ADTRAN INC
Form 10-Q
November 05, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended September 30, 2012

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 0-24612

ADTRAN, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**63-0918200** **(I.R.S. Employer**
(State of Incorporation)	**Identification No.)**

901 Explorer Boulevard, Huntsville, Alabama 35806-2807

(Address of principal executive offices, including zip code)

(256) 963-8000

(Registrant s telephone number, including area code)

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 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 ¨

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T (232.405 of this chapter) during the preceding 12 months (or for shorter period that the Registrant was required to submit and post such files). Yes x No ¨

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 definition of large accelerated filer , accelerated filer , and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer	x	Accelerated Filer	¨
Non-accelerated Filer	¨	Smaller Reporting Company	¨

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

Indicate the number of shares outstanding of each of the issuer s classes of Common Stock, as of the latest practicable date:

Class	Outstanding at October 22, 2012
Common Stock, $.01 Par Value	62,670,966 shares

Table of Contents

ADTRAN, INC.

Quarterly Report on Form 10-Q

For the Three and Nine Months Ended September 30, 2012

Table of Contents

FORWARD LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements made by or on behalf of ADTRAN. ADTRAN and its representatives may from time to time make written or oral forward-looking statements, including statements contained in this report, our other filings with the Securities and Exchange Commission (SEC) and other communications with our stockholders. Generally, the words, believe, expect, intend, estimate, anticipate, will, may, could and similar expressions identify forward-looking statements. W you that any forward-looking statements made by us or on our behalf are subject to uncertainties and other factors that could cause such statements to be wrong. A list of factors that could materially affect our business, financial condition or operating results is included under Factors that Could Affect Our Future Results in Management s Discussion and Analysis of Financial Condition and Results of Operations contained in Item 2 of Part I of this report. They have also been discussed in Item 1A of Part I in our most recent Annual Report on Form 10-K for the year ended December 31, 2011 filed on February 29, 2012 with the SEC. Though we have attempted to list comprehensively these important factors, we caution investors that other factors may prove to be important in the future in affecting our operating results. New factors emerge from time to time, and it is not possible for us to predict all of these factors, nor can we assess the impact each factor or a combination of factors may have on our business.

You are further cautioned not to place undue reliance on these forward-looking statements because they speak only of our views as of the date that the statements were made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ADTRAN, INC.

CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except per share amounts)

	September 30, 2012	December 31, 2011
ASSETS		
Current Assets		
Cash and cash equivalents	$ 43,535	$ 42,979
Short-term investments	190,333	159,347
Accounts receivable, less allowance for doubtful accounts of $5 and $8 at September 30, 2012 and December 31, 2011, respectively	102,693	76,130
Other receivables	8,260	9,743
Inventory	107,183	87,800
Prepaid expenses	4,354	3,119
Deferred tax assets, net	12,729	12,125
Total Current Assets	**469,087**	**391,243**
Property, plant and equipment, net	81,905	75,295
Deferred tax assets, net	6,843	8,345
Goodwill	3,492	3,492
Other assets	13,825	7,131
Long-term investments	327,106	332,008
Total Assets	**$ 902,258**	**$ 817,514**
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 52,285	$ 29,404
Unearned revenue	31,672	9,965
Accrued expenses	10,310	5,876
Accrued wages and benefits	16,894	13,518
Income tax payable, net	4,186	3,169
Total Current Liabilities	**115,347**	**61,932**
Non-current unearned revenue	19,805	4,874
Other non-current liabilities	15,162	12,077
Bonds payable	46,500	46,500
Total Liabilities	**196,814**	**125,383**
Commitments and contingencies (see Note 14)		
Stockholders Equity		
	797	797

Common stock, par value $0.01 per share; 200,000 shares authorized; 79,652 shares issued and 62,823 shares outstanding at September 30, 2012 and 79,652 shares issued and 63,703 shares outstanding at December 31, 2011				
Additional paid-in capital		222,156		213,560
Accumulated other comprehensive income		15,311		13,102
Retained earnings		864,258		840,206
Less treasury stock at cost: 16,829 and 15,949 shares at September 30, 2012 and December 31, 2011, respectively		(397,078)		(375,534)
Total Stockholders Equity		**705,444**		**692,131**
Total Liabilities and Stockholders Equity	**$**	**902,258**	**$**	**817,514**

See notes to consolidated financial statements

3

Table of Contents

ADTRAN, INC.

