First South Farm Credit, ACA

THIRD QUARTER 2003

Stephen L. Rochelle
Chief Executive Officer

William H. Voss
Chairman of the Board

October 29, 2003

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 First South Farm Credit, ACA (Association) for the period ended September 30, 2003. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2002 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. The Association's loan portfolio is diversified over a range of agricultural commodities in our region, including poultry, cotton, livestock, and forestry. 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 impacts the level of dependency on a given commodity.

The gross loan volume of the Association as of September 30, 2003, was $934,649, an increase of $90,148 as compared to $844,501 at December 31, 2002. Net loans outstanding at September 30, 2003, were $914,052 as compared to $823,784 at December 31, 2002. Net loans accounted for 90.22 percent of total assets at September 30, 2003, as compared to 89.47 percent of total assets at December 31, 2002.

The increase in gross and net loan volume during the reporting period is attributed primarily to seasonal lending. The short-term portfolio is heavily influenced by operating-type loans that normally peak in September and rapidly decline in the fall and winter months when farm commodities are marketed.

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 $3,683 at December 31, 2002, to $4,001 at September 30, 2003. As of September 30, 2003, there were no loans over 90 days past due but still accruing interest. In management's opinion, these loans are fully secured and are in the process of collection. 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, 2003, was $20,597 compared to $20,717 at December 31, 2002, and was considered by management to be adequate to cover possible losses.

RESULTS OF OPERATIONS

For the three months ended September 30, 2003

Net income for the three months ended September 30, 2003, totaled $4,555, as compared to $4,238 for the same period in 2002, an increase of $317. Net interest income increased $881, for the three months ended September 30, 2003, as compared to the same period in 2002.

At September 30, 2003, interest income on accruing loans decreased $666 compared to September 30, 2002. Nonaccrual income was $679 for the three months ended September 30, 2003, as compared to $197 for the same period in 2002. Interest expense decreased $1,065 for the three months ended September 30, 2003, as compared to the comparable period of 2002. Noninterest income for the three months ended September 30, 2003, totaled $2,155, as compared to $1,983 for the same period of 2002, an increase of $172. Noninterest expense for the three months ended September 30, 2003, increased $735 compared to the same period of 2002.

For the nine months ended September 30, 2003

Net income for the nine months ended September 30, 2003, totaled $10,570, as compared to $10,205 for the same period in 2002. This increase of $365, or 3.58 percent is attributed to an increase in net interest income of $2,173, an increase in noninterest income of $432, and a decrease in provision for income taxes of $89, partially offset by an increase in noninterest expense of $2,329. At September 30, 2003, interest income on accruing loans decreased $285 compared to September 30, 2002, as a result of a decrease in the average interest rate on loans to members of 66 basis points, partially offset by an increase in average loans outstanding of $83,770. Nonaccrual income was $1,030 for the nine months ended September 30, 2003, as compared to $409 for the same period in 2002. Interest expense decreased $1,837 for the nine months ended September 30, 2003, as compared to the same period in 2002. This change was primarily due to a decrease in the average interest rate on notes payable to AgFirst Farm Credit Bank (the Bank) of 75 basis points, partially offset by an increase in the average notes payable to the Bank of $76,585.

Noninterest income for the nine months ended September 30, 2003, totaled $6,259, as compared to $5,827 for the same period of 2002, an increase of $432. The increase resulted from an increase in loan fees of $178, an increase in equity in earnings of the Bank of $469 and an increase in gains on other property owned of $35, partially offset by a decrease in fees for financially related services of $232 and a decrease in miscellaneous income of $18.

Noninterest expense for the nine months ended September 30, 2003, increased $2,329 compared to the same period of 2002. This increase is attributed to an increase in salaries and benefits expense of $2,060 and an increase in the Insurance Fund premium of $575, partially offset by a decrease in occupancy and equipment expense of $19 and a decrease in other operating expenses of $287. The Association recorded a provision for income taxes of $112 for the nine months ended September 30, 2003, as compared to $201 for the same period in 2002. The increase in the Insurance Fund premium is the result of the increase in loan volume in the Farm Credit System. The association incurred additional expense for the retirement benefits to current and future retirees which accounted for $1,591, or 77.23 percent of the above increase in salary and benefits expense.

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 September 30, 2003, was $811,961 as compared to $718,417 at December 31, 2002. The increase during the period is primarily attributed to the expected seasonal increase in loan volume.

CAPITAL RESOURCES

Total members' equity at September 30, 2003, increased to $182,580 from the December 31, 2002, total of $176,973. The increase primarily resulted from net income for the nine months ended September 30, 2003, of $10,570 and an increase in capital stock and participation certificates of $617, partially offset by cash patronage of $5,618.

Total capital stock and participation certificates were $63,024 on September 30, 2003, compared to $62,407 on December 31, 2002. This increase is attributed to the issuance of member stock associated with the increase in loan volume at September 30, 2003, compared to December 31, 2002.

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, 2003, the Association's total surplus ratio and core surplus ratio were 11.71 percent and 8.76 percent, respectively, and the permanent capital ratio was 13.04 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.

