National Rural Utilities Cooperative Finance Corporation
FY20 Second-Quarter Investor Call
January 21, 2020
11:00 AM EST

Operator: Good day, and welcome to the FY2020 second 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, 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 second quarter fiscal year 2020 financial results. Andrew Don, our Senior Vice President and Chief Financial Officer, will discuss our financial results for our second quarter of fiscal year 2020, which ended on November 30, 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. The forward-looking statements are based on certain assumptions and describe our future plans, strategies, expectations, and 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 reasonable assumptions, actual results and performance may differ materially from our forward-looking statements. Factors that could cause future events to vary from our 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 questions via telephone 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 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 second quarter fiscal year 2020 for the period ended November 30, 2019. We report our results based on Generally Accepted Accounting Principles, or GAAP, in our Form 10-Q, which we filed on January 13, 2020. 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 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 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.

Our total assets at quarter ended November 30, 2019, were approximately $27.6 billion, a slight decrease of $12 million from the prior quarter end, but an increase of $442 million, or 2%, from May 31, 2019. The increase in our total assets during the first six months of the fiscal year was primarily driven by an increase in loans to members, largely due to loan advances during the first quarter of this fiscal year. During the second fiscal quarter, loans to members increased by $138 million compared with a $383 million increase in the first quarter. Loans to distribution members increased by $198 million, while loans to power supply members decreased by $69 million.

During the six-month period, loans to members increased by $521 million. Loans to distribution members and power supply members increased by $527 million and $23 million, respectively. There was also a slight increase in RTFC loans of $11 million. These increases were offset by a decrease in NCSC loans of $41 million.

We continue to experience steady loan demand from our members. Our long-term loan advances during the current fiscal quarter totaled nearly $500 million with approximately $319 million, or 64%, of those advances made for capital expenditure purposes, and $178 million or 36% for the refinancing of loans made by other lenders.

For the six-month period, our long-term loan advances totaled nearly $1.4 billion, with approximately $963 million or 69% of those advances made for capital expenditure purposes, and $345 million, or 25%, for the refinancing of loans made by other lenders. In comparison, our long-term loan advances during the same prior-year six-month period totaled $814 million, with approximately $676 million, or 83%, of those advances for capital expenditures, and $114 million, or 14%, for refinancing other lenders' loans.

Our members' equity increased by $42 million from May 31, 2019 as a result of adjusted net income of $105 million for the six months ended November 30, 2019, partially offset by the retirement of patronage capital in the first quarter of $63 million that was authorized by CFC's Board of Directors. Our adjusted debt-to-equity ratio was at 5.78 to 1 on November 30, 2019, a decrease from 5.84 to 1 at August 31, 2019, but an increase from 5.73 to 1 at May 31, 2019. The increase in the ratio from the prior fiscal year-end was primarily due to an increase in debt outstanding to fund loan growth. Based on our current projections, we expect our adjusted debt-to-equity ratio to remain below our 6 to 1 targeted threshold over the next 12 months.

In the most recent fiscal quarter ended November 30, 2019, CFC generated adjusted net income of $44 million and an adjusted TIER of 1.2 times compared with an adjusted net income of $45 million and an adjusted TIER of 1.21 times for the same prior-year quarter. While adjusted net income for the current quarter decreased slightly from the same prior-year quarter, the adjusted net interest income remained relatively unchanged from the comparable prior-year quarter at $65 million. Although there was a decrease in adjusted net interest yield of 5 basis points to 96 basis points, this decrease was offset by a 4% increase in our average interest-earning assets. The 5 basis points decrease in our adjusted net interest yield was driven by a decline in the average yield on our interest-earning assets of 8 basis points to 4.26%, which was partially offset by a reduction in our adjusted average cost of funds of 3 basis points to 3.50%.

For the six months ended November 30, 2019, CFC generated adjusted net income of $105 million and an adjusted TIER of 1.23 times, compared with adjusted net income of $73 million and an adjusted TIER of 1.17 times for the same prior-year period. The increase in adjusted net income of $32 million for the six-month period was attributable to four primary factors: (1), an increase in adjusted net interest income of $10 million; (2), an increase in fee income of $7 million; (3), a gain of $8 million from the sale of a parcel of land that had been purchased as a potential headquarter site but never developed; and (4), the absence of the loss of a $7 million expense related to an early redemption of debt in the prior-year period.

