Conference Title: FY2023 Third-Quarter Investor Call

Date: April 18, 2023

Operator: Good morning, and welcome to the National Rural Utilities Cooperative Finance Corporation fiscal year 2023 third quarter investor call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Heesun Choi, vice president, capital markets relations. You may begin.

Heesun Choi: Good morning. I'm Heesun Choi, vice president of capital markets relations at National Rural Utilities Cooperative Finance Corporation. Thanks for joining us in our fiscal year 2023 third-quarter investor conference call. On today's call, Andrew Don, our chief executive officer, and Ling Wang, our chief financial officer, will discuss our financial and operating performance during the three months ended as well as nine months ended February 28, 2023.

Before we begin our discussion, I want to remind you that some information provided and comments made during today's call will contain forward-looking statements within the Securities Act of 1933, as amended, and the Exchange Act of 1934, as amended. Forward-looking statements, which 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 reasonable assumptions, actual results and performance may differ materially from our forward-looking statements. Factors that could cause future results to vary from our forward-looking statements about our current expectations are included in our annual and quarterly reports filed with the U.S. Securities and Exchange Commission (SEC).

All the forward-looking statements are made as of today, April 18, 2023, and we undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances and changes in our expectations after the statements are made.

Today's discussion will also include certain non-GAAP measures. Please refer to our Form 10-Q, filed on April 12, 2023, with the SEC, and also posted on our website, for a discussion of why we believe our adjusted measures provide useful information in analyzing CFC's financial performance and the reconciliations to the most comparable GAAP measures.

We will open the call for Q&A at the end of the presentation. You can ask questions via phone or submit your questions online if you are participating in this event via webcast. We invite you to join the Q&A session to ask any questions you may have. Today's presentation, slides and financial reports filed with the SEC are available on our Investor Relations page on our website at www.nrufcfc.coop. A replay and call transcript will be made available in our Investor Relations page after this event. With that, I will turn this call over to Andrew.

Andrew Don: Thank you, Heesun. Good morning. This is Andrew Don, chief executive officer of CFC. Thank you for joining us today. I'm pleased to review our business results and operating performance for our third fiscal quarter of 2023, which was the three-month period ended on February 28, 2023. We've continued to generate solid financial results during the third fiscal quarter and for the nine months of our 2023 fiscal year. We had another strong quarter with very robust loan growth to fund our members' capital needs. In particular, our loans to members increased by $2.3 billion, or 8%, during the nine-month period and totalled $32.4 billion as of February 28, 2023. I will discuss our loan growth in more detail in a moment.

Our financial position remains strong as we generated solid financial metrics during the third quarter and for the current year-to-date period. During the nine months ended February 28, 2023, our adjusted TIER was 1.26 times, which was well above our goal of 1.1 times, and our members' equity surpassed $2.1 billion at the end of the third fiscal quarter. Our members' equity has grown by 55% to $2.1 billion from a level of $1.4 billion at May 31, 2017, as we are committed to grow our members' equity through retained earnings accumulation. Our liquidity position remains healthy as we maintain diverse, well-established funding sources to minimize the risk of being dependent on any single source or market.

Our diverse liquidity sources consist of cash, investments, committed bank loans, the Guaranteed Underwriter Program, the Farmer Mac note purchase agreement and repo facilities. We continue to be committed to maintaining strong investment credit ratings from Fitch, Moody's and S&P. We have long-term senior secured ratings of A+, A1 and A- and long-term unsecured credit ratings of A, A-2 and A-, all with a stable outlook. During the current fiscal quarter, all three rating agencies affirmed CFC's credit ratings and a stable outlook.

As I mentioned, we recorded a $2.3 billion increase in net loan growth during the current fiscal year to date. The $2.3 billion increase in loans to members during the nine months ended February 28, 2023, reflected net increases in long-term and line of credit loans of $1.2 billion and $1.1 billion, respectively. The $1.1 billion increase in line of credit loans was primarily attributable to three factors, the first being increased funding for higher operating expenses and material costs incurred by our members. The second factor being more bridge loans to long-term financing from the Rural Utility Service (RUS) for those members still utilizing RUS financing. With the third factor being increased construction financing for broadband infrastructure projects. As of February 28, 2023, our loans to distribution members totalled $25 billion and our loans to power supply members totalled $5.3 billion.

