Converted Organics Inc.
Form 10-Q
May 16, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

þ **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2011

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 number: 001-33304

Converted Organics Inc.

(Exact name of registrant as specified in its charter)

Delaware	**20-4075963**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

137A Lewis Wharf, Boston, MA 02110

(Address of principal executive offices) (Zip Code)

(617) 624-0111

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 þ NO o

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 Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES o NO 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.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: As of May 16, 2011, there were 110,323,723 shares of our common stock outstanding.

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Item 1. Financial Statements

CONVERTED ORGANICS INC.

CONSOLIDATED BALANCE SHEETS

	March 31, 2011 (Unaudited)	December 31, 2010
ASSETS		
CURRENT ASSETS		
Cash	$ 823,768	$ 3,039,941
Accounts receivable, net	606,702	579,946
Inventories	343,655	126,406
Prepaid expenses and other assets	402,589	251,589
Deferred financing costs, net	210,188	276,667
Current assets of discontinued operations		14,500
Total current assets	2,386,902	4,289,049
Deposits and other non-current assets	566,909	575,596
Property and equipment, net	3,157,580	1,477,589
Goodwill	1,667,957	1,667,957
Intangible assets, net	11,419,548	11,629,265
Total assets	$ 19,198,896	$ 19,639,456
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Term note payable	$	$ 350,000
Notes payable related party	72,351	72,351
Accounts payable	2,796,512	2,393,388
Accrued expenses	626,199	656,412
Convertible notes payable, net of unamortized discount	247,717	306,404
Obligation to issue shares	1,396,429	1,560,715
Derivative liabilities current	3,915,520	5,199,572
Liabilities of discontinued operations	935,359	2,438,253
Total current liabilities	9,990,087	12,977,095
Derivative liabilities	3,038,233	3,476,047
Total liabilities	13,028,320	16,453,142

COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Preferred stock, $.0001 par value ($1,000 stated value) authorized 10,000,000 shares	17,500,000	17,500,000
Common stock, $.0001 par value, authorized 250,000,000 shares	9,784	8,547
Additional paid-in capital	90,349,983	85,555,990
Accumulated deficit	(102,192,769)	(100,453,292)
Accumulated other comprehensive loss	(9,585)	(1,109)
	5,657,413	2,610,136
Noncontrolling interests	513,163	576,178
Total stockholders equity	6,170,576	3,186,314
Total liabilities and stockholders equity	$ 19,198,896	$ 19,639,456

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

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CONVERTED ORGANICS INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(UNAUDITED)

	Three month periods ended March 31, 2011	March 31, 2010
Revenues	$ 739,176	$ 711,876
Cost of goods sold	504,467	565,476
Gross profit	234,709	146,400
Operating expenses		
Selling, general and administrative expenses	2,317,174	3,843,704
Research and development	15,871	61,850
Amortization of intangible assets	221,267	72,002
	2,554,312	3,977,556
Loss from continuing operations	(2,319,603)	(3,831,156)
Other income/(expenses)		
Other income	171,309	281
Gain on settlement of debt	225,000	
Derivative gain (loss)	2,397,783	(635,155)
Interest expense	(2,274,462)	(4,373)
	519,630	(639,247)
Loss from continuing operations before provision for income taxes	(1,799,973)	(4,470,403)
Provision for income taxes		
Net loss from continuing operations	(1,799,973)	(4,470,403)
Loss from discontinued operations	(499)	(1,909,290)
Net loss	(1,800,472)	(6,379,693)
Net loss attributable to noncontrolling interests	(60,995)	

Net loss attributable to Converted Organics Inc. before other comprehensive loss	(1,739,477)	(6,379,693)
Other comprehensive loss:		
Foreign currency translation adjustment	(10,496)	
Comprehensive loss	(1,749,973)	(6,379,693)
Comprehensive loss attributable to noncontrolling interests	(2,020)	
Comprehensive loss attributable to Converted Organics Inc.	$ (1,747,953)	$ (6,379,693)
Net loss per share, basic and diluted		
Continuing operations	$ (0.02)	$ (0.12)
Discontinued operations	(0.00)	(0.05)
	$ (0.02)	$ (0.17)
Weighted average common shares outstanding	92,804,595	37,864,169

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

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CONVERTED ORGANICS INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
FOR THE THREE MONTH PERIOD ENDED MARCH 31, 2011
(UNAUDITED)

	Preferred Stock Series A		Common Stock				Accumulated			
	Shares Issued and Outstanding	Amount	Shares Issued and Outstanding	Amount	Additional Paid-in Capital	Accumulated Deficit	Other Comprehensive Loss	Total	Non-Controlling Interests	Total Stockhol Equity
nce, ember 31, 0	17,500	$ 17,500,000	85,468,127	$ 8,547	$ 85,555,990	$ (100,453,292)	$ (1,109)	$ 2,610,136	$ 576,178	$ 3,186,
mon k issued to e ertible gations			7,006,000	701	2,649,479			2,650,180		2,650,
mon k issued as pensation			2,165,000	216	800,834			801,050		801,
ance of mon stock ayment to e gations of ontinued ations			3,200,000	320	1,343,680			1,344,000		1,344,
ign ency slation stment							(8,476)	(8,476)	(2,020)	(10,
loss						(1,739,477)		(1,739,477)	(60,995)	(1,800,
nce, ch 31,	17,500	$ 17,500,000	97,839,127	$ 9,784	$ 90,349,983	$ (102,192,769)	$ (9,585)	$ 5,657,413	$ 513,163	$ 6,170,

