NORWOOD FINANCIAL CORP
Form 10-K
March 14, 2008
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-K**

(Mark One):

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the fiscal year ended December 31, 2007,

Or

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from __________ to __________

Commission File No. **0-28364**

**NORWOOD FINANCIAL CORP.**
(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| **Pennsylvania** | **23-2828306** |
| (State or other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| **717 Main Street, Honesdale, Pennsylvania** | **18431** |
| (Address of Principal Executive Offices) | (Zip Code) |

Registrant's Telephone Number, Including Area Code:**(570) 253-1455**

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Name of Each Exchange on Which Registered |
|---|---|
| **Common Stock, $.10 par value** | **The Nasdaq Stock Market LLC** |

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. x NO o YES

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. x NO o YES

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o
Non-accelerated filer o
(Do not check if a smaller reporting company)

Accelerated filer x
Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). o Yes x No

As of March 12, 2008, there were 2,740,149 shares outstanding of the registrant's Common Stock.

The Registrant's voting stock trades on the NASDAQ Global Market under the symbol "NWFL." The aggregate market value of the voting stock held by non-affiliates of the registrant, based on the last price the registrant's Common Stock was sold as of June 30, 2007, $32.75 per share, was $76,038,655 based on 2,321,791 shares of Common Stock outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

1. Portions of the Annual Report to Stockholders for the Fiscal Year ended December 31, 2007. (Parts I, II, and IV)
2. Portions of the Proxy Statement for the 2008 Annual Meeting of Stockholders. (Part III)

NORWOOD FINANCIAL CORP.

FORM 10-K

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**PART I**

**Forward Looking Statements**

The Private Securities Litigation Reform Act of 1995 contains safe harbor provisions regarding forward-looking statements. When used in this discussion, the words “believes,” “anticipates,” “contemplates,” “expects,” and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected. Those risks and uncertainties as detailed in Item 1A include:

- our ability to effectively manage future growth
- loan losses in excess of our allowance
- risks inherent in commercial lending
- real estate collateral which is subject to declines in value
- regional economic factors
- loss of senior officers
- comparatively low legal lending limits
- limited market for the Company’s stock
- restrictions on ability to pay dividends
- common stock may lose value
- competitive environment
- issuing additional shares may dilute ownership
- extensive and complex governmental regulation and associated cost
- interest rate risks

Norwood Financial Corp. undertakes no obligation to publicly release the results of any revisions to those forward-looking statements which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

## Item 1. Business

**General**

Norwood Financial Corp. (the “Company”), a Pennsylvania corporation, is the holding company for Wayne Bank. On March 29, 1996, the Bank completed a holding company reorganization and became a wholly owned subsidiary of the Company. As of December 31, 2007, the Company had total assets of $480.6 million, deposits of $370.0 million, and stockholders’ equity of $55.8 million. The Company’s ratio of average equity to average assets was 11.48%, 11.23% and 11.19% for fiscal years 2007, 2006 and 2005, respectively.

Wayne Bank is a Pennsylvania chartered commercial bank headquartered in Honesdale, Pennsylvania. The Bank was originally chartered on February 17, 1870 as Wayne County Savings Bank. Wayne County Savings Bank changed its name to Wayne County Bank and Trust in December 1943. In September 1993, the Bank adopted the name Wayne Bank. The Bank’s deposits are currently insured to applicable limits by the Deposit Insurance Fund (“DIF”) as administered by the Federal Deposit Insurance Corporation (“FDIC”). The Bank is regulated by the Pennsylvania Department of Banking (“PDB”) and the FDIC.

The Bank is an independent community bank with six offices in Wayne County, three offices in Pike County and three offices in Monroe County. The Bank offers a wide variety of personal and business credit services and trust and investment products and real estate settlement services to the consumers, businesses, nonprofit organizations, and municipalities in each of the communities that the Bank serves.