During the current fiscal year, we experienced increases in all of our business segments. Specifically, our distribution loan portfolio increased by $1.6 billion and our power supply loan portfolio increased by $417 million. We also experienced increases in CFC statewide and associate loans, NCSC and RTSC loans of $29 million, $278 million and $14 million, respectively.

Loans to our distribution and power supply members accounted for 95% of total loans to members as of February 28, 2023. During the current year-to-date period, we made long-term loan advances totalling \$2.5 billion. Approximately \$2.3 billion, or 94%, of those advances were for capital expenditure purposes, with the balance being for the refinancing of other lenders' debt or other corporate purposes.

For the same prior year-to-date period, we made long-term loan advances for a total of \$2.4 billion, of which \$1.9 billion, or 79%, were for capital expenditure purposes and \$481 million, or 20%, were for members' operating expenses, primarily due to increased power costs and natural gas price volatility during the winter of 2021 Winter Storm Uri weather event. A total of \$605 million of long-term loans were made for financing our electric distribution cooperative infrastructure investments in broadband projects during the current nine-month year-to-date period. As of February 28, 2023, our outstanding loans to our CFC distribution members for their broadband projects increased to approximately \$2.1 billion, which is a net \$480 million, or 29% increase, compared to the May 31, 2022, level of \$1.6 billion. With that, I'd like to turn the call over to Ling, who will review our financial results in more detail. Thank you.

Ling Wang: Hi, good morning. This is Ling Wang, chief financial officer at CFC, and I'm going to move on to slide eight to discuss our financial results during the third fiscal quarter of 2023 and for the nine months ended February 28, 2023. As of February 28, 2023, our total assets were approximately \$34 billion, representing a 9% increase, or \$2.8 billion, from the fiscal year ended May 31, 2022. The increase in our total assets was primarily due to the growth in our loan portfolio, which increased by \$2.3 billion, or 8%, to \$32.4 billion from the May 31, 2022, level. The majority of our total assets consist of loans that we have extended to our members. As of February 28, 2023, long-term fixed-rate loans accounted for 82% of our total assets, while line of credit loans represented 10%.

In comparison, long-term fixed-rate loans and line of credit loans accounted for 86% and 7% of our total assets, as of May 31, 2022, respectively. Andrew spoke about the drivers behind the increase in the line of credit loans outstanding. We typically offer long-term amortizing loans to our members for up to 35 years. The average remaining maturity of our long-term loans, which accounted for 89% of total loans outstanding as of February 28, 2023, was 19 years. In order to fund loan growth, our total liabilities increased by $2.3 billion, or 8%, to $31.4 billion as of February 28, 2023, compared to $29.1 billion as of May 31, 2022. The increase in total liabilities was driven by increases in long-term debt outstanding.

Our members' equity, which excludes cumulative derivative forward-value losses and accumulated other comprehensive income, increased by $127 million, or 6%, to $2.1 billion as of February 28, 2023, from the May 31, 2022, level. Because of strong loan growth, our adjusted debt-to-equity ratio was at 6.59 times-to-1 at February 28, 2023, an increase from 6.24-to-1 on May 31, 2022. That being said, about half of our current fiscal year loan growth, or $1.1 billion, came from increases in line of credit outstanding. It is difficult to predict if these balances will continue to remain outstanding.

While our goal is to maintain an adjusted debt-to-equity ratio of approximately 6 times-to-1, we expect that our adjusted debt-to-equity ratio will remain elevated above our target of 6 times-to-1. Due to sustained strong loan growth, we currently anticipate approximately $1.4 billion in net long-term loan growth over the next 12 months. Our adjusted TIER, or times interest earned ratio, for the current quarter and for the nine months ended February 28, 2023, was 1.3 times and 1.26 times respectively, compared to 1.33 times and 1.31 times for the same prior-year periods. The decrease in our adjusted TIER was due to an increase in adjusted interest expense—the denominator that's used to calculate the adjusted TIER.

