National Rural Utilities Cooperative Finance Corporation

First Quarter 2018 Earnings Conference Call

October 12, 2017

Operator: Greetings and welcome to the National Rural Utilities Cooperative Finance Corporation's fiscal year 2018 first quarter investor call. At this time, all participants are in a listen only mode. A brief question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference please press star zero on your telephone keypad. As a reminder, this conference is being recorded. I would now like to turn the conference over to Ling Wang. Please go ahead, Ling.

Ms. Ling Wang: Hi, good morning. This is Ling Wang, Vice President of Capital Markets Funding and Relations at National Rural Utilities Cooperative Finance Corporation. Thank you for joining us today to review our first quarter fiscal year 2018 financial results. Our Senior Vice President and Chief Financial Officer, Andrew Don, will discuss our first quarter financial results.

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. The 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 intent, 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 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 US 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 expectations after the date on which the statement is made. We will have a Q and 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 our webcast. We encourage you to take this opportunity to ask any questions you may have.

In addition, all materials for this event including the presentation slides and financial reports are available on our website at www.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.

Mr. Andrew Don: Thank you, Ling, and again, good morning and thank you for joining us today for National Rural Utilities Cooperative Finance Corporations' call to review our financial performance for our first quarter of fiscal 2018 for the period ended August 31, 2017.

We provide our results based on generally accepted accounting principles or GAAP in our form 10-Q which we filed on October 10. 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 adjusted metrics include adjusted net income, adjusted net interest income and 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 is important to note that we use our adjusted measures to manage our business and evaluate our results of operations. 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 useful to investors in evaluating our performance.

Total assets increased by $275 million from the May 31, 2017, fiscal year end date which was directly due to growth in our loan portfolio of $275 million. Specifically, we had an increase in CFC distribution loans of $244 million and an increase in National Cooperative Service

Corporation (NCSC) loans of $45 million offset by a decrease in CFC power supply loans of $14 million. Excluding regular loan amortization and repayments, CFC's long-term loan advances to electric borrowers for the current quarter totaled $665 million. Approximately 60% of those new advances were for capital expenditures and 38% were made to refinance other lenders' loans.

For the quarter ended August 31, 2017, total debt outstanding increased by $204 million from May 31, 2017, to fund the new loan growth. Other liabilities increased by $91 million during the quarter largely due to the $45 million in patronage capital retirement payable to our members, which is typical during the first quarter of each fiscal year.

In July 2017 CFC's Board of Directors' authorized the allocation of fiscal year 2017 earnings of $90 million to our members in the form of patronage capital, $45 million or 50% of this amount was retired and returned to our members in cash in September 2017. CFC will retain the remaining $45 million for 25 years. Other liabilities also include accrued interest payable which increased by $58 million during the quarter entirely due to timing differences.

Total equity decreased by $37 million due to the CFC Board of Directors' authorization in the first quarter to retire patronage capital of $45 million which was partially offset by GAAP net income of $9 million for the three months ended August 31, 2017.

Our members' equity which excludes the derivative forward value losses accumulated other comprehensive income, and non-controlling interest decreased slightly by $10 million at August 31, 2017, from May 31, 2017. The decrease was due to the Board's authorization to retire the $45 million of patronage capital mentioned earlier, offset by the adjusted net income of $35 million. Our adjusted debt to equity ratio increased to 6.05 to 1 at August 31, 2017, from 5.95 to 1 at May 31, 2017, due to an increase in debt outstanding to fund the loan growth and a decrease in adjusted equity related to the capital payout.

Throughout the remainder of the fiscal year, we expect the amount of new long-term loan advances to lightly exceed scheduled loan repayments. However, because of anticipated earnings during the balance of the fiscal year, we believe we will be able to maintain our adjusted debt to equity ratio at approximately 6 to 1.

For the three months ended August 31, 2017, that is from June 1 to August 31, 2017, CFC generated an adjusted TIER of 1.16 times, which is the same level compared with the same prior year quarter. Adjusted net income totaled $35 million for the first quarter as compared to $33 million for the same prior year quarter.

For the quarter ended August 31, 2017, adjusted net interest income totaled $53 million as compared to $52 million for the same prior year quarter. The $1 million increase in adjusted net interest income was driven by a 4% increase in average interest earning assets, which was partially offset by a slight decrease in the adjusted net interest yield from 86 basis points in the prior year quarter to 84 basis points for the current quarter.

The decrease in the adjusted net interest yield was primarily attributable to the increase in our short-term funding cost. Although we have been experiencing a decline in our adjusted net interest yield, we expect a relatively stable adjusted net interest yield over the next 12 months.

