

# FEDERAL NATIONAL MORTGAGE

Rating Analysis - 7/14/16

Debt: \$3.2Tr, Cash: \$52.8B

Est. Share Value: \$2.06 Price: \$2.02

\*EJR Sen Rating(Curr/Prj) A/ A+

\*EJR CP Rating: A1+

EJR's 3 yr. Default Probability: 1.3%

EJR 3 yr. Recov. Rate: 64.7%

Federal National Mortgage Association (FNMA) is in the capital markets sector and its operating income was \$1.7B for the quarter ending March 2016 vs \$2.7B for the prior year. Net income for the quarter was \$1.1B vs the prior year's \$1.9B.

The YoY decline in Fannie Mae's quarterly net inc was primarily the result of fair value losses driven by lower long-term int rates. Net int inc declined 5.9% to \$4.8B, reflecting a reduction of the retained mortgage portfolio. Fee and other income likewise fell 34.1% YoY to \$203M, leading to a 7.5% decline in net revenue (\$5.4B). Credit related income rose 13x. Net fair value losses were \$2.8B vs a loss of \$1.9B last year, citing unfavorable impact of low rates on the value of the risk management derivatives. Weaker rev performance coupled with higher fees from Temporary Payroll Tax Cut Continuation Act of 2011 (+15.2%) offset the 4.8% decline in administrative exps and led to a lower net inc. Mkt Cap is \$2.3B and Net Debt is \$3.1Tr. Affirming.

CREDIT POSITION	Annual Ratios		Ratios for 4 Rolling Quarters				
	Dec-15	PDec17	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Fixed Chg Cov(x)	1.2		1.2	1.2	1.2	1.2	1.2
Return on Equity (%)	269.9		299.5	190.7	244.8	269.9	481.5
PT Ret. on Avg Assets(%)	0.5		0.5	0.5	0.5	0.5	0.5
Ret on Perm Cap (%)	0.5		0.5	0.5	0.5	0.5	0.5
T Debt/Cap(w Debt)(%)	99.9		99.9	99.8	99.9	99.9	99.9
Short Term Debt/ Total Debt (%)	2.3		3.1	2.6	3.0	2.3	1.9
Implied Sen. Rating	A-		A-	A-	A-	A-	A-

INDUSTRY RATIOS	AA	A	BBB	BB	B	CCC
Fixed Chg Cov(x)	2.3	1.8	1.3	0.9	0.7	0.5
Return on Equity (%)	4.5	4.0	3.5	3.0	2.5	2.0
PT Ret. on Avg Assets(%)	6.0	4.0	2.0	0.0	-2.0	-4.0
Ret on Perm Cap (%)	20.0	10.0	7.0	4.0	2.0	-2.0
T Debt/Cap(w Debt)(%)	85.0	90.0	95.0	97.0	98.2	100.0
Short Term Debt/ Total Debt (%)	47.5	62.2	75.3	84.9	90.7	94.2

PEER RATIOS	Other	Fixed	Return	Return	Return	Ratio-	
	NRSRO	Charge	on Avg	on Perm	T Debt/	Implied	
	Sen.	Cov(x)	ROE(%)	Assets	Cap(%)	Cap(%)	Rating*
Federal Home Loan Mortgage Corporation	AAA	1.2	216.9	0.8	0.5	99.9	BBB-
JPMorgan Chase & Co.	A-	5.1	9.7	1.2	3.3	67.7	AA-
Citigroup Inc.	BBB+	3.1	7.7	1.4	3.4	62.3	AA
Fidelity National Financial	BBB	1,013.0	7.6	6.1	6.7	28.7	AAA
Ocwen Financial Corporation	B	0.6	0.0	4.6	-2.5	87.2	BB-

Note, Annual Implied Sen. Ratings are smoothed

Rating Change Anticipator (1 is best, 100 worst): 40.9 Last EJR Sen.: A Other NRSROs: AAA

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## REVENUE & PROFITABILITY

The Company's revenues declined at an average annual rate of 4.7% over the last five years while operating margin fell to 0.26% for the fiscal year ending December 2015, below the 0.27% average over the prior four years. Return on Assets fell to 0.34%, below the 0.49% average for the prior year.