For the current quarter ended February 28, 2023, CFC generated an adjusted net income of $80 million compared to an adjusted net income of $66 million for the same prior-year quarter. The

$14 million increase in adjusted net income in the current quarter from the same prior-year quarter was primarily attributable to a $5 million increase in adjusted net interest income, a $10 million reduction in losses recorded on our investment securities—partially offset by a $2 million increase in operating expenses—and a $2 million reduction in benefit for credit losses.

During the nine months ended February 28, 2023, our adjusted net income reached $185 million, nearly identical to the $184 million generated during the same prior-year period. The slight increase in adjusted net income was primarily due to an $11 million increase in adjusted net interest income and a $13 million reduction in losses recorded on our investment securities, partially offset by an unfavourable shift in the provision for credit losses of $16 million and an $8 million increase in operating expenses. Our adjusted net interest income increased $5 million, or 6%, to $90 million during the current quarter compared to the same prior-year quarter.

The $5 million increase was attributable to an increase in average earning assets of $2.8 billion, or 9%, partially offset by the decrease in adjusted net interest yield of 4 basis points, or 3%, to 111 basis points. The 4 basis points decrease in adjusted net interest yield was largely due to the combined impact of an increase in our adjusted average cost of borrowing of 58 basis points to 3.46%, partially offset by an increase in the average yield on interest-earning assets of 51 basis points to 4.35% and an increase in the benefit from non-interest-bearing funding of 3 basis points to 22 basis points.

Our adjusted net interest income increased $11 million, or 4%, to $260 million during the current nine-month period compared to the same prior-year period. The $11 million increase was primarily attributable to an increase in average earning assets of $2.3 billion, or 8%, partially offset by the decrease in adjusted net interest yield of 4 basis points, or 4%, to 1.09%. The 4 basis points decrease in the adjusted net interest yield was largely due to the combined impact of an increase in our adjusted average cost of borrowing of 34 basis points to 3.24%, partially offset by an increase in the average yield on interest-earning assets of 28 basis points to 4.12% and an increase in the benefit from non-interest-bearing funding of 2 basis points to 21 basis points.

We expect our adjusted net income will increase slightly over the next 12 months based on our projected modest increase in adjusted net interest income. However, we believe that our adjusted TIER will decrease slightly over the next 12 months, primarily due to our projected increase in adjusted interest expense. We also believe that our adjusted net interest yield will decline based on our current yield curve assumption and our balance sheet position.

The overall composition of our loan portfolio as of February 28, 2023, remained similar as compared to May 31, 2022, with $32 billion, or 98%, of our portfolio consisting of loans to rural electric systems and $482 million, or 2%, to the telecommunications sector. As of February 28, 2023, 79% of our loans were made to electric distribution borrowers, and 16% of our loans were made to power supply borrowers. The percentage of CFC's long-term fixed-rate loans was at 86% of total loans outstanding as of February 28, 2023, compared to 90% as of May 31, 2022, primarily due to the increase in line of credit loans outstanding. The line of credit loans accounted for 11% of total loans outstanding as of February 28, 2023, compared to 8% as of May 31, 2022. We typically lend to our members on a senior secured basis, with 91% of our loans being senior secured as of February 28, 2023, compared to 93% as of May 31, 2022.

As of February 28, 2023, we had two non-performing loans, both to CFC power supply borrowers, totalling $108 million, or 33 basis points, of total loans outstanding, compared to three non-performing loans totalling $228 million, or 76 basis points, as of May 31, 2022. The $120 million reduction in non-performing loans during the current fiscal year-to-date period was due to a combination of three factors. Number one, the loan principal payment received on the non-performing loans. Number two, the partial $15 million charge-off related to Brazos Electric Power Cooperative and Brazos Sandy Creek non-performing loans. And number three, the classification of the remaining Brazos non-performing loans to troubled debt restructuring loans during the current quarter. As of February 28, 2023, loans outstanding to Brazos and Brazos Sandy Creek totalled $23 million and $4 million, respectively.