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

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CONVERTED ORGANICS INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three month periods ended March 31, 2011	March 31, 2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (1,800,472)	$ (6,379,693)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of intangibles and other assets	370,377	83,919
Depreciation and amortization of property and equipment	50,674	462,358
(Reduction) provision for losses on accounts receivable	(75,875)	174,478
Amortization of discounts attributable on notes payable	1,998,924	
Interest expense in connection with issuance of convertible debt	268,486	
Common stock issued as compensation	801,050	160,050
Stock option compensation expense		1,292,492
Obligations to issue shares revaluation	(164,286)	
Gain on settlement of debt	(225,000)	
Derivative (gain) loss	(2,397,783)	635,155
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Accounts receivable	63,619	(529,271)
Inventories	(217,249)	77,447
Prepaid expenses and other current assets	(148,037)	(562,974)
Deposits and other non-current assets	9,195	(19,733)
Increase (decrease) in:		
Accounts payable	(612,382)	(336,870)
Accrued expenses	(180,250)	(672,311)
Net cash used in operating activities	(2,259,009)	(5,614,953)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(725,819)	(235,898)
Release of restricted cash		350,077
Patent costs	(11,551)	
Purchase of other assets		(166,667)
Net cash used in investing activities	(737,370)	(52,488)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of debt obligations	(125,000)	(925,155)
Repayment of capital lease obligations		(2,852)
Net proceeds from short-term notes	920,000	
Net cash provided by (used in) financing activities	795,000	(928,007)

Net effect of exchange rate changes on cash	(14,794)	
NET DECREASE IN CASH	(2,216,173)	(6,595,448)
Cash, beginning of period	3,039,941	10,708,807
Cash, end of period	$ 823,768	$ 4,113,359
Supplemental cash flow information:		
Cash paid during the period for:		
Interest	$ 4,378	$ 756,719
Non-cash financing activities:		
Equipment acquired through assumption of accounts payable	$ 1,000,000	$
Common stock issued to settle convertible note obligations	2,650,180	97,343
Fair value of derivatives issued in conjuction with debt and equity financing	1,268,486	
Common stock issued as settlement of obligations of discontinued operations	1,344,000	

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

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CONVERTED ORGANICS INC.
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION AND NATURE OF OPERATIONS

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission (the SEC) under Article 8-03 of Regulation S-X for interim financial reporting. Certain information and footnote disclosures normally included in the annual consolidated financial statements of Converted Organics Inc. (the Company) have been condensed or omitted. In the Company s opinion, the unaudited interim consolidated financial statements and accompanying notes reflect all adjustments, consisting of normal and recurring adjustments, that are necessary for a fair presentation of its financial position and operating results as of and for the three month interim periods ended March 31, 2011 and 2010.

The results of operations for the interim periods are not necessarily indicative of the results to be expected for the entire year. This Form 10-Q should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Form 10-K as of and for the year ended December 31, 2010.

NATURE OF OPERATIONS

Converted Organics Inc. and its subsidiaries (collectively the Company) utilize innovative clean technologies to establish and operate environmentally friendly businesses. The Company is dedicated to creating a cleaner, greener future, and operates using sustainable business practices that support this vision. The Company operates in three business areas: Organic Fertilizer, Industrial Wastewater Treatment and Vertical Farming.

Organic Fertilizer: The Company operates a processing facility that converts food waste and other raw materials into all-natural fertilizers, biostimulants, and soil amendment products.

Industrial Wastewater Treatment: Utilizing an innovative wastewater treatment process, Converted Organics Industrial Wastewater Resources business (IWR) provides a means of treating aqueous waste streams. This technology, which can use waste heat and renewable energy as fuel, produces only two byproducts: clean water vapor and landfill-appropriate solid residuals.

Vertical Farming: The Company engages in vertical farming through our TerraSphere business, which builds efficient systems for growing pesticide-free organic produce in a controlled indoor environment using its patented technology.

A summary of the subsidiaries that comprise of the Company are as follows:

Converted Organics of California, LLC (the Gonzales facility), is a California limited liability company and wholly-owned subsidiary of the Company. The Gonzales facility operates a plant in Gonzales, California, in the Salinas Valley and produces approximately 25 tons of organic fertilizer per day, which is sold primarily to the California agricultural market. The Gonzales facility employs a proprietary method called High Temperature Liquid Composting (HTLC). The facility has been upgraded to enable it to accept larger amounts of food waste from waste haulers and may be upgraded, depending on demand, to have the capability to produce a dry product in addition to the current liquid fertilizer it produces.

Converted Organics of Woodbridge, LLC, (the Woodbridge facility), is a New Jersey limited liability company and wholly-owned subsidiary of the Company, which was formed for the purpose of owning, constructing and operating the Company s facility in Woodbridge, New Jersey. During 2010, the Company discontinued operations at the Woodbridge plant. The Company has reported the results of operations of Converted Organics of Woodbridge, LLC as discontinued operations within the consolidated financial statements (See Note 5).

Converted Organics of Rhode Island, LLC, is a Rhode Island limited liability company and majority-owned subsidiary of the Company, which was formed in July 2008 for the purpose of developing a facility at the Rhode Island central landfill. Converted Organics of Rhode Island, LLC has not had any activity since its formation.