	<b>Dec-11</b>	<b>Dec-12</b>	<b>Dec-13</b>	<b>Dec-14</b>	<b>Dec-15</b>	<b>PDec16</b>	<b>PDec17</b>
Interest Income (bill \$)	143	129	118	114	109	111	112
Growth Rate (%)		(9.62)	(9.01)	(2.67)	(4.34)	1.20	1.20
Net Interest Income/Total Interest Income (%)	13.49	16.64	19.06	17.45	19.56	20.52	21.45
Loan Loss Coverage(%)	NMF	NMF	NMF	NMF	NMF	706.32	649.05
Pretax Return On Avg Assets (%)	(0.53)	0.54	1.19	0.65	0.50	0.54	0.57
Oper Return/ Earning Assets (%)	(0.17)	0.30	0.63	0.34	0.26	0.55	0.58
Non-Interest Inc/Revs (%)	7.8	6.7	2.7	13.18	9.49	9.54	9.59
Efficiency Ratio(%)	49.5	29.7	(6.8)	38.20	35.93	34.33	32.90
Return on Assets (%)	(0.5)	0.5	2.6	0.44	0.34	0.36	0.39

## LEVERAGE & ASSET LIQUIDITY

The Quick Asset Ratio has become weaker recently, slipping to 1.6:1 for the FYE December 2016, and Quick Assets/ ST Dep & Debt declined.

	<b>Dec-11</b>	<b>Dec-12</b>	<b>Dec-13</b>	<b>Dec-14</b>	<b>Dec-15</b>	<b>PDec16</b>	<b>PDec17</b>
Quick Asset Ratio(%)	2.5	3.1	1.7	1.9	1.6	1.7	1.7
Quick Assets/ ST Dep & Debt(%)	2.2	1.8	1.3	1.1	0.9	0.9	0.9
LT Debt/ Capital (%)	100.2	99.8	99.7	99.9	99.9	99.9	99.8
T Debt/Cap(w Debt)(%)	100.1	99.8	99.7	99.9	99.9	99.9	99.8

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## ASSUMPTIONS FOR FINANCIALS

### Valuation Driver: Interest Income Growth:

Federal National Mortgage has seen a decline in interest income at 4.3% per annum in the last fiscal year which is disappointing. We expect Company's revenues will grow approximately 1.2% per annum over the next couple of years and 1.2% per annum for the next couple of years thereafter.

### Valuation Driver: Net Interest Margin:

Company's net interest margin has been less than its peers and we assumed no growth in net interest margin over the next two years.

Income Statement	Peer Median	Co. Avg.	Assumptions	
			Yr 1&2	Yr 3,4,5
Interest Income Growth%	(3.4)	(4.3)	1.2	1.2
Interest Expense (% of outstanding debt)	2.6	2.8	2.8	2.8
Net Interest Margin (% of earning assets)	0.8	0.3	0.3	0.3
Provisions for Loan Losses(% of earning assets)	0.0	(0.0)	(0.0)	(0.0)
Trading Account Profit Growth%	0.0	(175.9)	2.0	2.2
Commissions & Fees Earned Growth%	0.0	(77.1)	2.0	2.0
Other Operating Income Growth%	4.7	49.3	5.0	5.0
Non-Interest Expense Growth%	4.1	(17.8)	1.2	1.2
Net Non-Operating Loss Growth%	(99.2)	(68.7)		
Income Tax Rate%	32.6	32.6	32.6	29.3
Special Items (billion \$)	0.0			
Cash & Near Cash Growth%	0.0	(16.5)	1.1	1.1
Accounts & Notes Receivable Growth%	0.0	(7.0)	0.6	0.6
Marketable Secs. & ST Investments Growth%	0.0	0.0		
Loans & Mortgages Growth%	0.0	(0.4)	100.0	90.0
Real Estate Investments Growth%	0.0	0.0		
Other Long-Term Investments Growth%	(7.3)	(6.0)	(3.5)	(3.5)
Long-Term Investments before Reserves Growth%	(5.1)	(0.8)	(0.8)	(0.8)
Loan Loss Reserves (% of Earn. Assets.)	0.0	0.5	1.1	1.1
Loans Net of Reserves Growth%	0.0			
Net Fixed Assets Growth%	0.0	(36.3)	1.1	1.1
Other Assets Growth%	(2.4)	0.0		
Demand Deposits Growth%	0.0			
Short-Term Borrowings Growth%	(16.4)	(32.5)	0.5	0.5
Customer Deposits Growth%	0.0	0.0		
Other ST Liabilities Growth%	0.0	0.0		
Long-Term Borrowings Growth%	0.2	0.3	0.3	0.3
Deferred Tax Liability Growth%	0.0	0.0		
Other Long-Term Liabilities Growth%	(6.2)	(9.3)	(4.5)	(4.5)
Shares sold (% of shares out.)	0.0	0.0		
Additional ST debt (1st year)(billions \$)	0.0	0.0		

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EJR 3 yr. Recov. Rate: 64.7%

## ANNUAL INCOME STATEMENTS

Below are Federal National Mortgage 's annual income statements with the projected years based on the assumptions listed on page 3.