First South Farm Credit, ACA

Consolidated Balance Sheets

(dollars in thousands)	September 30, 2003	December 31, 2002
	(unaudited)	
Assets		
Cash	$ 6,994	$ 5,091
Loans	934,649	844,501
Less: allowance for loan losses	20,597	20,717
Net loans	914,052	823,784
Accrued interest receivable	11,497	10,067
Investment in other Farm Credit institutions	63,706	63,705
Premises and equipment, net	3,296	3,260
Other property owned	687	56
Deferred tax asset, net	288	288
Other assets	12,653	14,533
Total assets	$ 1,013,173	$ 920,784
Liabilities		
Notes payable to AgFirst Farm Credit Bank	$ 811,961	$ 718,417
Accrued interest payable	2,045	2,178
Patronage refund payable	4	3,729
Postretirement benefits other than pensions	10,320	10,015
Other liabilities	6,263	9,472
Total liabilities	830,593	743,811
Commitments and contingencies		
Members' Equity		
Protected borrower equity	147	147
Capital stock and participation certificates	62,877	62,260
Retained earnings		
Allocated	40,397	46,056
Unallocated	79,159	68,510
Total members' equity	182,580	176,973
Total liabilities and members' equity	$ 1,013,173	$ 920,784

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

First South Farm Credit, ACA

Consolidated Statements of Income

(unaudited)

(dollars in thousands)	For the three months ended September 30, 2003	For the three months ended September 30, 2002	For the nine months ended September 30, 2003	For the nine months ended September 30, 2002
Interest Income				
Loans	$ 13,775	$ 13,959	$ 37,816	$ 37,480
Interest Expense				
Notes payable to AgFirst Farm Credit Bank	6,264	7,330	18,264	20,100
Other	2	1	7	8
Total interest expense	6,266	7,331	18,271	20,108
Net interest income	7,509	6,628	19,545	17,372
Provision for (reversal of) loan losses	300	300	900	900
Net interest income after provision for (reversal of) loan losses	7,209	6,328	18,645	16,472
Noninterest Income				
Loan fees	467	389	1,605	1,427
Fees for financially related services	104	146	226	458
Equity in earnings of other Farm Credit institutions	1,578	1,447	4,269	3,800
Gains (losses) on other property owned, net	4	—	26	(9)
Miscellaneous	2	1	133	151
Total noninterest income	2,155	1,983	6,259	5,827
Noninterest Expense				
Salaries and employee benefits	3,236	2,525	9,683	7,623
Occupancy and equipment	294	348	891	910
Insurance Fund premium	267	65	749	174
Other operating expenses	990	1,114	2,899	3,186
Total noninterest expense	4,787	4,052	14,222	11,893
Income before income taxes	4,577	4,259	10,682	10,406
Provision (benefit) for income taxes	22	21	112	201
Net income	$ 4,555	$ 4,238	$ 10,570	$ 10,205

The accompanying notes are an intergral part of these financial statements.

First South Farm Credit, ACA

Consolidated Statements of Changes in Members' Equity

(unaudited)

(dollars in thousands)	Protected Borrower Capital	Capital Stock and Participation Certificates	Retained Earnings Allocated	Retained Earnings Unallocated	Total Members' Equity
Balance at December 31, 2001	$ 175	$ 61,448	$ 41,390	$ 70,414	$ 173,427
Net income				10,205	10,205
Protected borrower equity retired	(28)				(28)
Capital stock/participation certificates issued		1,544			1,544
Capital stock/participation certificates retired		(787)			(787)
Retained earnings retired			(6,571)		(6,571)
Distribution adjustment			5	(9)	(4)
Balance at September 30, 2002	$ 147	$ 62,205	$ 34,824	$ 80,610	$ 177,786
Balance at December 31, 2002	$ 147	$ 62,260	$ 46,056	$ 68,510	$ 176,973
Net income				10,570	10,570
Capital stock/participation certificates issued		1,547			1,547
Capital stock/participation certificates retired		(930)			(930)
Retained earnings retired			(5,618)		(5,618)
Distribution adjustment			(41)	79	38
Balance at September 30, 2003	$ 147	$ 62,877	$ 40,397	$ 79,159	$ 182,580

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

First South 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 First South 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, 2002, are contained in the 2002 Annual Report to Stockholders. These unaudited third quarter 2003 consolidated financial statements should be read in conjunction with the 2002 Annual Report to Stockholders.

As disclosed in the 2002 Annual Report, pursuant to a plan of restructuring approved by the Farm Credit Administration and Association shareholders, the Association reorganized its organizational structure effective January 1, 2002. Pursuant to this restructuring, a Federal Land Credit Association (FLCA) and Production Credit Association (PCA) were formed as wholly owned subsidiaries of the Association. The formation of these subsidiaries enables the Association to take advantage of the tax-exempt status of net income from operations of the FLCA. This restructuring was accounted for as a reorganization of entities under common control similar to a pooling of interests.

Prior to the restructuring, the Association was subject to federal and state income tax. As a result of the restructuring, long-term participation lending activity has been separated into a wholly owned FLCA subsidiary which is exempt from federal and state income tax. The ACA, which is the holding company, along with the wholly owned PCA subsidiary, will continue to be subject to income tax.

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, 2003, are not necessarily indicative of the results to be expected for the year ending December 31, 2003.

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, 2003, 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 12-31-01	$ 19,628
(Reversal of) provision for loan losses	900
Loans (charged off), net of recoveries	(158)
Balance at 9-30-02	$ 20,370
Balance at 12-31-02	$ 20,717
(Reversal of) provision for loan losses	900
Loans (charged off), net of recoveries	(1,020)
Balance at 9-30-03	$ 20,597