Our adjusted net interest income for the six-month period was $131 million, an increase of $10 million, or 8%, from the comparable prior-year period. This increase was driven by an increase in the adjusted net interest yield of 4 basis points or 4% to 97 basis points, coupled with a 4% increase in average interest-earning assets. The increase in adjusted net interest yield reflected the favorable impact from a reduction in our adjusted average cost of funds of 5 basis points to 3.52%, partially offset by a slight decrease in the average yield on our interest-earning assets of 1 basis point to 4.28%. The reduction in our funding cost was largely due to the interest savings from the repayment of the 10.375% collateral trust bonds in fiscal year 2019 and the replacement of this debt with lower-cost funding, which more than offset an increase in the average cost of our short-term and variable rate funding. We expect our adjusted net interest income and adjusted net interest yield to increase slightly over the next 12 months, largely due to a projected decrease in our average funding costs and an increase in our average interest-earning assets.

The overall composition of our loan portfolio at quarter end November 30, 2019 remained largely unchanged from the prior fiscal year period, with $26 billion, or 99%, of our portfolio consisting of loans to rural electric systems and $356 million, or 1%, to the telecommunications sector. The percentage of CFC's long-term fixed-rate loans was at 90% as of November 30, 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 November 30, 2019, compared with 92% at May 31, 2019.

We did not have any payment defaults or charge-offs during the current quarter, or the six months ended November 30, 2019, nor during the last two fiscal years. We have not had any delinquent or nonperforming loans in our portfolio since June 1, 2016. The credit quality of our loan portfolio remains stable and strong, with our members continuing to demonstrate strong financial and operational performance. This is especially true for our electric utility portfolio borrowers, as we now have a sustained period of six consecutive fiscal years and 26 consecutive fiscal quarters for which we have had no credit issues in our electric utility portfolio.

Our total debt outstanding increased by $403 million during the six-month period ended November 30, 2019 to fund loan growth. We continue to see increases in our member investments largely due to the market effort we initiated during the first quarter of this fiscal year to raise awareness of the investment options we offer to our members for their excess cash. At November 30, 2019, our member investments stood at $5.4 billion and accounted for 21% of our total debt outstanding, compared with $4.4 billion or 18% of total debt outstanding at May 31, 2019. The increase of $1 billion was driven by increases in select notes, member commercial paper, and daily liquidity funds. Our funding under the guaranteed underwriter program and notes payable with Farmer Mac decreased by $7 million from the prior fiscal yearend. During the second quarter, we advanced a $150 million short-term note with Farmer Mac, which we repaid in full on December 4, 2019.

Our capital markets related funding sources, which accounted for 46% of our funding at November 30, 2019, decreased by $546 million from the prior fiscal yearend. The $546 million reduction was mainly due to reductions in dealer medium-term notes and collateral trust bonds outstanding that matured and were repaid during the second fiscal quarter. Because of the increase in member investments, we did not have the need to issue additional debt in the capital markets during the first six months of this fiscal year.

This slide presents CFC's long-term debt maturities and amortization over the next 12 months. We have very limited debt maturities over this period. Specifically, we have $400 million of collateral trust bonds maturing in June 2020, and another $355 million of collateral trust bonds maturing in November 2020. In addition to these collateral trust bond maturities, other significant debt maturities during this period include a $100 million Farmer Mac bullet note due in February 2020, and another $200 million Farmer Mac bullet note due in December 2020. 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 at November 30, 2019 compared with the prior fiscal year period. Our primary liquidity sources remain unchanged during the six-month period. The amount of available liquidity at the current quarter-end decreased by $558 million from the prior fiscal year-end. The decrease was largely due to a $250 million reduction in the availability under the bank revolving credit facilities, a $188 million decrease in scheduled long-term amortization and other repayments, and the $150 million reduction in the availability under our line of credit facility with Farmer Mac. In November 2019, we amended our 3- and 5-year bank revolving line of credit facilities to extend the maturity date of the 3-year facility to November 2022 and to terminate $125 million in commitments under the 3-year facility and $125 million under the 5-year facility. Also in June 2019, we advanced a $150 million short-term note under the $300 million Farmer Mac line of credit facility, leaving $150 million available at November 30, 2019. We subsequently repaid this advance in December of 2019.

We terminated the $300 million Farmer Mac line of credit facility effective December 20,

2019. Upon termination, the $300 million commitment under the Farmer Mac line of credit facility was added to the $5.2 billion revolving note purchase agreement we have with Farmer Mac. As a result, our overall borrowing capacity with Farmer Mac remained unchanged at $5.5 billion. As indicated in the graph, we had an aggregate of approximately $6.6 billion of member and non-member debt maturities over the next 12 months as of November 30, 2019, compared with $5.3 billion as of May 31, 2019.

At November 30, 2019, we had access to $8.7 billion of liquidity, which is 1.3 times the combined member and non-member debt maturities or $2.1 billion greater than the combined member and non-member debt maturities. Of the $6.6 billion debt maturities over the next 12 months, $3.8 billion, or 58%, represent 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 $3.8 billion in member short-term debt maturities related to our member short-term investments, we would have total liquidity equal to 3.2 times or $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 November 30, 2019.