### ANNUAL INCOME STATEMENTS (BILLIONS \$, EXCEPT PER SHARE AMOUNTS)

	Dec-12	Dec-13	Dec-14	Dec-15	PDec16	PDec17
Interest Income	129	118	114	109	111	112
Interest Expense	108	95	94	88	88	88
Net Interest Income	22	22	20	21	23	24
Provisions for Loan Losses	-1	-9	-4	-1	-1	0
Trading Account Profit	1	0	0	0	0	0
Commissions & Fees Earned	1	4	6	1	1	1
Other Operating Income	0	1	1	2	2	2
Non-Interest Expense	7	-2	10	9	9	9
Operating Income	18	39	21	16	17	18
Net Non-Operating Loss	1	0	0	0	0	0
Income Tax Expenses		-45	7	5	6	6
Income Before XO Items	17	84	14	11	12	12
Extraordinary Item Net of Tax						
Minority Interests	0	0	0	0	0	0
Consolidated Net Income	17	84	14	11	12	12
Total Cash Preferred Dividends	16	85	15	11	11	11
Net Income	1	-1	-1	0	1	1
Common Dividends						
Total Revenues	132	123	122	112	26	27
Comprehensive Income per Share	0	0	0	0		
Basic EPS Before Abnormal Items	0	0	0	0	0	
Basic EPS Before XO Items	0	0	0	0	0	0
Basic EPS	0	0	0	0	0	0
EBITDA						

### REVENUE & PROFITABILITY

Interest Income (bill \$)	129	118	114	109	111	112
Growth Rate (%)	-9.6	-9.0	-2.7	-4.3	1.2	1.2
Net Interest Income/Total Interest Income (%)	16.6	19.1	17.5	19.6	20.5	21.5
Loan Loss Coverage(%)	0.0	0.0	0.0	0.0	706.3	649.0
Pretax Return On Avg Assets (%)	0.5	1.2	0.6	0.5	0.5	0.6
Oper Return/ Earning Assets (%)	0.3	0.6	0.3	0.3	0.6	0.6
Non-Interest Inc/Revs (%)	6.7	2.7	13.2	9.5	9.5	9.6
Efficiency Ratio(%)	29.7	-6.8	38.2	35.9	34.3	32.9
Return on Assets (%)	0.5	2.6	0.4	0.3	0.4	0.4

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## ANNUAL BALANCE SHEETS

Below are Federal National Mortgage 's balance sheets with the projected years based on the assumptions listed on page 3. As of Dec17, the Company's total cash is assumed to increase from \$48B to \$48B while its Long-Term Borrowings is assumed to decline from \$3.2T to \$3.2T.

### ANNUAL BALANCE SHEETS (BILLIONS \$, EXCEPT PER SHARE AMOUNTS)

#### Base Case

#### ASSETS

	Dec-12	Dec-13	Dec-14	Dec-15	PDec16	PDec17
Cash & Near Cash	89	48	55	46	47	48
Accounts & Notes Receivable	13	10	10	9	9	9
Marketable Secs. & ST Investments						
Loans & Mortgages	3,008	3,070	3,055	3,042	3,044	3,045
Real Estate Investments					0	0
Other Long-Term Investments	136	108	93	87	84	81
Long-Term Investments before Reserves	3,203	3,221	3,183	3,158	3,128	3,126
Loan Loss Reserves	59	44	36	28	28	29
Loans Net of Reserves	3,085	3,134	3,112	3,102	3,100	3,098
Net Fixed Assets	10	12	11	7	7	7
Other Assets					59	59
Additional Assets	25	66	61	59		
Total Assets	<u>3,222</u>	<u>3,270</u>	<u>3,248</u>	<u>3,222</u>	<u>3,222</u>	<u>3,220</u>
Earning Assets	6,047	6,170	6,141	6,125	3,128	3,126

#### LIABILITIES

Demand Deposits						
Short-Term Borrowings	212	164	107	72	72	72
Customer Deposits						
Other ST Liabilities					0	0
Long-Term Borrowings	2,978	3,070	3,116	3,126	3,126	3,124
Deferred Tax Liability						
Other Long-Term Liabilities	26	26	22	20	19	18
Other Liabilities						
Total Liabilities	<u>3,215</u>	<u>3,261</u>	<u>3,244</u>	<u>3,218</u>	<u>3,217</u>	<u>3,215</u>
Total Preferred Equity	136	136	136	136	136	136
Minority Interest	0	0	0	0	0	0
Share Capital & APIC	1	1	1	1	1	1
Retained Earnings & Other Equity	-130	-127	-133	-133	-132	-131
Total Shareholders' Equity	<u>7</u>	<u>10</u>	<u>4</u>	<u>4</u>	<u>5</u>	<u>6</u>
Total Liabilities & Equity	<u>3,222</u>	<u>3,270</u>	<u>3,248</u>	<u>3,222</u>	<u>3,222</u>	<u>3,221</u>
Shares Outstanding			5,762	5,762	5,762	5,762

