

# SECOND QUARTER 2008

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Richard A. Eason  
Chief Executive Officer



Matthew J. Currin  
Chief Financial Officer



Ronald J. Allen  
Chairman of the Board

August 4, 2008

# Management's Discussion and Analysis of Financial Condition and Results of Operations

*(dollars in thousands)*

The following commentary reviews the financial condition and results of operations of Cape Fear Farm Credit ACA, (Association) for the period ended June 30, 2008. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2007 Annual Report of the Association. The accompanying consolidated financial statements were prepared under the oversight of the Audit Committee of the Board of Directors.

## **LOAN PORTFOLIO**

The Association provides funds to farmers, rural homeowners and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans. The Association's loan portfolio is diversified over a range of agricultural commodities in our region, including tobacco, swine, poultry, and row-crop operations. Farm size varies and many of the borrowers in the region have diversified farming operations. This factor, along with the numerous opportunities for non-farm income in the area, lessens the level of dependency on any single given commodity. Concentration risk is further mitigated by a substantial portfolio of participation loans purchased or originated and sold.

The gross loan volume of the Association as of June 30, 2008 was \$769,610, an increase of \$65,930 as compared to \$703,680 at December 31, 2007. Net loans outstanding at June 30, 2008, were \$765,223 as compared to \$699,687 at December 31, 2007. Net loans accounted for 92.42 percent of total assets at June 30, 2008, as compared to 90.96 percent of total assets at December 31, 2007.

The increase in gross and net loan volume during the reporting period is attributed to a general increase in lending activity including seasonal lending sufficient to reflect overall growth despite significant paydowns from assignments on contract grower loans. The short-term portfolio, which is heavily influenced by operating-type loans, normally reaches a peak in August and rapidly declines in the fall months as farm commodities are marketed and proceeds are applied to the operating loans.

There is an inherent risk in the extension of any type of credit. Portfolio credit quality continues to be maintained at an acceptable level, however, and credit administration remains satisfactory. Nonaccrual loans decreased from \$5,430 at December 31, 2007 to \$5,159 at June 30, 2008. This decrease is due to the liquidation of one large nonaccrual loan in the month of April.

Association management maintains an allowance for loan losses in an amount considered sufficient to absorb possible

losses in the loan portfolio based on current and expected future conditions. The allowance for loan losses at June 30, 2008 was \$4,387, an increase of \$394 from the December 31, 2007 amount of \$3,993. This increase is primarily due to growth in the portfolio in the past two quarters and was considered by management to be adequate to cover possible losses.

## **RESULTS OF OPERATIONS**

### **For the three months ended June 30, 2008**

Net income for the three months ended June 30, 2008 totaled \$4,856 as compared to \$4,732 for the same period in 2007. The increase of \$124 or 2.62 percent is attributed to an increase in net interest income resulting from growth in loan volume and also noninterest income in the areas of loan fees and equity earnings in other Farm Credit institutions.

Net interest income for the three months ended June 30, 2008 increased \$426 or 7.72 percent compared to June 30, 2007. Interest income on loans decreased by \$558 and interest income from other sources increased by \$21, while interest expense decreased \$969 compared to the same period last year. The increase in net interest income was a result of favorable pricing opportunities during the period. Nonaccrual income was \$125 for the three months ended June 30, 2008, as compared to \$19 for the same period in 2007.

Noninterest income for the three months ended June 30, 2008 totaled \$2,495 as compared to \$2,351 for the same period of 2007, an increase of \$144. The increase resulted from an increase of \$226 in patronage earnings from AgFirst Farm Credit Bank (Bank) and an increase of \$19 in fees for financially related services. These increases were offset by decreases of \$100 in loan fee income and \$1 in other noninterest income.

Noninterest expense for the three months ended June 30, 2008 increased \$313 compared to the same period of 2007. This increase resulted from increases of \$197 in salaries and benefits, \$14 in occupancy and equipment expense, \$29 in the Insurance Fund premium, and \$73 in other operating expenses.