The Bank primarily serves the Pennsylvania counties of Wayne, Pike and Monroe, and to a much lesser extent, the counties of Lackawanna and Susquehanna. In addition, the Bank operates twelve automated teller machines, one in each of its branch locations. The Company’s main office is located at 717 Main Street, Honesdale, Pennsylvania and its telephone number is (570) 253-1455. The Bank maintains a website at www.waynebank.com.

**Competition**

The competition for deposit products comes from other insured financial institutions such as commercial banks, thrift institutions, credit unions, and multi-state regional banks in the Company’s market area of Wayne, Pike and Monroe Counties, Pennsylvania. Based on data compiled by the FDIC as of June 30, 2007 (the latest date for which data is available), the Bank had the third largest share of FDIC-insured deposits in Wayne County with approximately 20.9%, second in Pike County with 16.8%, and 10th in Monroe County with 2.0%. This data does not reflect deposits held by credit unions with which the Bank also competes. Deposit competition also includes a number of insurance products sold by local agents and investment products such as mutual funds and other securities sold by local and regional brokers. Loan competition varies depending upon market conditions and comes from other insured financial institutions such as commercial banks, thrift institutions, credit unions, multi-state regional banks, and mortgage bankers.

**Personnel**

As of December 31, 2007, the Bank had 112 full-time and 5 part-time employees. None of the Bank’s employees are represented by a collective bargaining group.

**Lending Activities**

The Bank’s loan products include loans for personal and business use. This includes mortgage lending to finance principal residences and to a lesser extent second home dwellings. The products include adjustable rate mortgages with terms up to 30 years which are retained and serviced through the Bank, fixed rate mortgage products which may be sold, servicing retained, in the secondary market through the Federal National Mortgage Association (Fannie Mae) or held in the Bank’s portfolio subject to the extent consistent with our asset/liability management strategies. Fixed-rate home equity loans are originated on terms up to 180 months, as well as offering a home equity line of credit tied to prime rate. The Bank to a lesser extent also offers indirect dealer financing of automobiles (new and used), boats, and recreational vehicles through a limited network of dealers in Northeast Pennsylvania, but is allowing this portfolio to run-off. At December 31, 2007, there were $11.6 million of indirect loans.

Commercial loans and commercial mortgages are provided to local small and mid-sized businesses at a variety of terms and rate structures. Commercial lending activities include lines of credit, revolving credit, term loans, mortgages, various forms of secured lending and a limited amount of letter of credit facilities. The structure may be fixed, immediately repricing tied to the prime rate or adjustable at set intervals.

Adjustable-rate loans decrease the risks associated with changes in interest rates by periodically repricing, but involve other risks because as interest rates increase, the underlying payments by the borrower increase, thus increasing the potential for payment default. At the same time, the marketability of the underlying collateral may be adversely affected by higher interest rates. Upward adjustment of the contractual interest rate may also be limited by the maximum periodic interest rate adjustment permitted in certain adjustable-rate mortgage loan documents, and, therefore is potentially limited in effectiveness during periods of rapidly rising interest rates. These risks have not had an adverse effect on the

Bank.

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Consumer lending, including indirect financing provides benefits to the Bank’s asset/liability management program by reducing the Bank’s exposure to interest rate changes, due to their generally shorter terms. Such loans may entail additional credit risks compared to owner-occupied residential mortgage lending especially when unsecured or secured by collateral such as automobiles that depreciate rapidly. As a result, the Bank has de-emphasized the indirect lending product line.

Commercial lending including real-estate related loans entail significant additional risks when compared with residential real estate and consumer lending. For example, commercial loans typically involve larger loan balances to single borrowers or groups of related borrowers. The payment experience on such loans typically is dependent on the successful operation of the project and these risks can be significantly impacted by the cash flow of the borrowers and market conditions for commercial office, retail, and warehouse space. In periods of decreasing cash flows, the commercial borrower may permit a lapse in general maintenance of the property causing the value of the underlying collateral to deteriorate. The liquidation of commercial property is often more costly and may involve more time to sell than residential real estate. The Bank offsets such factors with requiring more owner equity, a lower loan to value ratio and by obtaining the personal guaranties of the principals. In addition, a majority of the Bank’s commercial real estate portfolio is owner occupied property.

