NORTHWAY FINANCIAL INC
Form 10-Q
May 14, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q

(Mark One)
[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended March 31, 2002

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 Number 000-23129

NORTHWAY FINANCIAL, INC
(Exact name of registrant as specified in its charter)

New Hampshire	04-3368579
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
9 Main Street Berlin, New Hampshire	03570
(Address of principal executive offices)	(Zip Code)

(603) 752-1171
(Registrant's telephone number, including area code)

No Change
(Former name, former address and former fiscal year, if changed since last year)

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 twelve (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 ninety (90) days. YES [X] NO [ ]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date. At April 30, 2002, there were 1,516,074 shares of common stock outstanding, par value $1.00 per share.

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NORTHWAY FINANCIAL, INC.

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements.

NORTHWAY FINANCIAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

(Dollars in thousands, except per share data)	Three Months Ended March 31, 2002	2001
Interest and dividend income:		
Loans	$7,104	$8,258
Interest on debt securities:		
Taxable	581	691
Tax-exempt	64	107
Dividends	58	105
Federal funds sold	47	20

Interest bearing deposits	--	1
Total interest and dividend income	7,854	9,182
Interest expense:		
Deposits	1,850	3,319
Borrowed funds	685	762
Total interest expense	2,535	4,081
Net interest and dividend income	5,319	5,101
Provision for loan losses	225	225
Net interest and dividend income after provision for loan losses	5,094	4,876
Noninterest income:		
Service charges and fees on deposit accounts	309	289
Securities gains, net	246	33
Other	397	283
Total noninterest income	952	605
Noninterest expense:		
Salaries and employee benefits	2,380	2,139
Office occupancy and equipment	763	731
Amortization of unidentifiable intangible assets	164	175
Other	1,082	996
Total noninterest expense	4,389	4,041
Income before income tax expense	1,657	1,440
Income tax expense	574	438
Net income	$1,083	$1,002
Comprehensive net income	$ 714	$1,110
Per share data:		
Earnings per common share	$ 0.72	$ 0.65
Cash dividends declared	$ 0.17	$ 0.17
Weighted average number of common shares	1,511,424	1,541,377

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

NORTHWAY FINANCIAL, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)	Mar. 31, 2002	Dec. 31, 2001
	(Unaudited)	
Assets		
Cash and due from banks and interest bearing deposits	$ 13,867	$ 22,741
Federal funds sold	7,700	6,900
Securities available-for-sale	60,057	60,276
Loans held-for-sale	922	2,026
Loans	395,858	400,316
Less: allowance for loan losses	4,712	4,642

Loans, net	391,146	395,674
Other real estate owned	--	22
Accrued interest receivable	2,308	2,237
Deferred income tax asset, net	1,916	1,861
Premises and equipment, net	11,421	11,485
Unidentifiable intangible assets	7,915	8,080
Other assets	2,789	2,637
Total assets	$500,041	$513,939
Liabilities and Stockholders' Equity		
Liabilities:		
Interest bearing deposits	$337,182	$349,994
Noninterest bearing deposits	57,584	62,846
Securities sold under agreements to repurchase	7,933	8,155
Long-term Federal Home Loan Bank advances	48,028	48,028
Other liabilities	5,476	1,577
Total liabilities	456,203	470,600
Stockholders' equity:		
Preferred stock, $1.00 par value; 1,000,000 shares authorized; none issued	--	--
Common stock, $1 par value; 9,000,000 shares authorized; 1,731,969 issued at March 31, 2002 and December 31, 2001 and 1,512,824 outstanding at March 31, 2002 and 1,511,324 outstanding at December 31, 2001	1,732	1,732
Surplus	2,102	2,101
Retained earnings	46,781	45,955
Treasury stock, at cost (219,145 and 220,645 shares, respectively)	(5,823)	(5,864)
Accumulated other comprehensive loss, net of tax	(954)	(585)
Total stockholders' equity	43,838	43,339
Total liabilities and stockholders' equity	$500,041	$513,939

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

NORTHWAY FINANCIAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(Dollars in thousands)	For the Three Months Ended March 31, 2002	2001
Cash flows from operating activities:		
Net income	$ 1,083	$ 1,002
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	225	225
Depreciation and amortization	455	437
Deferred income tax expense	187	--
Write-down of other real estate owned	--	3