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CONVERTED ORGANICS INC.
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION AND NATURE OF OPERATIONS *(Continued)*

NATURE OF OPERATIONS (Continued)

Converted Organics of Mississippi, LLC, a Mississippi limited liability company and a wholly-owned subsidiary of the Company, was formed for the purpose of hiring a sales force and adding a poultry litter-based fertilizer product to the Company s existing product lines. The Company does not expect to have operating activity in this subsidiary during 2011.

TerraSphere Inc. (TerraSphere), a Delaware corporation and a wholly-owned subsidiary of the Company, was formed for the purpose of acquiring the membership interests of TerraSphere Systems LLC (TerraSphere Systems). On November 12, 2010, TerraSphere acquired a 95% membership interest in TerraSphere Systems (See Note 4). TerraSphere Systems has two subsidiaries; wholly owned PharmaSphere, LLC (PharmaSphere) and majority owned TerraSphere Systems Canada, Inc. (TerraSphere Canada). PharmaSphere s business plan is to utilize TerraSphere Systems patented technology for the production of high value biocompounds sourced from plants and used as active pharmaceutical ingredients and for the production of transgenic plants (genetically engineered plants) for the biotechnology market. PharmaSphere has a wholly-owned subsidiary PharmaSphere Worcester, LLC, which was formed to build a facility in Worcester, Massachusetts utilizing PharmaSphere s business plan. The building of the facility has not commenced. PharmaSphere has no revenue to date. TerraSphere Canada, located in Vancouver, British Columbia, operates the research and manufacturing facility for TerraSphere and is eighty-five percent owned by TerraSphere Systems.

On December 30, 2010, Converted Organics, Inc. purchased a majority ownership interest of the vertical farming entity, GoLocalProduceRI, LLC located in Rhode Island, marking its entrance into the vertical farming industry as owners and operators of what is expected to be the first TerraSphere facility in the United States (See Note 4).

PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements include the balances of Converted Organics Inc. and its wholly-owned subsidiaries, Converted Organics of California, LLC, Converted Organics of Woodbridge, LLC, Converted Organics of Mississippi, LLC, TerraSphere Inc. and its majority-owned subsidiaries Converted Organics of Rhode Island, LLC and GoLocalProduceRI, LLC. The minority-owned interests in its subsidiaries are included in the Company s consolidated financial statements as noncontrolling interests. All intercompany transactions and balances have been eliminated in consolidation.

RECLASSIFICATIONS

As a result of the Woodbridge facility operations being discontinued during the third quarter of 2010, certain items of the comparative interim period have been reclassified as discontinued operations. These reclassifications have no affect on previously reported net income.

CONVERTED ORGANICS INC.
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

NOTE 2 MANAGEMENT S PLAN OF OPERATIONS

As reflected in the consolidated financial statements, the Company incurred a net loss of approximately $1.8 million for the three months ended March 31, 2011, and as of March 31, 2011 has an accumulated deficit of approximately $102 million and a working capital deficiency of $7.6 million. During 2010, the Company discontinued the operations at its Woodbridge facility, acquired a license to treat Industrial Waste Water and acquired the TerraSphere business. In addition, the Company currently has manufacturing capabilities at its Gonzales facility as a means to generate revenues and cash. Although the Gonzales facility is currently cash flow positive, the anticipated costs associated with corporate overhead and for the operations of TerraSphere will cause the Company to have negative cash flow in 2011. In addition, the Company feels that it will require cash, either through financing or equity transactions, in order to build out the IWR and TerraSphere projects planned for 2011. The Company believes that if it achieves planned sales from its Gonzales facility, establishes additional operational Industrial Wastewater sites, and completes the construction of a TerraSphere facility, then the Company will become cash flow positive in the future.

Presently, the Company s liquidity is limited to its cash on hand at March 31, 2011 and the $3.5 million that the Company received on April 20, 2011 as a result of the sale of notes under a financing agreement entered into on April 1, 2011 (see Note 13). In addition, on February 28, 2011 the Company received shareholder approval to permit an investor to exercise certain of its warrants, which could provide the Company with an additional $4.9 million. However, since receiving shareholder approval the Company s stock price has closed at both above and below the exercise price of these warrants, and it is not likely that any warrants would be exercised unless the price of its stock was greater than the exercise price of the warrants. There is no assurance that the investor will exercise the warrants in the near term, and as such, the Company may not receive these necessary funds.

If the Company does not receive additional funds in excess of the amount of cash on hand, whether as a result of the exercise of the warrants issued in its December 2010 financing, or otherwise, the Company will not be able to continue its operations. Even in the event that the Company does receive additional funds, there is no guarantee that such funds will be sufficient to continue operations. At this time the Company does not have any commitments for additional financing, and there is no assurance that capital in any form will be available to the Company on terms and conditions that are acceptable or at all. The Company projects net cash out flows of approximately $350,000 per month, and therefore based on the current cash on hand the Company has sufficient cash to operate until the end of 2011, however, that would not allow the Company to expend cash on IWR, TerraSphere or Fertilizer capital projects.

