

# SECOND QUARTER 2007

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Richard A. Eason  
Chief Executive Officer



Ronald J. Allen  
Chairman of the Board

July 27, 2007

# 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, 2007. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2006 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, 2007 was \$695,924, an increase of \$65,517 as compared to \$630,407 at December 31, 2006. Net loans outstanding at June 30, 2007, were \$692,044 as compared to \$626,800 at December 31, 2006. Net loans accounted for 91.98 percent of total assets at June 30, 2007, as compared to 90.90 percent of total assets at December 31, 2006.

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 increased from \$921 at December 31, 2006 to \$2,454 at June 30, 2007. This increase

results primarily from the transfer of two loans into nonaccrual status during the first two quarters of 2007.

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, 2007 was \$3,880, an increase of \$273 from the December 31, 2006 amount of \$3,607. 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, 2007***

Net income for the three months ended June 30, 2007 totaled \$4,732 as compared to \$4,018 for the same period in 2006. The increase of \$714 or 17.77 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, 2007 increased \$763 or 16.06 percent compared to June 30, 2006. Interest income on loans increased by \$2,914 and interest income from other sources increased by \$30, while interest expense increased \$2,181 compared to the same period last year. These increases are both due to a growth in loan volume and other interest bearing assets. Nonaccrual income was \$19 for the three months ended June 30, 2007, as compared to \$13 for the same period in 2006.

Noninterest income for the three months ended June 30, 2007 totaled \$2,351 as compared to \$1,743 for the same period of 2006, an increase of \$608. The increase resulted from an increase of \$306 in patronage earnings from AgFirst Farm Credit Bank (Bank), an increase of \$223 in loan fee income, and an increase of \$86 in other noninterest income. These increases were offset by a decline of \$6 in fees for financially related services and a decline of \$1 in gains on other property owned.

Noninterest expense for the three months ended June 30, 2007 increased \$405 compared to the same period of 2006. This increase resulted primarily from increases of \$268 in salaries and benefits, \$15 in occupancy and equipment expense, \$40 in the Insurance Fund premium, and \$82 in other operating expenses.

### **For the six months ended June 30, 2007**

Net income for the six months ended June 30, 2007 totaled \$9,614 as compared to \$7,900 for the same period in 2006. The increase of \$1,714 or 21.70 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, 2007, net interest income increased \$1,599 or 17.31 percent compared to June 30, 2006. Interest income on loans increased by \$5,938 and interest income from other sources increased by \$91, while interest expense increased \$4,430 compared to the same period last year. These increases are both due to growth in loan volume and other interest bearing assets. Nonaccrual income was \$82 for the six months ended June 30, 2007, as compared to \$91 for the same period in 2006.

Noninterest income for the six months ended June 30, 2007 totaled \$4,556 as compared to \$3,693 for the same period of 2006, an increase of \$863. The increase resulted from an increase of \$582 in patronage earnings from AgFirst Farm Credit Bank (Bank), an increase of \$245 in loan fee income, and an increase of \$39 in other noninterest income. These increases were offset by a decline of \$2 in fees for financially related services and a decline of \$1 in gains on other property owned.

Noninterest expense for the six months ended June 30, 2007 increased \$515 compared to the same period of 2006. This increase resulted primarily from increases of \$295 in salaries and benefits, \$3 in occupancy and equipment expense, \$79 in the Insurance Fund premium, and \$138 in other operating expenses.

### **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, 2007, were \$637,616 as compared to \$563,329 at December 31, 2006.

### **CAPITAL RESOURCES**

Total members' equity at June 30, 2007 increased to \$102,912 from the December 31, 2006 total of \$99,205. 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, 2007, the Association's total surplus ratio and core surplus ratio were 12.81 percent and 11.39 percent, respectively, and the permanent capital ratio was 13.17 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.

### **ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLANS**

On September 29, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 158 – Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans. The Standard requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Standard is effective for employers with publicly traded securities for the fiscal year ending after December 15, 2006 and for employers without publicly traded securities for the fiscal year ending after June 15, 2007. The Association will be required to implement the Standard for the year ended December 31, 2007. In addition, this Standard requires that the funded status of a plan be measured as of the date of the year-end financial statements. Currently, the Association uses a measurement date of September 30th. The requirement to measure the funded status as of the fiscal year-end is effective for fiscal years ending after December 15, 2008. The Association is currently evaluating the impact of implementing this Standard. It is anticipated that the impact from the implementation of this Standard will have no impact on the consolidated income statement and, based on the current funded status of the defined benefit plans, it is not expected to have a material or significant impact on the consolidated balance sheet.

