National Rural Utilities Cooperative Finance Corporation

SERVICE | INTEGRITY | EXCELLENCE

Kansas Accountant's Meeting

Equity Management

Garden City, KS

October 27, 2016

Created and Owned by America's Electric Cooperative Network

Discussion Topics

- Basics of Equity Management
- Determining the Member Impact of Different Equity Levels

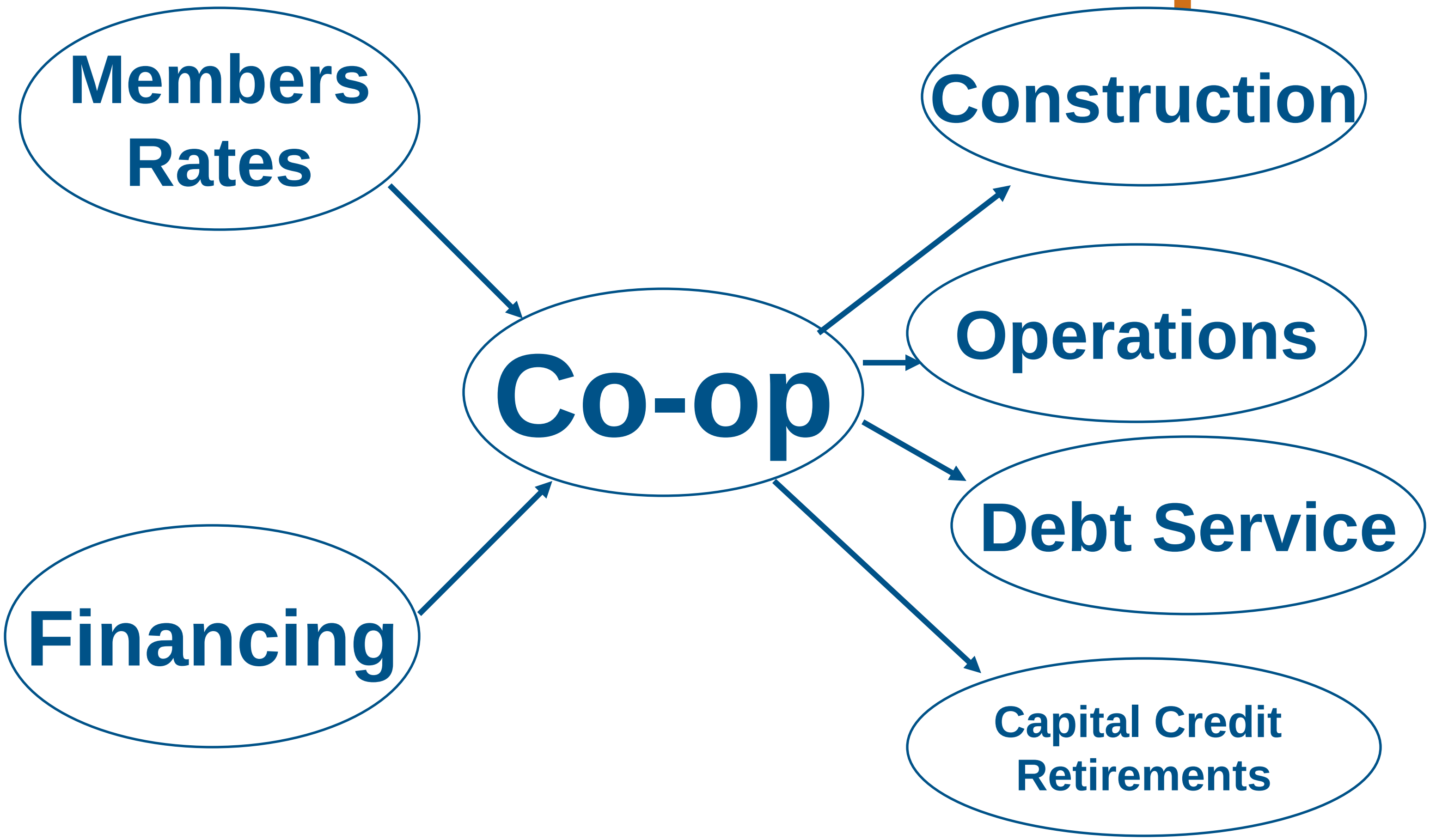
Two Measures

- **Equity as a percent of assets (Overall) – 50.74%**
  - Most common one talked about
    - Medians: US 44.23%
      KS 44.70%
- **Equity as a percent of total capitalization – 52.28%**
  - Total capitalization = long term debt plus total equity
    - Medians: US 50.19%
      KS 48.23%
  - Used in most equity management models
- **Both measure your members contributions to financing the cooperatives assets**

It Is All About Raising Capital

- **Borrow from a lender**
- **Contribution from our members**
  - Margins through rates
  - Contributions to construction cost
- **Each has its own cost**
- **Our members incur the cost of both**
- **If we provide safe reliable power at a "competitive" cost – I believe that our members are indifferent as to where we get the funds**