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Sales	$ 162,125	$ 192,194	$ 480,858	$ 541,943
Cost of sales	82,153	82,718	231,598	226,845
Gross Profit	**79,972**	**109,476**	**249,260**	**315,098**
Selling, general and administrative expenses	34,114	31,475	103,130	91,925
Research and development expenses	35,582	26,894	92,835	75,150
Operating Income	**10,276**	**51,107**	**53,295**	**148,023**
Interest and dividend income	1,864	2,037	5,651	5,829
Interest expense	(587)	(599)	(1,756)	(1,795)
Net realized investment gain	2,530	2,982	7,353	9,121
Other income (expense), net	(368)	(155)	265	(397)
Gain on bargain purchase of a business			1,753	
Income before provision for income taxes	**13,715**	**55,372**	**66,561**	**160,781**
Provision for income taxes	(4,443)	(19,159)	(23,259)	(53,367)
Net Income	**$ 9,272**	**$ 36,213**	**$ 43,302**	**$ 107,414**
Weighted average shares outstanding basic	63,066	64,023	63,495	64,300
Weighted average shares outstanding diluted	63,304	64,961	64,139	65,697
Earnings per common share basic	$ 0.15	$ 0.57	$ 0.68	$ 1.67
Earnings per common share diluted	$ 0.15	$ 0.56	$ 0.68	$ 1.63
Dividend per share	$ 0.09	$ 0.09	$ 0.27	$ 0.27

See notes to consolidated financial statements

Table of Contents

ADTRAN, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	**2011**	**2012**	**2011**
Net Income	$ 9,272	$ 36,213	$ 43,302	$ 107,414
Other Comprehensive Income (Loss), net of tax:				
Net change in unrealized gains (losses) on marketable securities	154	(5,468)	1,855	(11,259)
Reclassification adjustments for amounts included in net income	343	(287)	164	(682)
Foreign currency translation	134	(1,487)	191	(1,031)
Other Comprehensive Income (Loss), net of tax	**631**	**(7,242)**	**2,210**	**(12,972)**
Comprehensive Income, net of tax	**$ 9,903**	**$ 28,971**	**$ 45,512**	**$ 94,442**

See notes to consolidated financial statements

5

ADTRAN, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Cash flows from operating activities:		
Net income	$ 43,302	$ 107,414
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,366	8,435
Amortization of net premium on available-for-sale investments	6,343	4,697
Net realized gain on long-term investments	(7,353)	(9,121)
Net (gain) loss on disposal of property, plant and equipment	(213)	14
Gain on bargain purchase of a business	(1,753)	
Stock-based compensation expense	6,783	6,455
Deferred income taxes	(1,156)	128
Tax benefit from stock option exercises	1,813	10,457
Excess tax benefits from stock-based compensation arrangements	(1,412)	(9,311)
Changes in operating assets and liabilities:		
Accounts receivable, net	(26,178)	(18,440)
Other receivables	1,866	(8,525)
Income tax receivable, net		2,741
Inventory	2,142	(12,247)
Prepaid expenses and other assets	(1,193)	207
Accounts payable	17,607	8,924
Accrued expenses and other liabilities	12,769	15,047
Income tax payable, net	1,022	1,916
Net cash provided by operating activities	**64,755**	**108,791**
Cash flows from investing activities:		
Purchases of property, plant and equipment	(10,759)	(9,531)
Proceeds from disposals of property, plant and equipment	266	
Proceeds from sales and maturities of available-for-sale investments	198,566	378,288
Purchases of available-for-sale investments	(220,355)	(443,275)
Acquisition of business	7,496	(22,762)
Net cash used in investing activities	**(24,786)**	**(97,280)**
Cash flows from financing activities:		
Proceeds from stock option exercises	4,932	33,631
Purchases of treasury stock	(28,578)	(35,178)
Dividend payments	(17,173)	(17,395)
Excess tax benefits from stock-based compensation arrangements	1,412	9,311
Net cash used in financing activities	**(39,407)**	**(9,631)**
Net increase in cash and cash equivalents	562	1,880

Effect of exchange rate changes	(6)	(1,031)
Cash and cash equivalents, beginning of period	**42,979**	**31,677**
Cash and cash equivalents, end of period	**$ 43,535**	**$ 32,526**

See notes to consolidated financial statements

Table of Contents

ADTRAN, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(In thousands, except per share amounts)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements of ADTRAN®, Inc. and its subsidiaries (ADTRAN) have been prepared pursuant to the rules and regulations for reporting on Quarterly Reports on Form 10-Q. Accordingly, certain information and notes required by generally accepted accounting principles for complete financial statements are not included herein. The December 31, 2011 Consolidated Balance Sheet is derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States.

