LIBERTY CORP
Form 10-Q
August 03, 2004

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

(Mark One)

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2004

[ ] 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 1-5846

THE LIBERTY CORPORATION

(Exact name of registrant as specified in its charter)

South Carolina (State or other jurisdiction of incorporation or organization)	57-0507055 (IRS Employer identification No.)

135 South Main Street, Greenville, SC 29601

(Address of principal executive offices)

Registrant s telephone number, including area code: 864/241-5400

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [**X**] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [**X**] No [ ]

Indicate the number of shares outstanding of each of the Registrant s classes of common stock as of the latest practicable date.

Title of each class	Number of shares Outstanding as of June 30, 2004
Common Stock	18,770,530

PART I, ITEM 1

THE LIBERTY CORPORATION AND SUBSIDIARIES
CONSOLIDATED AND CONDENSED BALANCE SHEETS

(In 000 s)	June 30, 2004	December 31, 2003
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 35,807	$ 62,177
Receivables (net of allowance for doubtful accounts)	39,910	42,364
Program rights	1,200	4,564
Prepaid and other current assets	5,468	3,013
Deferred income taxes	2,398	2,183
Total current assets	84,783	114,301
Property, plant, and equipment		
Land	5,647	5,657
Buildings and improvements	50,387	48,969
Furniture and equipment	171,740	167,775
Less: Accumulated depreciation	(134,517)	(125,417)
	93,257	96,984
Intangible assets subject to amortization (net of $606 and $841 accumulated amortization in 2004 and 2003, respectively)	329	270
FCC licenses	304,525	304,525
Goodwill	101,387	101,387
Investments and other assets	26,349	44,798
Total assets	$ 610,630	$ 662,265
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 16,412	$ 19,283
Dividends payable	4,593	4,534
Program contract obligations	1,165	4,734
Accrued income taxes	899	3,874
Total current liabilities	23,069	32,425
Unearned revenue	13,580	11,802

Deferred income taxes	**92,060**	89,417
Other liabilities	**6,869**	6,621
Revolving credit facility	**55,000**	
Total liabilities	**190,578**	140,265
Shareholders equity		
Common stock	**62,127**	71,788
Unearned stock compensation	**(19,849)**	(4,405)
Retained earnings	**377,578**	454,379
Unrealized investment gains	**196**	238
Total shareholders equity	**420,052**	522,000
Total liabilities and shareholders equity	**$ 610,630**	$ 662,265

See Notes to Consolidated and Condensed Financial Statements.

THE LIBERTY CORPORATION AND SUBSIDIARIES
CONSOLIDATED AND CONDENSED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
(In 000 s, except per share data)	**2004**	**2003**	**2004**	**2003**
		(Unaudited)		
REVENUES				
Station revenues (net of commissions)	**$51,138**	$48,062	**$ 95,738**	$88,941
Cable advertising and other revenues	**3,899**	3,599	**7,130**	6,654
Net revenues	**55,037**	51,661	**102,868**	95,595
EXPENSES				
Operating expenses	**32,441**	30,300	**62,680**	59,504
Amortization of program rights	**1,781**	1,744	**3,516**	3,460
Depreciation and amortization of intangibles	**5,047**	4,522	**9,539**	8,822
Corporate, general, and administrative expenses	**5,882**	3,583	**9,185**	6,825
Total operating expenses	**45,151**	40,149	**84,920**	78,611
Operating income	**9,886**	11,512	**17,948**	16,984
Net investment loss	**(4,739)**	(644)	**(5,389)**	(748)
Interest expense	**(242)**		**(262)**	
Income before income taxes	**4,905**	10,868	**12,297**	16,236
Provision for income taxes	**1,839**	4,076	**4,611**	6,089
NET INCOME	**$ 3,066**	$ 6,792	**$ 7,686**	$10,147
BASIC EARNINGS PER COMMON SHARE:	**$ 0.17**	$ 0.36	**$ 0.41**	$ 0.53
DILUTED EARNINGS PER COMMON SHARE:	**$ 0.16**	$ 0.35	**$ 0.41**	$ 0.53
Dividends per common share	**$ 0.25**	$ 0.24	**$ 0.50**	$ 0.48
Special dividend per common share	**$**	$	**$ 4.00**	$

See Notes to Consolidated and Condensed Financial Statements.

THE LIBERTY CORPORATION AND SUBSIDIARIES
CONSOLIDATED AND CONDENSED STATEMENTS OF CASH FLOWS

(In 000 s)	Six Months Ended June 30, 2004	2003
	(Unaudited)	
OPERATING ACTIVITIES		
Net income	**$ 7,686**	$ 10,147
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Loss on sale of operating assets	**28**	8
Realized investment losses	**6,215**	1,410
Depreciation	**9,449**	8,699
Amortization of intangibles	**90**	123
Amortization of program rights	**3,516**	3,460
Cash paid for program rights	**(3,721)**	(3,441)
Provision for deferred income taxes	**2,428**	1,313
Changes in operating assets and liabilities:		
Receivables	**2,454**	3,065
Other assets	**(1,234)**	1,350
Accounts payable and accrued expenses	**(1,230)**	(2,589)
Accrued income taxes	**(1,877)**	
Unearned revenue	**1,778**	2,448
Other liabilities	**248**	228
All other operating activities	**(531)**	(414)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	**25,299**	25,807
INVESTING ACTIVITIES		
Purchase of property, plant, and equipment	**(5,817)**	(11,941)
Proceeds from sale of property, plant, and equipment	**67**	
Investments acquired	**(500)**	(5,500)
Investments sold	**11,257**	
Proceeds from sale of investment properties	**1,055**	1,871
Other		45
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	**6,062**	(15,525)
FINANCING ACTIVITIES		
Proceeds from borrowings	**55,000**	
Dividends paid	**(84,429)**	(9,219)
Stock issued for employee benefit and compensation programs	**4,087**	1,213
Repurchase of common stock	**(32,389)**	(12,321)
NET CASH PROVIDED BY(USED IN) FINANCING ACTIVITIES	**(57,731)**	(20,327)

DECREASE IN CASH	**(26,370)**	(10,045)
Cash at beginning of period	**62,177**	67,917
CASH AT END OF PERIOD	**$ 35,807**	$ 57,872

See Notes to Consolidated and Condensed Financial Statements.