### **For the six months ended June 30, 2008**

Net income for the six months ended June 30, 2008 totaled \$11,176 as compared to \$9,614 for the same period in 2007. The increase of \$1,562 or 16.25 percent is attributed primarily to an increase in net interest income resulting from growth in loan volume and an increase in noninterest income.

At June 30, 2008, net interest income increased \$1,056 or 9.74 percent compared to June 30, 2007. Interest income on loans

increased by \$264 and interest income from other sources increased by \$23, while interest expense decreased \$769 compared to the same period last year. The increase in interest income was due to the growth in loan volume and interest bearing assets that offset a reduction in interest rates. The reduction in interest expense was due to the reduction in yields on notes payable outstanding to AgFirst Farm Credit Bank (Bank). Nonaccrual income was \$251 for the six months ended June 30, 2008, as compared to \$82 for the same period in 2007.

Noninterest income for the six months ended June 30, 2008 totaled \$5,466 as compared to \$4,556 for the same period of 2007, an increase of \$910. The increase resulted from an increase of \$442 in patronage earnings from the Bank, \$501 in loan fee income, and \$4 in fees for financially related services. These increases were offset by declines of \$33 in other noninterest income and \$4 in gains on other property owned.

Noninterest expense for the six months ended June 30, 2008 increased \$271 compared to the same period of 2007. This increase resulted primarily from increases of \$36 in occupancy and equipment expense, \$61 in the Insurance Fund premium, and \$189 in other operating expenses. These increases were offset by a decrease in salaries and employee benefits of \$15.

## FUNDING SOURCES

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate note is utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate note is used specifically to fund fixed rate loan advances made by the Association. The total notes payable to the Bank at June 30, 2008, were \$709,138 as compared to \$641,059 at December 31, 2007.

## CAPITAL RESOURCES

Total members' equity at June 30, 2008 increased to \$108,121 from the December 31, 2007 total of \$102,502. The increase results primarily from earnings retained from the prior year in excess of the current year rollout of allocated surplus.

Farm Credit Administration (FCA) regulations require all Farm Credit institutions to maintain minimum permanent capital, total surplus and core surplus ratios. These ratios are calculated by dividing the Association's permanent capital, total surplus and core surplus as defined in FCA regulations, by a risk-adjusted asset base. As of June 30, 2008, the Association's total surplus ratio and core surplus ratio were 11.95 percent and 11.40 percent, respectively, and the permanent capital ratio was 12.29 percent. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

**NOTE:** Shareholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of AgFirst's annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 378, or writing Stephen Gilbert, AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained at their website, [www.agfirst.com](http://www.agfirst.com). Copies of the Association's annual and quarterly reports are also available upon request free of charge by calling 1-800-368-5819 ext. 3243, writing Matthew J. Currin, Cape Fear Farm Credit, P. O. Box 2405, Fayetteville, NC 28302, or accessing the website, [www.capefearfarmcredit.com](http://www.capefearfarmcredit.com). The Association prepares a quarterly report within 40 days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution.

*Cape Fear Farm Credit, ACA*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>June 30, 2008</b> <i>(unaudited)</i>	<b>December 31, 2007</b> <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 2,204	\$ 2,102
Loans	769,610	703,680
Less: allowance for loan losses	4,387	3,993
Net loans	765,223	699,687
Other investments	27,576	29,430
Accrued interest receivable	10,874	12,057
Investment in other Farm Credit institutions	10,259	10,259
Premises and equipment, net	3,440	3,490
Other property owned	95	95
Due from AgFirst Farm Credit Bank	3,208	6,799
Other assets	5,133	5,308
Total assets	<u>\$ 828,012</u>	<u>\$ 769,227</u>
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 709,138	\$ 641,059
Accrued interest payable	2,663	3,084
Patronage refund payable	106	11,579
Other liabilities	7,984	11,003
Total liabilities	<u>719,891</u>	<u>666,725</u>
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower equity	87	124
Capital stock and participation certificates	2,615	2,542
Retained earnings		
Allocated	11,367	16,631
Unallocated	94,382	83,542
Accumulated other comprehensive income (loss)	(330)	(337)
Total members' equity	<u>108,121</u>	<u>102,502</u>
Total liabilities and members' equity	<u>\$ 828,012</u>	<u>\$ 769,227</u>