Our allowance for credit losses decreased to $56 million as of February 28, 2023, compared to $68 million as of May 31, 2022. The allowance coverage ratio decreased to 17 basis points as of February 28, 2023, from 22 basis points as of May 31, 2022. The allowance for credit losses reflected a decrease in the asset-specific allowance of $13 million, partially offset by a $1 million increase in the collective allowance. The decrease in the asset-specific allowance was attributable to primarily the charge-offs totalling $15 million related to Brazos and Brazos Sandy Creek loans, partially offset by an increase in the asset-specific allowance for another long-performing CFC power supply loan due to a reduction in the timing change in the expected payment on this loan.

The increase in the collective allowance was primarily due to the loan portfolio growth. We had no loan charge-offs during the current quarter and we recorded $15 million in charge-offs during the current fiscal year-to-date period, which represented 6 basis points of our average loans outstanding. Prior to this charge-off, we had not experienced any defaults or charge-offs in our electric utility portfolio and the telecommunication loan portfolio since the fiscal years 2013 and 2017, respectively. We continue to believe that the overall quality of our loan portfolio remains strong as of February 28, 2023, evidenced by the limited default and losses in our electric utility loan portfolio since the inception of CFC.

Our total debt outstanding was $30.9 billion as of February 28, 2023, an increase of $2.2 billion, or 8%, from May 31, 2022, primarily to fund our loan growth. We maintain diverse funding sources, including funding from our members, as well as capital markets and non-capital markets funding, to minimize the risk of being dependent on any single source or market. As of February 28, 2023, 52% of our funding came from capital markets, 22% from the Guaranteed Underwriter Program, 15% from our members and 11% from our Farmer Mac note purchase program.

Compared to our fiscal year ended May 31, 2022, our capital markets funding increased by $1.8 billion and our funding from the Guaranteed Underwriter Program and Farmer Mac increased by $1.1 billion, offset by a decrease in our member investment of $720 million.

As of February 28, 2023, 58% of our total debt was secured and 42% was unsecured, compared to 56% secured and 44% unsecured as of May 31, 2022. Our short-term borrowing remained relatively at the same level at $4.9 billion, accounting for about 16% of our total debt outstanding at February 28, 2023, compared with $5 billion, or 17%, of total debt outstanding at May 31, 2022. A total of $3.2 billion, or 65%, of our short-term borrowings came from our members' short-term investments at February 28, 2023, compared to $4 billion, or 79%, at May 31, 2022.

Our short-term member investment level was lower at February 28, 2023, as our members had utilized a portion of their investment for operating cash needs. As of March 31, 2023, we had a total of $3.4 billion in our short-term member investments. We believe that our member investments are a stable and reliable funding source for us as we continue to receive strong support from our members. Over the last 12 fiscal quarters, our member short-term investments have averaged $3.7 billion and our total member investments have averaged $5.2 billion. We intend to manage our short-term wholesale funding risk by maintaining dealer commercial paper outstanding balance at each quarter end within a range of $1 billion to $1.5 billion. As of February 28, 2023, our dealer commercial paper outstanding was at $1.2 billion.

This slide shows the various sources of liquidity that CFC had in place at February 28, 2023. Our available liquidity from various sources included cash and investments, committed bank lines, the Guaranteed Underwriter Program and the Farmer Mac revolving note purchase agreement, totalling $6.8 billion at February 28, 2023. During the current quarter, we closed a new facility totalling $750 million under the Guaranteed Underwriter Program. Our total liquidity amount does not include the $1.5 billion scheduled repayment and amortization on long-term loans that we expect to receive from our members over the next 12 months.