THE LIBERTY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED AND CONDENSED FINANCIAL STATEMENTS
June 30, 2004
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated and condensed financial statements of The Liberty Corporation and Subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

The information included is not necessarily indicative of the annual results that may be expected for the year ended December 31, 2004, but does reflect all adjustments (which are of a normal and recurring nature) considered, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented. In addition, the Company s revenues are usually subject to seasonal fluctuations. The advertising revenues of the stations are generally highest in the second and fourth quarters of each year, due in part to increases in consumer advertising in the spring and retail advertising in the period leading up to and including the holiday season. Additionally, advertising revenues in even-numbered years tend to be higher as they benefit from advertising placed by candidates for political offices and demand for advertising time in Olympic broadcasts.

The December 31, 2003 financial information was derived from the Company s previously filed 2003 Form 10-K. For further information, refer to the consolidated financial statements and footnotes thereto included in The Liberty Corporation annual report on Form 10-K for the year ended December 31, 2003.

2. COMPREHENSIVE INCOME

The components of comprehensive income, net of related income taxes, for the three and six month periods ended June 30, 2004 and 2003, respectively, are as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(In 000 s)	**2004**	**2003**	**2004**	**2003**
Net income	**$3,066**	$6,792	**$7,686**	$10,147
Unrealized gains (losses) on securities	**(23)**	23	**(42)**	92
Comprehensive income	**$3,043**	$6,815	**$7,644**	$10,239

3. SEGMENT REPORTING

The Company operates primarily in the television broadcasting and cable advertising businesses. The Company currently owns and operates fifteen television stations, primarily in the Southeast and Midwest. Each of the stations is affiliated with a major network, with eight NBC affiliates, five ABC affiliates, and two CBS affiliates. The Company evaluates segment performance based on income before income taxes, excluding unusual, or non-operating items.

The following table summarizes financial information by segment for the three and six month periods ended June 30, 2004 and 2003:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(In 000 s)	**2004**	**2003**	**2004**	**2003**
Revenues (net of commissions)				
Broadcasting	**$ 51,138**	$48,062	**$ 95,738**	$88,941
Cable advertising	**3,883**	3,490	**7,076**	6,471
Other	**16**	109	**54**	183
Total net revenues	**$ 55,037**	$51,661	**$102,868**	$95,595
Income before income taxes				
Broadcasting	**$ 15,588**	$15,061	**$ 27,165**	$24,254
Cable advertising	**589**	455	**782**	353
Corporate and other	**(11,272)**	(4,648)	**(15,650)**	(8,371)
Total income before income taxes	**$ 4,905**	$10,868	**$ 12,297**	$16,236

There were no material changes in assets by segment from those disclosed in the Company s 2003 annual report. The goodwill that appears on the face of the balance sheet arose through the acquisition of certain television stations, and therefore has been assigned in its entirety to the Broadcasting segment.

4. EMPLOYEE BENEFITS

The Company has a postretirement plan that provides medical and life insurance benefits for qualified retired employees. The postretirement medical plan is generally contributory with retiree contributions adjusted annually to limit employer contributions to predetermined amounts. The postretirement life plan provides free insurance coverage for retirees and is insured with an unaffiliated company.

The information presented in this footnote does not reflect the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the Act) signed into law December 8, 2003. Specifically, the measures of Net Periodic

Postretirement Benefit cost shown do not reflect this Act. Specific authoritative guidance on the accounting treatment of the Act is pending and upon issuance, may require a change in previously reported information.

Net periodic postretirement benefit cost included the following components:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In 000 s)	**2004**	**2003**	**2004**	**2003**
Service cost	**$ 6**	$ 7	**$ 13**	$ 14
Amortization of prior service cost	**1**	1	**1**	1
Amortization of actuarial net gain	**5**		**10**	
Interest cost	**34**	27	**67**	55
Net periodic postretirement benefit cost	**$ 46**	$ 35	**$ 91**	$ 70

5. EARNINGS PER SHARE

The calculation of basic and diluted earnings per common share from continuing operations is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In 000 s except per share data)	**2004**	**2003**	**2004**	**2003**
Numerator Earnings:				
Net income	**$ 3,066**	$ 6,792	**$ 7,686**	$10,147
Effect of dilutive securities				
Numerator for basic and diluted earnings per common share	**$ 3,066**	$ 6,792	**$ 7,686**	$10,147
Denominator Average Shares Outstanding:				
Denominator for basic earnings per common share weighted average shares	**18,526**	19,095	**18,633**	19,169
Effect of dilutive securities:				
Stock options	**137**	134	**154**	114
Denominator for diluted earnings per common share	**18,663**	19,229	**18,787**	19,283
Basic earnings per common share	**$ 0.17**	$ 0.36	**$ 0.41**	$ 0.53

Diluted earnings per common share	**$ 0.16**	$ 0.35	**$ 0.41**	$ 0.53

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6. EQUITY COMPENSATION

In accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation , the Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25) and related interpretations in accounting for its equity compensation plans and does not recognize compensation expense for its stock-based compensation plans other than for awards of restricted shares. Expense is recognized over the vesting period of the restricted shares.

