National Rural Utilities Cooperative Finance Corporation
FY 2019 First Quarter Investor Call
October 16, 2018
11:00 AM EDT

Operator: Good day and welcome to the FY 2019 First Quarter 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.

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 2019 financial results. Andrew Don, our Senior Vice President and Chief Financial Officer will discuss our financial results for the quarter ended August 31, 2018.

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 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 obligations 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&A session at the end of this presentation. You can ask question 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 of the materials for this event, including the presentation slides and financial reports, are available on our website at nrucfc.coop. A replay and a call transcript will be made available on our website after the event. With that, I will turn the call over to Andrew.

J. 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 2019 for the period ended August 31, 2018. We provide our results based on Generally Accepted Accounting Principles or GAAP in our

Form 10-Q which we filed on October 10, 2018. 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 included 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-Q. 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.

Our total assets at quarter end on August 31, 2018 were approximately $26.7 billion, a nominal decrease of $14 million from the May 31, 2018 level, primarily due to a decrease in time deposits that was largely offset by an increase in cash and cash equivalents and investment securities. Over 94% of our assets consist of loans to our members. The net growth in our loan portfolios was flat during the quarter, due to lower loan demand coupled with the amortizing nature of the substantial majority of our loans.

During the quarter net loans to distribution borrowers increased by $87 million, which was partially offset by a decrease of $76 million in loans to power supply borrowers. We also experienced a decrease in NCSC and RTFC loans outstanding of $11 million during the quarter.

As mentioned, we experienced modest loan demand from our members during the current quarter. Long-term loan advances to members totaled $468 million with approximately 71% of those advances for capital expenditures and 25% for the refinancing of loans made by other lenders. Our total equity of $1.5 billion as of August 31, 2018, remained relatively unchanged from May 31, 2018 as our net income of $48 million for the current quarter was offset by patronage capital retirement of $48 million.

At August 31, 2018, our members' equity which excludes the non-cash impact of derivative forward value gains and losses, accumulated other comprehensive income, and non-controlling interest; decreased slightly by $10 million to $1.49 billion from May 31, 2018. The decrease was due to the patronage capital retirement mentioned earlier.

Our adjusted debt-to-equity ratio increased to 6.21 to 1 at August 31, 2018, from 6.18 to 1 at May 31, 2018. This increase is typical in the first quarter of each fiscal year, due to the retirement of patronage capital. Over the next 12 months, we expect our loan growth to be very modest. As a result, we expect that our adjusted debt-to-equity ratio will move closer to our target level of 6 to 1 due to an anticipated increase in equity from earnings.

For the three months ended August 31, 2018, CFC generated an adjusted TIER of 1.13 times compared with an adjusted TIER of 1.16 times for the same prior-year quarter. Our adjusted net income totaled $28 million for the current quarter, compared with $35 million for the same prior year period. The $7 million decrease in adjusted net income for the current quarter from the same prior year period was primarily driven by a $7 million expense related to the $300 million early redemption of our 10.375% collateral trust bonds due November 1, 2018 and a $2 million increase in operating expenses, offset partially by a $2 million increase in adjusted net interest income. We expect that the interest savings from the early redemption date of this debt amount through the November 1 maturity date will offset the $7 million expense.

Our adjusted net interest income was $55 million for the current quarter, an increase of $2 million from the same prior year period. The increase was attributable to a $1 billion or 4% increase in average interest-earning assets and a slight increase in the adjusted net interest yield of 1 basis point to 85 basis points from the same prior year period. We expect our adjusted net interest yield, adjusted net interest income, and adjusted TIER to increase over the next 12 months as a result of a projected decrease on our overall funding cost. We have $880 million of higher-cost collateral trust bonds with a weighted average coupon rate of 9.6% scheduled to mature on November 1, 2018. We expect that we will be able to replace these collateral trust bonds with lower-cost debt which will reduce our average overall cost of funding.

We recorded $20 million of derivative forward value gains during the current quarter, compared with $26 million of losses in the same prior year period. The derivative forward value gains in the current period were attributable to a slight increase in medium and long-term interest rates from May 31, 2018 to August 31, 2018. As we have regularly disclosed, the derivative forward value gains or losses reflect the change in estimated fair value of our interest rate swaps at the end of each reporting period based on the projected movement in interest rates due to the maturity of the swap transactions in place at the end of each period. These amounts do not represent current period realized gains or losses. Therefore as previously noted, in managing our operating performance and for purposes of compliance with our financial debt covenants, we exclude derivative forward value gains and losses from our adjusted net income and adjusted equity calculations.

The overall composition of our loan portfolio at quarter end August 31, 2018 remained unchanged from the composition at May 31, 2018, our prior fiscal year end, with $25 billion or 99% of our portfolio consisting of loans to rural electric systems, and $359 million or 1% to the telecommunications sector. The percentage of CFC's long-term fixed rate loans was 90% as of August 31, 2018, unchanged from May 31, 2018. We typically lend to our members on a senior secured basis, with 93% of the outstanding balance of loans being senior secured at both August 31, 2018 and May 31, 2018.

The credit quality of our loan portfolio remains strong with our members continuing to demonstrate solid financial and operational performance. At August 31, 2018, we had no delinquent or non-performing loans in our loan portfolio. In addition, during the current quarter we had no loan defaults or charge-offs. As of August 31, 2018, our total debt outstanding was $24.6 billion, a decrease of $44 million from May 31, 2018. CFC continues to maintain diverse funding sources so as to minimize the risk of being dependent on any single source or market. At August 31, 2018, $4.6 billion or 19% of CFC's funding came from our members in the form of short-term and long-term investments. Our member investments are stable and reliable, offering CFC funding with little reinvestment risk, as our members have historically and consistently invested a large portion of their excess funds with CFC.