**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. 316, or writing Wanda Martin, 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, Chief Financial Officer, 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 45 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>	June 30, 2007 <i>(unaudited)</i>	December 31, 2006 <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 2,041	\$ 1,529
Loans	695,924	630,407
Less: allowance for loan losses	3,880	3,607
Net loans	692,044	626,800
Other investments, held to maturity	26,179	27,484
Accrued interest receivable	11,993	10,704
Investment in other Farm Credit institutions	8,370	8,370
Premises and equipment, net	3,553	3,261
Prepaid retirement expense	4,805	5,078
Due from AgFirst Farm Credit Bank	2,762	5,701
Other assets	639	645
Total assets	<u>\$ 752,386</u>	<u>\$ 689,572</u>
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 637,616	\$ 563,329
Accrued interest payable	3,102	2,736
Patronage refund payable	114	9,023
Postretirement benefits other than pensions	4,087	3,995
Minimum pension liability	377	372
Other liabilities	4,178	10,912
Total liabilities	<u>649,474</u>	<u>590,367</u>
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower equity	141	204
Capital stock and participation certificates	2,472	2,333
Retained earnings		
Allocated	9,890	15,881
Unallocated	90,767	81,145
Accumulated other comprehensive income (loss)	(358)	(358)
Total members' equity	<u>102,912</u>	<u>99,205</u>
Total liabilities and members' equity	<u>\$ 752,386</u>	<u>\$ 689,572</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,	
	2007	2006	2007	2006
<b>Interest Income</b>				
Loans	\$ 14,143	\$ 11,229	\$ 27,273	\$ 21,335
Other	402	372	789	698
Total interest income	14,545	11,601	28,062	22,033
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	9,029	6,848	17,225	12,795
Net interest income	5,516	4,753	10,837	9,238
Provision for (reversal of allowance for) loan losses	252	—	252	—
Net interest income after provision for (reversal of allowance for) loan losses	5,264	4,753	10,585	9,238
<b>Noninterest Income</b>				
Loan fees	810	587	1,579	1,334
Fees for financially related services	23	29	95	97
Equity in earnings of other Farm Credit institutions	1,434	1,128	2,779	2,197
Gains (losses) on other property owned, net	1	2	3	4
Other noninterest income	83	(3)	100	61
Total noninterest income	2,351	1,743	4,556	3,693
<b>Noninterest Expense</b>				
Salaries and employee benefits	1,951	1,683	3,675	3,380
Occupancy and equipment	180	165	356	353
Insurance Fund premium	243	203	470	391
Other operating expenses	509	427	1,026	888
Total noninterest expense	2,883	2,478	5,527	5,012
Income before income taxes	4,732	4,018	9,614	7,919
Provision (benefit) for income taxes	—	—	—	19
Net income	\$ 4,732	\$ 4,018	\$ 9,614	\$ 7,900

*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, 2005	\$ 269	\$ 2,154	\$ 22,035	\$ 72,268	\$ (404)	\$ 96,322
Net income				7,900		7,900
Protected borrower equity retired	(54)					(54)
Capital stock/participation certificates issued		198				198
Capital stock/participation certificates retired		(106)				(106)
Retained earnings retired			(6,150)			(6,150)
Distribution adjustment			3	139		142
Balance at June 30, 2006	\$ 215	\$ 2,246	\$ 15,888	\$ 80,307	\$ (404)	\$ 98,252
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		235				235
Capital stock/participation certificates retired		(96)				(96)
Retained earnings retired			(5,991)			(5,991)
Distribution adjustment			—	8		8
Balance at June 30, 2007	\$ 141	\$ 2,472	\$ 9,890	\$ 90,767	\$ (358)	\$ 102,912

*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

A description of the organization and operations of Cape Fear Farm Credit, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2006, are contained in the 2006 Annual Report to Shareholders. These unaudited second quarter 2007 consolidated financial statements should be read in conjunction with the 2006 Annual Report to Shareholders.

On September 29, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 158 – Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans. The Standard requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Standard is effective for employers with publicly traded securities for the fiscal year ending after December 15, 2006 and for employers without publicly traded securities for the fiscal year ending after June 15, 2007. The Association will be required to implement the Standard for the year ended December 31, 2007. In addition, this Standard requires that the funded status of a plan be measured as of the date of the year-end financial statements. Currently, the Association uses a measurement date of September 30th. The requirement to measure the funded status as of the fiscal year-end is effective for fiscal years ending after December 15, 2008. The Association is currently evaluating the impact of implementing this Standard. It is anticipated that the impact from the implementation of this Standard will have no impact on the consolidated income statement and, based on the current funded status of the defined benefit plans, it is not expected to have a material or significant impact on the consolidated balance sheet.

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. The results for the six months ended June 30, 2007, are not necessarily indicative of the results to be expected for the year ending December 31, 2007.

Certain amounts in prior period consolidated financial statements may have been reclassified to conform to current 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 generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the

adequacy of the allowance for losses. As of June 30, 2007, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

### NOTE 2 – ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

	For the six months ended June 30,	
	2007	2006
Balance at beginning of period	\$ 3,607	\$ 3,434
Provision for (reversal of) loan losses	252	–
Recoveries, net of loans charged off	21	–
Balance at end of period	<u>\$ 3,880</u>	<u>\$ 3,434</u>

### NOTE 3 – EMPLOYEE BENEFIT PLANS

The Association participates in a Districtwide defined benefit retirement plan. The costs of the plan are not segregated by participating entities but are allocated among the participating entities. Pension costs are allocated by multiplying the District's net pension expense times each institution's salary expense as a percentage of the District's salary expense. The Association also participates in Districtwide Thrift and other postretirement benefit plans.

The following is a table of retirement and postretirement benefit expense:

	For the six months ended June 30,	
	2007	2006
Pension	\$ 291	\$ 373
Thrift/deferred compensation	102	74
Other postretirement benefits	193	200
Total	<u>\$ 586</u>	<u>\$ 647</u>

As of June 30, 2007, no contributions have been made to the pension plan for 2007. Actuarial projections as of the last plan measurement date (September 30, 2006) did not anticipate any contributions for 2007; however, market conditions could impact discount rates and return on plan assets which could change this expectation, making contributions necessary before the next plan measurement date.

The Association also sponsors a supplemental retirement plan for certain key employees. The expenses of this plan are included in the pension costs above. The Association contributed \$14 to this plan during the first six months of 2007. The Association anticipates making additional contributions of \$14 to the supplemental retirement plan during the remainder of 2007.