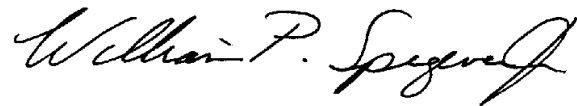


# THIRD QUARTER 2004

Management's Discussion and Analysis of	
Financial Condition and Results of Operations.....	2
Consolidated Financial Statements	
Consolidated Balance Sheets.....	5
Consolidated Statements of Income.....	6
Consolidated Statements of Changes in Members' Equity.....	7
Notes to the Consolidated Financial Statements.....	8



William P. Spigener, Jr.  
Chief Executive Officer



Harry S. Bell  
Chairman of the Board

October 29, 2004

# 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 AgSouth Farm Credit, ACA, (Association) for the period ended September 30, 2004. Effective January 1, 2004, pursuant to a consolidation plan approved by the Farm Credit Administration (FCA) and the Association stockholders, AgSouth Farm Credit, headquartered in Statesboro, Georgia and Palmetto Farm Credit, headquartered in Orangeburg, South Carolina merged. The surviving entity assumed the name, AgSouth Farm Credit.

This information should be read in conjunction with the accompanying financial statements, notes to the financial statements, and the 2003 Annual Reports of Palmetto Farm Credit and AgSouth Farm Credit.

## **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 wide range of agricultural commodities produced in our region, including poultry (broilers and turkeys), timber, field crops and grains, and beef cattle. Loans to producers of these commodities total \$839,468 or 72.86 percent of the Association's portfolio. Farm size varies, and many of the Association customers have diversified farming operations. These factors, along with the numerous opportunities for non-farm income in the area, reduce to some degree the level of income dependency on any given commodity.

During the third quarter of 2004 the Association originated \$47,814 in loans for the secondary market. As of September 30, 2004, the Association held \$898 in qualifying loans for sale. These loans are classified as Other Assets on the Association's balance sheet.

### ***South Carolina Region***

Currently, fall harvest in South Carolina is in process with corn combining nearly complete, peanut harvest progressing rapidly toward completion, cotton picking at about 50 percent complete and soybean harvest just getting started. Weather conditions experienced during the growing cycle are the primary factor in varying crop results from area to area in South Carolina. Overall, there have been no significant shortfalls in yields, but some producers

have communicated that the excess rainfall in August and September adversely affected the crop yields to some degree in many areas of SC. Poultry houses continue to be constructed at a relatively brisk pace and the rapid increases in construction prices noted during the spring and early summer have now eased somewhat with the cost of construction stabilizing. A significant portion of the available commitment balance on SC loans consists of money designated for construction of broiler houses.

There has been minimal change in South Carolina timber markets since August. Beef markets have been weaker over the past few months; however, they remain consistent with the late summer months in terms of sales returns. Turkey production remains a concern in SC as one of two integrators in this region has reduced the number of flocks on some farms. The integrator has communicated with the growers that the strategy is to increase the number of flocks back to historical levels again in 2006. Contacts and research completed by SC management indicate that the returns for turkey production are improving and the plans of this integrator appear realistic. The association lending staff continues to monitor the status of turkey loans in SC closely.

### ***Georgia Region***

Storms in September had some effect on the major commodities in the area. Growers of cotton, tobacco, and peanuts report average to above average yields. There was insignificant damage to other crops such as timber, soybeans and corn. We anticipate that most customers will be able to meet their debt obligations. The tobacco buy out that was recently passed will cause a shift in the production of tobacco. While there will likely be fewer tobacco farmers, the amount of leaf grown will increase depending on the contracts offered by the major tobacco companies.

The economy in Georgia continues to improve and land values continue to hold firm although recent sales reflect moderation in the amount of increase in value of unimproved land. The poultry producers continue to enjoy record profits even with increases in the costs of production.

The gross loan volume of the Association as of September 30, 2004, was \$1,135,429, an increase of \$6,601 or less than one percent as compared to \$1,128,828 at December 31, 2003. Net loans outstanding at September 30, 2004 were \$1,110,135 as compared to \$1,103,575 at December 31, 2003. Net loans accounted for 95.36 percent of total assets at September 30, 2004, as compared to 95.65 percent of total assets at December 31, 2003.

The increase in gross and net loan volume during the reporting period is primarily attributed to several new large loans made during the reporting period as well as draws on annual operating credits to farmer/borrowers during the planting season.

The Association typically structures loans to meet the needs of the borrower. Many term loans are made for ten years or less allowing the borrower to build equity faster and thus reducing the risk in the loan portfolio.