In the opinion of management, all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal and recurring nature. The results of operations for an interim period are not necessarily indicative of the results for the full year. The interim statements should be read in conjunction with the financial statements and notes thereto included in ADTRAN s Annual Report on Form 10-K for the year ended December 31, 2011, filed on February 29, 2012 with the SEC.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expense during the reporting period. Our more significant estimates include the allowance for doubtful accounts, obsolete and excess inventory reserves, warranty reserves, customer rebates, allowance for sales returns, determination of the deferred revenue components of multiple element sales agreements, estimated costs to complete obligations associated with deferred revenues, estimated income tax contingencies, the fair value of stock-based compensation, impairment of goodwill, value and estimated lives of intangible assets, and the evaluation of other-than-temporary declines in the value of investments. Actual amounts could differ significantly from these estimates.

Recent Accounting Pronouncements

During the nine months ended September 30, 2012, we adopted the following accounting standards, which had no material effect on our consolidated results of operations or financial condition:

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2011-05, Presentation of Comprehensive Income (ASU 2011-05). ASU 2011-05 requires companies to present the components of net income and other comprehensive income either as one continuous statement or as two consecutive statements. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders equity. While ASU 2011-05 changes the presentation of comprehensive income, it does not change the components that are recognized in net income or comprehensive income under current accounting guidance. This update is effective for fiscal years, and interim periods within those years, ending after December 15, 2011, with early adoption permitted. We adopted this amendment during the first quarter of 2012, and we have provided the disclosures required for the three and nine months ended September 30, 2012 and 2011.

In December 2011, the FASB issued Accounting Standards Update No. 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05 (ASU 2011-12). ASU 2011-12 defers the effective date for certain presentation requirements that relate to reclassification adjustments and the effect of those reclassification adjustments on the financial statements. This update is effective for fiscal years, and interim periods within those years, ending after December 15, 2011, with early adoption permitted. We adopted this amendment during the first quarter of 2012. The adoption of this amendment had no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2012.

Table of Contents

In May 2011, the FASB issued Accounting Standards Update No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (ASU 2011-04). ASU 2011-04 is intended to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and IFRS. The amendments are of two types: (i) those that clarify the Board s intent about the application of existing fair value measurement and disclosure requirements and (ii) those that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. This update is effective for annual periods beginning after December 15, 2011. We adopted this amendment during the first quarter of 2012. The adoption of this amendment had no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2012.

2. BUSINESS COMBINATIONS

On May 4, 2012, we acquired the Nokia Siemens Networks (NSN) Broadband Access business (NSN BBA business). This acquisition provides us with an established customer base in key markets and complementary, market-focused products and was accounted for as a business combination. We have included the financial results of the NSN BBA business in our consolidated financial statements since the date of acquisition. These revenues are included in the Carrier Networks division in the Broadband Access subcategory.

We received a cash payment of $7.5 million from NSN and recorded a bargain purchase gain of $1.8 million, net of income taxes, subject to customary working capital adjustments between the parties as defined in the purchase agreement. As of September 30, 2012, the parties were in the process of resolving the working capital adjustments. The bargain purchase gain of $1.8 million represents the excess of the consideration exchanged over the fair value of the assets acquired and liabilities assumed. We have assessed the recognition and measurements of the assets acquired and liabilities assumed based on historical and pro forma data for future periods and have concluded that our valuation procedures and resulting measures were appropriate. The gain is included in the line item Gain on bargain purchase of a business in the 2012 Consolidated Statements of Income.

The preliminary allocation of the purchase price to the estimated fair value of the assets acquired and liabilities assumed at the acquisition date is as follows:

(In Thousands)	
Other receivables	$ 395
Inventory	22,278
Property, plant and equipment	5,035
Accounts payable	(5,194)
Unearned revenue	(13,579)
Accrued expenses	(1,931)
Accrued wages and benefits	(2,251)
Deferred tax liability	(788)
Non-current unearned revenue	(18,059)
Net liabilities assumed	**(14,094)**
Customer relationships	5,162
Developed technology	3,176
Other	13
Gain on bargain purchase of a business, net of tax	(1,753)
Net consideration received by buyer	**$ (7,496)**

The fair value of the customer relationships acquired was calculated using a discounted cash flow method (excess earnings) and is being amortized using a declining balance method derived from projected customer revenue over an average estimated useful life of 13 years. The fair value of the developed technology acquired was calculated using a discounted cash flow method (relief from royalty) and is being amortized using the straight-line method over an estimated useful life of five years.

