

# SECOND QUARTER 2005

Management's Discussion and Analysis of Financial Condition and Results of Operations.....	2
Consolidated Financial Statements	
Consolidated Balance Sheets.....	4
Consolidated Statements of Income.....	5
Consolidated Statements of Changes in Members' Equity.....	6
Notes to the Consolidated Financial Statements.....	7



Richard A. Eason  
Chief Executive Officer



Ronald J. Allen  
Chairman of the Board

July 29, 2005

# 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, 2005. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2004 Annual Report of the Association.

## **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, 2005, was \$512,785, an increase of \$36,565 as compared to \$476,220 at December 31, 2004. Net loans outstanding at June 30, 2005, were \$509,348 as compared to \$472,713 at December 31, 2004. Net loans accounted for 95.16 percent of total assets at June 30, 2005, as compared to 94.23 percent of total assets at December 31, 2004.

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 \$1,399 at December 31, 2004, to \$2,053 at June 30, 2005. This increase results primarily from the transfer of one loan to nonaccrual status.

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, 2005, was \$3,437 compared to \$3,507 at December 31, 2004, and was considered by management to be adequate to cover possible losses. The decline results primarily from a reduction in the allowance based on updated analysis of risk in the loan portfolio.

## **RESULTS OF OPERATIONS**

### ***For the three months ended June 30, 2005***

Net income for the three months ended June 30, 2005, totaled \$3,496 as compared to \$3,312 for the same period in 2004. The increase of \$184 or 5.56 percent is attributed primarily to an increase in net interest income resulting from growth in loan volume and an increase in market interest rates.

Net interest income for the three months ended June 30, 2005, increased \$250 or 6.70 percent compared to June 30, 2004. Interest income on loans increased by \$1,406 while interest expense increased \$1,156 compared to the same period last year due, both due primarily to increases in market interest rates. Nonaccrual income was \$21 for the three months ended June 30, 2005, as compared to \$27 for the same period in 2004.

Noninterest income for the three months ended June 30, 2005, totaled \$1,666 as compared to \$1,711 for the same period of 2004, a decline of \$45. The decline resulted from a decline of \$89 in patronage earnings from AgFirst Farm Credit Bank (Bank), a decline of \$1 in gains on other

property owned, and a decline of \$40 in other noninterest income, offset in part by an increase in loan fee income of \$58 and an increase of \$27 in fees for financially related services.

Noninterest expense for the three months ended June 30, 2005, increased \$26 compared to the same period of 2004. This increase resulted primarily from an increase of \$11 in occupancy and equipment expense and an increase of \$97 in other operating expense, offset in part by a decline of \$13 in salaries and benefits and a decline in Insurance Fund premium of \$69.

#### ***For the six months ended June 30, 2005***

Net income for the six months ended June 30, 2005, totaled \$6,984 as compared to \$6,912 for the same period in 2004. The increase of \$72 or 1.04 percent is attributed primarily to an increase in net interest income resulting from growth in loan volume and an increase in market interest rates.

At June 30, 2005, net interest income increased \$151 or 1.93 percent compared to June 30, 2004. Interest income on loans increased by \$2,052 while interest expense increased \$1,901 compared to the same period last year due, both due primarily to increases in market interest rates. Nonaccrual income was \$242 for the six months ended June 30, 2005, as compared to \$555 for the same period in 2004.

Noninterest income for the six months ended June 30, 2005, totaled \$3,349 as compared to \$3,379 for the same period of 2004, a decline of \$30. The decline resulted from a decline of \$204 in patronage earnings from the Bank, a decline of \$1 in gains on other property owned, and a decline of \$39 in other noninterest income, offset in part by an increase in loan fee income of \$167 and an increase of \$47 in fees for financially related services.

Noninterest expense for the six months ended June 30, 2005, increased \$54 compared to the same period of 2004. This increase resulted primarily from an increase of \$22 in salaries and benefits, an increase of \$3 in occupancy and equipment expense and an increase of \$168 in other operating expense, offset in part by a decline in Insurance Fund premium of \$139.

## **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, 2005, was \$431,840 as compared to \$393,652 at December 31, 2004.

## **CAPITAL RESOURCES**

Total members' equity at June 30, 2005, increased to \$94,372 from the December 31, 2004, total of \$93,621. 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, 2005, the Association's total surplus ratio and core surplus ratio were 16.74 percent and 13.19 percent, respectively, and the permanent capital ratio was 17.17 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.