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 slightly from \$4,950 at December 31, 2003, to \$5,408 at September 30, 2004. This increase is the result of transfers to nonaccrual exceeding payments and payoffs on existing nonaccrual accounts.

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 September 30, 2004, was \$25,294 compared to \$25,253 at December 31, 2003, and was considered by management to be adequate to cover possible losses.

In June 2003, the American Institute of Certified Public Accountants' (AICPA) Accounting Standards Executive Committee (AcSEC) issued a proposed Statement of Position – Allowance for Credit Losses, which was intended to clarify the methodology for estimating the allowance for credit losses and to enhance financial statement disclosures related to the allowance for credit losses. In January 2004, AcSEC abandoned its proposed Statement of Position and announced that it would focus instead on improving financial statement disclosures regarding the allowance for loan losses.

System institutions have initiated studies to further refine their methodologies for calculating their respective allowances for loan losses, taking into account generally accepted accounting principles and applicable Farm Credit Administration requirements, as well as the Securities and Exchange Commission and Federal Financial Institutions Examination Council guidelines. These studies will be completed by the fourth quarter of 2004 with any appropriate reductions to the allowance for loan losses implemented at that time. The resulting reductions in the allowance for loan losses may be significant.

In April 2004, the Farm Credit Administration, the System's regulator, issued an "Informational Memorandum" to System institutions regarding the allowance for loan losses. The memorandum addresses the status of the AICPA's project and the Securities and Exchange Commission and the Federal Financial Institutions Examination Council guidance on the subject. The objective of the Farm Credit Administration's

memorandum was to clarify its expectations regarding the analysis and related documentation for the allowance for loan losses. The Farm Credit Administration endorsed the direction provided by these other regulatory agencies and will include the conceptual framework addressed in this guidance in their examination process.

## **RESULTS OF OPERATIONS**

### ***For the three months ended September 30, 2004***

Net income for the three months ended September 30, 2004, totaled \$7,336 as compared to \$6,350 for the same period in 2003. The increase in net income of \$986 is primarily due to higher net interest income in 2004 when compared to the same period in 2003 and higher noninterest expense in 2003 when compared to 2004.

Net interest income increased \$561 for the three months ended September 30, 2004, as compared to the same period in 2003 due primarily to higher loan volume and focused repricing activities that increased net spreads while also generally reducing interest rates for customers. Additionally, the Association fixed the interest rate on \$120,000 of loanable funds in the later part of the second quarter of 2004.

At September 30, 2004, interest income on accruing loans increased \$281 compared to September 30, 2003. The majority of this variance was due to the increase in loan volume. Nonaccrual income was \$410 for the three months ended September 30, 2004, as compared to \$403 for the same period in 2003. Interest expense decreased \$280 for the three months ended September 30, 2004. The decrease is linked to the annual formula change in the direct note for variable rate by the district bank and the lower interest rate environment.

Noninterest income decreased \$308 over the same period last year primarily due to lower gains on the sale of rural home loans. These gains decreased \$70 during the reporting period. Loan fees also declined \$370 during the reporting period. The Association experienced a slight decrease in the equity in the earnings of AgFirst Farm Credit Bank (the Bank). In 2003, a write-down of the value in other property owned asset occurred. This did not reoccur and had a positive effect on noninterest income in the reporting period.

Noninterest expense for the three months ended September 30, 2004, decreased \$649 compared to the same period of 2003. This variance is due to lower salary and benefits expense due to the consolidation. The Association also received a refund of \$131 in Insurance Fund premiums due to the fund reaching a fully secure base as mandated. During the reporting period the Association had \$53 of restructuring charges. These amounts are not to be considered reoccurring. Restructuring charges included payments for severance, employee benefits, legal and other general operating expenses.

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**For the nine months ended September 30, 2004**

Net income for the nine months ended September 30, 2004, totaled \$16,105 as compared to \$18,099 for the same period in 2003. Net interest income increased \$1,956 when compared to the same period in 2003.

At September 30, 2004, interest income decreased \$751 compared to September 30, 2003. The variance was due to the decrease in lower rate environment between the comparative reporting periods. Nonaccrual income was \$924 for the nine months ended September 30, 2004, as compared to \$853 for the same period in 2003. Interest expense decreased \$2,582 for the nine months ended September 30, 2004. The decrease is directly linked to the decrease in interest rates charged on our notes payable and the movement of \$120,000 of its loanable funds to a fixed rate note.

