HCC INSURANCE HOLDINGS INC/DE/
Form 10-Q
August 09, 2004

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

þ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarter Ended June 30, 2004.

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from _______ to __________

Commission file number 001-13790

HCC Insurance Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware	76-0336636
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
13403 Northwest Freeway, Houston, Texas	77040-6094
(Address of principal executive offices)	(Zip Code)

(713) 690-7300

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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 is an accelerated filer (as defined in Rule 12B-2 of the Act).

Yes þ No o

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

On July 30, 2004, there were approximately 64.7 million shares of common stock, $1.00 par value issued and outstanding.

HCC INSURANCE HOLDINGS, INC.
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This report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by those laws. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as anticipate, believe, estimate, expect, intend, plan, probably or similar ex we are making forward-looking statements. Many risks and uncertainties may impact the matters addressed in these forward-looking statements.

Many possible events or factors could affect our future financial results and performance. These could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions, and therefore also the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements which are included in this report, our inclusion of this information is not a representation by us or any other person that our objectives and *plans will be achieved.*

Our forward-looking statements speak only as of the date made and we will not update these forward-looking statements unless the securities laws require us to do so. In light of these risks, uncertainties and assumptions, any forward-looking events discussed in this report may not occur.

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(unaudited, in thousands, except per share data)

	June 30, 2004	**December 31, 2003**
ASSETS		
Investments:		
Fixed income securities, at market (cost: 2004 $1,395,833; 2003 $1,134,128)	$1,401,867	$ 1,164,166
Marketable equity securities, at market (cost: 2004 $12,007; 2003 $12,007)	12,055	12,002
Short-term investments, at cost, which approximates market	570,024	518,482
Other investments, at cost, which approximates fair value	17,506	8,696
Total investments	2,001,452	1,703,346
Cash	37,968	96,416
Restricted cash and cash investments	188,087	210,301
Premium, claims and other receivables	969,851	899,031
Reinsurance recoverables	985,677	916,190
Ceded unearned premium	301,193	291,591
Ceded life and annuity benefits	75,412	77,548
Deferred policy acquisition costs	136,584	106,943
Goodwill	400,795	386,507
Other assets	188,255	176,423
Total assets	$5,285,274	$ 4,864,296
LIABILITIES		
Loss and loss adjustment expense payable	$1,720,050	$ 1,535,288
Life and annuity policy benefits	75,412	77,548
Reinsurance balances payable	269,842	296,916
Unearned premium	705,572	592,311
Deferred ceding commissions	88,311	88,129
Premium and claims payable	797,450	745,559
Notes payable	322,396	310,404
Accounts payable and accrued liabilities	177,551	171,221
Total liabilities	4,156,584	3,817,376

SHAREHOLDERS EQUITY		
Common stock, $1.00 par value; 250.0 million shares authorized (shares issued and outstanding: 2004 64,643; 2003 63,964)	64,643	63,964
Additional paid-in capital	463,937	447,671
Retained earnings	590,458	509,159
Accumulated other comprehensive income	9,652	26,126
Total shareholders equity	1,128,690	1,046,920
Total liabilities and shareholders equity	$5,285,274	$ 4,864,296

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(unaudited, in thousands, except per share data)

	For the six months ended June 30,		For the three months ended June 30,	
	2004	**2003**	**2004**	**2003**
REVENUE				
Net earned premium	$ 469,133	$ 345,914	$ 252,070	$ 183,492
Fee and commission income	89,945	63,715	46,102	38,063
Net investment income	29,402	22,865	14,967	11,868
Net realized investment gain	569	184	51	205
Other operating income	6,239	5,134	4,080	4,240
Total revenue	595,288	437,812	317,270	237,868
EXPENSE				
Loss and loss adjustment expense, net	273,762	220,112	147,898	120,080
Operating expense:				
Policy acquisition costs, net	98,641	65,964	55,422	34,001
Compensation expense	46,438	38,611	23,625	19,865
Other operating expense	33,175	26,038	17,796	12,939
Total operating expense	178,254	130,613	96,843	66,805
Interest expense	3,958	3,596	1,746	1,914
Total expense	455,974	354,321	246,487	188,799
Earnings from continuing operations before income tax provision	139,314	83,491	70,783	49,069
Income tax provision from continuing operations	48,132	30,037	24,403	17,955
Earnings from continuing operations	91,182	53,454	46,380	31,114
Earnings (loss) from discontinued operations, net of income taxes (benefit) of $(110), $1,905, $36 and $1,165	(199)	3,281	35	1,854

Net earnings	$ 90,983	$ 56,735	$ 46,415	$ 32,968
Basic earnings per share data:				
Earnings from continuing operations	$ 1.42	$ 0.85	$ 0.72	$ 0.49
Earnings (loss) from discontinued operations	(0.01)	0.05		0.03
Net earnings	$ 1.41	$ 0.90	$ 0.72	$ 0.52
Weighted average shares outstanding	64,399	62,753	64,538	62,867
Diluted earnings per share data:				
Earnings from continuing operations	$ 1.39	$ 0.84	$ 0.71	$ 0.49
Earnings from discontinued operations		0.05		0.03
Net earnings	$ 1.39	$ 0.89	$ 0.71	$ 0.52
Weighted average shares outstanding	65,557	63,667	65,686	63,990
Cash dividends declared, per share	$ 0.15	$ 0.13	$ 0.075	$ 0.065