For the first quarter CFC recorded a recovery from loan loss allowance of $0.3 million compared with a provision for loan losses of $2 million during the prior year quarter. We had no charge-offs or recoveries during the current quarter. In comparison, we recorded a net charge-off of $2 million in the same prior year quarter.

CFC recorded $26 million in derivative forward value losses during the current quarter compared with $165 million losses in the prior year quarter. The current quarter derivative forward value losses were primarily attributable to a modest flattening of the yield curve at August 31, 2017, from May 31, 2017, while the derivative forward value losses in the prior year quarter were attributable to more pronounced flattening of the yield curve during that period.

As we have consistently disclosed, the derivative forward value gains or losses reflect the changes in estimated fair value of our interest rate swaps at August 31, 2017, based on the projected movement in interest rates through the maturity of swap agreements in place at August 31, 2017. As such, these amounts do not represent current period realized cash gains or losses. As noted previously and in managing our operating performance for purposes of our debt covenant compliance, we exclude derivative forward value gains and losses from adjusted net income and adjusted equity calculations.

There have not been any changes at quarter end August 31, 2017, from May 31, 2017, in the overall composition of our loan portfolio with $24 billion or 99% of our portfolio consisting of loans to rural electric systems and $353 million or 1% to the telecommunications sector at the quarter end which is comparable with the levels at May 31, 2017.

The percentage of CFC's long-term fixed-rate loans was at 91% as of August 31, 2017, similar to the level at May 31, 2017. We typically lend to our members on a senior secured basis with 92% of our loans being senior secured at August 31, 2017, which is essentially unchanged compared to the May 31, 2017 level.

At August 31, 2017, we had no nonperforming loans in our loan portfolio. As mentioned earlier, we had no charge-offs during the quarter. The credit quality of our loan portfolio remains strong with our members continuing to demonstrate solid financial and operational performance.

CFC continues to maintain diverse funding sources so as never to be dependent on any one source. At August 31, 2017, $4.4 billion or 19% of CFC's funding came from our members in the form of short-term and long-term investments compared to $4.2 billion or 18% at May 31,

2017. Generally speaking, our total member investments average around $4 billion. Our member investments are stable and reliable, offering CFC funding with little reinvestment risk as our members consistently invest a large portion of their excess funds with CFC.

Our federal government based funding increased slightly by $77 million at August 31, 2017, from the fiscal year end date. During the quarter, we advanced $100 million under the guaranteed underwriter program to fund a portion of loan growth.

Our capital market related funding sources decreased slightly by $89 million at August 31, 2017, from the May 31, 2017 year end date. The decrease was primarily due to an increase in our member commercial paper outstanding, reducing our need to raise funds in the dealer commercial paper market.

This slide presents CFC's long-term debt maturities over the next 12 months that is from October 2017 through September 2018. As indicated, our total long-term debt maturities over the next 12 months are relatively modest totaling $1.7 billion with approximately half of the debt maturities coming from non-capital market issuances.

Our capital market debt maturities over the next 12 months total $905 million including a $700 million collateral trust bond issuance maturing in February 2018 and a $200 million medium-term note issuance maturing in April 2018. We have a total of $423 million of member medium-term notes due over the next 12 months. Historically our members have chosen to roll over their investments at maturity. We also have a $250 million note with Farmer Mac maturing in September 2018. We believe we have ample sources of liquidity to meet each of the maturities as would be highlighted in the next slide.

This slide depicts the various non-capital market dependent sources of liquidity that CFC had in place at August 31, 2017, which in the aggregate totaled $7.7 billion. As reflected by the two red bars on the right-hand portion of the slide, CFC has an aggregate of $4.3 billion of member and non-member short-term debt maturities over the next 12 months, which results in CFC having access to $3.4 billion as shown by the green bar or 1.8 times of defined liquidity greater than the combined member and non-member short-term debt maturity needs. The $4.3 billion in debt maturities over the next 12 months includes $2.8 billion of short-term investments that our members have with CFC. As mentioned earlier, our member investments are very stable and reliable funding sources. If we were to exclude short-term debt maturities related to our member investments, we would have access to $6.2 billion or 5.1 times defined liquidity greater than our non-member short-term maturities with these representing both dealer commercial paper maturities and the current portion of long-term debt maturing during the next 12 months from August 31, 2017.

As disclosed previously, in August 2017 we received approval of an additional $750 million commitment from the Rural Utilities Service under the guaranteed underwriter program. We expect to close this loan facility by the end of this calendar year. Upon the closing of this facility we will have up to $1.375 billion of committed loan facilities available from the Federal Financing Bank.

