projected net loan growth as well as the strong member investments we have experienced, which is reflected under the "other sources uses of cash" column.

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. Fitch recently reaffirmed CFC's ratings and outlook on September 24th, 2019. CFC has a long-term incentive compensation plan, which is tied to our credit ratings. The primary corporate goal is to maintain strong long-term credit fundamentals. The overall quality of our loan portfolio continues to be very strong, with 99% of our loans to rural electric systems and 93% of our loans being on a senior secured basis.

We have not had any delinquent or non-performing loans in our portfolio for over three years, that is, since June 1, 2016, and we have not had any loan charge-offs during the past 12 quarters. The coverage ratio of our allowance for loan losses, which is an estimate of probable losses inherent in our loan portfolio, remained at 0.07% or seven basis points of our total loan portfolio as of August 31, 2019. 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 increased to $5 billion at August 31, 2019, now representing 20% of our total funding, compared with $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 grow our equity through retained earnings. Our member's 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 August 31, 2019, we have $3 billion in revolving credit facilities from our relationship banks, $1.4 billion committed availability in the guaranteed underwriter program, and $2.5 billion revolving credit capacity via the Farmer Mac secured note purchase agreements.

In addition, as a supplemental source of liquidity, at August 31, 2019, we had $570 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 schedule loan amortization and other repayments from our members, resulted in CFC having $9.2 billion of liquidity available at August 31, 2019, to meet the $6.3 billion of debt maturities over the next 12 months, a 1.5 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 3.6 times.

Thank you once again for joining us today to review our results for our fiscal quarter ended August 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, ladies and gentlemen. If you would like to ask a question, please 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 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. Once again, if you would like to ask a question, please signal by pressing star one on your telephone keypad.

Andrew Don: Okay. Operator, it seems like we don't have any questions at the current time, so again, we'll thank everybody for dialing in, and if you have any questions in the future, please feel free to reach out to me or Ling Wang. Thank you.

Operator: This concludes today's call. Thank you for your participation. You may now disconnect your lines, and have a wonderful day.