The strong member investment level reduced our funding needs during the current quarter. Specifically at August 31, 2018, the total outstanding balance under the Guaranteed Underwriter Program and notes payable with Farmer Mac decreased by $129 million from the prior fiscal year end, primarily driven by $113 million decrease in notes payable with Farmer Mac. In addition, our capital markets related funding sources, which represent 50% of our funding, decreased by $139 million August 31, 2018 from the May 31, 2018 fiscal year end date.

This slide presents CFC's long-term debt maturities from October 2018 through September 2019. As indicated, our total long-term debt maturities over this period are expected to be $2.6 billion, which includes the previously noted higher cost collateral trust bonds, totaling $880 million with a weighted average coupon rate of 9.6% that mature on November 1, 2018. As mentioned earlier, we expect to replace this debt with lower coupon debt. Our other significant debt maturities during this period include $650 million collateral trust bonds due in February 2019 and a $350 million dealer medium-term note due in April 2019.

With respect to the $478 million 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 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, 2018 compared with our fiscal year end of May 31, 2018. The amount of sources of liquidity CFC had at August 31, 2018 remained relatively unchanged at $9.2 billion compared to May 31, 2018. Our liquidity sources include approximately $1.3 billion of scheduled loan amortization repayments expected over the next 12 months from August 31, 2018.

As of August 31, 2018, we had an aggregate of $6.4 billion of member and non-member debt maturities over the next 12 months, a slightly lower level than as of May 31, 2018. At August 31, 2018, we had access to $2.9 billion, or 1.5 times liquidity greater than the combined member and non-member debt maturity needs. The $6.4 billion of debt maturities over the next 12 months includes $3 billion of 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 billion in debt maturities related to our member investments, we would have access to $6 billion or 2.8 times of liquidity in excess of non-member debt maturities of dealer commercial paper and the current portion of long-term debt scheduled to mature during the next 12 months from August 31, 2018.

This slide presents CFC's projected sources and uses of cash over the next 18 months from August 31, 2018. As indicated, our total projected cash needs over this time period are approximately $6.5 billion, with 38% of this amount expected to satisfy projected new loan advances and 62% to meet maturities of long-term debt. Overall we expect growth in our long-term loan portfolio to be very modest at $565 million over the next 18 months.

As indicated on this table, we expect to issue $1 billion of long-term debt during the second quarter to refinance the maturing debt. We executed a pricing agreement with Farmer Mac in September and will advance $250 million in November under the note purchase agreement. For the remaining refinancing needs, we expect to issue long-term debt in the capital markets and potentially advance under the Guaranteed Underwriter Program.

This table highlights certain financing activities we completed year-to-date in fiscal year 2019. Our funding needs are primarily driven by the loan growth and debt maturity schedule, both of which have been light during the fiscal year-to-date. For future potential funding needs, we will continue to look to balance capital market and non-capital market secured and unsecured financing while always looking to access the most attractive cost of funds for our member borrowers.

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 our ratings and outlook on October 1, 2018. Our ratings and outlook for Moody's and S&P remain unchanged and were both reaffirmed within the last 12 months. Our long-term incentives are tied to our credit ratings and our goal is to maintain strong long-term credit fundamentals.

The overall quality of our loan portfolios remain high. 99% of our loans are to rural electric systems and 93% of our loans are on a senior secured basis. We have not had any delinquent loans, non-performing loans, or charge-offs in our electric utility portfolio since 2014. At August 31, 2018, our allowance for loan losses, which is an estimate of probable losses inherent in our loan portfolio, was 0.07% or 7 basis points of our total loan portfolio, the same allowance coverage ratio as of 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 members have made significant investments in CFC in the form of short and medium-term investments, as well as long-term capital. We view these investments to have limited reinvestment risk, thus providing a stable and reliable funding source for CFC. Our member investments stood at $4.6 billion at August 31, 2018; representing 19% of our total funding.

As a member-owned cooperative organization, CFC cannot issue common or preferred equity. However, CFC is committed to grow our equity through retained earnings. Our members' equity has grown by nearly 50% to $1.5 billion from $998 million since 2013. We continue to maintain diversified funding sources and demonstrate a strong liquidity profile. For short-term funding, our plan is to maintain our dealer commercial paper balance below a level of $1.25 billion for the foreseeable future. With respect to long-term funding, we will continue to target index eligible and manageable tranches 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.

From a liquidity perspective, at August 31, 2018 we had $3.1 billion committed revolving credit facilities from our relationship banks, $1.2 billion committed availability in the Guaranteed Underwriter Program, and $2.7 billion revolving credit capacity via the Farmer Mac secured note purchase agreements. In addition, as a supplemental source of liquidity, at August 31, 2018 we had $554 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 or the repayments from our members, resulted in CFC having $9.2 billion of liquidity available at August 31, 2018 to meet the debt maturities over the next 12 months of $6.4 billion, 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 will be 2.8 times.

Thank you once again for joining us today to review our results for our fiscal quarter ended August 31, 2018. 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 your 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, 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. And we'll pause for just a moment to allow everyone an opportunity to signal for questions.

There are currently no questions in the phone queue at this time.

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

Operator: This concludes today's call. Thank you for you participation. You may now disconnect.