Under APB No. 25, because the exercise price of the Company s employee stock options at least equals the market price of the underlying stock on the date of the grant, no compensation expense is recognized. Pro forma information regarding net income and earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the Black-Scholes fair value method described in that statement.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. The Company s employee stock options have characteristics significantly different from those of traded options, and changes in the subjective input assumptions can materially affect the fair value estimate.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options vesting periods. The Company s pro forma information is as follows:

	For the Three Months Ended June 30,		**For the Six Months Ended June 30,**	
(In 000 s, except per share amounts)	**2004**	**2003**	**2004**	**2003**
Stock-based compensation cost included in net income (net of taxes)	**$ 515**	$ 226	**$ 749**	$ 733
Net income:				
As reported	**$3,066**	$6,792	**$7,686**	$10,147
Pro forma compensation expense (net of taxes)	**(202)**	(204)	**(405)**	(359)
Pro forma net income	**$2,864**	$6,588	**$7,281**	$ 9,788
Basic earnings per share:				
As reported	**$ 0.17**	$ 0.36	**$ 0.41**	$ 0.53
Pro forma	**0.15**	0.35	**0.39**	0.51
Diluted earnings per share:				
As reported	**$ 0.16**	$ 0.35	**$ 0.41**	$ 0.53
Pro forma	**0.15**	0.34	**0.39**	0.51

7. COMMON STOCK

The following table summarizes the Common Stock activity from the date of the Company s most recently audited annual financial statements to the end of the period covered by this report:

(In 000 s)	**Common Shares Outstanding**	**Common Stock**
Balance as of 12/31/03	18,931	$ 71,788
Stock issued for employee benefit and performance incentive compensation programs	512	21,630
Income tax benefit resulting from employee exercise of options		1,098
Stock Repurchased	(672)	(32,389)
Balance as of 6/30/04	**18,771**	**$ 62,127**

During the first quarter of 2004 the Company funded the accrued 2003 discretionary contribution to its employee retirement and savings plan. Half of this funding, approximately $1.6 million, was in the form of approximately 32,000 shares of Liberty common stock.

8. CREDIT FACILITY

PART I, ITEM 2
MANAGEMENT S DISCUSSION AND ANALYSIS OF
RESULTS OF OPERATIONS AND FINANCIAL CONDITION
(Unaudited)

The Liberty Corporation is a holding company with operations primarily in the television broadcasting industry. The Company s television broadcasting subsidiary, Cosmos Broadcasting, consists of fifteen network-affiliated stations located in the Southeast and Midwest, along with other ancillary businesses. Eight of the Company s television stations are affiliated with NBC, five with ABC, and two with CBS.

SEASONALITY OF TELEVISION REVENUES

The Company s revenues are usually subject to seasonal fluctuations. The advertising revenues of the stations are generally highest in the second and fourth quarters of each year, due in part to increases in consumer advertising in the spring and retail advertising in the period leading up to and including the holiday season. Additionally, advertising revenues in even-numbered years tend to be higher as they benefit from advertising placed by candidates for political offices and demand for advertising time in Olympic broadcasts.

RESULTS OF OPERATIONS

Three Months Ended June 30, 2004 Compared to Three Months Ended June 30, 2003

Total net revenue increased $3.4 million, on a year-over-year basis. Station net revenue increased $3.1 million for the same period. Cable and other net revenue increased $0.3 million on increases in local and political revenue. While station local and national revenue were both up four percent, the most significant portion of the year-over-year increase was from political revenue. Political revenue for the second quarter of 2004 was $3.9 million as compared to $2.0 million in the second quarter of 2003. The Company s core local and national revenues were up due mainly to increases in the automotive, retail, and financial services categories, while most of the other categories tracked by the Company were flat compared with their 2003 levels.

Operating expenses, which include amortization of program rights, were $34.2 million for the second quarter of 2004, an increase of $2.2 million, seven percent, over the $32.0 million reported for the second quarter of 2003. The increase in operating expenses is due mainly to increased medical insurance costs, programming costs, and planned annual increases in employee compensation.

Corporate expenses were $5.9 million in the second quarter of 2004, an increase of $2.3 million as compared to the $3.6 million reported for the second quarter of 2003. The increase in corporate expenses is due to annual increases in employee compensation coupled with the $1.6 million charge taken related to the settlement of all outstanding issues associated with the terminated GNS Media (GNS) transaction. During 2003, the Company announced that it was in negotiations with GNS for the purpose of entering into certain agreements associated with GNS s proposed purchase of a television station. Those negotiations were subsequently terminated.

Net investment income for the second quarter of 2004 was a loss of $4.7 million. Interest earned on cash balances and notes receivable, and a $0.7 million gain on sale of an investment in the Company s venture capital portfolio were offset by a $5.3 million impairment of one of the Company s strategic investments, a developer of digital entertainment to be viewed at existing movie theaters. The Company fully reserved this investment due to the investee company s current inadequate cash balances and inability to secure financing from additional investors.

Six Months Ended June 30, 2004 Compared to Six Months Ended June 30, 2003

Total net revenue increased $7.3 million on a year-over-year basis. Station net revenue increased $6.8 million for the same period. Cable and other net revenue increased $0.5 million on increases in local and political revenue. While station local and national revenue were both up five percent, the most significant portion of the year-over-year increase was from political revenue. Political revenue for the first half of 2004 was $6.5 million as compared to $2.7 million in the first half of 2003. The Company s core local and national revenues increased as the automotive, retail, financial services, and telecommunications categories were up modestly to significantly, while most of the other categories tracked by the Company were flat to off slightly from their 2003 levels.