Table of Contents

The actual revenue and pre-tax loss included in our Consolidated Statements of Income for the three months ended September 30, 2012 and from the acquisition date to September 30, 2012 are as follows:

(In thousands)	Three Months Ended September 30, 2012	May 4, 2012 to September 30, 2012
Revenue	$ 26,343	$ 48,983
Pre-tax loss	$ (2,547)	$ (2,947)

The following supplemental pro forma information presents the financial results as if the acquisition of the NSN BBA business had occurred on January 1, 2011. This supplemental pro forma information does not purport to be indicative of what would have occurred had the acquisition of the NSN BBA business been completed on January 1, 2011, nor are they indicative of any future results.

	Three Months Ended September 30,	Nine Months Ended September 30,	
(In thousands)	2011	2012	2011
Pro forma revenue	$ 44,978	$ 100,413	$ 153,263
Pro forma pre-tax loss	$ (10,947)	$ (18,006)	$ (31,987)
Weighted average exchange rate during the period (EURO/USD)	1.00/$1.42	1.00/$1.29	1.00/$1.40

For the three and nine months ended September 30, 2012, we incurred acquisition and integration related expenses and amortization of acquired intangibles of $1.2 million and $6.7 million, respectively, related to this acquisition.

On August 4, 2011, we acquired all of the outstanding stock of Bluesocket, Inc., a provider of wireless network solutions with virtual control capabilities, for $23.7 million in cash. The acquisition provides us with IEEE802.11N enterprise class wireless LAN expertise, technology, and products to address the growing transition within small-medium enterprises and large enterprises to wireless networks and mobile devices. We have included the financial results of Bluesocket in our consolidated financial statements since the date of acquisition. Pro forma results of operations prior to the closing date for the acquisition have not been presented because the effect of the acquisition was not material to our financial results.

Table of Contents

The allocation of the purchase price to the estimated fair value of the assets acquired and liabilities assumed at the acquisition date is as follows:

(In Thousands)	
Cash	$ 1,027
Accounts receivable	298
Inventory	792
Prepaid expenses	357
Property, plant and equipment	173
Deferred tax assets, net	12,962
Accounts payable	(441)
Unearned revenue	(600)
Accrued expenses	(332)
Net assets acquired	**14,236**
Customer relationships	1,530
Developed technology	3,230
Intellectual property	930
Trade names	270
Goodwill	3,492
Total purchase price	**$ 23,688**

During the fourth quarter of 2011, the purchase price and purchase price allocation were adjusted for our final valuations. The adjustments resulted in a decrease to the goodwill recognized in the transaction.

The net deferred tax assets acquired are primarily related to net operating losses and previously capitalized and unamortized research and development expense for tax deduction purposes.

The fair value of the customer relationships, developed technology and intellectual property acquired was calculated using an income approach (excess earnings method) and is being amortized using the straight-line method. The customer relationships and intellectual property are being amortized over an estimated useful life of 7 years and the developed technology is being amortized over an average estimated useful life of 4.5 years.

The fair value of the trade names acquired was calculated using an income approach (relief from royalty method) and is being amortized using the straight-line method over the estimated useful life of 4.5 years.

The goodwill of $3.5 million generated from this acquisition is primarily related to expected synergies and was assigned to our Enterprise Networks division. The goodwill will not be deductible for U.S. federal income tax purposes.

For the three and nine months ended September 30, 2012, we incurred integration related expenses and amortization of acquired intangibles of $0.3 million and $1.2 million, respectively, related to this acquisition.

