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Fitch Affirms National Rural at 'A'/'F1'; Outlook Stable

Fitch Ratings - Chicago - 01 Sep 2023: Fitch Ratings has affirmed the Long-Term and Short-Term Issuer Default Ratings (IDRs) of National Rural Utilities Cooperative Finance Corporation (CFC) at 'A' and 'F1', respectively. The Rating Outlook is Stable. Fitch has also affirmed the company's senior secured debt rating at 'A+', senior unsecured debt rating at 'A', subordinated debt rating at 'BBB+' and commercial paper (CP) rating at 'F1'.

Key Rating Drivers

The rating affirmations are supported by CFC's unique competitive position within the U.S. electric cooperative lending space, strong asset quality, sufficient liquidity, funding diversity and adequate coverage of interest expenses. The ratings are constrained by CFC's higher leverage relative to similarly rated peers, its unique capital structure, a business model that results in modest earnings performance relative to peers, and an inability to access the public equity markets.

CFC has a demonstrated track record in risk management, having recorded very low credit losses over time. Over the company's 54-year operating history, CFC has experienced only 18 defaults in its electric cooperative loan portfolio, which included the 2021 and 2022 defaults of Brazos Power Cooperative, Inc. and Brazos Sandy Creek Electric Cooperative, Inc., respectively, resulting from the bankruptcy filings following their exposure to elevated wholesale electric power costs during a winter storm in February 2021. Cumulative net charge-offs totaled $101 million (0.3% of average loans) since inception, evidencing strong and stable underwriting, as well as solid risk management.

As a cooperative lender, CFC's mission is not to generate large profits, but instead to cover its cost of funding, cost of 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), which amounted to 1.25x at FYE May 31, 2023; compared with 1.30x a year ago. Given the company's strong asset quality and ability to adjust loan pricing, Fitch expects adjusted TIER to remain in excess of CFC's target of 1.1x over time.

Fitch adjusts its leverage calculation based on the agency's "Corporate Hybrids Treatment and Notching Criteria." Specifically, Fitch affords CFC's subordinated deferrable debt and member capital securities 50% equity credit 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 member guarantee subordinated certificates (LGSC) 100% equity credit given the instruments' deep subordination and the ability to absorb loan losses.

Fitch calculated CFC's debt to tangible equity leverage to be 6.8x at May 31, 2023, down from 7.2x a year ago due to growth in GAAP equity from retained earnings, and to a lesser extent, positive derivative fair value changes. While Fitch views CFC's leverage as reasonable given the low portfolio credit risk and CFC's ability and willingness to access the subordinated deferrable debt markets to support growth, CFC's current leverage metrics are higher than similarly rated non-bank financial institutions, and remain a rating constraint.

Fitch believes CFC has been able to maintain appropriate funding sources through various cycles and has successfully diversified its funding base over time. Unsecured debt as a percentage of total funding was 44% at May 31, 2023, which, while stable, is modestly below similarly rated peers.

Fitch's analysis of CFC is heavily influenced by the firm's ability to maintain sufficient liquidity to meet short- and long-term funding needs. At May 31, 2023, CFC had liquidity of $7.1 billion, comprised of $674 million of cash and investments and $6.5 billion of borrowing capacity on various credit facilities. Additionally, CFC had $1.5 billion of anticipated long-term loan repayments over the next 12 months. Accordingly, Fitch believes CFC has sufficient liquidity, covering $6.9 billion of debt maturities over the next 12 months by 1.2x, as of May 31, 2023.

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

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/ Downgrade

--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 would be negative for ratings;

--An increase in Fitch-calculated leverage sustained above 10x, and/or deterioration in the firm's liquidity profile below 1.0x coverage of liquidity sources to uses could also yield negative rating action.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Fitch believes the likelihood of a ratings upgrade over the medium term is limited given CFC's higher-than-peer leverage;

--Over time, positive rating momentum could be driven by a decline in leverage approaching 5x on a Fitch-calculated basis, which is more consistent with Fitch's investment-grade benchmark ratio for balance sheet heavy finance and leasing companies, and enhanced funding flexibility as evidenced by the lengthening of CFC's debt maturity profile.

DEBT AND OTHER INSTRUMENT RATINGS: KEY RATING DRIVERS

According to Fitch's "Non-Bank Financial Institutions Rating Criteria," dated May 5, 2023, a Long-Term IDR of 'A' maps to a Short-Term IDR of 'F1' or 'F1+'. In order to qualify for the higher rating, CFC would need to have a minimum Funding, Liquidity and Coverage (FLC) score of 'aa-'. CFC's score is currently 'bbb'. Accordingly, Fitch has affirmed the Short-Term IDR at '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.

The senior unsecured debt ratings are equalized with CFC's Long-Term IDR, reflecting their subordination to secured debt and average recovery prospect for debtholders in a stress scenario.

The subordinated deferrable debt ratings are two notches below the Long-Term IDR due to the poor recovery prospects for debtholders in a stress scenario given their deep subordination to senior secured and senior unsecured debt.

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

DEBT AND OTHER INSTRUMENT RATINGS: RATING SENSITIVITIES

The Short-Term IDR is primarily sensitive to the Long-Term IDR and would be expected to move in tandem. However, a material improvement in CFC's FLC profile, resulting in an upgrade of the subfactor score to 'aa-', could result in the upgrade of the Short-Term IDR to 'F1+'.

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

CFC's hybrid debt ratings are sensitive to changes in CFC's Long-Term IDR and would be expected to move in tandem.

CFC's CP rating is sensitive to changes in the firm's Short-Term IDR and would be expected to move in tandem.

ADJUSTMENTS

The Standalone Credit Profile has been assigned above the implied Standalone Credit Profile due to the following adjustment reason: Business Profile (positive).

The Sector Risk Operating Environment has been assigned above the implied score due to the following adjustment reason: Business model (positive).

The Business Profile score has been assigned above the implied score due to the following adjustment reason: Market position (positive).

The Asset Quality score has been assigned above the implied score due to the following adjustment reason: Underwriting standards (positive).

The Earnings & Profitability score has been assigned above the implied score due to the following adjustment reason: Portfolio risk (positive).

The Capitalization & Leverage score has been assigned above the implied score due to the following adjustment reasons: Risk profile and business model (positive), Capital flexibility and ordinary support (positive).

The Funding, Liquidity & Coverage score has been assigned in line with the implied score.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579

Criteria Variation

The treatment of the LGSC as 100% equity is considered a variation to the hybrids criteria because the LGSC have a contractual or implied maturity, more akin to a hybrid instrument, which would typically receive 50% equity credit.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
National Rural Utilities Cooperative Finance Corporation	LT IDR	A	Affirmed		A
	ST IDR	F1	Affirmed		F1
• senior unsecured	LT	A	Affirmed		A
• subordinated	LT	BBB+	Affirmed		BBB+
• senior	LT	A+	Affirmed		A+

ENTITY/DEBT		RATING		RECOVERY	PRIOR
secured					
• senior unsecured	LT	A	Affirmed		A
• senior unsecured	ST	F1	Affirmed		F1

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Hybrids Treatment and Notching Criteria (pub.12 Nov 2020)

Non-Bank Financial Institutions Rating Criteria (pub.05 May 2023) (including rating assumption sensitivity)

Additional Disclosures

Solicitation Status

Endorsement Status

National Rural Utilities Cooperative Finance Corporation	EU Endorsed, UK Endorsed

DISCLAIMER & DISCLOSURES

Endorsement policy

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.