NOTE 3 NEW ACCOUNTING STANDARDS

In December 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2010-28, *When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts* (ASU 2010-28). The amendments in ASU 2010-28 affect all entities that have recognized goodwill and have one or more reporting units whose carrying amount for purposes of performing Step 1 of the goodwill impairment test is zero or negative. The amendments in ASU 2010-28 modify Step 1 so that for those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. The qualitative factors are consistent with existing guidance, which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. ASU 2010-28 is effective for fiscal years beginning after December 15, 2010. The Company will apply ASU 2010-28 on a prospective basis.

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CONVERTED ORGANICS INC.
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

NOTE 3 NEWLY ACCOUNTING STANDARDS *(Continued)*

In December 2010, the FASB issued Accounting Standards Update No. 2010-29, *Business Combinations (Topic 805)* (ASU 2010-29). ASU 2010-29 is intended to address diversity in practice regarding pro forma revenue and earnings disclosure requirements for business combinations. ASU 2010-29 specifies that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments also expand the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The amendments affect any public entity as defined by Topic 805 that enters into business combinations that are material on an individual or aggregate basis. ASU 2010-28 is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period after December 15, 2010. The Company will apply on a prospective basis.

NOTE 4 ACQUISITIONS

TERRASPHERE SYSTEMS LLC

On November 12, 2010, the Company acquired 95% of the membership interests of TerraSphere Systems LLC. The acquisition will enable the Company to license TerraSphere s patented Growth System, which is a system of modules and processes for growing plants in a controlled environment. The system uses and controls precise combinations of light, water, nutrition, gravity, centrifugal forces, and gasses to produce growing conditions that can be controlled and manipulated to result in desired plant growth and maximum crop production.

GoLocalProduceRI, LLC

On December 30, 2010, the Company acquired 83.34% of GoLocalProduceRI, LLC, marking its entrance into the vertical farming industry as owners and operators of what is expected to be the first TerraSphere facility in the United States.

The unaudited pro forma consolidated financial information for the three months ended March 31, 2010 as though the above acquisitions had been completed at the beginning of the interim period is as follows:

	For the Three Months Ended March 31, 2010
Revenue	$ 2,544,009
Net loss	$ (6,000,008)
Net loss per share, basic and diluted	$ (0.11)
Weighted-average shares	56,389,068

CONVERTED ORGANICS INC.
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

NOTE 5 DISCONTINUED OPERATIONS

In 2010, the Company discontinued operations at its facility in Woodbridge, New Jersey. The following table summarizes the components of the loss from discontinued operations:

	For the Three Months Ended March 31, 2011		For the Three Months Ended March 31, 2010	
Revenue from discontinued operations	$		$	147,949
Loss from discontinued operations	$	(499)	$	(1,909,291)

The Company does not expect to have any continuing cash flows from operations associated with the Woodbridge facility.

The following table provides the assets and liabilities of the Woodbridge facility, classified as discontinued operations, in the consolidated balance sheets dated March 31, 2011 and December 31, 2010:

	March 31, 2011		December 31, 2010	
Accounts receivable, net	$		$	14,500
Assets of discontinued operations	$		$	14,500
Accounts payable	$	828,712	$	837,606
Accrued expenses		77,874		1,571,874
Other liabilities		28,773		28,773
Liabilities of discontinued operations	$	935,359	$	2,438,253

On January 25, 2011, the Company paid cash of $150,000 and issued 3.2 million shares of Company common stock with a fair value of $1,344,000 in payment for consulting services accrued at December 31, 2010 related to the settlement of certain Woodbridge obligations. The Company is actively working with its creditors to settle the liabilities outstanding at March 31, 2011.

NOTE 6 FAIR VALUE MEASUREMENTS

The Company applies *ASC 820 Fair Value Measurements and Disclosures* (ASC 820), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair valuCAL-ALIGN: top; WIDTH: 14.1%">

Final Basket Level:

80.35

Basket Return:

-19.65%

In this example, the hypothetical final index level of the EURO STOXX 50® Index is less than its hypothetical initial index level, while the hypothetical final index levels of the FTSE® 100 Index and the TOPIX® Index are equal to their applicable hypothetical initial index levels and the hypothetical final index levels of the Swiss Market Index and the S&P®/ASX 200 Index are greater than their applicable hypothetical initial index levels.

Because the basket is unequally weighted, increases in the lower weighted basket underliers will be offset by decreases in the more heavily weighted basket underliers. In this example, the large decline in the EURO STOXX 50® Index results in the hypothetical final basket level being less than the buffer level of 87.50% of the initial basket level, even though the FTSE® 100 Index and the TOPIX® Index remained flat and the Swiss Market Index and the S&P®/ASX 200 Index increased.

Since the hypothetical final basket level of 80.35 is less than the buffer level of 87.50% of the initial basket level, the hypothetical cash settlement amount for each $1,000 face amount of your notes will equal:

Cash settlement amount = $1,000 + ($1,000 × 114.29% × (-19.65% + 12.50%)) = $918.29

Example 5: The final basket level is less than the buffer level. The cash settlement amount is less than the $1,000 face amount.