Due to the type and nature of the collateral, consumer lending generally involves more credit risk when compared with residential real estate lending. Consumer lending collections are typically dependent on the borrower’s continuing financial stability, and thus, are more likely to be adversely affected by job loss, divorce, illness and personal bankruptcy. In most cases, any repossessed collateral for a defaulted consumer loan will not provide an adequate source of repayment of the outstanding loan balance. The remaining deficiency is usually turned over to a collection agency.

There are additional risks associated with indirect automobile lending since we must rely on the automobile dealer to provide accurate information to us and accurate disclosures to the borrowers. These loans are principally done on a non-recourse basis. We seek to mitigate these risks by only dealing with dealers with whom we have a long-standing relationship.

**Loan Solicitation and Processing**

The Bank has established various lending limits for its officers and also maintains an Officer Loan Committee to approve higher loan amounts. The loan committee is comprised of the President and Chief Executive Officer, Senior Lending Officer and other Bank officers. The Loan Committee has the authority to approve all loans up to set limits based on the type of loan and the collateral. Requests in excess of these limits must be submitted to the Directors’ Loan Committee or Board of Directors for approval. Additionally, the President and Chief Executive Officer, and the Senior Lending Officer and other officers have the authority to approve secured and unsecured loans up to amounts approved by the Board of Directors and maintained in the Bank’s Loan Policy. Notwithstanding individual lending authority, certain loan policy exceptions must be submitted to the loan committee for approval.

Hazard insurance coverage is required on all properties securing loans made by the Bank. Flood insurance is also required, when applicable.

Loan applicants are notified of the credit decision by letter. If the loan is approved, the loan commitment specifies the terms and conditions of the proposed loan including the amount, interest rate, amortization term, a brief description of the required collateral, and the required insurance coverage. The borrower must provide proof of fire, flood (if applicable) and casualty insurance on the property serving as collateral and title insurance, and these applicable insurances must be maintained during the full term of the loan.

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**Types of Loans**. Set forth below is selected data relating to the composition of the Bank’s loan portfolio at the dates indicated.

| | As of December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2007 | | 2006 | | 2005 | | 2004 | | 2003 | |
| | $ | % | $ | % | $ | % | $ | % | $ | % |
| | (dollars in thousands) | | | | | | | | | |
| Type of Loans: | | | | | | | | | | |
| Commercial, Financial and Agricultural | $ 29,159 | 8.8 | $ 34,019 | 10.8 | $ 26,755 | 9.2 | $ 20,263 | 7.9 | $ 17,022 | 7.3 |
| Real Estate-Construction | 20,404 | 6.2 | 18,955 | 6.0 | 5,944 | 2.0 | 4,890 | 1.9 | 5,904 | 2.5 |
| Real Estate-Mortgage Residential. | 129,888 | 39.2 | 113,783 | 36.0 | 100,705 | 34.6 | 90,606 | 35.5 | 77,459 | 33.1 |
| Commercial | 133,593 | 40.3 | 127,640 | 40.4 | 133,495 | 45.8 | 111,164 | 43.6 | 96,276 | 41.1 |
| Lease financing, net of unearned income | — | — | — | — | — | — | — | — | 316 | .1 |
| Consumer Loans to Individuals. | 18,526 | 5.5 | 21,520 | 6.8 | 24,353 | 8.4 | 28,193 | 11.1 | 37,219 | 15.9 |
| | 331,570 | 100.0 | 315,917 | 100.0 | 291,252 | 100.0 | 255,116 | 100.0 | 234,196 | 100.0 |
| Unearned income and deferred fees | (274 ) | | (350 ) | | (362 ) | | (359 ) | | (463 ) | |
| Allowance for loan losses | (4,081 ) | | (3,828 ) | | (3,669 ) | | (3,448 ) | | (3,267 ) | |
| | $ 327,215 | | $ 311,739 | | $ 287,221 | | $ 251,309 | | $ 230,466 | |