Noninterest income for the nine months ended September 30, 2004, totaled \$9,456 as compared to \$9,821 for the same period of 2003, a decrease of \$365. The decrease resulted from lower equity in earnings from the Bank, lower gains on the sale of rural home loans sold into the secondary market and lower fee income. The gain on the sale of loans sold in the secondary market was \$391 less than the same reporting period in 2003. The Association refunded \$195 in fees collected on loans sold into the secondary market to correct an error in disclosure. In 2003, the Association booked a loss on other property owned that did not reoccur in 2004 and this had a positive effect on the difference between the two reporting periods.

Noninterest expense for the nine months ended September 30, 2004, increased \$3,647 compared to the same period of 2003. The increase is attributable to increases in salary and benefit expenses and restructuring charges. During the first nine months of 2004, the Association paid expenses totaling \$3,645 related to the consolidation. The majority of these expenses, \$3,619 are personnel expenses including severance salaries and benefits. The consolidation expenses are not considered to be recurring. Noninterest expense also includes the accrual of \$678 of incentive. The Association's incentive plan is a comprehensive plan that requires that a certain level of income and defined goals be achieved prior to participation. At September 30, 2004, Association management elected to book the accrual in anticipation of payout of the plan.

**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 Bank

advances the funds 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 September 30, 2004 was \$993,055 as compared to \$967,041 at December 31, 2003. The increase is related to the increase in loan volume between the two reporting periods.

In June 2004, the Association invested \$120,000 of its lendable equity (loanable funds) in fixed rate notes with maturities varying from 1 to 4 years. The investment should generate additional income for the Association during that period of time. Income generated will be reflected as a reduction to interest expense.

**CAPITAL RESOURCES**

Total members' equity at September 30, 2004, increased to \$153,553 from the December 31, 2003 total of \$151,878. The increase is primarily attributed to the higher earnings of the Association offset by the retirement of capital stock, and participation certificates during the period.

Total capital stock and participation certificates were \$7,249 on September 30, 2004, compared to \$7,834 on December 31, 2003. The decrease is attributed to the retirement of protected stock and participation certificates on loans liquidated in the normal course of business, the retirement of excess stock, and new loans being capitalized at lower regulatory levels.

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 September 30, 2004, the Association's total surplus ratio and core surplus ratio were 13.28 percent and 9.42 percent, respectively, and the permanent capital ratio was 13.88 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.

The Association has a portion of the portfolio in an in-portfolio guarantee program with Farmer Mac. At September 30, 2004, the Association had loans totaling \$57,266. No additional placement of loans is scheduled at this time. The cost of the guarantees year to date was \$245. The use of the Farmer Mac In-portfolio guarantee has a positive effect on the Association's capital ratios.

*AgSouth Farm Credit, ACA*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>September 30, 2004</b>	<b>December 31, 2003</b>
	<i>(unaudited)</i>	
<b>Assets</b>		
Cash	\$ 1,839	\$ 3,411
Loans	1,135,429	1,128,828
Less: allowance for loan losses	25,294	25,253
Net loans	1,110,135	1,103,575
Accrued interest receivable	13,235	10,283
Investment in other Farm Credit institutions	16,368	16,207
Premises and equipment, net	8,089	6,810
Other property owned	1,236	1,030
Other assets	13,229	12,392
Total assets	<u>\$ 1,164,131</u>	<u>\$ 1,153,708</u>
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 993,055	\$ 967,041
Accrued interest payable	2,908	2,981
Patronage refund payable	652	6,212
Postretirement benefits other than pensions	8,953	7,609
Minimum pension liability	916	6,445
Other liabilities	4,094	11,542
Total liabilities	<u>1,010,578</u>	<u>1,001,830</u>
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower equity	1,220	1,530
Capital stock and participation certificates	6,029	6,304
Retained earnings		
Allocated	66,486	79,978
Unallocated	91,254	75,502
Accumulated other comprehensive income (loss)	(11,436)	(11,436)
Total members' equity	<u>153,553</u>	<u>151,878</u>
Total liabilities and members' equity	<u>\$ 1,164,131</u>	<u>\$ 1,153,708</u>