	Column A	Column B	Column C	Column D	Column E
Basket Underlier	Hypothetical Initial Index Level	Hypothetical Final Index Level	Column B/Column A	Initial Weighted Value	Column C x Column D
EURO STOXX 50® Index	100.00	44.00	44.00%	37.00	16.28
FTSE® 100 Index	100.00	62.00	62.00%	23.00	14.26
TOPIX® Index	100.00	55.00	55.00%	23.00	12.65
Swiss Market Index	100.00	43.00	43.00%	9.00	3.87
S&P®/ASX 200 Index	100.00	56.00	56.00%	8.00	4.48
			Final Basket Level:		51.54
			Basket Return:		-48.46%

In this example, the hypothetical final index levels for all of the basket underliers are less than the applicable hypothetical initial index levels, which results in the hypothetical final basket level being less than the initial basket level of 100.00. Since the hypothetical final basket level of 51.54 is less than the buffer level of 87.50% of the initial basket level, the hypothetical cash settlement amount for each $1,000 face amount of your notes will equal:

Cash settlement amount = $1,000 + ($1,000 × 114.29% × (-48.46% + 12.50%)) = $589.03

No one can predict the final basket level. The actual amount that a holder of the notes will receive at maturity and the actual return on your investment in the notes, if any, will depend on the actual final basket level which will be determined by the calculation agent as described below. In addition, the actual return on your notes will further depend on the original issue price. Moreover, the assumptions on which the hypothetical tables, chart and examples are based may turn out to be inaccurate. Consequently, the return on your investment in the notes, if any, and the actual cash settlement amount to be paid in respect of the notes at maturity may be very different from the information reflected in the tables, chart and examples above.

ADDITIONAL RISK FACTORS SPECIFIC TO YOUR NOTES

An investment in your notes is subject to the risks described below, as well as the risks described under "Risk Factors" beginning on page S-1 of the accompanying prospectus supplement and page 1 of the accompanying prospectus. You should carefully review these risks as well as the terms of the notes described herein and in the accompanying prospectus, dated January 8, 2016, as supplemented by the accompanying prospectus supplement, dated January 8, 2016, and the accompanying product prospectus supplement PB-1, dated January 14, 2016, of Royal Bank of Canada. Your notes are a riskier investment than ordinary debt securities. Also, your notes are not equivalent to investing directly in the underlier stocks, i.e., the stocks comprising the basket underliers. You should carefully consider whether the offered notes are suited to your particular circumstances.

You May Lose Your Entire Investment in the Notes

The principal amount of your investment is not protected and you may lose a significant amount, or even all of your investment in the notes. The cash settlement amount, if any, will depend on the performance of the basket underliers and the change in their levels from the trade date to the determination date, and you may receive significantly less than the principal amount of the notes. Subject to our credit risk, you will receive at least the principal amount of the notes at maturity only if the final basket level is greater than or equal to the buffer level. If the final basket level is less than the buffer level, then you will lose, for each $1,000 in principal amount of the notes, an amount equal to the product of (i) the buffer rate times (ii) the sum of basket return plus the buffer amount (iii) times $1,000. You could lose some or all of the principal amount. Thus, depending on the final basket level, you could lose a substantial portion, and perhaps all, of your investment in the notes, which would include any premium to the principal amount you may have paid when you purchased the notes.

In addition, if the notes are not held until maturity, assuming no changes in market conditions or to our creditworthiness and other relevant factors, the price you may receive for the notes may be significantly less than the price that you paid for them.

Our Initial Estimated Value of the Notes Is Less than the Original Issue Price

Our initial estimated value that is set forth on the cover page of this document is less than the original issue price of the notes, and does not represent a minimum price at which we, RBCCM or any of our other affiliates would be willing to purchase the notes in any secondary market (if any exists) at any time. This is due to, among other things, the fact that the original issue price of the notes reflects the borrowing rate we pay to issue securities of this kind (an internal funding rate that is lower than the rate at which we borrow funds by issuing conventional fixed rate debt), and the inclusion in the original issue price of the costs relating to our hedging of the notes.

The Price, if Any, at Which You May Be Able to Sell Your Notes Prior to Maturity May Be Less than the Original Issue Price and Our Initial Estimated Value

Assuming no change in market conditions or any other relevant factors, the price, if any, at which you may be able to sell your notes prior to maturity may be less than the original issue price and our initial estimated value. This is because any such sale price would not be expected to include our estimated profit and the costs relating to our hedging of the notes. In addition, any price at which you may sell the notes is likely to reflect customary bid-ask spreads for similar trades, and the cost of unwinding any related hedge transactions. In addition, the value of the notes determined for any secondary market price is expected to be based in part on the yield that is reflected in the interest rate on our conventional debt securities of similar maturity that are traded in the secondary market, rather than the internal funding rate that we used to price the notes and determine the initial estimated value. As a result, the secondary market price of the notes will be less than if the internal funding rate was used. These factors, together with various credit, market and economic factors over the term of the notes, and, potentially, changes in the levels of the basket underliers, are expected to reduce the price at which you may be able to sell the notes in any secondary market and will affect the value of the notes in complex and unpredictable ways.

As set forth below in the section "Supplemental Plan of Distribution (Conflicts of Interest)," for a limited period of time after the trade date, your broker may repurchase the notes at a price that is greater than the estimated value of the notes at that time. However, assuming no changes in any other relevant factors, the price you may receive if you sell your notes is expected to decline gradually during that period.

The notes are not designed to be short-term trading instruments. Accordingly, you should be able and willing to hold your notes to maturity.