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## Comments on the Difference between the Model and Assigned Rating

In this case, there has been little change in the recent results and therefore we have used our best judgement in making adjustments which are reflected in the results for the projected ratings. We have assigned a rating of "A" whereas the ratio-implied rating for the most recent period is "A-"; the median rating for the peers is significantly lower than the Company's rating.

## Changes in Industry Ratios

We have not made any adjustment in the industry ratios at this time.

## CUSIPs and EJR rating

TT3169600 rated A; EI9999620 rated A; EH3329412 rated A; EF1442054 rated A; 31398AZZ8 rated A; 31398AZV7 rated A; 31398AZ54 rated A; 31398AAY2 rated A; 31398AXJ6 rated A; 31398AX31 rated A; 31398AVZ2 rated A; 31398AVD1 rated A; 31398AUJ9 rated A; 31398AU34 rated A; 31398AT44 rated A; 31398ASD5 rated A; 31398ANQ1 rated A; 31398AMT6 rated A; 31398AMH2 rated A; 31398A6D9 rated A; 31398A6C1 rated A; 31398A6A5 rated A; 31398A5Z1 rated A; 31398A5W8 rated A; 31398A5R9 rated A; 31398A4S8 rated A; 31398A4N9 rated A; 31398A4M1 rated A; 31398A4K5 rated A; 31398A4H2 rated A; 31398A3T7 rated A; 31398A3R1 rated A; 31398A3L4 rated A; 31398A3K6 rated A; 31398A3J9 rated A; 31398A3G5 rated A; 31398A3A8 rated A; 31398A2W1 rated A; 31398A2S0 rated A; 31398A2M3 rated A; 3136G1WM7 rated A; 3136G1WA3 rated A; 3136G1VW6 rated A; 3136G1VK2 rated A; 3136G1VB2 rated A; 3136G1VA4 rated A; 3136G1V63 rated A; 3136G1UY3 rated A; 3136G1UV9 rated A; 3136G1U56 rated A; 3136G1U31 rated A; 3136G1T33 rated A; 3136G1SY6 rated A; 3136G1SX8 rated A; 3136G1SE0 rated A; 3136G1S34 rated A; 3136G1RS0 rated A; 3136G1RJ0 rated A; 3136G1Q44 rated A; 3136G1PV5 rated A; 3136G1PT0 rated A; 3136G1PD5 rated A; 3136G1PB9 rated A; 3136G1P37 rated A; 3136G1NV7 rated A; 3136G1NU9 rated A; 3136G1NT2 rated A; 3136G1NS4 rated A; 3136G1NR6 rated A; 3136G1NQ8 rated A; 3136G1NP0 rated A; 3136G1NN5 rated A;

**SEC Rule 17g-7(a) Disclosure**

Below are the disclosures as required by Paragraph (a) of Rule 17g-7.

**1. The symbol in the rating scale used to denote the credit rating categories and notches within categories and the identity of the obligor, security, or money market instrument as required by Paragraph (a)(1)(ii)(A) of Rule 17g-7:**

For the issuer FEDERAL NATIONAL MORTGAGE with the ticker of FNMA we have assigned the senior unsecured rating of A. There are three notches in our rating categories (e.g., A-, A, and A+) other than those deep into speculative grade; for CC, C, and D there are no notches.

**2. The version of the procedure or methodology used to determine the credit rating as required by Paragraph (a)(1)(ii)(B) of Rule 17g-7:**

We are using the methodology available in our Form NRSRO Exhibit #2 dated Nov. 10, 2015 available via [egan-jones.com](http://egan-jones.com) under the tab at the bottom of the page "Methodologies".

**3. The main assumptions and principles used in constructing the procedures and methodologies used to determine the credit rating as required by Paragraph (a)(1)(ii)(C) of Rule 17g-7:**

The credit rating assigned reflects our judgement regarding the future credit quality of the issuer. Regarding the specific assumptions used, please refer to page 3 of this Rating Analysis Report.