3. INCOME TAXES

Our effective tax rate increased from 33.2% in the nine months ended September 30, 2011 to 34.9% in the nine months ended September 30, 2012. The tax provision rate in the nine months ended September 30, 2012 did not include the benefit of the research tax credit, which expired on December 31, 2011. The exclusion of this benefit during the nine months ended September 30, 2012 resulted in a 2.2 percentage point increase in our effective tax rate. Reduced stock option exercises, increase in a valuation allowance related to foreign subsidiary losses, and an increase in reserves related to state apportionment resulted in an additional 6.1 percentage point increase in our effective tax rate for the nine months ended September 30, 2012. These increases were partially offset by provision to return reconciliation adjustments related to 2011, adjustments related to closed tax years and associated audits, and employment related state income tax incentives, which resulted in a 6.6 percentage point decrease in our effective tax rate for the nine months ended September 30, 2012.

Table of Contents

During the nine months ended September 30, 2012, we acquired the NSN BBA business, which resulted in a bargain purchase gain reported on the income statement. The bargain purchase gain is presented net of tax in the income statement and a deferred tax liability was established in the opening balance sheet for the acquired entity.

4. PENSION BENEFIT PLAN

As a result of our acquisition of the NSN BBA business, we assumed a defined benefit obligation of $17.0 million as of May 4, 2012. We established a Contribution Trust Arrangement (CTA) to hold the pension assets, and NSN has transferred assets to us equal to the defined benefit obligation.

The following table summarizes the components of net periodic pension cost for the three months ended September 30, 2012 and the period May 4, 2012 to September 30, 2012:

(In thousands)	**Three Months Ended September 30, 2012**	**May 4, 2012 to September 30, 2012**
Service cost	$ 288	$ 478
Interest cost	187	314
Expected return on plan assets	(250)	(415)
Net periodic pension cost	**$ 225**	**$ 377**

5. STOCK-BASED COMPENSATION

The following table summarizes the stock-based compensation expense related to stock options, restricted stock units (RSUs) and restricted stock for the three and nine months ended September 30, 2012 and 2011, which was recognized as follows:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
(In thousands)	**2012**	**2011**	**2012**	**2011**
Stock-based compensation expense included in cost of sales	**$ 106**	**$ 100**	**$ 304**	**$ 280**
Selling, general and administrative expense	1,107	1,090	3,205	3,096
Research and development expense	1,138	1,100	3,274	3,079
Stock-based compensation expense included in operating expenses	**2,245**	**2,190**	**6,479**	**6,175**
Total stock-based compensation expense	**2,351**	**2,290**	**6,783**	**6,455**
Tax benefit for expense associated with non-qualified options	(313)	(302)	(916)	(1,018)
Total stock-based compensation expense, net of tax	**$ 2,038**	**$ 1,988**	**$ 5,867**	**$ 5,437**

The fair value of our stock options was estimated using the Black-Scholes model. The determination of the fair value of stock options on the date of grant using the Black-Scholes model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables that may have a significant impact on the fair value estimate.

11

Table of Contents

The weighted-average assumptions and value of options granted for the three and nine months ended September 30, 2012 and 2011 are summarized as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Expected volatility	40.20%	38.31%	40.20%	38.31%
Risk-free interest rate	0.63%	1.00%	0.63%	1.00%
Expected dividend yield	1.30%	1.19%	1.30%	1.19%
Expected life (in years)	4.95	5.14	4.95	5.14
Weighted-average estimated value	$ 8.69	$ 9.52	$ 8.69	$ 9.54

The fair value of our RSUs is calculated using a Monte Carlo Simulation valuation method. There were no RSU grants during the nine months ended September 30, 2012 or 2011.

The fair value of restricted stock is equal to the closing price of our stock on the date of grant. There were no restricted stock grants during the nine months ended September 30, 2012 or 2011.

Stock-based compensation expense recognized in our Consolidated Statements of Income for the three and nine months ended September 30, 2012 and 2011 is based on options, RSUs and restricted stock ultimately expected to vest, and has been reduced for estimated forfeitures. Estimated forfeitures for stock options were based upon historical experience and approximate 1.6% annually. We estimated a 0% forfeiture rate for our RSUs and restricted stock due to the limited number of recipients and historical experience for these awards.

As of September 30, 2012, total compensation expense related to non-vested stock options, RSUs and restricted stock not yet recognized was approximately $15.8 million, which is expected to be recognized over an average remaining recognition period of 2.4 years.