The Initial Estimated Value of the Notes Is an Estimate Only, Calculated as of the Time the Terms of the Notes Were Set

Our initial estimated value of the notes is based on the value of our obligation to make the payments on the notes, together with the mid-market value of the derivative embedded in the terms of the notes. See “Structuring the Notes” below. Our estimate is based on a variety of assumptions, including our internal funding rate (which represents a discount from our credit spreads), expectations as to dividends on the underlier stocks, interest rates and volatility, and the expected term of the notes. These assumptions are based on certain forecasts about future events, which may prove to be incorrect. Other entities may value the notes or similar securities at a price that is significantly different than we do.

The value of the notes at any time after the trade date will vary based on many factors, including changes in market conditions, and cannot be predicted with accuracy. As a result, the actual value you would receive if you sold the notes in any secondary market, if any, should be expected to differ materially from our initial estimated value of your notes.

Your Notes Will Not Bear Interest

You will not receive any interest payments on the notes. Even if the amount payable on the notes at maturity exceeds the principal amount of the notes, the overall return you earn on the notes may be less than you would otherwise have earned by investing in a non-indexed debt security of comparable maturity that bears interest at a prevailing market rate. Your investment may not reflect the full opportunity cost to you when you take into account factors that affect the time value of money.

The Potential for the Value of Your Notes to Increase Will Be Limited

Your ability to participate in any change in the levels of the basket underliers and the level of the basket over the term of your notes will be limited because of the cap level. The cap level will limit the amount in cash you may receive for each of your notes at maturity, no matter how much the level of the basket may rise beyond the cap level over the term of your notes. Accordingly, the amount payable for each of your notes may be significantly less than your return had you invested directly in the underlier stocks.

Payment of the Amount Payable on Your Notes Is Subject to Our Credit Risk, and Market Perceptions About Our Creditworthiness May Adversely Affect the Market Value of Your Notes

The notes are our unsecured debt obligations. Investors are subject to our credit risk, and market perceptions about our creditworthiness may adversely affect the market value of the notes. Any decrease in the market's view on or confidence in our creditworthiness is likely to adversely affect the market value of the notes.

The Lower Performance of One Basket Underlier May Offset an Increase in One or More Other Basket Underliers

Declines in the level of one basket underlier may offset increases in the level of one or more other basket underliers. As a result, any return on the basket — and thus on your notes — may be reduced or eliminated, which will have the effect of reducing the amount payable in respect of your notes at maturity. In addition, because the basket underliers are not equally weighted, increases in the lower weighted basket underliers may be offset by even small decreases in the more heavily weighted basket underliers.

The Amount Payable on Your Notes Is Not Linked to the Level of the Basket at Any Time Other than the Determination Date

The amount payable on your notes will be based on the final basket level. Therefore, for example, if the closing level of one or more basket underliers decreased precipitously on the determination date, the amount payable at maturity may be significantly less than it would otherwise have been had the amount payable been linked to the closing levels of the basket underliers prior to that decrease. Although the actual levels of the basket underliers at maturity or at other times during the term of the notes may be higher than their levels on the determination date, you will not benefit from the closing level of any basket underlier at any time other than the determination date.

The Notes May Not Have an Active Trading Market

The notes will not be listed on any securities exchange. The dealer intends to offer to purchase the notes in the secondary market, but is not required to do so. The dealer or any of its affiliates may stop any market-making activities at any time. Even if there is a secondary market, it may not provide enough liquidity to allow you to easily trade or sell the notes. Because other dealers are not likely to make a secondary market for the notes, the price at which you may be able to trade the notes is likely to depend on the price, if any, at which the dealer is willing to buy the notes. We expect that transaction costs in any secondary market would be high. As a result, the difference between bid and asked prices for your notes in any secondary market could be substantial.

If you sell your notes before maturity, you may have to do so at a substantial discount from the price that you paid for them, and as a result, you may suffer substantial losses.

The Market Value of Your Notes May Be Influenced by Many Unpredictable Factors

The following factors, among others, many of which are beyond our control, may influence the market value of your notes:

- the levels of the basket underliers;
- the volatility—i.e., the frequency and magnitude of changes—of the levels of the basket underliers;
- the dividend rates of the underlier stocks;
- economic, financial, regulatory, political, military and other events that affect stock markets generally and the underlier stocks;
- interest and yield rates in the market;
-

- the time remaining until the notes mature; and
- our creditworthiness, whether actual or perceived, and including actual or anticipated upgrades or downgrades in our credit ratings or changes in other credit measures.

These factors may influence the market value of your notes if you sell your notes before maturity, including the price you may receive for your notes in any market making transaction. If you sell your notes prior to maturity, you may receive less than the principal amount of your notes.

An Investment in the Notes Is Subject to Risks Associated with Foreign Securities Markets

The basket underliers track the value of certain foreign equity securities. The basket underliers are five separate indices, which track the equity markets in a variety of countries and regions. You should be aware that investments in securities linked to the value of foreign equity securities involve particular risks. The foreign securities markets comprising the basket

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underliers may have less liquidity and may be more volatile than U.S. or other securities markets and market developments may affect foreign markets differently from U.S. or other securities markets. Direct or indirect government intervention to stabilize these foreign securities markets, as well as cross-shareholdings in foreign companies, may affect trading prices and volumes in these markets. Also, there is generally less publicly available information about foreign companies than about those U.S. companies that are subject to the reporting requirements of the U.S. Securities and Exchange Commission, and foreign companies are subject to accounting, auditing and financial reporting standards and requirements that differ from those applicable to U.S. reporting companies.