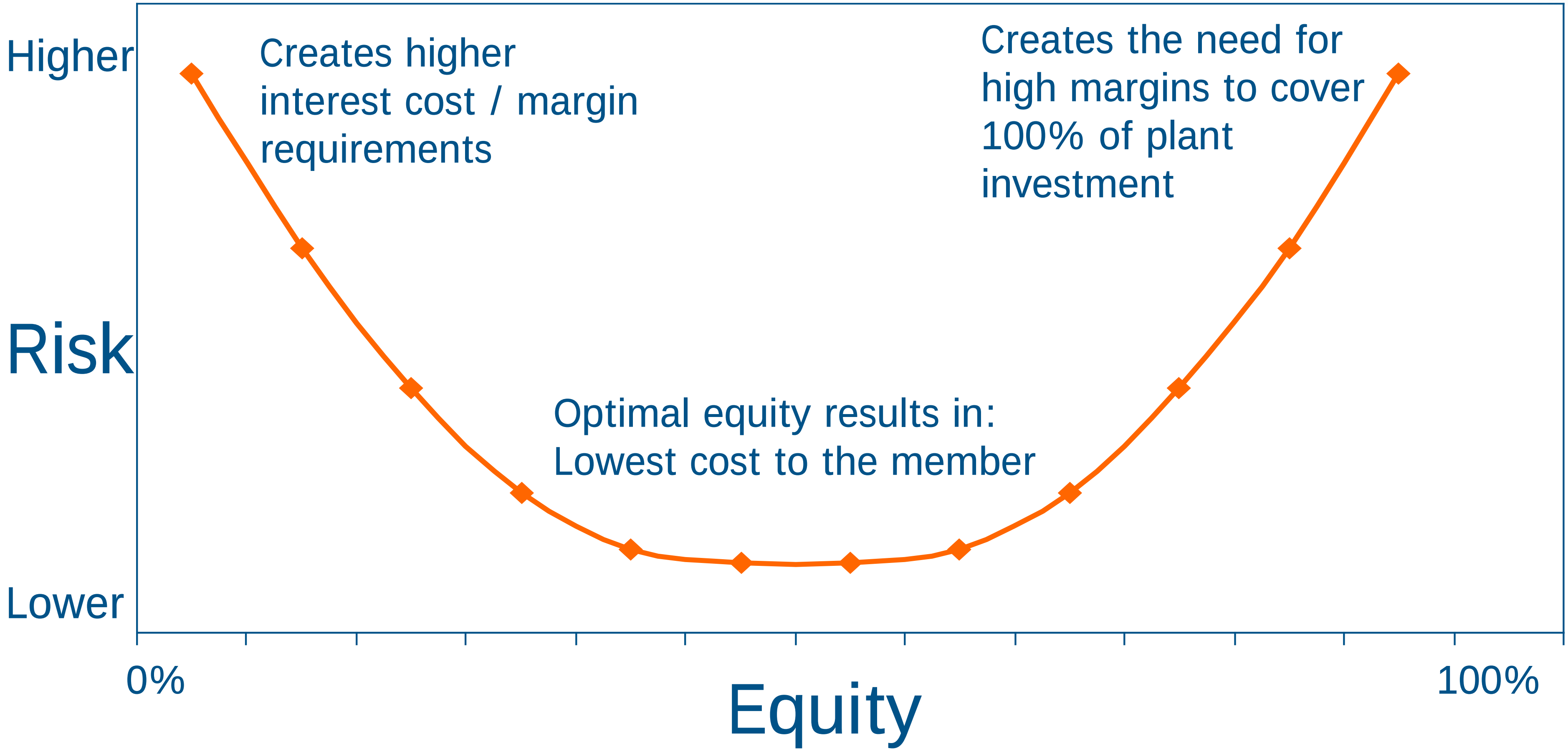
The Source/Use of Capital



Equity Management Goal

- Provide the capital needed by the cooperative at the lowest cost to our members
- Is consistent with most mission statements
- Only caveat – must maintain financial strength and flexibility considering our risks and opportunities

Desired Equity Target



Finding the "Just Right" Equity Level

- **Lender requirements**
- **Financial flexibility**
  - —Availability of funds
  - —Implementing new rate structure
- **Benchmarks**
  - – Median KRTA equity level (2015)
    - National: 44.23%
    - State: 44.70%
  - – Capital credit task force
    - 30% to 50%

Risk and Opportunities

- **Tie to strategic planning**
- **Does your cooperative have risks greater than the "average" cooperative?**
  - If so, is your equity position a way to mitigate those risks?
- **Does your cooperative have opportunities greater than the "average" cooperative?**
  - If so, is your equity position a way to take advantage of those opportunities?

Choosing an Equity Level

- **After examining your risk and opportunities and key decisions does your equity level need to be**
  - Higher
  - Lower
  - Same
  - In any case, hopefully a range can be identified

Managing to an Equity Target

Growth in Assets

Construction Work Plan

1

Retiring Capital Credits

Capital Credit Policy

2

Equity Target

Ability to Create Margins

Rates – Operating Budgets

3

Key Decisions that Affect Equity

1. Growth in assets (construction work plan)

- New members
- Increased usage
- Normal plant replacement
- The faster your growth the harder it will be to maintain the equity of the "average" cooperative

Key Decisions that Affect Equity

2. Capital credit policy - is typically referred to as capital credit rotation policy

- If you want to retain your current equity position, dollars paid back need to be replaced
