

Research

National Rural Utilities Cooperative Finance Corp.

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Table Of Contents

Major Rating Factors

Outlook

Rationale

Ratings Score Snapshot

Related Criteria

National Rural Utilities Cooperative Finance Corp.

Major Rating Factors

Issuer Credit Rating
A/Stable/A-1

Strengths:	Weaknesses:
<ul style="list-style-type: none">• Very strong business stability as a result of decades of providing financing to member electric utility cooperatives• Low credit risk of electric utility loans• Access to low cost funding from the Federal Financing Bank, Farmer Mac, and its members	<ul style="list-style-type: none">• Relatively high leverage and modest earnings• Single borrower and industry concentrations

Outlook

The stable outlook on National Rural Utilities Cooperative Finance Corp. (CFC) reflects S&P Global Ratings' expectation that, over the 18-24 month outlook horizon, the company will maintain its role as an important source of financing for the rural electric utility industry, a risk-adjusted capital (RAC) ratio of 7.0% or better, minimal credit losses, and diversified funding that includes the Federal Financing Bank, the Federal Agricultural Mortgage Corp. (Farmer Mac), and CFC's members.

Downside scenario

We could lower our ratings if the company's RAC ratio declines below 7.0% on a consistent basis or if the company's unique business position or funding becomes eroded, in our view.

Upside scenario

Though less likely, we could raise our ratings if the company's RAC ratio rises well above 10.0% while it maintains minimal credit risk in its loan portfolio and maintains its funding from the Federal Financing Bank, Farmer Mac, and its members. The company's concentrated business model limits the probability of a higher rating.

Rationale

Our ratings reflect the company's very strong business stability as a result of decades of providing financing to member electric utility cooperatives, low credit risk of electric utility loans, and access to low cost funding from the Federal

Financing Bank, Farmer Mac, and its members. Conversely, our ratings reflect the company's relatively high gross leverage, modest earnings, as well as single borrower and industry concentrations in their loan portfolio.

We rate all the company's senior secured and senior unsecured debt at the same level of the issuer credit rating. We rate the companies subordinated deferrable interest notes two notches below the issuer credit rating to reflect the subordination and optional interest deferral.

Business description

CFC is a tax-exempt, member-owned cooperative that provides credit to rural electric cooperatives and rural utilities. CFC has played an important role—even though it is not government sanctioned—for decades in financing the rural electric utility industry because many of its members have limited direct access to the capital markets.

Anchor: Reflects CFC's unique competitive position among finance companies

Our starting point—or anchor—for our ratings on nonbank financial institution finance companies (fincos) in the U.S. is currently 'bb+'. We initially set the anchor for fincos three notches below the anchor for banks in the same country to reflect the typical lack of central bank access, lower regulatory oversight, and higher competitive risk for fincos relative to banks. U.S. fincos typically rely on bank facilities, secured and unsecured debt, and other wholesale funding, whereas U.S. banks mainly rely on deposit funding. While consumer finance companies generally are subject to consumer protection laws, U.S. fincos are not subject to the significant prudential regulatory oversight of banks' capital and liquidity, which we view as generally supportive of creditworthiness. While U.S. fincos may compete with banks, they often focus on higher-risk lending than banks and are subject to greater cyclical volatility. Like banks, the U.S. fincos' anchor reflects the country's diversified and high-income economy.

Given CFC's unique competitive position, we raise the finco anchor one notch to 'bbb-', reflecting its lower competitive risk relative to other fincos. CFC supplements financing offered by the Rural Utilities System (RUS) to not-for-profit rural electric utilities and has few direct competitors. Moreover, CFC has access to low-cost government funding from Federal Financing Bank and low-cost funding from Farmer Mac, a government-sponsored enterprise.

Business position: Strong market position in lending to rural electric utility cooperatives

CFC makes loans to its members so they can acquire, construct, and operate electric distribution, generation, transmission, and related facilities. Its members, who are dispersed throughout the U.S. and its territories, often borrow from the federal government's RUS. CFC and its main competitor, CoBank ACB, provide most of these electric cooperatives' supplementary financing needs. Some members borrow from CFC even when they have additional capacity with the RUS, and an increasing number have been borrowing solely from CFC. We believe CFC's focus on and knowledge of the industry—as well as some of the ancillary services it provides to members—has engendered loyalty over many years. As of May 31, 2019, CFC had 1,447 members and 222 associates. As a member owned cooperative, CFC's objective is not to maximize profit but to provide cost-based financial products and services to its members.

Capital, leverage, and earnings: Adequate for the risk profile

We view CFC as adequately capitalized on a risk-adjusted basis, as reflected in a RAC ratio of 8.4% as of May 31, 2019. We generally consider a RAC ratio of 7%-10% to be indicative of adequate capital. We adjust CFC's adjusted common equity for the prior-year cumulative derivative forward-value adjustment and current year-to-date derivative

forward-value gains or losses, which totaled losses of \$355 million as of May 31, 2019. These adjustments are related to interest-rate swaps that CFC uses to hedge interest-rate risk related to differences in the repricing characteristics of its loan portfolio and its borrowings. Those hedges create some timing asymmetry in the company's financial reporting under generally accepted accounting principles. Although CFC has not sought the hedge accounting treatment necessary to have its interest-rate swaps classified as cash flow hedges for financial reporting, we believe these hedges are economically effective, so we adjust reported equity in the same manner that we do for cash flow hedges. If market interest rates rise and the forward-value adjustments convert to gains, we would deduct such gains from total adjusted capital.