Operating expenses, which include amortization of program rights, were $66.2 million for the first half of 2004, an increase of $3.2 million, five percent, over the $63.0 million reported for the first half of 2003. The increase in operating expenses is due mainly to increases in medical insurance costs, programming costs, increased payroll related costs associated with higher levels of local sales commissions as a direct result of higher local sales revenue, and planned annual increases in employee compensation.

Corporate expenses were $9.2 million in the first half of 2004, an increase of $2.4 million as compared to the $6.8 million reported for the first half of 2003. The increase in corporate expenses is due to annual increases in employee compensation coupled with the $1.6 million charge taken related to the settlement of all outstanding issues associated with the terminated GNS Media (GNS) transaction. During 2003, the Company announced that it was in negotiations with GNS for the purpose of entering into certain agreements associated with GNS s proposed purchase of a television station. Those negotiations were subsequently terminated.

Net investment income for the first half of 2004 was a loss of $5.4 million. Interest earned on cash balances and notes receivable, and a $0.7 million gain on sale of an investment in the Company s venture capital portfolio were offset by $1.1 million of impairments taken during the first quarter of 2004 and a $5.3 million impairment of one of the Company s strategic investments taken during the second quarter of 2004.

Capital, Financing and Liquidity

At June 30, 2004, the Company had cash of $35.8 million, outstanding debt of $55.0 million, and $45.0 million available under its $100 million credit facility. During the first quarter of 2004, the Company declared a special dividend of $4.00 per share in addition to its normal recurring quarterly dividend of $0.25 per share. The accrued dividends of $79.3 million were paid during the second quarter of 2004 using a significant portion of the Company s cash balances.

The revolving credit facility has both an interest coverage and a leverage coverage covenant. These covenants, which involve debt levels, interest expense, EBIT, and EBITDA (measures of cash earnings defined in the revolving credit agreement), can affect the interest rate on current and future borrowings. The Company was in compliance with all covenants throughout the quarter.

The Company anticipates that its primary sources of cash, those being current cash balances, operating cash flow, and the available line of credit will be sufficient to finance the Company s operating requirements and anticipated capital expenditures, for both the next 12 months and the foreseeable future thereafter.

Cash Flows

The Company s net cash flow provided by operating activities was $25.3 million for the first six months of 2004 compared to $25.8 million for the same period of the prior year. The Company s net cash provided by in investing activities was $6.1 million for the six month period ended June 30, 2004, as compared to net cash used in investing activities of $15.5 million for the same period of 2003. The increase in net cash provided by investing activities is attributable to lower levels of fixed asset purchases related to digital television broadcasting during 2004 and the cash realized on the sale of investments in the Company s venture capital and strategic investment portfolios. Net cash used in financing activities for the six months ended June 30, 2004 was $57.7 million compared to $20.3 million for the first six months of 2003. During 2004, the Company completed the first draw of $55.0 million on its previously unused $100 million line of credit. Excluding the effect of these borrowings, the increase in net cash used in financing activities is due mainly to the special dividend of $4.00 per share paid during the second quarter of 2004, and to higher levels of repurchase activity in the Company s stock buy-back program during 2004 as compared to 2003.

Forward Looking Information

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Certain information contained herein or in any other written or oral statements made by, or on behalf of the Company, is or may be viewed as forward-looking. The words expect, believe, anticipate or similar expressions identify forward-looking statements. Although the Company has used appropriate care in developing any such forward-looking information, forward-looking information involves risks and uncertainties that could significantly impact actual results. These risks and uncertainties include, but are not limited to, the following: changes in national and local markets for television advertising; changes in general economic conditions, including the performance of financial markets and interest rates; competitive, regulatory, or tax changes that affect the cost of or demand for the Company s products; and adverse litigation results. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future developments, or otherwise.

PART I, ITEM 4
CONTROLS AND PROCEDURES

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of the end of the period covered by this report the Company s disclosure controls and procedures are effective in providing reasonable assurance that material information relating to the Company required to be included in the Company s periodic SEC filings was made known to them during the period covered by this report. There have been no significant changes in the Company s internal controls or in other factors that could significantly affect internal controls subsequent to this evaluation.

PART II, ITEM 2e.
CHANGES IN SECURITIES AND USE OF PROCEEDS

opolitical conditions and economic, financial, political, regulatory or judicial events that affect the Indices or the markets generally;

¨ supply and demand for the Securities; and

¨ our creditworthiness, including actual or anticipated downgrades in our credit ratings.

¨ **Trading and Other Transactions by Us, UBS AG or Our or Its Affiliates in the Equity and Equity Derivative Markets May Impair the Value of the Securities** — We or our affiliates expect to hedge our exposure from the Securities by entering into equity and equity derivative transactions, such as over-the-counter options, futures or exchange-traded instruments. We, UBS AG or our or its affiliates may also engage in trading in instruments linked or related to the Indices on a regular basis as part of our or its general broker-dealer and other businesses, for proprietary accounts, for other accounts under management or to facilitate transactions for customers, including block transactions. Such trading and hedging activities may affect the levels of the Indices, and therefore make it less likely that you will receive a positive return on your investment in the Securities. It is possible that we, UBS AG or our or its affiliates could receive substantial returns from these hedging and trading activities while the value of the Securities declines. We, UBS AG or our or its affiliates may also issue or underwrite other securities or financial or derivative instruments with returns linked or related to the Indices. To the extent that we, UBS AG or our or its affiliates serves as issuer, agent or underwriter for such securities or financial or derivative instruments, our, UBS AG's or our or its affiliates' interests with respect to such products may be adverse to those of the holders of the Securities. Introducing competing products into the marketplace in this manner could adversely affect the levels of the Indices and the value of the Securities. Any of the foregoing activities described in this paragraph may reflect trading strategies that differ from, or are in direct opposition to, investors' trading and investment strategies related to the Securities.