Gains on sales of securities available-for-sale, net	(246)	(33)
Amortization of premiums & accretion of discounts on securities, net	56	6
Increase (decrease) in unearned income, net	12	(6)
Gain on sales of other real estate owned and other personal property, net	(4)	(12)
Net decrease (increase) in loans held-for-sale	1,104	(398)
Net change in other assets and other liabilities	3,647	(141)
Net cash provided by operating activities	6,519	1,083
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	5,880	3,957
Proceeds from maturities of securities available-for-sale	5,684	19,061
Purchase of securities available-for-sale	(11,766)	(15,304)
Loan originations and principal collections, net	4,100	3,589
Recoveries of previously charged-off loans	59	42
Proceeds from sales of and payments received on other real estate owned	26	15
Proceeds from sales of and payments received on other personal property	161	128
Additions to premises and equipment	(226)	(315)
Net cash provided by investing activities	3,918	11,173
Cash flows from financing activities:		
Net decrease in deposits	(18,074)	(10,203)
Advances from FHLB	--	4,000
Net decrease in short-term FHLB advances	--	(2,950)
Net increase (decrease) in securities sold under agreements to repurchase	(222)	2,391
Exercise of stock options	42	--
Purchases of treasury stock	--	(637)
Cash dividends paid	(257)	(261)
Net cash used in financing activities	(18,511)	(7,660)
Net increase (decrease) in cash and cash equivalents	(8,074)	4,596
Cash and cash equivalents at beginning of period	29,641	15,401
Cash and cash equivalents at end of period	$21,567	$19,997
Supplemental disclosure of cash flows:		
Interest paid	$ 2,761	$ 4,483
Taxes paid	$ 70	$ --
Loans transferred to other real estate owned	$ --	$ 24
Loans transferred to other personal property	$ 132	$ 134
Carrying amount of held-to-maturity securities transferred to available-for-sale	$ --	$ 2,752

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

NORTHWAY FINANCIAL, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2002
(Unaudited)

1. Basis of Presentation.

The unaudited condensed consolidated financial statements of Northway Financial, Inc. and its two wholly-owned bank subsidiaries (collectively, "the Company") included herein have been prepared by the Company in accordance with the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted in accordance with such rules and regulations. The Company, however, believes that the disclosures are adequate to make the information presented not misleading. The amounts shown reflect, in the opinion of management, all adjustments necessary for a fair presentation of the financial statements for the periods reported.

The results of operations for the three month periods ended March 31, 2002 and 2001 are not necessarily indicative of the results of operations to be expected for the full year or any other interim periods. The interim financial statements are meant to be read in conjunction with the Company's audited financial statements presented in its Annual Report on Form 10-K for the fiscal year ended December 31, 2001.

In preparing financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the dates of the balance sheet and revenues and expenses for the reported periods. Actual results could differ from these estimates. Material estimates that are particularly susceptible to change relate to the determination of the allowance for loan losses.

The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP.

2. Impact of New Accounting Standards.

On January 1, 2001, the Company adopted Stated of Financial Accounting Standards ("SFAS") No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133 establishes accounting and reporting standards for derivative instruments and hedging activities, including certain derivative instruments embedded in other contracts, and requires that an entity recognize all derivatives as assets or liabilities in the balance sheet and measure them at fair value. If certain conditions are met, an entity may elect to designate a derivative as follows: (1) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (2) a hedge of the exposure to variable cash flows of a forecasted transaction, or (3) a hedge of the foreign currency exposure of an unrecognized firm commitment, an available-for-sale security, a foreign currency denominated forecasted transaction, or a net investment in a foreign operation. SFAS No. 133 generally provides for matching the timing of the recognition of the gain or loss on derivatives designated as hedging instruments with the recognition of the changes in the fair value of the item being hedged. Depending on the type of hedge, such recognition will be either net income or other comprehensive income. For a derivative not designated as a hedging instrument, changes in fair value will be recognized in net income in the period of change. SFAS No. 133 allows for a one-time change in the classification of securities in the investment portfolio. Therefore, in conjunction with the adoption of SFAS No. 133, the Company transferred all securities held-to-maturity to the available-for-sale category at their market value of $2,731,000 as of January 1, 2001. In connection with the transfer, the Company recorded in comprehensive income an unrealized holding loss of approximately $13,000, net of tax effect. Under SFAS No. 133, this transfer will not call into question the Company's intent to hold other debt securities to maturity in the future. The adoption of SFAS No. 133 did not have any material impact on the Company's consolidated financial statements.

SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, replaces SFAS No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and rescinds SFAS No. 127, Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125. SFAS No. 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. SFAS No. 140 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings. SFAS No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001; however, the disclosure provisions are effective for fiscal years ending after December 15, 2000. The adoption of SFAS No. 140 has had no material impact on the Company's consolidated financial statements.

SFAS No. 141, Business Combinations, improves the consistency of the accounting and reporting of business combinations by requiring that all business combinations be accounted for under a single method - the purchase method. Use of the pooling-of-interests method is no longer permitted. SFAS No. 141 requires that the purchase method be used for business combinations initiated after June 30, 2001. The adoption of this SFAS No. 141 has had no material impact on the Company's consolidated financial statements.