This slide presents CFC's projected long-term debt issuance needs over the next 18 months, subsequent to November 30, 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 18-month period are approximately $3.5 billion, primarily to refinance existing long-term debt maturities of $3 billion, as we forecast our loan growth to be relatively flat over this period.

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. All three credit rating agencies reaffirmed CFC's ratings and outlook during the current quarter. CFC has a long-term incentive compensation plan, which is tied to our credit ratings. A primary corporate 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 93% of our loans being on a senior secured basis. We have not had any delinquent or nonperforming 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 13 quarters.

The coverage ratio of our allowance for loan losses, which is an estimate of probable losses inherent in our loan portfolio, was at 0.06%, or 6 basis points of our total loan portfolio at November 30, 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 $5.4 billion at November 30, 2019, now representing 21% of our total funding, compared with $5 billion at August 31, 2019, or 20% of total funding, and $4.4 billion at May 31, 2019, or 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 members' equity has grown by 67% to nearly $1.7 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 November 30, 2019, we had $2.7 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 Farmer Mac secured note purchase agreements. In addition, as a supplemental source of liquidity, at November 30, 2019, we had $574 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 over the next 12 months from our members, resulted in CFC having $8.7 billion of liquidity available at November 30, 2019 to meet the $6.6 billion in debt maturities over the next 12 months, a 1.3 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 3.2 times.

Thank you once again for joining us today to review our results for our fiscal quarter ended November 30, 2019. We appreciate your interest in CFC and look forward to discussing our financial performance and funding plans in the future.

I would like to ask the operator to open the lines for questions and also suggest that you submit 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, 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. A voice prompt on the phone line will indicate when your line is open. Please state your name before posing your question. Again, press star, one, to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal for questions. Thank you.

And our first question comes from Ted Olshanski. Please go ahead.

Ted Olshanski: Yes, good morning, Andrew. Your organization--

Andrew Don: Hey, Ted.

Ted Olshanski: Hi. Good morning. Your organization has done a really good job of maintaining a pretty strong financial profile, as rates have really gone much lower than what people expected. When you look out through the next, say, 3 to 6 months, even 9 months; what sort of interest rate forecasts are you looking at, or what are your underlying assumptions for managing your net interest margins?

Andrew Don: Sure. We basically look at the futures curves and basically use what's coming out of those curves for our projections. We don't speculate on rates, certainly, but we basically look at, again, the futures curves as a forecast. We obviously recognize it's not necessarily always accurate, but that's the best that we can do. So we don't have a house view on rates and the direction of rates. We basically look at what the market is forecasting and go with that.

Ted Olshanski: Okay, great. I have a second question, unrelated. There's been obviously an increased awareness on ESG issues, and it's something that we hear about on almost every call. Yet, I didn't hear all that much coming out of you guys today. I wonder if maybe you could talk about what sort of strategies you're thinking about when you think about ESG, and how that might impact your lending portfolio.

Andrew Don: Sure. As it relates to CFC directly, from an ESG perspective, I mean to be frank, the environmental part doesn't really impact CFC as a corporation, because we're a finance company. So we're more focused on the social and the governance part of it. And we are from a corporate strategy perspective, going to be enhancing our website through a digital strategy to incorporate areas where we've been engaged, primarily from a social perspective. I think you might have been familiar with what's called the REDL&G Program, where under the Guaranteed Underwriter Program, we pay a fee to the Rural Utilities Service which uses those funds to basically make investment in rural America, whether it's in the form of grant or loan funds for rural development. So that's an area, for instance, which we would look to highlight in the future. And so that's really where, from our corporate perspective that we're focused on.

As far as our members, the environmental impact would be an area where they're more focused on, and we're looking to assist them as needed in providing financing for renewable projects. Having said that, our borrowers are I think as you know, generally tax exempt organizations. So they don't have the ability to do tax advantage financing. So they are typically doing that through the signing of the power purchase agreements from developers and other sources to add to their generation portfolio, to add renewable resources. So that's kind of what I'd describe as the breakout from an ESG perspective. But we are very cognizant of the interest by investors and others, and we are looking to respond in that way.

Ted Olshanski: Okay. Thank you very much.

Andrew Don: Thank you.

Operator: Once again, participants, that's star, one, for any and all questions. Thank you.

It appears there are no further questions at this time, and I would like to turn the conference back over to you. Thank you.

Andrew Don: Okay. Thank you, operator. Thank you, all, again for dialing in. We look forward to talking to you in the future and discussing both our financial performance and funding plans. Have a good day.

Operator: This does conclude today's conference. Thank you all for your participation. You may now disconnect.