This slide presents CFC's projected sources and uses of cash over the next 18 months from the date of August 31, 2017. As indicated, our total projected cash needs over this time period are approximately $6 million with 39% of this amount expected to satisfy projected new loan advances and 61% to meet maturities of long-term debt. We expect to grow our loan portfolio by a very modest amount of $463 million over the next 18 months.

Sources of cash are expected to be generated from the ongoing amortization of loans extended to our members with the balance to be provided by the variety of funding vehicles CFC has established. The timing, size and tenor of issuance will be dependent on the timing of our loan advances and the maturity of the loans we extend to our members, as well as the most attractive cost of funds.

There were limited financing activities during the quarter due to relatively modest loan growth and no scheduled debt maturities. In August 2017 we issued $350 million of five-year unsecured medium-term notes. This issuance allowed us to take advantage of the favorable market conditions and preserve our collateral for longer dated issuances. During the quarter we also advanced $100 million under the guaranteed underwriter program.

For the potential funding needs during fiscal 2018, CFC will continue to look to balance capital market and non-capital market secured and unsecured financings while always looking to access the most attractive cost of funds from our member borrowers.

To conclude our call, I'd like to leave you with a few key takeaways when you consider CFC as investment opportunity. These items are areas that CFC is consistently focused on and represent key credit strengths when viewing CFC as an investment.

As indicated, CFC's ratings remain robust as discussed on prior calls. CFC's management and all staff has a certain amount of its annual compensation tied to the levels of CFC's credit ratings. CFC's Board of Directors strongly believes this incentive structure will align investor interest and management interest to maintaining strong credit fundamentals.

The mainstay of CFC's financial strength is in the quality of our portfolio. Similar to CFC, our members are focused on meeting the needs of their customers, not generating sales or earnings growth to meet shareholder requirements. The loan portfolio is well diversified with 99% of our assets to financially sound, strong cash flow generating, rural electric systems that have limited rate regulation and are geographically dispersed across the United States.

CFC has a long history of low non-performing loans in its portfolio reflective of the strong financial condition of our borrowers. In addition, 92% of our loans are secured with utility assets and our members' revenue on a senior secured basis. At August 31, 2017 we have no non-performing loans in our loan portfolio.

As a member-owned cooperative, CFC continues to receive strong support from our members, both in terms of new lending business and a valuable funding source. Our members have made significant investments in CFC in the form of short-term investments, as well as long-term capital. We view these investments to have limited reinvestment risk thus providing a stable funding source for CFC. Our member investments stood at $4.4 billion at August 31, 2017, representing 19% of our funding.

CFC will continue to utilize different funding vehicles, public and private, to maintain our low-cost funding structure for the benefit of our members. For short-term funding our plan is to maintain our dealer commercial paper balance at the low level of $1.25 billion for the foreseeable future.

With respect to long-term funding, we will continue to target smaller but index eligible tranches and a consistent issuance pattern for public debt capital market offerings while looking to maintain flexibility and availability in our private funding sources, namely the guaranteed underwriter program and Farmer Mac.

CFC maintains a more than adequate liquidity reserves from a variety of sources to meet our members' borrowing needs as well as service all of our debt obligations. Specifically, CFC has

$3.2 billion committed revolving credit facilities from our relationship banks, $625 million committed availability in the guaranteed underwriter program and the $2.3 billion revolving credit capacity via the Farmer Mac secured note placement program. These sources, together with cash, time deposits and scheduled loan amortization and other repayments from our members, results in CFC having $7.7 billion of liquidity available at August 31, 2017, to meet the next 12 months of all of our debt maturities of $4.3 billion, 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 will be 5.1 times. These numbers do not include the $750 million commitment under the guaranteed underwriter program, which we expect to close by the end of the calendar year.

Thank you once again for joining us today to review our results for our fiscal quarter ended August 31, 2017. 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 any other questions via the web service so that we may respond to those as well. Thank you.

Operator: Thank you. If you would like to ask a question today please press star one from your telephone keypad and the confirmation code tone will indicate your line is in the question queue. You may press star two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for questions.

We have a question coming from the line of Dan Jenkins with The State of Wisconsin Investment Board. Please go ahead with your question.

Mr. Dan Jenkins: Hi, good morning.

Mr. Andrew Don: Good morning.

Mr. Dan Jenkins: First question I have is related to the net interest yield. I know that you mentioned that you expect that to stabilize over the next 12 months. You know, it has been coming down some over the last few quarters.

