

FITCH AFFIRMS NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION AT 'A'; OUTLOOK STABLE

Fitch Ratings-Chicago-08 May 2018: Fitch Ratings has affirmed National Rural Utilities Cooperative Finance Corporation's (CFC) Long-Term and Short-Term Issuer Default Ratings (IDR) at 'A' and 'F1', respectively. A full list of rating actions is at the end of this press release.

KEY RATING DRIVERS

IDRs

CFC's Long-Term IDR is supported by its unique competitive position within the electric cooperative lending space, strong asset quality, sufficient liquidity, funding diversity and adequate coverage of interest expenses. The ratings are constrained by relatively higher leverage compared to peers, unique capital structure and inability to access the equity markets and modest earnings given CFC's business model.

Fitch estimates that CFC consistently garners over 20% of the electric cooperative lending market. Moreover, the company continues to strengthen its franchise, demonstrated by the number of borrowers that use CFC exclusively for all borrowing needs, increasing to 234 as of third-quarter ended Feb. 28, 2018 (3Q18) compared to 224 at fiscal year-ended May 31, 2017 (YE17).

CFC has a demonstrated track record in credit risk management, having recorded very low credit losses over time. The company's primary credit exposure is to rural electric cooperatives that provide essential electric services to end-users. Over CFC's 49-year operating history, the company has only experienced 16 electric cooperative borrower defaults, with net write-offs totaling \$86 million, evidencing a strong and stable lending space, as well as solid credit risk management. Fitch expects management to maintain its strategic focus on CFC core members as the firm has significantly reduced exposure to telecommunications entities, which have been the cause of most of CFC's credit losses over its history. CFC had no loans on nonaccrual status at 3Q18 and nominal accruing troubled debt restructured loans.

Fitch's analysis of CFC is heavily influenced by the firm's ability to maintain adequate liquidity to meet short- and long-term funding needs. As of Feb. 28, 2018, CFC had aggregate liquidity of \$7.6 billion, comprised of \$590 million in cash and investment securities and \$7.0 billion in available borrowing capacity. The firm also expects to generate \$1.5 billion in liquidity from loan repayments over the next 12 months. Fitch believes the firm has sufficient liquidity to address its \$6.1 billion of debt maturities over the next 12 months.

Fitch believes CFC has been able to maintain appropriate funding through various interest rate and credit cycles and has successfully diversified its funding base over time. Still, CFC remains heavily reliant on wholesale funding sources.

Private funding programs with the Federal Financing Bank, under a guarantee from the Rural Utilities Service, and the Federal Agricultural Mortgage Corporation have become more prominent sources of funding in recent years given their reliability, flexibility and cost. As of Feb. 28, 2018, capital markets funding (collateral trust bonds, non-member commercial paper and medium-term notes; and subordinated deferrable debt) represented 51.1% of total funding, compared to roughly 80% in FY04. Fitch views CFC's economic access to diversified funding sources favorably.

Fitch calculates CFC's debt to equity leverage to be 7.4x at 3Q18, down modestly from 7.8x at YE17. The improvement results from growth in GAAP equity (inclusive of derivative fair value changes). In Fitch's view, leverage remains a rating constraint, and above similarly rated non-bank financial institutions. Fitch's leverage calculation makes adjustments based on the 'Corporate Hybrids Treatment and Notching Criteria' (hybrids criteria). The agency gives CFC's subordinated deferrable debt and member capital securities 50% equity due to the instruments' deep subordination and the cumulative nature of the coupon in the event of a deferral. Fitch also affords CFC's loan and guarantee subordinated certificates (LGSC) 100% equity credit given the instruments' deep subordination and ability to absorb loan losses. However, the treatment of the LGSC as equity is considered a variation to the hybrids criteria because the LGSC have a contractual or implied maturity, more akin to a hybrid instrument.

CFC assesses its leverage based on an adjusted debt to equity calculation, which strips out derivative fair value changes, and treats all member-held capital member-held debt, and subordinated deferrable debt as 100% equity. Based on this treatment, CFC's adjusted leverage metric stood at 6.2x at Feb. 28, 2018, up modestly from 6.0x at FYE17 given an increase in debt outstanding to fund anticipated loan growth. The adjusted leverage metric is high relative to other rated non-bank financing institutions. However, Fitch views CFC's leverage as reasonable given low portfolio credit risk and CFC's ability and willingness to access subordinated debt markets to support growth.

CFC's ability to grow equity is limited to its ability to source hybrid equity from its members and retain earnings. CFC's capital is comprised of GAAP equity (retained earnings), member subordinated certificates, member capital securities, and subordinated deferrable debt. Management has taken steps to build equity by changing its patronage payout policy in 2009, which increased the level of retained earnings and the length of time excess earnings are retained on the balance sheet before being returned to CFC's members. At 3Q18, GAAP equity represented 40% of CFC capital of \$3.6 billion, compared to 2009 when it was just under 20%. Fitch views the growth in GAAP equity positively.

Earnings and profitability metrics are very low compared to similarly rated non-bank financial institutions, with pre-tax income as a percentage of assets averaging 0.5% in FY14-FY17. Nevertheless, Fitch believes CFC's earnings have a lower influence on the overall ratings as CFC's mission is not to generate large profits, but instead to cover its cost of funding, cost operations and its loan losses.