As indicated in the table, at February 28, 2023, short-term investments from our members totalled $3.2 billion. Because our members have traditionally rolled over a large portion of their short-term investments with us at maturity, we consider our member investments to be a very stable and reliable source of funding for CFC. Excluding our member's short-term debt maturities, we had approximately $4 billion of debt maturities over the next 12 months as of February 28, 2023. These debt maturities consist of short-term notes payable under the Farmer Mac revolving note purchase agreement of $500 million, dealer commercial paper of $1.2 billion and a long-term and subordinated debt obligation of $2.3 billion. Excluding the $3.2 billion debt maturities related to our members' short-term investments, we have a total liquidity equalling to 1.7 times, or $2.8 billion of liquidity in excess of our debt maturities during the next 12 months subsequent to February 28, 2023.

This slide represents CFC's projected long-term debt issuance needs over the next 18 months, subsequent to February 28, 2023. Our cash needs are derived from two primary areas—refinancing existing debt maturities and funding loan advances to our members, partially offset by the amortization and repayments of loans from our members. Our funding needs are also driven by our member investment levels.

During the current quarter, we accessed the capital markets and issued $300 million 10-year collateral trust bonds, $600 million five-year medium-term notes and $600 million three-year medium-term notes. We borrowed $500 million with a three-month term under the Farmer Mac note purchase agreement and $500 million with a 30-year amortizing structure under the Guaranteed Underwriter Program. In addition, subsequent to February 28, 2023, we borrowed an additional $150 million under the Farmer Mac note purchase agreement.

We expect a total of $3.1 billion of long-term debt maturities and amortization over the next 18 months, from March 2023 through August 2024, consisting of $1.8 billion in capital markets debt and $1.3 billion in non-capital markets debt. We expect our net long-term growth over the next 18-month period to be approximately $1.9 billion. As indicated in the last column of this table, we expect to issue approximately $3.9 billion in long-term debt over this time period to refinance existing debt maturities and to fund the expected loan growth.

Thank you once again for joining us today to review our results for our fiscal quarter ended February 28, 2023. 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 line for questions and also suggest that you submit the questions via the web service so we may respond to those as well. Thank you.

Operator: Thank you. Ladies and gentlemen from the phone lines, if you would like to signal for a question, it is star one on your telephone keypad. Again, that is star one for any questions at this time. And, a reminder, star one for any questions. We have a question from Chris Haberlin at Agincourt Capital Management. Your line is open. Please go ahead. Chris, your line is open, you may want to check your mute button.

Chris Haberlin: Sorry about that. Can you hear me now?

Operator: Yeah, Please go ahead.

Chris Haberlin: Okay. Great. Thank you. So I first wanted to ask about the increase in the debt-to-equity ratio, and you're kind of at a new high watermark here at 6.6 times. You're targeting approximately six times, and I think you've kind of spoken to the loan growth exceeding the earnings growth, which is kind of the primary driver. Just kind of thinking over perhaps the medium term, kind of what's the end game here? Is the intention to get that back down to six times or would you eventually consider adjusting your target range? Then what's the feedback that you're getting from the rating agencies as they look at the increase in that ratio?

Andrew Don: Great. Thanks for your question and obviously, it's something that we're paying very close attention to because obviously, it has increased. Our primary mission and goal is obviously to meet our members' needs, which, as you noted, have been very elevated for the reasons we cited. But having said that, we are very mindful of it. We've had discussions with the agencies. We are looking at a variety of options to address the debt-to-equity and the increase, because obviously if we continue to have the increases, that is not sustainable.

Having said that, bear in mind that almost 50% of our loan increase this year was in the form of line of credit loans, which may or may not stay on our balance sheet. Some of that is bridge financing for RUS takeout, so that would potentially go away. So we obviously have to see what will happen in terms of, does those increases in line of credits, is that kind of a permanent part of the loan portfolio or is it really just attributable to some things that happened over the last nine months. So we kind of want to focus on that, but we do expect loan growth to continue to be robust on a long-term basis.

And as I said, we are looking at a variety of options including the sub-debt market where we get obviously some equity credit, differing amounts, with agencies. And so we have to factor that in. Obviously, costs are higher for that at the current time. But we also are looking at options for maybe kind of, let's say, increasing our members' equity at a more rapid pace than what we've seen in the past. We can certainly—there's options such as looking at our Patronage Capital retirement or there's other things that we can do from a member equity standpoint.