SFAS No. 142, Goodwill and Other Intangible Assets, requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. The amortization of goodwill ceases upon adoption of the statement, which for most companies, was January 1, 2002. The adoption of SFAS No. 142 has had no material impact on the Company's consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

The following discussion and analysis and the related condensed consolidated financial statements relate to Northway Financial, Inc. and its two wholly-owned subsidiaries, The Berlin City Bank and Pemigewasset National Bank (collectively the "Company").

Forward-Looking Statements

Certain statements in this Form 10-Q are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may include, but are not limited to, projections of revenue, income or loss, plans for future operations and acquisitions, and plans related to products or services of the Company. Such forward-looking statements are subject to known and unknown risks, uncertainties and contingencies, many of which are beyond the control of the Company. To the extent any such risks, uncertainties and contingencies are realized, the Company's actual results, performance or achievements could differ materially from anticipated results, performance or achievements. Factors that might affect such forward-looking statements include, among other things, overall economic and business conditions, economic and business conditions in the Company's market areas, interest rate fluctuations, the demand for the Company's products and services, competitive factors in the industries in which the Company competes, changes in government regulations, and the timing, impact and other uncertainties of future acquisitions.

In addition to the factors described above, the following are some additional factors that could cause our financial performance to differ from any forward-looking statement contained herein; a) the current economic downturn nation-wide and regionally, as well as a deterioration of local business conditions, including termination of operations of a major employer in the primary market area of the Berlin City Bank, b) a change in product mix attributable to changing interest rates, customer preferences or competition; c) a significant portion of the Company's loan customers are in the hospitality business and therefore could be affected by weather conditions and/or high gasoline prices; and d) the effectiveness of advertising, marketing and promotional programs.

The words "believe," "expect," "anticipate," "intend," "estimate," "project," or the negative of such terms and other expressions which are predictions of or indicate future events and trends and which do not relate to historical matters identify forward-looking statements. Reliance should not be placed on forward-looking statements because they involve known or unknown risks, uncertainties or other factors, which may cause the actual results, performance or achievements of the Company to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. The Company undertakes no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Although the Company has attempted to list comprehensively the factors which might affect forward-looking statements, the Company wishes to caution investors that other factors may in the future prove to be important in affecting the Company's results of operations. New factors emerge from time to time and it is not possible for management to anticipate all of such factors, nor can it assess the impact of each such factor, or combination of factors, which may cause actual results to differ materially from forward-looking statements.

Financial Condition

The Company's total assets at March 31, 2002 were $500.0 million compared to $513.9 million at December 31, 2001, a decrease of $13.9 million. Net loans, including loans held-for-sale, decreased $5.6 million to $392.1 million. Cash and cash equivalents decreased $8.1 million to $21.6 million as a result of a decrease in vault cash as well as a decrease in Federal Reserve uncollected balances. Deposits decreased $18.1 million primarily due to lower DDA and time deposits. Total stockholders' equity increased $0.5 million from $43.3 million at December 31, 2001 to $43.8 million at March 31, 2002. The increase in stockholders' equity was a result of net income of $1.1 million partially offset by an increase in accumulated comprehensive loss of $0.4 million and dividends paid of $0.3 million.

The Company maintains an allowance for loan losses to absorb future charge-offs of loans in the existing portfolio. The allowance is increased when a loan loss provision is recorded as an expense. When a loan, or portion thereof, is considered uncollectible, it is charged against this allowance. Recoveries of amounts previously charged-off are added to the allowance when collected. At March 31, 2002 the allowance for loan losses was $4.7 million, or 1.19% of total loans, compared to $4.6 million, or 1.16% of total loans at December 31, 2001. The allowance for loan losses is based on an evaluation by each bank's management and Board of Directors of current and anticipated economic conditions, changes in the diversification, size and risk within the loan portfolio, and other factors. An analysis of the allowance for loan losses for the three-month periods ended March 31, 2002 and 2001 is as follows:

(Dollars in thousands)	Three Months Ended March 31, 2002	2001
Balance at beginning of period	$4,642	$4,354
Charge-offs	(214)	(161)
Recoveries	59	42
Net charge-offs	(155)	(119)
Provision for loan losses	225	225
Balance at end of period	$4,712	$4,460

Nonperforming loans totaled $1.0 million as of March 31, 2002, compared to $1.4 million at December 31, 2001. The ratio of nonperforming loans to total loans was 0.25% as of March 31, 2002 compared to 0.35% at December 31, 2001 and the ratio of nonperforming assets to total assets was 0.21% as of March 31, 2002 compared to 0.30% at December 31, 2001.

Results of Operations

The Company reported net income of $1,083,000, or $0.72 per common share, for the three months ended March 31, 2002, compared to $1,002,000, or $0.65 per common share, for the three months ended March 31, 2001. The increase in net income for the quarter is primarily attributable to higher net interest income and noninterest income partially offset by higher noninterest expense. The increase in per share net income reflects these factors as well as a reduction of common stock outstanding as a result of stock repurchased by the Company since March 2001. Net interest and dividend income for the three months ended March 31, 2002 increased $218,000 to $5,319,000 compared to $5,101,000 for the first quarter of the prior year.