¨ **Potential Deutsche Bank AG Impact on Price** — Trading or transactions by Deutsche Bank AG or its affiliates in the stocks composing the Indices and/or in futures, over-the-counter options, exchange-traded funds or other instruments with returns linked to the performance of the Indices or the stocks composing the Indices may adversely affect the price of the stocks composing the Indices, the levels of the Indices, and therefore the value of the Securities.

¨ **We, UBS AG or Our or Its Affiliates May Publish Research, Express Opinions or Provide Recommendations That Are Inconsistent with Investing in or Holding the Securities. Any Such Research, Opinions or Recommendations Could Adversely Affect the Levels of The Indices and the Value of the Securities** — We, UBS

AG or our or its affiliates may publish research from time to time on financial markets and other matters that could adversely affect the levels of the Indices and the value of the Securities, or express opinions or provide recommendations that are inconsistent with purchasing or holding the Securities. Any research, opinions or recommendations expressed by us, UBS AG or our or its affiliates may not be consistent with each other and may be modified from time to time without notice. You should make your own independent investigation of the merits of investing in the Securities and the Indices.

¨ **Potential Conflicts of Interest** — Deutsche Bank AG or its affiliates may engage in business with the issuers of the stocks composing the Indices, which may present a conflict between Deutsche Bank AG and you, as a holder of the Securities. We and our affiliates play a variety of roles in connection with the issuance of the Securities, including acting as calculation agent, hedging our obligations under the Securities and determining the Issuer's estimated value of the Securities on the Trade Date and the price, if any, at which we or our affiliates would be willing to purchase the Securities from you in secondary market transactions. In performing these roles, our economic interests and those of our affiliates are potentially adverse to your interests as an investor in the Securities. The calculation agent will determine, among other things, all values, prices and levels required to be determined for the purposes of the Securities on any relevant date or time. The calculation agent will also be responsible for determining whether a market disruption event has occurred as well as, in some circumstances, the prices or levels related to the Indices that affect whether the Securities are automatically called. Any determination by the calculation agent could adversely affect the return on the Securities.

There Is Substantial Uncertainty Regarding the U.S. Federal Income Tax Consequences of an Investment in the Securities — There is no direct legal authority regarding the proper U.S. federal income tax treatment of the Securities, and we do not plan to request a ruling from the Internal Revenue Service (the "**IRS**"). Consequently, significant aspects of the tax treatment of the Securities are uncertain, and the IRS or a court might not agree with the treatment of the Securities as prepaid financial contracts that are not debt, with associated contingent coupons, as described below under "What Are the Tax Consequences of an Investment in the Securities?" If the IRS were successful in asserting an alternative treatment for the Securities, the tax consequences of ownership and disposition of the Securities could be materially affected. In addition, as described below under "What Are the Tax Consequences of an Investment in the Securities?", in 2007 the U.S. Treasury Department and the IRS released a notice requesting comments on various issues regarding the U.S. federal income tax treatment of "prepaid forward contracts" and similar instruments. Any Treasury regulations or other guidance promulgated after consideration of these issues could materially affect the tax consequences of an investment in the Securities, possibly with retroactive effect. You should review carefully the section of the accompanying product supplement entitled "U.S. Federal Income Tax Consequences," and consult your tax adviser regarding the U.S. federal tax consequences of an investment in the Securities (including possible alternative treatments and the issues presented by the 2007 notice), as well as tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

Scenario Analysis and Hypothetical Examples of Payment upon an Automatic Call or at Maturity

The following hypothetical examples below illustrate the payment upon an automatic call or at maturity for a hypothetical range of performances for the Indices. The following examples are hypothetical and provided for illustrative purposes only. They do not purport to be representative of every possible scenario concerning increases or decreases in the levels of the Indices relative to their respective Initial Levels. We cannot predict the Final Levels or the closing levels of the Indices on any of the Observation Dates (including the Final Valuation Date). You should not take these examples as an indication or assurance of the expected performance of the Indices. You should consider carefully whether the Securities are suitable to your investment goals. The numbers in the examples and table below may have been rounded for ease of analysis.

The following examples illustrate the payment at maturity or upon an automatic call per $10.00 Face Amount of Securities on a hypothetical offering of Securities based on the following assumptions*:

Term:	3 years, subject to an automatic call
Hypothetical Contingent Coupon Rate*:	8.00% per annum (or 2.00% per quarter)
Contingent Coupon:	$0.20 per quarter
Observation Dates:	Quarterly (callable after 6 months)
Hypothetical Initial Levels*:	
Russell 2000®` Index:	1,200
EURO STOXX 50® Index:	3,600
Hypothetical Trigger Levels*:	
Russell 2000®` Index:	840.00 (70.00% of its Hypothetical Initial Level)
EURO STOXX 50® Index:	2,520.00 (70.00% of its Hypothetical Initial Level)
Hypothetical Coupon Barriers*:	
Russell 2000®` Index:	840.00 (70.00% of its Hypothetical Initial Level)
EURO STOXX 50® Index:	2,520.00 (70.00% of its Hypothetical Initial Level)

* Based on a hypothetical Contingent Coupon Rate of 8.00% per annum. The actual Initial Level, Trigger Level and Coupon Barrier for each Index and the Contingent Coupon Rate for the Securities will be set on the Trade Date.