- The faster you are giving back capital credits the harder it will be to maintain the equity of the cooperative

Key Decisions that Affect Equity

3. Ability to generate margins

- Once you determine your growth rate and capital credit retirement rate you can determine the margins required to maintain your current level of equity
- **If your rates generate more than that level equity will increase**
- **If your rates generate less than that level equity will decrease**

Key Decisions that Affect Equity

- **Change in Equity position**
- **If you want to increase equity**
  - Margins must be greater than that needed to keep up with growth and capital credit retirements
- **If you want to decrease equity**
  - Margins can be less than that needed to keep up with growth and capital credit retirements

It's Just Math

- **If assets are growing at 5%**
- **And capital credit retirements = 2%**

- **Margins must equal 7% of equity**
  - Return or cost of equity = 7%

Equity as a Percent of Assets

Balance Sheet

		Total Equities	$ 38,000,000
		Total Liabilities	$ 62,000,000
Total Assets	$ 100,000,000	Total E & L	$ 100,000,000

38%

It's Just Math

- **Asset growth**
  - **$100,000,000 + 5% = $105,000,000**

  - **Beginning Equity = $38,000,000**
  - $ 38,000,000 * 2.0% (retirements) = < $ 760,000>
  - **$** 38,000,000 * 7.0% (margins) = $2,660,000
  - **Ending Equity = $39,900,000**

- **$39,900,000 / $105,000,000 = 38%**
- **Debt funding of $3,100,000**

Equity Conclusions

- Select an equity range that strategically will provide the cooperative a future level of financial flexibility
- Understand the key decisions that will allow the board and staff to manage to the selected equity
  - Growth
  - Capital credit policy
  - Rates
  - Desire to change equity position

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