The following table is a summary of our stock options outstanding as of December 31, 2011 and September 30, 2012 and the changes that occurred during the nine months ended September 30, 2012:

(In thousands, except per share amounts)	Number of Options	Weighted Avg. Exercise Price	Weighted Avg. Remaining Contractual Life In Years	Aggregate Intrinsic Value
Options outstanding, December 31, 2011	**5,400**	**$ 25.66**	**6.78**	**$ 27,270**
Options granted	98	$ 27.75		
Options cancelled/forfeited	(42)	$ 26.63		
Options exercised	(284)	$ 17.39		
Options outstanding, September 30, 2012	**5,172**	**$ 26.15**	**6.24**	**$ 1,632**

Correlation of the Underlyings

The graph below illustrates the daily performance of the Underlyings from March 27, 2009 through March 27, 2019. For comparison purposes, each Underlying has been normalized to have a closing price of $100.00 on March 27, 2009 by dividing the closing price of that Underlying on each day by the closing price of that Underlying on March 27, 2009 and multiplying by $100.00. We obtained the closing prices used to determine the normalized closing prices set forth below from Bloomberg L.P., without independent verification.

Past performance of the Underlyings is not indicative of their future performance.

The correlation of a pair of Underlyings represents a statistical measurement of the degree to which the returns of those Underlyings were similar to each other over a given period in terms of timing and direction (i.e., positive or negative). The closer the relationship of the daily returns of the Underlyings over a given period, the more positively correlated those Underlyings are. The graph above illustrates the historical performance of the Underlyings relative to one another over the time period shown and provides an indication of how close the relative performance of the daily returns of one Underlying has historically been to the other. The lower (or more negative) the correlation between two Underlyings, the less likely it is that those Underlyings will move in the same direction and, therefore, the greater the potential for one of those Underlyings to close below its Coupon Barrier or Downside Threshold on any Coupon Observation Date or the Final Valuation Date, respectively. This is because the less positively correlated a pair of Underlyings are, the greater the likelihood that at least one of those Underlyings will decrease in value. This results in a greater potential for a Contingent Coupon not to be paid during the term of the Notes and for a loss of principal at maturity. However, even if the two Underlyings have a higher positive correlation, one or both of those Underlyings might close below its Coupon Barrier or Downside Threshold on a Coupon Observation Date or the Final Valuation Date, as both of those Underlyings may decrease in value together.

The lower the correlation between two Underlyings, the greater the potential for one of those Underlyings to close below its Coupon Barrier or its Downside Threshold on any Coupon Observation Date or the Final Valuation Date, respectively. Therefore, the greater the number of Underlyings, the greater the potential for missed Contingent Coupons and for a loss of principal at maturity. We determined the Contingent Coupons for the Notes based, in part, on the correlation among the Underlyings, calculated using internal models at the time the terms of the Notes were set. As discussed above, increased risk resulting from lower correlation or from a greater number of Underlyings are reflected in a higher Contingent Coupon than would be payable on securities linked to fewer Underlyings or that have a higher degree of correlation.

Supplemental Plan of Distribution (Conflicts of Interest)

We have agreed to indemnify UBS and RBCCM against liabilities under the Securities Act of 1933, as amended, or to contribute payments that UBS and RBCCM may be required to make relating to these liabilities as described in the prospectus supplement and the prospectus.

All sales of the Notes will be made to certain fee-based advisory accounts for which UBS is an investment advisor and UBS will act as placement agent. The purchase price will be $10.00 per Note and UBS will forgo any commissions related to these sales. Investors that purchase and hold the Notes in fee-based advisory accounts will pay advisory fees to UBS based on the amount of assets held in those accounts.

Subject to regulatory constraints and market conditions, RBCCM intends to offer to purchase the Notes in the secondary market, but it is not required to do so.

We or our affiliates may enter into swap agreements or related hedge transactions with one of our other affiliates or unaffiliated counterparties in connection with the sale of the Notes and RBCCM and/or an affiliate may earn additional income as a result of payments pursuant to the swap or related hedge transactions. See "Use of Proceeds and Hedging" in the accompanying product prospectus supplement no. UBS-TACYN-1.