**Maturities and Sensitivities of Loans to Changes in Interest Rates**. The following table sets forth maturities and interest rate sensitivity for selected categories of loans as of December 31, 2007. Scheduled repayments are reported in the maturity category in which payment is due.

| | Less than One Year (In thousands) | One to Five Years | Over Five Years | Total |
|---|---|---|---|---|
| Commercial, Financial and Agricultural | $ 10,210 | $ 7,838 | $ 11,111 | $ 29,159 |
| Real Estate - Construction | 20,404 | — | — | 20,404 |
| Total | $ 30,614 | $ 7,838 | $ 11,111 | $ 49,563 |
| Loans with fixed rates | $ 11,249 | $ 5,444 | $ 6,345 | $ 15,518 |
| Loans with floating rates | 19,635 | 2,394 | 4,766 | 26,795 |
| Total | $ 30,614 | $ 7,838 | $ 11,111 | $ 49,563 |

**Non-performing Assets.** The following table sets forth information regarding non-accrual loans, foreclosed real estate owned and loans that are 90 days or more delinquent but on which the Bank was accruing interest at the dates indicated. The Bank did not have any loans accounted for as troubled debt restructurings at the dates indicated. For the year ended December 31, 2007, interest income that would have been recorded on loans accounted for on a non-accrual basis under the original terms of such loans was $6,000 of which $1,000 was collected.

| | As of December 31, | | | | |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| | (dollars in thousands) | | | | |
| Non-accrual loans: | | | | | |
| Commercial and all other | $ — | $ — | $ — | $ — | $ — |
| Real estate | 109 | 392 | 330 | 32 | 125 |
| Consumer | 2 | 17 | 11 | 8 | — |
| Total | 111 | 409 | 341 | 40 | 125 |
| Accruing loans which are contractually past-due 90 days or more: | | | | | |
| Commercial and all other | — | — | — | — | — |
| Real estate | 49 | — | — | 5 | — |
| Consumer | 3 | — | 12 | 22 | 18 |
| Total | 52 | — | 12 | 27 | 18 |
| Total non-performing loans | 163 | 409 | 353 | 67 | 143 |
| Foreclosed real estate | — | — | — | — | — |
| Total non-performing assets | $ 163 | $ 409 | $ 353 | $ 67 | $ 143 |
| Total non-performing loans to total loans | .05 % | .13 % | .12 % | .03 % | .06 % |
| Total non-performing loans to total assets | .03 % | .09 % | .08 % | .02 % | .04 % |
| Total non-performing assets to total assets | .03 % | .09 % | .08 % | .02 % | .04 % |

The recorded investment in impaired loans, not requiring an allowance for loan losses was $3,208,000 and $290,000 at December 31, 2007 and 2006, respectively. The recorded investment in impaired loans requiring an allowance for loan losses was $-0- at December 31, 2007 and 2006. The related allowance for loan losses associated with these loans was $-0- at December 31, 2007 and 2006. For the years ended December 31, 2007, 2006 and 2005, the average recorded investment in these impaired loans was $3,127,000, $286,000 and $316,000 and the interest income recognized on these impaired loans was $290,000, $1,000 and $11,000, respectively. The increase in impaired loans is due to two related credits, which are collateral dependent, with no required allowance. The loans were current as of December 31, 2007.

**Potential Problem Loans.** As of December 31, 2007, there were no loans not previously disclosed, where known information about possible credit problems of borrowers causes management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms.

**Analysis of the Allowance for Loan Losses**. The following table sets forth information with respect to the Bank’s allowance for loan losses for the years indicated:

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| | (dollars in thousands) | | | | |
| Total loans receivable net of unearned income | $ 331,296 | $ 315,567 | $ 290,890 | $ 254,757 | $ 233,733 |