Example 1 — The Securities are automatically called on the First Autocall Observation Date.

Date	Closing Level		Payment (per $10.00 Face Amount of Securities)
	Russell 2000® Index	EURO STOXX 50® Index	
First Observation Date	1,250 (greater than its Initial Level)	3,700 (greater than its Initial Level)	$0.20 (Contingent Coupon — Not Callable)

Second Observation Date (First Autocall Observation Date)	1,400 (greater than its Initial Level)	3,800 (greater than its Initial Level)	$10.20 (Face Amount *plus* Contingent Coupon)
		Total Payment:	$10.40 (4.00% return)

In this example, because the closing levels of both Indices on the first Observation Date are greater than their respective Coupon Barriers, Deutsche Bank AG will pay you the Contingent Coupon on the applicable Coupon Payment Date. Because the closing levels of both Indices on the First Autocall Observation Date (the second Observation Date) are greater than their respective Initial Levels, the Securities will be automatically called on the First Autocall Observation Date. Deutsche Bank AG will pay you on the applicable Call Settlement Date a total of $10.20 per $10.00 Face Amount of Securities, reflecting the Face Amount plus the Contingent Coupon. When added to the Contingent Coupon Payment of $0.20 paid in respect of the prior Observation Date, Deutsche Bank AG will have paid you a total of $10.40 per $10.00 Face Amount of Securities, representing a 4.00% return on the Securities over the approximately six months the Securities were outstanding before they were automatically called. No further amount will be owed to you under the Securities.

Example 2 — The Securities are automatically called on the eighth Observation Date.

Date	Closing Level Russell 2000® Index	EURO STOXX 50® Index	Payment (per $10.00 Face Amount of Securities)
First Observation Date	1,300 (greater than its Initial Level)	3,500 (greater than its Coupon Barrier; less than its Initial Level)	$0.20 (Contingent Coupon)
Second Observation Date (First Autocall Observation Date)	1,100 (greater than its Coupon Barrier; less than its Initial Level)	3,800 (greater than its Initial Level)	$0.20 (Contingent Coupon)
Third Observation Date	1,000 (greater than its Coupon Barrier; less than its Initial Level)	3,400 (greater than its Coupon Barrier; less than its Initial Level)	$0.20 (Contingent Coupon)
Fourth to Seventh Observation Dates	Various (all less than its Coupon Barrier)	Various (all less than its Coupon Barrier)	$0.00
Eighth Observation Date	1,400 (greater than its Initial Level)	3,900 (greater than its Initial Level)	$10.20 (Face Amount plus Contingent Coupon)
		Total Payment:	$10.80 (8.00% return)

In this example, because the closing levels of both Indices are greater than their respective Coupon Barriers on the first three Observation Dates, Deutsche Bank AG will pay you the Contingent Coupon on the applicable Coupon Payment Dates. On the fourth to seventh Observation Dates, the closing levels of both Indices are less than their respective Coupon Barriers. Therefore, no Contingent Coupon is paid on any applicable Coupon Payment Date. Because the closing levels of both Indices on the eighth Observation Date are greater than their respective Initial Levels, the Securities will be automatically called on the eighth Observation Date. Deutsche Bank AG will pay you on the applicable Call Settlement Date a total of $10.20 per $10.00 Face Amount of Securities, reflecting the Face Amount *plus* the Contingent Coupon. When added to the Contingent Coupon Payments of $0.60 paid in respect of prior Observation Dates, Deutsche Bank AG will have paid you a total of $10.80 per $10.00 Face Amount of Securities, representing an 8.00% return on the Securities over the approximately two year term the Securities were outstanding before they were automatically called. No further amount will be owed to you under the Securities.

Example 3 — The Securities are NOT automatically called and the Final Level of the Lesser Performing Index is greater than its Trigger Level and Coupon Barrier.

Date	Closing Level Russell 2000® Index	EURO STOXX 50® Index	Payment (per $10.00 Face Amount of Securities)
First Observation Date	1,150 (greater than its Coupon Barrier; less than its Initial Level)	3,450 (greater than its Coupon Barrier; less than its Initial Level)	$0.20 (Contingent Coupon)
	800 (less than its Coupon Barrier)		$0.00

Second Observation Date (First Autocall Observation Date)		2,600 (greater than its Coupon Barrier; less than its Initial Level)	
Third Observation Date	850 (greater than its Coupon Barrier; less than its Initial Level)	2,200 (less than its Coupon Barrier)	$0.00
Fourth to Eleventh Observation Dates	Various (all less than its Coupon Barrier)	Various (all less than its Coupon Barrier)	$0.00
Final Observation Date	1,180 (greater than both its Trigger Level and Coupon Barrier; less than its Initial Level)	3,800 (greater than its Initial Level)	$10.20 (Payment at Maturity)
		Total Payment:	$10.40 (4.00% return)

In this example, because the closing levels of both Indices are greater than their respective Coupon Barriers on the first Observation Date, Deutsche Bank AG will pay you the Contingent Coupon on the applicable Coupon Payment Date. On the second to eleventh Observation Dates, the closing level of at least one Index is less than its applicable Coupon Barrier. Therefore, no Contingent Coupon is paid on any applicable Coupon Payment Date. On the Final Valuation Date, because the Index Return of the Russell 2000® Index is -1.67% while the Index Return of the EURO STOXX 50® Index is 5.56%, the Russell 2000® Index is designated the Lesser Performing Index. Because the Final Level of the Lesser Performing Index is greater than its Trigger Level and Coupon Barrier, Deutsche Bank AG will pay you at maturity a total of $10.20 per $10.00 Face Amount of Securities, reflecting the Face Amount plus the Contingent Coupon. When added to the Contingent Coupon payment of $0.20 paid in respect of prior Observation Dates, Deutsche Bank AG will have paid you a total of $10.40 per $10.00 Face Amount of Securities, representing a 4.00% return over the approximately three year term of the Securities.