The value of the Notes shown on your account statement may be based on RBCCM's estimate of the value of the Notes if RBCCM or another of our affiliates were to make a market in the Notes (which it is not obligated to do). That estimate will be based upon the price that RBCCM may pay for the Notes in light of then prevailing market conditions, our creditworthiness and transaction costs. For a period of approximately one month after the issue date of the Notes, the value of the Notes that may be shown on your account statement may be higher than RBCCM's estimated value of the Notes at that time. This is because the estimated value of the Notes will not include our hedging costs and profits; however, the value of the Notes shown on your account statement during that period may be a higher amount, reflecting the addition of our estimated costs and profits from hedging the Notes. Any such excess is expected to decrease over time until the end of this period. After this period, if RBCCM repurchases your Notes, it expects to do so at prices that reflect their estimated value. This period may be reduced at RBCCM's discretion based on a variety of factors, including but not limited to, the amount of the Notes that we repurchase and our negotiated arrangements from time to time with UBS.

For additional information as to the relationship between us and RBCCM, please see the section "Plan of Distribution—Conflicts of Interest" in the prospectus dated September 7, 2018.

Structuring the Notes

The Notes are our debt securities, the return on which is linked to the performance of the Underlyings. As is the case for all of our debt securities, including our structured notes, the economic terms of the Notes reflect our actual or perceived creditworthiness at the time of pricing. In addition, because structured notes result in increased operational, funding and liability management costs to us, we typically borrow the funds under these Notes at a rate that is more favorable to us than the rate that we might pay for a conventional fixed or floating rate debt security of comparable maturity. Using this relatively lower implied borrowing rate rather than the secondary market rate is a factor that resulted in a higher initial estimated value of the Notes at the time their terms are set than if the secondary market rate was used. Unlike the estimated value included on the cover of this pricing supplement, any value of the Notes determined for purposes of a secondary market transaction may be based on a different borrowing rate, which may result in a lower value for the Notes than if our initial internal borrowing rate were used.

In order to satisfy our payment obligations under the Notes, we may choose to enter into certain hedging arrangements (which may include call options, put options or other derivatives) on the issue date with RBCCM or one of our other subsidiaries. The terms of these hedging arrangements take into account a number of factors, including our creditworthiness, interest rate movements, the volatility of each Underlying, and the tenor of the Notes. The economic terms of the Notes and their initial estimated value depend in part on the terms of these hedging arrangements.

The lower implied borrowing rate is a factor that reduced the economic terms of the Notes to you. The initial offering price of the Notes also reflects our estimated hedging costs. These factors resulted in the initial estimated value for the Notes on the trade date being less than their public offering price. See "Key Risks—The Initial Estimated Value of the Notes Is Less than the Price to the Public" above.

Terms Incorporated in Master Note

The terms appearing above under the caption “Final Terms of the Notes” and the provisions in the accompanying product prospectus supplement no. UBS-TACYN-1 dated October 3, 2018 under the caption “General Terms of the Notes” are incorporated into the master note issued to DTC, the registered holder of the Notes.

Validity of the Notes

In the opinion of Norton Rose Fulbright Canada LLP, the issue and sale of the Notes has been duly authorized by all necessary corporate action of the Bank in conformity with the Indenture, and when the Notes have been duly executed, authenticated and issued in accordance with the Indenture and delivered against payment therefor, the Notes will be validly issued and, to the extent validity of the Notes is a matter governed by the laws of the Province of Ontario or Québec, or the laws of Canada applicable therein, and will be valid obligations of the Bank, subject to equitable remedies which may only be granted at the discretion of a court of competent authority, subject to applicable bankruptcy, to rights to indemnity and contribution under the Notes or the Indenture which may be limited by applicable law; to insolvency and other laws of general application affecting creditors' rights, to limitations under applicable limitations statutes, and to limitations as to the currency in which judgments in Canada may be rendered, as prescribed by the Currency Act (Canada). This opinion is given as of the date hereof and is limited to the laws of the Provinces of Ontario and Québec and the federal laws of Canada applicable thereto. In addition, this opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and certain factual matters, all as stated in the letter of such counsel dated September 7, 2018, which has been filed as Exhibit 5.1 to Royal Bank's Form 6-K filed with the SEC dated September 7, 2018.

In the opinion of Morrison & Foerster LLP, when the Notes have been duly completed in accordance with the Indenture and issued and sold as contemplated by the prospectus supplement and the prospectus, the Notes will be valid, binding and enforceable obligations of Royal Bank, entitled to the benefits of the Indenture, subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith). This opinion is given as of the date hereof and is limited to the laws of the State of New York. This opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and to such counsel's reliance on the Bank and other sources as to certain factual matters, all as stated in the legal opinion dated September 7, 2018, which has been filed as Exhibit 5.2 to the Bank's Form 6-K dated September 7, 2018.