NORWOOD FINANCIAL CORP
Form 10-K
March 10, 2011

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, 2010

or

o 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 (State or Other Jurisdiction of Incorporation or Organization)	23-2828306 (I.R.S. Employer Identification No.)
717 Main Street, Honesdale, Pennsylvania (Address of Principal Executive Offices)	18431 (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.
o YES x NO

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

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. x YES o NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). o YES o NO

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. x

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.

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	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 4, 2011, there were 2,768,804 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, 2010, $25.25 per share, was $66.8 million based on 2,644,740 shares of Common Stock outstanding. For purposes of this calculation, the term "affiliate" refers to all directors and executive officers of the registrant, and all persons beneficially owning more than 5% of the registrant's common stock.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of the Annual Report to Stockholders for the Fiscal Year Ended December 31, 2010. (Parts I, II, and IV)

2. Portions of the definitive Proxy Statement for the 2011 Annual Meeting of Stockholders. (Part III)

NORWOOD FINANCIAL CORP.
ANNUAL REPORT ON 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 realize the anticipated benefits from our acquisition of North Penn Bancorp, Inc.
- 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
- potential other-than-temporary impairments
- higher deposit insurance premiums
- soundness of other financial institutions
- increased compliance burden under new financial reform legislation
- risk of failure to stabilize the financial system
- current market volatility
- potential liquidity risk
- availability of capital
- 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, 2010, the Company had total assets of $537.0 million, deposits of $393.9 million, and stockholders' equity of $67.7 million. The Company's ratio of average equity to average assets was 12.56%, 12.09% and 11.57% for fiscal years 2010, 2009 and 2008, respectively.

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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 five 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 eleven 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 Company maintains a website at www.waynebank.com. Information on our website should not be treated as part of this Annual Report on Form 10-K. The Company makes copies of its SEC filings available free of charge as soon as reasonably practicable after they are filed, through a link on its website to the SEC's website.

Pending Acquisition of North Penn Bancorp, Inc.

On December 14, 2010, Norwood Financial Corp. ("Norwood Financial") and its wholly owned subsidiary, Wayne Bank, and North Penn Bancorp, Inc. ("North Penn"), and its wholly owned subsidiary, North Penn Bank, entered into an Agreement and Plan of Merger (the "Merger Agreement") pursuant to which North Penn will merge with and into Norwood Financial, with Norwood Financial as the surviving corporation. Concurrent with the merger, it is expected that North Penn Bank will merge with and into Wayne Bank.

Under the terms of the Merger Agreement, each outstanding share of North Penn common stock will be converted into either the right to receive $19.12 in cash or 0.6829 shares of Norwood Financial common stock. In addition, the elections of North Penn stockholders will be subject to the requirement that $12,194,000 of the merger consideration (which includes amounts paid in cancellation of existing stock options, for the unallocated shares held by the ESOP and any shares as to which the holders have exercised dissenters' rights) be paid in cash and that the remainder be paid in Norwood common stock. All North Penn stock options, whether or not vested, will be canceled at the effective time of the merger in exchange for a cash payment equal to the difference between $19.12 and the exercise price of the stock option. In the event of a greater than 20% decline in market value of Norwood Financial common stock, North Penn may, in certain circumstances, be able to terminate the Merger Agreement unless Norwood Financial increases the number of shares into which North Penn common stock may be converted.

The senior management of Wayne Bank will remain the same following the merger. At the closing of the merger, Norwood Financial and Wayne Bank will each expand the size of its board by one member and appoint one member of the North Penn board of directors to their boards.

The transaction is subject to customary closing conditions, including the receipt of regulatory approvals and approval by the shareholders of North Penn. The merger is currently expected to be completed in the second quarter of 2011.

Each of the directors and executive officers of North Penn have agreed to vote their shares in favor of the approval of the Merger Agreement at the shareholders meeting to be held to vote on the proposed transaction. If the merger is not consummated under certain circumstances, North Penn has agreed to pay Norwood Financial a termination fee of $1,125,000.

The Merger Agreement also contains usual and customary representations and warranties that Norwood Financial and North Penn made to each other as of specific dates. The assertions embodied in those representations and warranties were made solely for purposes of the contract between Norwood Financial and North Penn, and may be subject to important qualifications and limitations agreed to by the parties in connection with negotiating its terms. Moreover, the representations and warranties are subject to a contractual standard of materiality that may be different from what may be viewed as material to shareholders, and the representations and warranties may have been used to allocate risk between Norwood Financial and North Penn rather than establishing matters as facts.

The foregoing summary of the Agreement is not complete and is qualified in its entirety by reference to the complete text of such document, which is filed as Exhibit 2.1 to this Annual Report on Form 10-K and which is incorporated herein by reference in its entirety.

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, 2010 (the latest date for which data is available), the Bank had the third largest share of FDIC-insured deposits in Wayne County with approximately 19.2%, third largest in Pike County with 18.6%, 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, 2010, the Bank had 113 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. Personal lending includes mortgage lending to finance principal residences and to a lesser extent second home dwellings. The products include fixed rate mortgage products with terms up to 30 years which may be sold, in the secondary market through the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Bank (FHLB) 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, 2010, there were $7.5 million of indirect loans in the portfolio.

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Commercial loans and commercial mortgages are provided to local small and mid-sized businesses at a variety of terms and rate structures. At December 31, 2010, the Bank had approximately $38.9 million in loans to the hospitality, lodging industry. 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 rate structure may be fixed, immediately repricing tied to the prime rate or adjustable at set intervals.