Example 4 — The Securities are NOT automatically called and the Final Level of the Lesser Performing Index is less than its Trigger Level.

Date	Closing Level Russell 2000® Index	EURO STOXX 50® Index	Payment (per $10.00 Face Amount of Securities)
First Observation Date	900 (greater than its Coupon Barrier; less than its Initial Level)	2,750 (greater than its Coupon Barrier; less than its Initial Level)	$0.20 (Contingent Coupon)
Second Observation Date (First Autocall Observation Date)	960 (greater than its Coupon Barrier; less than its Initial Level)	2,600 (greater than its Coupon Barrier; less than its Initial Level)	$0.20 (Contingent Coupon)
Third Observation Date	850 (greater than its Coupon Barrier; less than its Initial Level)	4,000 (greater than its Initial Level)	$0.20 (Contingent Coupon)
Fourth to Eleventh Observation Dates	Various (all less than its Coupon Barrier)	Various (all less than its Coupon Barrier)	$0.00
			$10.00 + [$10.00 × Index Return of the Lesser Performing Index] =
Final Observation Date	600 (less than both its Trigger Level and Coupon Barrier)	3,800 (greater than its Initial Level)	$10.00 + [$10.00 × -50.00%] =
			$5.00 (Payment at Maturity)
		Total Payment:	$5.60 (-44.00% return)

In this example, because the closing levels of both Indices are greater than their respective Coupon Barriers on the first three Observation Dates, Deutsche Bank AG will pay you the Contingent Coupon on the applicable Coupon Payment Dates. On the fourth to eleventh Observation Dates, the closing levels of both Indices are less than their respective Coupon Barriers. Therefore, no Contingent Coupon is paid on any applicable Coupon Payment Date. On the Final Valuation Date, because the Index Return of the Russell 2000® Index is -50.00% while the Index Return of the EURO STOXX 50® Index is 5.56%, the Russell 2000® Index is designated the Lesser Performing Index. Because the Final Level of the Lesser Performing Index is less than its Trigger Level, Deutsche Bank AG will pay you at maturity $5.00 per $10.00 Face Amount of Securities. When added to the Contingent Coupon Payments of $0.60 paid in respect of prior Observation Dates, Deutsche Bank AG will have paid you $5.60 per $10.00 Face Amount of Securities, representing a -44.00% return over the approximately three year term of the Securities.

The Issuer will not pay a Contingent Coupon if the closing level of either Index is below its respective Coupon Barrier on an Observation Date. The Issuer will not call the Securities after one year if the closing level of

either Index is below its respective Initial Level on an Observation Date. If the Securities are not automatically called and the Final Level of the Lesser Performing Index is less than its Trigger Level, your initial investment will be fully exposed to the negative Index Return of the Lesser Performing Index, and, for each $10.00 Face Amount of Securities, you will lose 1.00% of the Face Amount for every 1.00% decline in the Final Level of the Lesser Performing Index as compared to its Initial Level, regardless of the performance of the other Index. In this circumstance, you will lose a significant portion or all of your initial investment. Any payment on the Securities, including any payment of a Contingent Coupon, any payment upon an automatic call and any payment of your initial investment at maturity, is subject to the creditworthiness of the Issuer and if the Issuer were to default on its payment obligations or become subject to a Resolution Measure, you could lose your entire investment.

The Russell 2000® Index

The Russell 2000® Index is designed to track the performance of the small capitalization segment of the U.S. equity market. The Russell 2000® Index measures the composite price performance of stocks of approximately 2,000 companies domiciled in the U.S. and its territories and consists of the smallest 2,000 companies included in the Russell 3000® Index. The Russell 2000® Index represents approximately 10% of the total market capitalization of the Russell 3000® Index. This is only a summary of the Russell 2000® Index. *For more information on the Russell 2000® Index, including information concerning its composition, calculation methodology and adjustment policy, please see the section entitled "The Russell Indices – The Russell 2000® Index" in the accompanying underlying supplement No. 1 dated August 17, 2015.*

The graph below illustrates the performance of the Russell 2000® Index from August 14, 2010 to August 14, 2015. The closing level of the Russell 2000® Index on August 14, 2015 was 1,212.688. The dotted line represents a hypothetical Coupon Barrier and Trigger Level equal to 70.00% of 1,212.688, which was the closing level of the Russell 2000® Index on August 14, 2015 (the actual Initial Level, Coupon Barrier and Trigger Level will be set on the Trade Date). We obtained the historical closing levels of the Russell 2000® Index from Bloomberg L.P., and we have not participated in the preparation of, or verified, such information. Currently, whereas the sponsor of the Russell 2000® Index publishes the official closing level of the Russell 2000® Index to six decimal places, Bloomberg L.P. reports the closing level to three decimal places. As a result, the closing level of the Russell 2000® Index reported by Bloomberg L.P. may be lower or higher than the official closing level of the Russell 2000® Index published by the sponsor of the Russell 2000® Index. The historical closing levels of the Russell 2000® Index should not be taken as an indication of future performance and no assurance can be given as to the Final Level or any future closing level of the Russell 2000® Index. We cannot give you assurance that the performance of the Russell 2000® Index will result in a positive return on your initial investment and you could lose a significant portion or all of your initial investment at maturity.