It's certainly a high-level priority for us to look at the debt-to-equity and look at the factors, the variables that we can to continue to adjust it down closer to that 6-to-1. Changing the target, I think that's obviously something that we've disclosed with investors. Obviously, the agencies have different calculations, so we're mindful of that on a separate basis. I don't know if Ling has any other comments she wants to add.

Ling Wang: No, I think I just wanted to say, like Andrew said, about half of our loan growth this fiscal year is from that line of credit outstanding. So our line of credit outstanding increased by about $1.1 billion. So if you just kind of take a simple calculation, kind of adjust our loans outstanding down by $1.1 billion, that adjusted debt to equity would decrease to about 6.35, around that level.

Andrew Don: And a good portion of that, again, that $1.1 billion increase was debt. That line of credit advances for those borrowers that are looking for long-term takeout from the RUS, just to be clear, there's about 900 electric cooperatives in the country, there's about 350 or so that are independent. So that means there's obviously still a large universe of borrowers that do borrow from the RUS. And again, where we actually probably saw some of the largest increases was actually in the line of credit advances to RUS borrowers with the expectation that some of that line of credit borrowings would be taken out on a long-term basis with the RUS as opposed to other financings.

Chris Haberlin: Okay, great. Thanks very much for that. The second question for you, just on the Brazos loans and the Brazos Sandy Creek loans, I'm just trying to kind of understand exactly kind of where we stand here. In the Q2 10-Q, there was some language in there about the remaining balance being repaid over the next 12 months. I know that I want to say $56 million was paid in December, but then you moved what, $23 or $24 million to troubled debt restructuring. Just kind of, can you give an update on what's the remaining Brazos balance between the two entities? What's in nonperforming, what's in troubled debt restructuring, and what's the outlook or the expectation is in terms of repayment of those balances?

Ling Wang: Sure. So the loans outstanding to Brazos at the quarter end is $23 million, and that's classified as total debt restructuring. That's there, and the payoff of the outstanding loan balance will basically come from the generation asset sales from the Brazos, so which we expect that to happen in the next 12 months. The non-performing loans, the Brazos Sandy Creek loans outstanding at the quarter end is $4 million. So that's still in the non-performing loans. And so under the restructuring agreement, Brazos will likely be responsible for the payment of that $4 million as well.

Chris Haberlin: So there's $23 million that's in the troubled debt restructuring, $4 million in nonperforming, $56 million that was paid in December, and $15 million that was charged off?

Ling Wang: Charged off, yes.

Chris Haberlin: That's the entirety of all of the exposure to the two Brazos entities?

Ling Wang: There is also, related to the Brazos Sandy Creek, the noteholders of Brazos Sandy Creek actually created an entity called Resale Holdings to hold the coal fire plant ownership interest in the Resale Holdings company. So we do have I think around $7 million of equity interest in the Brazos Sandy Creek plant as part of ownership interest. And that $7 million on our balance sheet is basically an investment, so it's part of the other assets.

Chris Haberlin: And is the intention of the lenders' group that's taken the equity interest there to eventually sell that equity interest, or is it just to hold it in the near term?

Ling Wang: Eventually, it will be sold to equity interest.

Chris Haberlin: Okay. Understood. All right. Thanks so much for the call. I appreciate all the color.

Ling Wang: Sure.

Andrew Don: Thank you.

Ling Wang: So we do have a question that's submitted through the website. So the question is: is CFC actively engaged with ESG rating services like MSCI? So we are aware we have an ESG rating from MSCI. Our understanding is that they have basically taken our public information and put it in their model to derive that rating. We occasionally look at how they assess our ESG rating, but we are not actively involved with anybody at MSCI for the ESG rating.

Operator: And currently, I do not have any other questions holding from the phone lines.

Ling Wang: Okay. It looks like we don't have any questions here either.

Andrew Don: All right. Well, thank you for joining us today. Hope you have a good day and we look forward to talking to you in the future. Thank you.

Operator: Thank you. Ladies and gentlemen, that will conclude today's conference. We thank you for your participation. You may disconnect at this time and have a great day.