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

*AgSouth Farm Credit, ACA*  
**Consolidated Statements of Income**

*(unaudited)*

<i>(dollars in thousands)</i>	<b>For the three months ended September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<b>Interest Income</b>				
Loans	\$ 18,578	\$ 18,297	\$ 54,094	\$ 54,845
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	8,623	8,903	25,773	28,355
Net interest income	9,955	9,394	28,321	26,490
Provision for (reversal of) loan losses	—	—	—	125
Net interest income after provision for (reversal of) loan losses	9,955	9,394	28,321	26,365
<b>Noninterest Income</b>				
Loan fees	342	712	1,805	2,132
Fees for financially related services	85	82	209	214
Equity in earnings of other Farm Credit institutions	2,078	2,127	6,153	6,300
Gains (losses) on other property owned, net	—	15	74	(437)
Gains (losses) on sale of rural home loans	300	370	829	1,220
Other noninterest income	240	47	386	392
Total noninterest income	3,045	3,353	9,456	9,821
<b>Noninterest Expense</b>				
Salaries and employee benefits	4,162	4,317	13,104	12,353
Occupancy and equipment	404	404	1,164	1,167
Insurance Fund premium	(131)	324	407	978
Other operating expenses	1,197	1,289	3,350	3,525
Restructuring charge	53	—	3,645	—
Total noninterest expense	5,685	6,334	21,670	18,023
Income before income taxes	7,315	6,413	16,107	18,163
Provision (benefit) for income taxes	(21)	63	2	64
Net income	\$ 7,336	\$ 6,350	\$ 16,105	\$ 18,099

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

*AgSouth Farm Credit, ACA*

# Consolidated Statements of Changes in Members' Equity

*(unaudited)*

*(dollars in thousands)*

	<b>Protected Borrower Capital</b>	<b>Capital Stock and Participation Certificates</b>	<b>Retained Earnings</b>		<b>Accumulated Other Comprehensive Income</b>	<b>Total Members' Equity</b>
			<b>Allocated</b>	<b>Unallocated</b>		
Balance at December 31, 2002	\$ 2,021	\$ 6,468	\$ 77,088	\$ 70,619	\$ (12,476)	\$ 143,720
Net income				18,099		18,099
Protected borrower equity retired	(429)					(429)
Capital stock/participation certificates issued		551				551
Capital stock/participation certificates retired		(635)				(635)
Retained earnings retired			(9,386)			(9,386)
Distribution adjustment			(71)	110		39
Balance at September 30, 2003	\$ 1,592	\$ 6,384	\$ 67,631	\$ 88,828	\$ (12,476)	\$ 151,959
Balance at December 31, 2003	\$ 1,530	\$ 6,304	\$ 79,978	\$ 75,502	\$ (11,436)	\$ 151,878
Net income				16,105		16,105
Protected borrower equity retired	(310)					(310)
Capital stock/participation certificates issued		511				511
Capital stock/participation certificates retired		(786)				(786)
Retained earnings retired			(13,738)			(13,738)
Distribution adjustment			246	(353)		(107)
Balance at September 30, 2004	\$ 1,220	\$ 6,029	\$ 66,486	\$ 91,254	\$ (11,436)	\$ 153,553

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

AgSouth Farm Credit, ACA

# Notes to the Consolidated Financial Statements

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

## NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Effective January 1, 2004, AgSouth Farm Credit, ACA (AgSouth) and Palmetto Farm Credit, ACA (Palmetto) consolidated to form AgSouth Farm Credit, ACA (the Association) pursuant to a consolidation plan approved by the Farm Credit Administration (FCA) and the Association stockholders. This consolidation was accounted for in a manner similar to a pooling of interests and accordingly, the Association's combined financial statements have been restated to include the accounts and operations of both associations for all periods prior to the consolidation.

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, 2003 are contained in the 2003 Annual Report to Stockholders of the AgSouth and Palmetto associations. These unaudited third quarter 2004 consolidated financial statements should be read in conjunction with the 2003 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 nine months ended September 30, 2004, are not necessarily indicative of the results to be expected for the year ending December 31, 2004.

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 September 30, 2004, 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 12-31-02	\$ 25,446
(Reversal of) provision for loan losses	125
Loans (charged off), net of recoveries	<u>(104)</u>
Balance at 9-30-03	<u>\$ 25,467</u>
Balance at 12-31-03	\$ 25,253
(Reversal of) provision for loan losses	–
Recoveries, net of loans charged off	<u>41</u>
Balance at 9-30-04	<u>\$ 25,294</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 nine months ended September 30, 2004:

	<b>For the nine months ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
Pension	\$ 3,561	\$ 1,924
Thrift/deferred compensation	248	229
Other postretirement benefits	<u>1,782</u>	<u>1,376</u>
Total	<u>\$ 5,591</u>	<u>\$ 3,529</u>

The increase in pension and other postretirement benefits is due to \$2,171 in employee benefit expense related to the consolidation of the Association effective January 1, 2004. This expense should not be considered a recurring expense.

As of September 30, 2004, the Association had contributed \$13,697 to the Districtwide defined benefit retirement plan, which was sufficient to meet its accumulated benefit obligation. The contributions eliminated the minimum pension liability with \$3,977 of the contributions being classified as prepaid retirement expense in Other Assets on the Consolidated Balance Sheets. The Association does not anticipate making additional contributions for the remainder of 2004.