The EURO STOXX 50® Index

The EURO STOXX 50® Index is composed of 50 component stocks of market sector leaders from within the 19 EURO STOXX® Supersector indices, which represent the Eurozone portion of the STOXX Europe 600® Supersector indices. The STOXX Europe 600® Supersector indices contain the 600 largest stocks traded on the major exchanges of 18 European countries. The component stocks have a high degree of liquidity and represent the largest companies across all market sectors. This is only a summary of the EURO STOXX 50® Index. *For more information on the EURO STOXX 50® Index, including information concerning its composition, calculation methodology and adjustment policy, please see the section entitled "Indices — EURO STOXX 50® Index" in the accompanying underlying supplement No. 1 dated August 17, 2015.*

The graph below illustrates the performance of the EURO STOXX 50® Index from August 14, 2010 to August 14, 2015. The closing level of the EURO STOXX 50® Index on August 14, 2015 was 3,491.03. The dotted line represents a hypothetical Coupon Barrier and Trigger Level equal to 70.00% of 3,491.03, which was the closing level of the EURO STOXX 50® Index on August 14, 2015 (the actual Initial Level, Coupon Barrier and Trigger Level will be set on the Trade Date). We obtained the historical closing levels of the EURO STOXX 50® Index from Bloomberg L.P., and we have not participated in the preparation of, or verified, such information. The historical closing levels of the EURO STOXX 50® Index should not be taken as an indication of future performance and no assurance can be given as to the Final Level or any future closing level of the EURO STOXX 50® Index. We cannot give you assurance that the performance of the EURO STOXX 50® Index will result in a positive return on your initial investment and you could lose a significant portion or all of your initial investment at maturity.

What Are the Tax Consequences of an Investment in the Securities?

Due to the lack of direct legal authority, there is substantial uncertainty regarding the U.S. federal income tax consequences of an investment in the Securities. In determining our responsibilities for information reporting and withholding, if any, we intend to treat the Securities as prepaid financial contracts that are not debt, with associated contingent coupons that constitute ordinary income and that, when paid to a non-U.S. holder, are generally subject to 30% (or lower treaty rate) withholding. Our special tax counsel, Davis Polk & Wardwell LLP, has advised that while it believes this treatment to be reasonable, it is unable to conclude that it is more likely than not that this treatment will be upheld, and that other reasonable treatments are possible that could materially affect the timing and character of income or loss on your Securities. If this treatment is respected, you generally should recognize short-term capital gain or loss on the taxable disposition (including retirement) of your Securities, unless you have held the Securities for more than one year, in which case your gain or loss should be long-term capital gain or loss. However, it is likely that any sales proceeds that are attributable to the next succeeding contingent coupon after it has been fixed will be treated as ordinary income and also possible that any sales proceeds attributable to the next succeeding contingent coupon prior to the time it has been fixed will be treated as ordinary income.

In 2007, the U.S. Treasury Department and the IRS released a notice requesting comments on various issues regarding the U.S. federal income tax treatment of “prepaid forward contracts” and similar instruments. The notice focuses in particular on whether beneficial owners of these instruments should be required to accrue income over the term of their investment. It also asks for comments on a number of related topics, including the character of income or loss with respect to these instruments; the relevance of factors such as the nature of the underlying property to which the instruments are linked; and the degree, if any, to which income (including any mandated accruals) realized by non-U.S. persons should be subject to withholding tax. While the notice requests comments on appropriate transition rules and effective dates, any Treasury regulations or other guidance promulgated after consideration of these issues could materially affect the tax consequences of an investment in the Securities, possibly with retroactive effect.

You should review carefully the section of the accompanying product supplement entitled “U.S. Federal Income Tax Consequences.” The preceding discussion, when read in combination with that section, constitutes the full opinion of our special tax counsel regarding the material U.S. federal income tax consequences of owning and disposing of the Securities.

Under current law, the United Kingdom will not impose withholding tax on payments made with respect to the Securities.

For a discussion of certain German tax considerations relating to the Securities, you should refer to the section in the accompanying prospectus supplement entitled “Taxation by Germany of Non-Resident Holders.”

You should consult your tax adviser regarding the U.S. federal tax consequences of an investment in the Securities (including possible alternative treatments and the issues presented by the 2007 notice), as well as tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

Supplemental Plan of Distribution (Conflicts of Interest)

UBS Financial Services Inc. and its affiliates, and Deutsche Bank Securities Inc., acting as agents for Deutsche Bank AG, will receive or allow as a concession or reallowance to other dealers discounts and commissions of $0.20 per $10.00 Face Amount of Securities. We will agree that UBS Financial Services Inc. may sell all or part of the Securities that it purchases from us to investors at the price to public indicated on the cover of the pricing supplement, the document that will be filed pursuant to Rule 424(b)(2) containing the final pricing terms of the Securities, or to its affiliates at the price to public indicated on the cover of the pricing supplement minus a concession not to exceed the discounts and commissions indicated on the cover. DBSI, one of the agents for this offering, is our affiliate. Because DBSI is both our affiliate and a member of the Financial Industry Regulatory Authority, Inc. (“**FINRA**”), the underwriting arrangement for this offering must comply with the requirements of FINRA Rule 5121 regarding a FINRA member firm’s distribution of the securities of an affiliate and related conflicts of interest. In accordance with FINRA Rule 5121, DBSI may not make sales in this offering of the Securities to any of its discretionary accounts without the prior written approval of the customer. See “Underwriting (Conflicts of Interest)” in the accompanying product supplement.