In its analysis of earnings, Fitch places a greater emphasis on the company's adjusted net income, and adjusted times interest earned ratio (TIER) metrics. These measures have been adequate and consistent with Fitch's expectations. CFC's adjusted TIER, excludes the impact of unrealized derivative forward fair value gains and losses, and includes periodic cash derivative settlements in adjusted interest expense. Adjusted TIER amounted to 1.16x in the nine-months ended Feb. 28, 2018 (9M18), down modestly from 1.17x for the comparable period in 2017. Modest growth in interest income from portfolio growth was offset by increased interest expense from higher interest rates and debt balances. Given the company's strong credit quality and ability to adequately price loans, Fitch expects adjusted TIER to remain in excess of its 1.1x target over time.

The Stable Outlook reflects Fitch's expectation for strong asset quality evidenced by low credit losses, sufficient liquidity, continued access to diversified funding sources, and the maintenance of appropriate leverage and coverage of interest expenses.

The Short-Term IDR is derived from the mapping between the Long-Term and Short-Term IDRs outlined in Fitch's 'Non-Bank Financial Institutions Rating Criteria'. CFC's Long-Term IDR of 'A' corresponds to a Short-Term IDR of 'F1'.

COMMERCIAL PAPER AND SENIOR DEBT

The commercial paper rating of 'F1' is equalized with the Short-Term IDR of 'F1'.

The senior secured debt ratings benefit from a one-notch uplift from the Long-Term IDR given the strong collateral coverage backing such notes and the good recovery prospects for debtholders under a stress scenario. Fitch notes that CFC's collateral trust bonds (CTB) are backed by high-performing mortgage notes with strong, stable underlying hard assets and substitution requirements in the event of collateral underperformance.

The senior unsecured debt ratings are equalized with CFC's Long-Term IDR, reflecting their subordination to secured debt and average recovery prospects for debtholders in a stressed scenario. Medium-term notes represent unsecured obligations that may be issued through dealers in the capital markets or directly to CFC's members.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The subordinated deferrable debt ratings are two notches below the Long-Term IDR due to the poor recovery prospects for debtholders in a stressed scenario given their deep subordination to senior secured and senior unsecured debt. Nevertheless, Fitch believes these instruments would have higher recovery prospects than bank-issued debt, thus warranting narrow notching (two-notches) than a traditional hybrid instrument (up to three-notches).

RATING SENSITIVITIES

IDRs

While Fitch does not anticipate upward rating movement in the near to medium term, positive momentum could develop over time from a decline in leverage, approaching 5.0x on a Fitch-calculated basis, which is more consistent with Fitch's investment grade benchmark ratios for finance & leasing companies, and enhanced funding flexibility as evidenced by the lengthening of CFC's debt maturity profile.

While not currently anticipated, ratings could be adversely impacted by a perceived drift in focus, evidenced by an increased level of lending to sectors outside of its rural electric member base, a spike in nonperforming loans due to financial stress within the sector indicating an inability to adapt to new legislation or an inability to pass along cost increases to end users, an increase in Fitch's leverage metric approaching 9.0x, and/or deterioration in the firm's liquidity profile.

COMMERCIAL PAPER AND SENIOR DEBT

CFC's commercial paper rating is sensitive to changes in the firm's short-term IDR and could be expected to move in tandem.

CFC's senior debt ratings are sensitive to changes in the firm's Long-Term IDR, its funding mix, and the availability of collateral for each class of debt.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

CFC's hybrid debt ratings are sensitive to changes in CFC's Long-Term IDR.

Based in Dulles, VA, CFC was formed in 1969 to provide financial and business management services to approximately 1,400 electric cooperative distribution and power supply owners/members across the U.S. As of Feb. 28, 2017, CFC had a loan portfolio amounting to \$25.3 billion.

Fitch has affirmed the following ratings:

National Rural Utilities Cooperative Finance Corporation

--Long-Term IDR at 'A';

--Short-Term IDR at 'F1';
--Commercial paper at 'F1';
--Senior secured debt at 'A+';
--Senior unsecured debt at 'A';
--Subordinated deferrable debt at 'BBB+'.

The Rating Outlook is Stable

Contact:

Primary Analyst
Bain K. Rumohr, CFA
Senior Director
+1-312-368-3153
Fitch Ratings, Inc.
70 West Madison Street
Chicago, IL 60602

Secondary Analyst
Johann Juan
Director
+1-312-368-3339

Committee Chairperson
Joo-Yung Lee
Managing Director
+1-212-908-0560

Media Relations: Hannah James, New York, Tel: + 1 646 582 4947, Email:
hannah.james@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Corporate Hybrids Treatment and Notching Criteria (pub. 27 Mar 2018)
<https://www.fitchratings.com/site/re/10024296>
Non-Bank Financial Institutions Rating Criteria (pub. 22 Mar 2018)
<https://www.fitchratings.com/site/re/10023420>

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory). FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2018 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the

information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided “as is” without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the “NRSRO”). While certain of the NRSRO’s credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see <https://www.fitchratings.com/site/regulatory>), other credit rating subsidiaries are not listed on Form NRSRO (the “non-NRSROs”) and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.