Noninterest income increased $347,000 to $952,000 in the first quarter of 2002 compared to $605,000 in the first quarter of 2001. The increase was primarily due to an increase in securities gains and loan extension fees, as well as an increase in the recognition of FAS125 servicing asset income.

Noninterest expense increased $348,000 to $4,389,000 for the quarter ended March 31, 2002 compared to the $4,041,000 recorded during the same period last year primarily due to significant increases in pension and employee insurance plan expenses over the same period last year. In addition, the Littleton branch acquisition, which occurred during the fourth quarter of 2001, resulted in an increase in salaries and employee benefits as well as occupancy and other expense.

Income Tax Expense

The Company recognized income tax expense of $574,000 and $438,000 for the three months ended March 31, 2002 and 2001, respectively. The effective tax rates were 34.6% and 30.4% for those respective periods. The increase in the effective tax rate is due to the fact that during 2001 the Company obtained a number of State of New Hampshire tax credits related to economic development grants and carried a larger percentage of tax exempt securities and loans versus the amount carried this year.

Liquidity

Liquidity risk management refers to the Company's ability to raise funds in order to meet existing and anticipated financial obligations. These obligations to make payment include withdrawal of deposits on demand or at their contractual maturity, the repayment of borrowings as they mature, funding new and existing loan commitments as well as new business opportunities. Liquidity may be provided through amortization, maturity or sale of assets such as loans and securities available-for-sale, liability sources such as increased deposits, utilization of the Federal Home Loan Bank ("FHLB") credit facility, purchased or other borrowed funds, and access to the capital markets. Liquidity targets are subject to change based on economic and market conditions and are controlled and monitored by the Company's Asset/Liability Committee.

At the subsidiary bank level, liquidity is managed by measuring the net amount of marketable assets after deducting pledged assets, plus lines of credit, primarily with the FHLB, which are available to fund liquidity requirements. Management then measures the adequacy of that aggregate amount relative to the aggregate amount of liabilities deemed to be sensitive or volatile. These include core deposits in excess of $100,000, term deposits with short maturities, and credit commitments outstanding.

Additionally, the parent holding company requires cash for various operating needs including dividends to shareholders, the stock repurchase program, capital injections to the subsidiary banks, and the payment of general corporate expenses. The primary sources of liquidity for the parent holding company are dividends from the subsidiary banks.

Management believes that the Company's current level of liquidity and funds availability from outside sources is sufficient to meet the Company's needs.

Capital

The Company's Tier 1 and Total Risk Based Capital ratios were 9.37% and 10.59%, respectively, at March 31, 2002. The Company's Tier 1 leverage ratio at March 31, 2002 was 7.30%. As of March 31, 2002, the capital ratios of the Company and Pemigewasset National Bank exceeded the minimum capital ratio requirements of the "well-capitalized" category under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"). Berlin City Bank's capital ratios as of March 31, 2002 exceeded the minimum capital ratio requirements of the "adequately-capitalized" category under FDICIA. This was the result of the branch acquisition during the fourth quarter of 2001, which caused Total Risk Based Capital to fall below the "well-capitalized" level.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Since December 31, 2001, there have been no material changes in the Company's quantitative and qualitative disclosures about market risk. A fuller description of the quantitative and qualitative disclosures about market risk was provided by the Company on pages 8 through 18 of the Company's 2001 Annual Report to Stockholders filed as Exhibit 13 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2001.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings - None

Item 2. Changes in Securities - None

Item 3. Defaults upon Senior Securities - None

Item 4. Submission of Matters to a Vote of Security Holders - None

Item 5. Other Information - None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

3.1 Amended and Restated Articles of Incorporation of Northway Financial Inc. (incorporated by reference to Exhibit 3.1 to Registration Statement No. 333-33033).

3.2 By-laws of Northway Financial Inc. (incorporated by reference to Exhibit 3.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997).

4 Form of Certificate representing the Company Common Stock (reference is also made to Exhibits 3.1 and 3.2) (incorporated by reference to Exhibit 4 to Registration Statement No. 333-33033).

(b) The Company did not file any Reports on Form 8-K during the quarter ended March 31, 2002

SIGNATURES

Pursuant to requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

NORTHWAY FINANCIAL, INC.

May 14, 2002

BY: \S\ William J. Woodward

William J. Woodward
President & CEO
(Principal Executive Officer)

May 14, 2002

BY: \S\ Richard P. Orsillo

Richard P. Orsillo
Senior Vice President & CFO
(Principal Financial and Accounting Officer)