Prices of securities in foreign countries are subject to political, economic, financial and social factors that apply in those geographical regions. These factors, which could negatively affect those securities markets, include the possibility of recent or future changes in a foreign government's economic and fiscal policies, the possible imposition of, or changes in, currency exchange laws or other laws or restrictions applicable to foreign companies or investments in foreign equity securities and the possibility of fluctuations in the rate of exchange between currencies, the possibility of outbreaks of hostility and political instability and the possibility of natural disaster or adverse public health development in the region. Moreover, foreign economies may differ favorably or unfavorably from the U.S. economy in important respects such as growth of gross national product, rate of inflation, capital reinvestment, resources and self-sufficiency.

The Notes Are Linked to the Underlier Stocks, and Are Therefore Subject to Foreign Currency Exchange Rate Risk

Although the underlier stocks are traded principally in non-U.S. dollars, the payments on the notes will not be adjusted due to any changes in currency exchange rates. Changes in the value of one or more of the currencies in which the underlier stocks are traded could have an adverse impact on the value of the notes and the payment at maturity.

Foreign currency exchange rates vary over time, and may vary considerably during the life of the notes. Changes in a particular exchange rate result from the interaction of many factors directly or indirectly affecting economic and political conditions.

Of particular importance are:

- existing and expected rates of inflation;
- existing and expected interest rate levels;
- the balance of payments;
- the extent of governmental surpluses or deficits in the relevant countries; and
- other financial, economic, military and political factors.

All of these factors are, in turn, sensitive to the monetary, fiscal and trade policies pursued by the governments of the various component countries and the United States and other countries important to international trade and finance.

It has been reported that the U.K. Financial Conduct Authority and regulators from other countries are in the process of investigating the potential manipulation of published currency exchange rates. If such manipulation has occurred or is continuing, certain published exchange rates may have been, or may be in the future, artificially lower (or higher) than they would otherwise have been. Any such manipulation could have an adverse impact on any payments on, and the value of, your notes and the trading market for your notes. In addition, we cannot predict whether any changes or reforms affecting the determination or publication of exchange rates or the supervision of currency trading will be implemented in connection with these investigations. Any such changes or reforms could also adversely impact your notes.

If the Level or Price of the Basket Underliers or the Underlier Stocks Changes, the Market Value of the Notes May Not Change in the Same Manner

The notes may trade quite differently from the performance of the basket underliers or the underlier stocks. Changes in the level or price, as applicable, of the basket underliers or the underlier stocks may not result in a comparable change in the market value of the notes. Some of the reasons for this disparity are discussed under "— The Market Value of Your Notes May Be Influenced by Many Unpredictable Factors" above.

The Return on the Notes Will Not Reflect Any Dividends Paid on the Underlier Stocks

The basket underlier sponsors calculate the levels of the basket underliers by reference to the prices of the applicable underlier stocks without taking account of the value of dividends paid on those underlier stocks. Therefore, the return on the notes will not reflect the return you would realize if you actually owned the underlier stocks and received the dividends paid on those underlier stocks.

You Have No Shareholder Rights or Rights to Receive Any Underlier Stock

Investing in your notes will not make you a holder of any of the underlier stocks. Neither you nor any other holder or owner of your notes will have any voting rights, any right to receive dividends or other distributions, any rights to make a claim against the underlier stock issuers or any other rights with respect to the underlier stocks. Your notes will be paid in cash to the extent any amount is payable at maturity, and you will have no right to receive delivery of any of the underlier stocks.

We Will Not Hold Any of the Underlier Stocks for Your Benefit, if We Hold Them at All

The indenture and the terms governing your notes do not contain any restriction on our ability or the ability of any of our affiliates to sell, pledge or otherwise convey all or any portion of the underlier stocks that we or they may acquire. Neither we nor our affiliates will pledge or otherwise hold any assets for your benefit, including any of these securities. Consequently, in the event of our bankruptcy, insolvency or liquidation, any of those securities that we own will be subject to the claims of our creditors generally and will not be available for your benefit specifically.

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Our Hedging Activities and/or Those of Our Distributors May Negatively Impact Investors in the Notes and Cause Our Interests and Those of Our Clients and Counterparties to Be Contrary to Those of Investors in the Notes

The dealer or one or more of our other affiliates and/or distributors has hedged or expects to hedge its obligations under the hedging transaction that it may enter into with us by purchasing futures and/or other instruments linked to the basket or to one or more basket underliers or the underlier stocks. The dealer or one or more of our other affiliates and/or distributors also expects to adjust the hedge by, among other things, purchasing or selling any of the foregoing, and perhaps other instruments linked to the basket, or one or more of the basket underliers or underlier stocks, at any time and from time to time, and to unwind the hedge by selling any of the foregoing on or before the determination date.

We, the dealer, or one or more of our other affiliates and/or distributors may also enter into, adjust and unwind hedging transactions relating to other basket- or index-linked notes whose returns are linked to changes in the level or price of the basket, the basket underliers or the underlier stocks. Any of these hedging activities may adversely affect the levels of the basket underliers —directly or indirectly by affecting the price of the underlier stocks—and therefore the market value of the notes and the amount you will receive, if any, on the notes. In addition, you should expect that these transactions will cause us, the dealer or our other affiliates and/or distributors, or our clients or counterparties, to have economic interests and incentives that do not align with, and that may be directly contrary to, those of an investor in the notes. We, the dealer and our other affiliates and/or distributors will have no obligation to take, refrain from taking or cease taking any action with respect to these transactions based on the potential effect on an investor in the notes, and may receive substantial returns with respect to these hedging activities while the value of the notes may decline. Additionally, if the distributor from which you purchase notes is to conduct hedging activities for us in connection with the notes, that distributor may profit in connection with such hedging activities and such profit, if any, will be in addition to the compensation that the distributor receives for the sale of the notes to you. You should be aware that the potential to earn fees in connection with hedging activities may create a further incentive for the distributor to sell the notes to you in addition to the compensation they would receive for the sale of the notes.