Mr. Andrew Don: Right.

Mr. Dan Jenkins: I was wondering if you could like, if the yield curve continues to flatten would you still expect that to be stable or how would that, how does changes in the yield curve impact your expectations for the net interest yield?

Mr. Andrew Don: Yes, we've done analysis and sensitivities on changes in the yield curve and there's not a significant difference. The reason for the yield coming down, our average yield coming down has more to do with the note loans that are going on the balance sheet going on at a lower average yield than the loans that are being repaid. So, that's really what's driving it, as a practical matter.

We've been able to refinance, the majority of our higher cost legacy debt. So, we've essentially taken advantage of that opportunity. So, what we've been experiencing over the past few quarters is purely a reduction in the kind of the average yield on our assets versus, the cost of being able to reduce the cost of the debt.

So, as I said we have done sensitivities and we expect it to stay at this kind of relatively, at this level of around 84 to 85 basis points. Obviously, we are seeing a significant potential increase in that yield after and during calendar 2018 with the repayment of some higher cost legacy debt.

Mr. Dan Jenkins: Okay. Also, I was wondering how it'll impact your business, the fact that Libor is going to be going away and how will that impact your current loans that are based – that are floating rate and your current borrowing, floating-rate borrowing?

Mr. Andrew Don: Sure. We're obviously having dialogue with our banks and doing our own independent analysis of the potential impacts. We haven't, it's quite early to be frank, about where those impacts will really be felt. So, I think it's a little premature to kind of come up with anything definitive but we think we'll be able to manage through it without too much difficulty.

Mr. Dan Jenkins: Okay. And then I was curious if you have any borrowers in Puerto Rico or any that were impacted in Texas or Florida from the hurricanes in terms of the like, distribution systems and so forth?

Mr. Andrew Don: Sure. No, we don't have any borrowers in Puerto Rico. We obviously do have borrowers that are impacted in Texas as well as Florida and Georgia by the hurricanes that impacted those states. To be frank, I think there's probably more of an impact in the states of Florida and Georgia than Texas, but we've looked at the line outages and what I'll call the services that have put in place.

There were quite a few outages. I think it was around 500,000 lines, slightly over 500,000 lines in Georgia and Florida combined but the majority of those, if not all of those, are back on line. In terms of, the capital expenditures related to that, that's still being determined and as a practical matter, cooperatives are eligible for FEMA reimbursement for up to 75% of any losses they have related to things like hurricane damage. So, we think, they've managed through these types of natural disasters in the past. There was obviously an impact but we feel they're in good shape to respond to it from a service perspective they're in very good shape. And from a capital requirements we haven't seen a lot of, we've seen some request for what's called emergency lines of credit that we put in place to fund those kind of immediate needs. Then again, and those lines of credit stay in place until they get their FEMA reimbursement.

Mr. Dan Jenkins: Okay. That's all I had. Thank you.

Mr. Andrew Don: Thank you.

Operator: As a reminder, if you have a question over the phone you may press star one from your telephone keypad. There are no additional phone questions at this time.

Mr. Andrew Don: It looks like we got one that was submitted. We're having a hard time reading it. Let's see. It looks like it says -- I think the question that we're receiving is "Can you talk about funding of alternative energy sources wind, solar, hydro and what is the threat of these alternatives on your primary borrowers in the electric generation and distribution space?"

So, I think to respond to that, we are starting to see some cooperatives looking at renewable resources. But to be frank, it's very small scale what they're typically doing. There's been some community solar and as a practical matter where they're really participating in the renewable space is through the signing of power purchase agreements with other providers, primarily with the IOUs. So, there hasn't been any significant investment, therefore a significant need for capital related to renewables at the current time. As I said because again primarily they're looking at providing energy for purchasing energy from renewable sources through power purchase agreements.

In terms of the disruption, there's a lot of that still to be determined. There has not been a significant amount of disruption obviously at the current time. I think as a practical matter on the residential side we're not anticipating that being a factor at all and it will be more potentially on the commercial and industrial side.

Having said that, I think something like 65%, 70% of member load is residential. So, it's still early on, it hasn't been an impact as of yet and we think the co-ops are well-positioned to be able to respond. I don't know if whoever submitted that has any other questions but that's the question we received through the web service.

Operator: There are no additional phone questions at this time.

Mr. Andrew Don: Okay. Thank you, operator and thank you all for dialing in today. We look forward to talking to you in the future.

Operator: Thank you. This will conclude today's conference. You may disconnect your lines at this time. Thank you for your participation.