**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 Jay Wise, 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 910-323-9188, writing Henry McDuffie, 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>	<b>June 30, 2005</b> <i>(unaudited)</i>	<b>December 31, 2004</b> <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 1,053	\$ 2,052
Loans	512,785	476,220
Less: allowance for loan losses	3,437	3,507
Net loans	509,348	472,713
Accrued interest receivable	7,547	5,466
Investment in other Farm Credit institutions	6,009	6,009
Premises and equipment, net	3,449	3,472
Other assets	7,871	11,932
Total assets	\$ 535,277	\$ 501,644
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 431,840	\$ 393,652
Accrued interest payable	1,548	1,277
Patronage refund payable	99	5,553
Other liabilities	7,418	7,541
Total liabilities	440,905	408,023
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower equity	297	354
Capital stock and participation certificates	2,118	2,114
Retained earnings		
Allocated	22,036	28,250
Unallocated	70,320	63,302
Accumulated other comprehensive income (loss)	(399)	(399)
Total members' equity	94,372	93,621
Total liabilities and members' equity	\$ 535,277	\$ 501,644

*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>	<b>For the three months ended June 30,</b>		<b>For the six months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Interest Income</b>				
Loans	\$ 8,413	\$ 7,007	\$ 16,328	\$ 14,276
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	4,430	3,274	8,349	6,448
Net interest income	3,983	3,733	7,979	7,828
Provision for (reversal of) loan losses	(65)	—	(65)	—
Net interest income after provision for (reversal of) loan losses	4,048	3,733	8,044	7,828
<b>Noninterest Income</b>				
Loan fees	601	543	1,206	1,039
Fees for financially related services	52	25	159	112
Equity in earnings of other Farm Credit institutions	957	1,046	1,884	2,088
Gains (losses) on other property owned, net	2	3	4	5
Other noninterest income	54	94	96	135
Total noninterest income	1,666	1,711	3,349	3,379
<b>Noninterest Expense</b>				
Salaries and employee benefits	1,488	1,501	3,063	3,041
Occupancy and equipment	173	162	336	333
Insurance Fund premium	48	117	92	231
Other operating expenses	449	352	858	690
Total noninterest expense	2,158	2,132	4,349	4,295
Income before income taxes	3,556	3,312	7,044	6,912
Provision (benefit) for income taxes	60	—	60	—
Net income	\$ 3,496	\$ 3,312	\$ 6,984	\$ 6,912

*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, 2003	\$ 489	\$ 2,057	\$ 35,025	\$ 47,532	\$ (4,497)	\$ 80,606
Net income				6,912		6,912
Protected borrower equity retired	(92)					(92)
Capital stock/participation certificates issued		106				106
Capital stock/participation certificates retired		(79)				(79)
Retained earnings retired			(6,727)			(6,727)
Distribution adjustment			(39)	59		20
Balance at June 30, 2004	\$ 397	\$ 2,084	\$ 28,259	\$ 54,503	\$ (4,497)	\$ 80,746
Balance at December 31, 2004	\$ 354	\$ 2,114	\$ 28,250	\$ 63,302	\$ (399)	\$ 93,621
Net income				6,984		6,984
Protected borrower equity retired	(57)					(57)
Capital stock/participation certificates issued		195				195
Capital stock/participation certificates retired		(191)				(191)
Retained earnings retired			(6,214)			(6,214)
Distribution adjustment			—	34		34
Balance at June 30, 2005	\$ 297	\$ 2,118	\$ 22,036	\$ 70,320	\$ (399)	\$ 94,372

*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, 2004, are contained in the 2004 Annual Report to Shareholders. These unaudited second quarter 2005 consolidated financial statements should be read in conjunction with the 2004 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. The results for the six months ended June 30, 2005, are not necessarily indicative of the results to be expected for the year ending December 31, 2005.

Certain amounts in prior period consolidated financial statements 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, 2005, 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:

Balance at 12-31-03	\$ 9,993
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	10
Balance at 6-30-04	<u>\$ 10,003</u>
Balance at 12-31-04	\$ 3,507
(Reversal of) provision for loan losses	(65)
Loans (charged off), net of recoveries	<u>(5)</u>
Balance at 6-30-05	<u>\$ 3,437</u>

As discussed in the 2004 Annual Report, the Association recorded a loan loss reversal of \$6,497 in the fourth quarter of 2004 that resulted in a decrease in the allowance for loan losses.

### 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, 2005:

	For the six months ended June 30,	
	2005	2004
Pension	\$ 373	\$ 403
Thrift/deferred compensation	74	57
Other postretirement benefits	309	349
Total	<u>\$ 756</u>	<u>\$ 809</u>

As of June 30, 2005, no contributions have been made to the pension plan for 2005. Actuarial projections as of the last plan measurement date (September 30, 2004) did not anticipate any contributions for 2005; 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.