Market Activities by Us and by the Dealer for Our Own Account or for Our Clients Could Negatively Impact Investors in the Notes

We, the dealer and our other affiliates provide a wide range of financial services to a substantial and diversified client base. As such, we each may act as an investor, investment banker, research provider, investment manager, investment advisor, market maker, trader, prime broker or lender. In those and other capacities, we, the dealer and/or our other affiliates purchase, sell or hold a broad array of investments, actively trade securities (including the notes or other securities that we have issued), the underlier stocks, derivatives, loans, credit default swaps, indices, baskets and other financial instruments and products for our own accounts or for the accounts of our customers, and we will have other direct or indirect interests, in those securities and in other markets that may be not be consistent with your interests and may adversely affect the levels of the basket underliers and/or the value of the notes. Any of these financial market activities may, individually or in the aggregate, have an adverse effect on the levels of the basket underliers and the market value of your notes, and you should expect that our interests and those of the dealer and/or our other affiliates, or our clients or counterparties, will at times be adverse to those of investors in the notes.

In addition to entering into these transactions itself, we, the dealer and our other affiliates may structure these transactions for our clients or counterparties, or otherwise advise or assist clients or counterparties in entering into these transactions. These activities may be undertaken to achieve a variety of objectives, including: permitting other purchasers of the notes or other securities to hedge their investment in whole or in part; facilitating transactions for other clients or counterparties that may have business objectives or investment strategies that are inconsistent with or contrary to those of investors in the notes; hedging the exposure of us, the dealer or our other affiliates in connection with the notes, through their market-making activities, as a swap counterparty or otherwise; enabling us, the dealer or our other affiliates to comply with internal risk limits or otherwise manage firmwide, business unit or product risk; and/or enabling us, the dealer or our other affiliates to take directional views as to relevant markets on behalf of itself or our clients or counterparties that are inconsistent with or contrary to the views and objectives of investors in the notes.

We, the dealer and our other affiliates regularly offer a wide array of securities, financial instruments and other products into the marketplace, including existing or new products that are similar to the notes or other securities that we may issue, the underlier stocks or other securities or instruments similar to or linked to the foregoing. Investors in the notes should expect that we, the dealer and our other affiliates will offer securities, financial instruments, and other products that may compete with the notes for liquidity or otherwise.

We, the Dealer and Our Other Affiliates Regularly Provide Services to, or Otherwise Have Business Relationships with, a Broad Client Base, Which Has Included and May Include Us and the Issuers of the Underlier Stocks

We, the dealer and our other affiliates regularly provide financial advisory, investment advisory and transactional services to a substantial and diversified client base. You should assume that we or they will, at present or in the future, provide such services or otherwise engage in transactions with, among others, us and the issuers of the underlier stocks, or transact in securities or instruments or with parties that are directly or indirectly related to these entities. These services could include making loans to or equity investments in those companies, providing financial advisory or other investment banking services, or issuing research reports. You should expect that we, the dealer and our other affiliates, in providing these services, engaging in such transactions, or acting for our own accounts, may take actions that have direct or indirect effects on the notes or other securities that we may issue, the underlier stocks or other securities or instruments similar to or linked to the foregoing, and that such actions could be adverse to the interests of investors in the notes. In addition, in connection with these activities, certain personnel within us, the dealer or our other affiliates may have access to confidential material non-public information about these parties that would not be disclosed to investors of the notes.

Past Basket Underlier Performance Is No Guide to Future Performance

The actual performance of the basket underliers over the term of the notes may bear little relation to their historical levels. Likewise, the amount payable at maturity may bear little relationship to the hypothetical return table or charts set forth elsewhere in this pricing supplement. We cannot predict the future performance of the basket underliers or the basket. Trading activities undertaken by market participants, including certain investors in the notes or their affiliates, including in short positions and derivative positions, may adversely affect the levels of the basket underliers.

As the Calculation Agent, RBCCM Will Have the Authority to Make Determinations that Could Affect the Amount You Receive, if Any, at Maturity

As the calculation agent for the notes, RBCCM will have discretion in making various determinations that affect the notes, including determining the final basket level, which will be used to determine the cash settlement amount at maturity, and determining whether to postpone the determination date because of a market disruption event or because that day is not a trading day. The calculation agent also has discretion in making certain adjustments relating to a discontinuation or modification of a basket underlier, as described under "General Terms of the Notes—Unavailability of the Level of the Underlier" beginning on page PS-6 of the accompanying product prospectus supplement PB-1. The exercise of this discretion by RBCCM, which is our wholly owned subsidiary, could adversely affect the value of the notes and may create a conflict of interest between you and RBCCM. For a description of market disruption events as well as the consequences of the market disruption events, see the section entitled "General Terms of the Notes—Market Disruption Events" beginning on page PS-7 of the accompanying product prospectus supplement PB-1. We may