**4. The potential limitations of the credit rating as required by Paragraph (a)(1)(ii)(D) of Rule 17g-7:**

Our rating pertains solely to our view of current and prospective credit quality. Our rating does not address pricing, liquidity, or other risks associated with holding investments in the issuer.

**5. Information on the uncertainty of the credit rating as required by Paragraph (a)(1)(ii)(E) of Rule 17g-7:**

Our rating is dependant on numerous factors including the reliability, accuracy, and quality of the data relied used in determining the credit rating. The data is sourced from publicly-available 10Q and 10K statements, quarterly reports, 8K filings, earnings reports, and other similar sources. In some cases, the information is limited because of issues such as short operating histories, the lack of reported data, a delay in reporting data, restatements, inaccurate accounting, and other issues. Such shortcomings are not always readily apparent. EJR aims to identify such shortcomings and make adjustments using its best judgement.

**6. Whether and to what extent third-party due diligence services have been used in taking the rating action as required by Paragraph (a)(1)(ii)(F) of Rule 17g-7:**

EJR does not utilize third-party due diligence services.

**7. How servicer or remittance reports were used, and with what frequency, to conduct surveillance of the credit rating as required by Paragraph (a)(1)(ii)(G) of Rule 17g-7:**

Servicer or remittance reports normally pertain to structured finance issuers; this report does not pertain to a structured finance issuer (EJR is not an NRSRO for structured finance or sovereigns/ municipal issuers). Regarding surveillance, the minimum time period for corporation issuers is normally one year.

**8. A description of the data that were relied upon for the purpose of determining the credit rating as required by Paragraph (a)(1)(ii)(H) of Rule 17g-7:**

EJR uses 10Q and 10K statements, quarterly reports, 8K filings, earnings reports, and other similar sources for ratings on publicly-traded issuers. In the case of private issuers, EJR relies on information provided mainly by issuers.

**9. A statement containing an overall assessment of the quality of information available and considered in the credit rating as required by Paragraph (a)(1)(ii)(I) of Rule 17g-7: The information is generally high quality and readily avail.****10. Information relating to conflicts of interest as required by Paragraph (a)(1)(ii)(J) of Rule 17g-7:**

This rating is unsolicited.

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### 11. An explanation or measure of the potential volatility of the credit rating as required by Paragraph (a)(1)(ii)(K) of Rule 17g-7:

Our rating aims to assess the probability of the payment of obligations in full and on-time. Factors which affect such probability, and in turn our rating, include changes in the operating performance of the issuer, changes in capital structure, and merger and acquisition events.

### 12. Information on the content of the credit rating as required by Paragraph (a)(1)(ii)(L) of Rule 17g-7:

Regarding the historical performance of the credit rating, our rating transition matrix is available in our Form NRSRO, exhibit 1. The expected probability of default and the expected loss in the event of default is listed on the first page of this report.

### 13. Information on the sensitivity of the credit rating to assumptions as required by Paragraph (a)(1)(ii)(M) of Rule 17g-7:

Below is a summary of the impact of the 5 assumptions which independently would have the greatest impact on our "ratio-implied rating":

	Assumptions			Resulting Ratio-Implied Rating		
	Base	Optimistic	Pessimistic	Base	Optimistic	Pessimistic
Interest Income Growth%	1.2	5.2	(2.8)	A-	A-	A-
Interest Expense (% of outstanding debt)	2.8	(0.2)	5.8	A-	BBB	BBB
Provisions for Loan Losses(% of earning assets)	(0.0)	(3.0)	3.0	A-	A+	BBB-
Commissions & Fees Earned Growth%	2.0	-	4.0	A-	A-	A-
Loan Loss Reserves (% of Earn. Assets.)	1.1	(0.9)	3.1	A-	A-	A-

### 14. If the credit rating is assigned to an asset-backed security, a description of: (i) the representations, warranties, and enforcement mechanisms available to investors; and (ii) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities, as required by Paragraph (a)(1)(ii)(N) of Rule 17g-7:

This credit rating is not assigned to an asset-backed security.

## ATTESTATION FORM

In compliance with the US Securities and Exchange Commission (SEC) Rule 17g-7(a), the Egan-Jones analyst who published the report is responsible for the rating action and to the best knowledge of the person:

- 1) No part of the credit rating was influenced by any other business activities,
- 2) The credit rating was based solely upon the merits of the obligor, security, or money market instrument being rated, and
- 3) The credit rating was an independent evaluation of the credit risk of the obligor, security, or money market instrument.

**Analyst Signature:**

Mina Ding  
Rating Analyst

**Today's Date**

July 14, 2016

**Reviewer Signature:**

Caroline Ding  
Rating Analyst

**Today's Date**

July 14, 2016