

# FIRST QUARTER 2005

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Richard A. Eason  
Chief Executive Officer



Lyle Ray King  
Chairman of the Board

April 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 March 31, 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 and poultry. 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, somewhat lessens the level of dependency on any single given commodity.

The gross loan volume of the Association as of March 31, 2005, was \$475,701, a decrease of \$519 as compared to \$476,220 at December 31, 2004. Net loans outstanding at March 31, 2005, were \$472,189 as compared to \$472,713 at December 31, 2004. Net loans accounted for 95.46 percent of total assets at March 31, 2005, as compared to 94.23 percent of total assets at December 31, 2004.

The decline in gross and net loan volume during the reporting period is attributed to a decline in the purchase of loan participations and significant pay-downs 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 \$2,215 at March 31, 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 March 31, 2005, was \$3,512 compared to \$3,507 at December 31, 2004, and was considered by management to be adequate to cover possible losses.

## **RESULTS OF OPERATIONS**

### ***For the three months ended March 31, 2005***

Net income for the three months ended March 31, 2005, totaled \$3,488 as compared to \$3,600 for the same period in 2004. The decrease of \$112 or 3.11 percent is attributed primarily to lower recoveries on nonaccrual loans than in the same period the prior year.

At March 31, 2005, net interest income declined by \$99 or 2.42 percent compared to March 31, 2004. Interest income on loans increased by \$646 as increases in market interest rates offset a decline in recoveries on nonaccrual loans as compared to the prior year. Interest expense increased \$745 compared to the same period last year due primarily to increases in market interest rates. Nonaccrual income was \$220 for the three months ended March 31, 2005, as compared to \$528 for the same period in 2004.

Noninterest income for the three months ended March 31, 2005, totaled \$1,683 as compared to \$1,668 for the same period of 2004, an increase of \$15. The increase resulted from an increase in loan fee income of \$109, an increase of \$20 in fees for financially related services and an increase of \$1 in other noninterest income, offset in part by a decline of \$115 in patronage earnings from AgFirst Farm Credit Bank (Bank).

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Noninterest expense for the three months ended March 31, 2005, increased \$28 compared to the same period of 2004. This increase resulted primarily from an increase of \$35 in salaries and benefits and an increase of \$71 in other operating expense, offset in part by a decline of \$8 in occupancy and equipment expense and a decline in Insurance Fund premium of \$70.

## **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 March 31, 2005, was \$389,598 as compared to \$393,652 at December 31, 2004.

## **CAPITAL RESOURCES**

Total members' equity at March 31, 2005, declined to \$90,937 from the December 31, 2004, total of \$93,621. The decline results from the payment of patronage dividends and rollout of the 1999 series of surplus allocated.

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 March 31, 2005, the Association's total surplus ratio and core surplus ratio were 17.03 percent and 13.17 percent, respectively, and the permanent capital ratio was 17.47 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.

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

<i>(dollars in thousands)</i>	<b>March 31, 2005</b>	<b>December 31, 2004</b>
	<i>(unaudited)</i>	
<b>Assets</b>		
Cash	\$ 329	\$ 2,052
Loans	475,701	476,220
Less: allowance for loan losses	3,512	3,507
Net loans	472,189	472,713
Accrued interest receivable	5,582	5,466
Investment in other Farm Credit institutions	6,009	6,009
Premises and equipment, net	3,397	3,472
Other assets	7,142	11,932
Total assets	\$ 494,648	\$ 501,644
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 389,598	\$ 393,652
Accrued interest payable	1,375	1,277
Patronage refund payable	602	5,553
Other liabilities	12,136	7,541
Total liabilities	403,711	408,023
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower equity	304	354
Capital stock and participation certificates	2,171	2,114
Retained earnings		
Allocated	22,038	28,250
Unallocated	66,823	63,302
Accumulated other comprehensive income (loss)	(399)	(399)
Total members' equity	90,937	93,621
Total liabilities and members' equity	\$ 494,648	\$ 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 March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Interest Income</b>		
Loans	\$ 7,915	\$ 7,269
<b>Interest Expense</b>		
Notes payable to AgFirst Farm Credit Bank	3,919	3,174
Net interest income	3,996	4,095
Provision for (reversal of) loan losses	—	—
Net interest income after provision for (reversal of) loan losses	3,996	4,095
<b>Noninterest Income</b>		
Loan fees	605	496
Fees for financially related services	107	87
Equity in earnings of other Farm Credit institutions	927	1,042
Gains (losses) on other property owned, net	2	2
Other noninterest income	42	41
Total noninterest income	1,683	1,668
<b>Noninterest Expense</b>		
Salaries and employee benefits	1,575	1,540
Occupancy and equipment	163	171
Insurance Fund premium	44	114
Other operating expenses	409	338
Total noninterest expense	2,191	2,163
Income before income taxes	3,488	3,600
Provision (benefit) for income taxes	—	—
Net income	\$ 3,488	\$ 3,600

*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				3,600		3,600
Protected borrower equity retired	(87)					(87)
Capital stock/participation certificates issued		51				51
Capital stock/participation certificates retired		(44)				(44)
Retained earnings retired			(6,719)			(6,719)
Distribution adjustment			(38)	59		21
Balance at March 31, 2004	\$ 402	\$ 2,064	\$ 28,268	\$ 51,191	\$ (4,497)	\$ 77,428
Balance at December 31, 2004	\$ 354	\$ 2,114	\$ 28,250	\$ 63,302	\$ (399)	\$ 93,621
Net income				3,488		3,488
Protected borrower equity retired	(50)					(50)
Capital stock/participation certificates issued		102				102
Capital stock/participation certificates retired		(45)				(45)
Retained earnings retired			(6,212)			(6,212)
Distribution adjustment			-	33		33
Balance at March 31, 2005	\$ 304	\$ 2,171	\$ 22,038	\$ 66,823	\$ (399)	\$ 90,937

*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 Stockholders. These unaudited first quarter 2005 consolidated financial statements should be read in conjunction with the 2004 Annual Report to Stockholders.

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 three months ended March 31, 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 March 31, 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 3-31-04	<u>\$ 10,003</u>
Balance at 12-31-04	\$ 3,507
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	5
Balance at 3-31-05	<u>\$ 3,512</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 three months ended March 31, 2005:

	For the three months ended March 31,	
	2005	2004
Pension	\$ 186	\$ 202
Thrift/deferred compensation	47	33
Other postretirement benefits	154	174
Total	<u>\$ 387</u>	<u>\$ 409</u>

As of March 31, 2005, the Association had made no contributions to the Districtwide defined benefit retirement plan. 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.