*The accompanying notes are an integral part of these financial statements.*

*Cape Fear Farm Credit, ACA*

# Consolidated Statements of Income

*(unaudited)*

<i>(dollars in thousands)</i>	For the three months ended June 30,		For the six months ended June 30,	
	2008	2007	2008	2007
<b>Interest Income</b>				
Loans	\$ 13,585	\$ 14,143	\$ 27,537	\$ 27,273
Other	417	402	812	789
Total interest income	14,002	14,545	28,349	28,062
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	8,060	9,029	16,456	17,225
Net interest income	5,942	5,516	11,893	10,837
Provision for (reversal of allowance for) loan losses	385	252	385	252
Net interest income after provision for (reversal of allowance for) loan losses	5,557	5,264	11,508	10,585
<b>Noninterest Income</b>				
Loan fees	710	810	2,080	1,579
Fees for financially related services	42	23	99	95
Equity in earnings of other Farm Credit institutions	1,660	1,434	3,221	2,779
Gains (losses) on other property owned, net	1	1	(1)	3
Other noninterest income	82	83	67	100
Total noninterest income	2,495	2,351	5,466	4,556
<b>Noninterest Expense</b>				
Salaries and employee benefits	2,148	1,951	3,660	3,675
Occupancy and equipment	194	180	392	356
Insurance Fund premium	272	243	531	470
Other operating expenses	582	509	1,215	1,026
Total noninterest expense	3,196	2,883	5,798	5,527
Income before income taxes	4,856	4,732	11,176	9,614
Provision (benefit) for income taxes	—	—	—	—
Net income	\$ 4,856	\$ 4,732	\$ 11,176	\$ 9,614

*The accompanying notes are an integral part of these financial statements.*

*Cape Fear Farm Credit, ACA*

# Consolidated Statements of Changes in Members' Equity

*(unaudited)*

*(dollars in thousands)*

	Protected Borrower Capital	Capital Stock and Participation Certificates	Retained Earnings		Accumulated Other Comprehensive Income	Total Members' Equity
			Allocated	Unallocated		
Balance at December 31, 2006	\$ 204	\$ 2,333	\$ 15,881	\$ 81,145	\$ (358)	\$ 99,205
Net income				9,614		9,614
Protected borrower equity retired	(63)					(63)
Capital stock/participation certificates issued/(retired), net		139				139
Retained earnings retired			(5,991)			(5,991)
Patronage distribution adjustment			—	8		8
Balance at June 30, 2007	\$ 141	\$ 2,472	\$ 9,890	\$ 90,767	\$ (358)	\$ 102,912
Balance at December 31, 2007	\$ 124	\$ 2,542	\$ 16,631	\$ 83,542	\$ (337)	\$ 102,502
Net income				11,176		11,176
Protected borrower equity retired	(37)					(37)
Capital stock/participation certificates issued/(retired), net		73				73
Retained earnings retired			(5,651)			(5,651)
Patronage distribution adjustment			387	(327)		60
Employee benefit plans adjustments				(9)	7	(2)
Balance at June 30, 2008	\$ 87	\$ 2,615	\$ 11,367	\$ 94,382	\$ (330)	\$ 108,121

*The accompanying notes are an integral part of these financial statements.*

## Cape Fear Farm Credit, ACA

# Notes to the Consolidated Financial Statements

(dollars in thousands, except as noted)  
(unaudited)

### NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements include the accounts of Cape Fear Farm Credit, ACA (the Association). A description of the organization and operations of the Association, the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2007, are contained in the 2007 Annual Report to Shareholders. These unaudited second quarter 2008 consolidated financial statements should be read in conjunction with the 2007 Annual Report to Shareholders.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles (GAAP) and prevailing practices within the banking industry. The results for the six months ended June 30, 2008, are not necessarily indicative of the results to be expected for the year ending December 31, 2008.