The Bank's construction lending has primarily involved lending for commercial construction projects and for single-family residences. All loans for the construction of speculative sale homes have a loan value ratio of not more than 80%. For both commercial and single-family projects loan proceeds are disbursed during the construction phase according to a draw schedule based on the stage of completion. Construction projects are inspected by contracted inspectors or bank personnel. Construction loans are underwritten on the basis of the estimated value of the property as completed. For commercial projects, the Bank typically also provides the permanent financing after the construction period, as a commercial mortgage.

The Bank also, from time to time originates loans secured by undeveloped land. Land loans granted to individuals have a term of up to 5 years. Land loans granted to developers may have an interest only period during development. The substantial majority of land loans have a loan-to-value ratio not exceeding 75%. The Bank has limited its exposure to land loans but may expand its lending on raw land, as market conditions allow, to qualified borrowers experienced in the development and sale of raw land.

Loans involving construction financing and loans on raw land have a higher level of risk than loans for the purchase of existing homes since collateral values, land values, development costs and construction costs can only be estimated at the time the loan is approved. The Bank has sought to minimize its risk in construction lending and in lending for the purchase of raw land by offering such financing primarily to builders and developers to whom the Bank has loaned funds in the past and to persons who have previous experience in such projects. The Bank also limits construction lending and loans on raw land to its market area, with which management is familiar.

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.

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.

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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.

Loan Portfolio Composition. Set forth below is selected data relating to the composition of the Bank's loan portfolio at the dates indicated.

	As of December 31,									
	2010		2009		2008		2007		2006	
	$	%	$	%	$	%	$	%	$	%
	(dollars in thousands)									
Commercial, Financial and Agricultural	$ 22,386	6.3	$ 24,116	6.6	$ 25,886	7.4	$ 29,159	8.8	$ 34,019	10.8
Real Estate-Construction	12,638	3.5	14,405	4.0	14,856	4.2	20,404	6.2	18,955	6.0
Real Estate-Mortgage	308,656	86.4	310,584	85.3	292,893	83.8	263,481	79.5	241,423	76.4
Consumer Loans to Individuals	13,668	3.8	14,850	4.1	16,087	4.6	18,526	5.5	21,520	6.8
	357,348	100.0	363,955	100.0	349,722	100.0	331,570	100.0	315,917	100.0
Unearned income and deferred fees	(493)		(481)		(318)		(274)		(350)	
Allowance for loan losses	(5,616)		(5,453)		(4,233)		(4,081)		(3,828)	
	$ 351,239		$ 358,021		$ 345,171		$ 327,215		$ 311,739	

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, 2010. Scheduled repayments are reported in the maturity category in which payment is due. Demand loans, loans having no stated schedule of repayments and no stated maturity and overdrafts are reported as due in one year or less.

	One Year or Less	After One to Five Years	Over Five Years	Total
		(dollars in thousands)		
Commercial, Financial and Agricultural	$ 9,722	$ 8,043	$ 4,621	$ 22,386
Real Estate - Construction	9,507	2,166	965	12,638
Total	$ 19,229	$ 2,166	$ 5,586	$ 35,024
Loans with fixed rates	$ 14,546	$ 7,706	$ 5,586	$ 27,838
Loans with floating rates	5,911	1,275	-	7,186
Total	$ 20,457	$ 8,981	$ 5,586	$ 35,024

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. For the year ended December 31, 2010, interest income that would have been recorded on loans accounted for on a non-accrual basis under the original terms of such loans was $390,000 of which $51,000 was collected.

	As of December 31,				
	2010	2009	2008	2007	2006
	(dollars in thousands)				
Non-accrual loans:					
Commercial and all other	$ 513	$ —	$ —	$ —	$ —
Real estate	3,527	4,916	2,087	109	392
Consumer	—	—	—	2	17
Total	4,040	4,916	2,087	111	409
Accruing loans which are contractually past-due 90 days or more:					
Commercial and all other	—	9	—	—	—
Real estate	39	90	—	49	—
Consumer	—	—	—	3	—
Total	39	99	—	52	—
Total non-performing loans	4,079	5,015	2,087	163	409
Foreclosed real estate	748	392	660	—	—
Total non-performing assets	$ 4,827	$ 5,407	$ 2,747	$ 163	$ 409
Total non-performing loans to total loans	1.14%	1.38%	0.60%	0.05%	0.13%
Total non-performing loans to total assets	0.76%	0.95%	0.41%	0.03%	0.09%
Total non-performing assets to total assets	0.90%	1.02%	0.54%	0.03%	0.09%

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The recorded investment in impaired loans, not requiring an allowance for loan losses was $6,111,000 (net of a charge-off against the allowance for loan losses of $220,000) and $6,962,000 (net of charge-offs against the allowance of $154,000) at December 31, 2010 and 2009, respectively. The recorded investment in impaired loans requiring an allowance for loan losses was $8,641,000 (net of charge-off against the allowance for loan losses of $480,000) and $1,065,000 (net of a charge-off against the allowance of $480,000) at December 31, 2010 and 2009. For the years ended December 31, 2010, 2009 and 2008, the average recorded investment in these impaired loans was $10,090,000, $3,585,000 and $3,331,000 and the interest income recognized on these impaired loans was $385,000, $139,000 and $143,000, respectively.

Potential Problem Loans. As of December 31, 2010, 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:

	As of December 31,				
	2010	2009	2008	2007	2006
	(dollars in thousands)				
Total loans receivable net of unearned income	$ 356,855	$ 363,474	$ 349,404	$ 331,296	$ 315,567
Average loans receivable	$ 355,980	$ 356,345	$ 335,137	$ 323,444	$ 301,533
Allowance balance at beginning of period	$ 5,453	$ 4,233	$ 4,081	$ 3,828	$ 3,669
Charge-offs:					
Commercial and all other					