The company's business model historically has generated relatively modest--yet stable--earnings. It aims to provide its members with attractively priced loans and allows them to benefit from CFC's relatively low-cost funding. The loan portfolio had average yield of 4.35%, and the net interest spread was 0.95% for the year ended May 31, 2019.

CFC also reports a "times interest earned ratio" (TIER), a measure of its ability to cover its interest expense. Adjusted for noncash derivative items, it is essentially a ratio of net income plus interest expense over interest expense. The company targets a minimum annual adjusted TIER of 1.10x. Under a covenant on the company's revolving credit lines, an average ratio over a six-quarter period cannot drop below 1.025x. For the year ended May 31, 2019, the company's adjusted TIER was 1.19x. Adjusted TIER is calculated based on adjusted net income plus adjusted interest expense for the period divided by adjusted interest expense for the period.

Risk position: Low credit risk in the electric utility loan portfolio

CFC has a low-risk loan portfolio, strong asset quality metrics, and prudent risk-management policies, in our view. We believe CFC's loans to electric utilities have low risk of default, which is reflected in the modest charge-offs the company historically has reported on mostly senior secured loans. We have seen a consistent improvement in the asset quality metrics as the company reduced its exposure to telecom loans--totaling \$345 million as of May 31, 2019, compared to \$2.99 billion reported as of May 31, 2005. The company did not have any nonperforming loans, excluding total debt restructurings (TDR) as of May 31, 2019, and TDR loans were 0.05% of the loan portfolio.

However, borrower concentration remains a risk, though CFC's senior secured position mitigates expected losses in a default. Although the company has reduced its exposure to individual borrowers in recent years, its 20 largest borrowers still accounted for 21% of its loans as of May 31, 2019. CFC, however, maintains a strong quality portfolio with no nonperforming loans.

Funding and liquidity: Stable funding sources and improving liquidity profile

We believe CFC has adequate funding and liquidity, given its access to stable funding sources, short-term debt usage, and improving liquidity profile. The Federal Financing Bank, a government entity, and Farmer Mac, a government-sponsored entity, provide CFC with 33% of its debt, offering a source of relatively low-cost, long-term financing to help fund rural utility lending. While the company's funding profile is adequately diversified, the company is very active issuing debt in the capital markets. Debt from capital markets makes up 49% of the company's current debt outstanding, giving the company some sensitivity to potential changes in investor confidence or credit ratings. We would view increased usage and reliance on short-term borrowings as a weakness; however, the company currently has a very diverse capital structure with numerous counterparties.

The company now has about \$2.45 billion in availability with Farmer Mac, \$1.35 billion with the Federal Financing Bank program, and \$178 million in cash and equivalents. Also, it has access to \$2.97 billion in unsecured revolving credit facilities with a group of banks, as well as a liquid fixed income investment portfolio of roughly \$565 million.

Comparable ratings adjustment: Benefits from favorable access to funding, and member subordinated debt provides a cushion to senior creditors

The Federal Financing Bank and Farmer Mac provide CFC with about 32% of its total debt, offering a source of relatively low-cost, long-term financing to help fund rural utility lending. Members not only borrow from CFC, but they also provide about 18% of its total debt, including members' subordinated certificates. CFC's member subordinated debt is subordinated to all other debt issues, including nonmember subordinated securities. Member subordinated debt consists of membership subordinated certificates (\$630 million), loan and guarantee subordinated certificates (\$505 million), and member capital securities (\$221 million).

External influence: None

We don't factor any external influence into the ratings.

Ratings Score Snapshot

Ratings Score Snapshot--National Rural Utilities Cooperative Finance Corp.	
Issuer Credit Rating	A/Stable/A-1
SACP	a
Anchor	bb+
Entity-Specific Anchor Adjustment	1
Business Position	Very Strong (+2)
Capital, Leverage, and Earnings	Adequate (0)
Risk Position	Strong (+1)
Funding and Liquidity	Adequate and Adequate (0)
Comparable Ratings Adjustment	1
External Influence	0
Government Influence	0
Group Influence	0
Rating Above the Sovereign	0

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Financial Institutions | General: Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies, Dec. 9, 2014

- Criteria | Financial Institutions | General: Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004
- Criteria | Financial Institutions | Finance Companies: Commercial Paper II: Finance Companies, March 22, 2004

Ratings Detail (As Of November 4, 2019)*

National Rural Utilities Cooperative Finance Corp.

Issuer Credit Rating	A/Stable/A-1
Commercial Paper	
<i>Local Currency</i>	A-1
Senior Secured	A
Short-Term Debt	A-1
Subordinated	BBB+

Issuer Credit Ratings History

12-Apr-2016	A/Stable/A-1
06-Jul-2015	A/Negative/A-1
20-Jan-2015	A/Stable/A-1
12-Dec-2014	A/Negative/A-1

Sovereign Rating

United States	AA+/Stable/A-1+
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*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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