Certain amounts in the prior period's consolidated financial statements may have been reclassified to conform to the current period's consolidated financial statement presentation. Such reclassifications had no effect on the prior period net income or total capital as previously reported.

The Association maintains an allowance for loan losses in accordance with GAAP. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of June 30, 2008, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

In December 2007, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141R, "Business Combinations" (SFAS 141R). SFAS 141R requires business combinations to be accounted for under the acquisition method of accounting (previously called the purchase method). The acquisition method requires (a) identifying the acquirer, (b) determining the acquisition date, (c) recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, at their acquisition date fair values, and (d) recognizing and measuring goodwill or a gain from a bargain purchase. SFAS 141R should be applied prospectively to business combinations for which the

acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early application is prohibited. The Association is still evaluating the provisions of SFAS 141R, but believes that its adoption will significantly impact its accounting for combinations/acquisitions that may occur in 2009 and beyond.

### NOTE 2 – ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

	For the six months ended June 30,	
	2008	2007
Balance at beginning of period	\$ 3,993	\$ 3,607
Provision for (reversal of) loan losses	385	252
Loans (charged off), net of recoveries	9	21
Balance at end of period	<u>\$ 4,387</u>	<u>\$ 3,880</u>

### NOTE 3 – EMPLOYEE BENEFIT PLANS

The following is a table of retirement and other postretirement benefit expenses for the Association:

	For the six months ended June 30,	
	2008	2007
Pension	\$ 194	\$ 291
401(k)	101	102
Other postretirement benefits	170	193
Total	<u>\$ 465</u>	<u>\$ 586</u>

The following is a table of retirement and other postretirement benefit contributions for the Association:

	Actual YTD Through 6/30/08	Projected Contributions For Remainder of 2008	Projected Total Contributions 2008
Pension	\$ 14	\$ 14	\$ 28
Other postretirement benefits	122	110	232
Total	<u>\$ 136</u>	<u>\$ 124</u>	<u>\$ 260</u>

Market conditions could impact discount rates and return on plan assets which could change the above contribution projections by making additional contributions necessary before the next plan measurement date.

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In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS 158)*, which required the recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. The balance sheet recognition provisions of SFAS 158 were adopted at December 31, 2007 by the Association.

SFAS 158 also requires that employers measure the benefit obligation and plan assets as of the fiscal year end for fiscal years ending after December 15, 2008. In fiscal 2007 and earlier, a September 30 measurement date was used for pension and other postretirement benefit plans. The Standard provides two approaches for an employer to transition to a fiscal year end measurement date. The approach applied by the Association allows for the use of the measurements determined for the prior year end. Under this alternative, pension and other postretirement benefit expense measured for the three-month period October 1, 2007 to December 31, 2007 (determined using the September 30, 2007 measurement date) is reflected as an adjustment to beginning 2008 unallocated retained earnings. As a result, the Association decreased unallocated retained earnings and increased the pension liability by \$9 thousand.

Upon adoption, SFAS 158 further required the determination of the fair value of plan assets and recognition of actuarial gains and losses, prior service costs or credits, and transition assets or obligations as a component of accumulated other comprehensive income (AOCI). These amounts are subsequently recognized as components of net periodic benefit costs. For the first six months of 2008, \$7 thousand has been recognized as a credit to accumulated other comprehensive income and a debit to pension expense to reflect the amortization of the components previously recognized in AOCI.

Further details regarding employee benefit plans and adoption of SFAS 158 are contained in the 2007 Annual Report to Shareholders.