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statement of Changes in Shareholders Equity

For the six months ended June 30, 2004

(unaudited, in thousands, except per share data)

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Balance as of December 31, 2003	$63,964	$447,671	$509,159	$ 26,126	$ 1,046,920
Net earnings			90,983		90,983
Other comprehensive loss				(16,474)	(16,474)
Comprehensive income					74,509
645 shares of common stock issued upon exercise of options, including tax benefit of $2,715	645	15,140			15,785
34 shares of common stock issued to acquire strategic investment	34	1,126			1,160
Cash dividends declared, $0.15 per share			(9,684)		(9,684)
Balance as of June 30, 2004	$64,643	$463,937	$590,458	$ 9,652	$ 1,128,690

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(unaudited, in thousands, except per share data)

	For the six months ended June 30,		For the three months ended June 30,	
	2004	**2003**	**2004**	**2003**
Cash flows from operating activities:				
Net earnings	$ 90,983	$ 56,735	$ 46,415	$ 32,968
Adjustments to reconcile net earnings to net cash provided by operating activities:				
Change in premium, claims and other receivables	(65,155)	(169,946)	37,833	(107,729)
Change in reinsurance recoverables	(64,772)	(64,084)	(21,154)	(17,052)
Change in ceded unearned premium	(6,642)	(65,813)	1,724	(41,382)
Change in loss and loss adjustment expense payable	169,225	149,833	75,602	70,912
Change in reinsurance balances payable	(28,803)	64,265	(28,840)	35,430
Change in unearned premium	86,183	166,720	58,551	110,496
Change in premium and claims payable, net of restricted cash	74,105	58,845	(23,340)	18,965
Depreciation and amortization expense	7,368	5,564	3,978	2,588
Other, net	(48,858)	(2,847)	(38,000)	(7,795)
Cash provided by operating activities	213,634	199,272	112,769	97,401
Cash flows from investing activities:				
Sales of fixed income securities	133,694	123,181	30,602	27,952
Maturity or call of fixed income securities	72,340	69,086	39,224	41,728
Sales of equity securities	4,671	1,165	4,371	182
Other proceeds		16,846		16,846
Change in short-term investments	(8,807)	(89,563)	50,238	58,636
Cost of securities acquired	(406,263)	(407,875)	(192,909)	(243,638)
Payments for purchase of subsidiaries, net of cash received	(71,038)	(4,079)	(27,731)	(4,079)
Other, net	72	(3,135)	(2,194)	(1,612)
Cash used by investing activities	(275,331)	(294,374)	(98,399)	(103,985)
Cash flows from financing activities:				
Issuance of notes payable, net of costs	2,000	134,845	2,000	
Sale of common stock	13,070	11,969	3,146	8,238
Payments on notes payable	(2,185)	(67,622)	(2,094)	(95)
Dividends paid	(9,636)	(8,137)	(4,836)	(4,076)

Cash provided (used) by financing activities	3,249	71,055	(1,784)	4,067
Net change in cash	(58,448)	(24,047)	12,586	(2,517)
Cash at beginning of period	96,416	40,306	25,382	18,776
Cash at end of period	$ 37,968	$ 16,259	$ 37,968	$ 16,259

See Notes to Condensed Consolidated Financial Statements

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data)

(1) GENERAL INFORMATION

HCC Insurance Holdings, Inc. and its subsidiaries (we, us and our) provide specialized property and casualty, surety and accident and health insurance coverages and related agency and brokerage services to commercial customers. Our lines of business include group life, accident and health; diversified financial products (which includes directors and officers liability, errors and omissions, employment practices liability and surety); our London market account (which includes energy, marine, property and accident and health); aviation; and other specialty lines of insurance. We operate primarily in the United States, the United Kingdom, Spain and Bermuda, although some of our operations have a broader international scope. We market our products both directly to customers and through a network of independent and affiliated agents and brokers.

Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and include all adjustments which are, in our opinion, necessary for a fair presentation of the results of the interim periods. All adjustments made to the interim periods are of a normal recurring nature. The condensed consolidated financial statements include the accounts of HCC Insurance Holdings, Inc. and those of our wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated. The condensed consolidated financial statements for periods reported should be read in conjunction with the annual audited consolidated financial statements and related notes. The condensed consolidated balance sheet as of December 31, 2003 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

During the third quarter of 2003, we completed one acquisition. The results of operations of this entity are included in our consolidated financial statements beginning on the effective date of the transaction. Thus, our condensed consolidated statements of earnings and cash flows for the six months and three months ended June 30, 2003 do not contain any activity generated by this entity. See Note (2) for discussion of our 2004 acquisition.

In the second quarter of 2004, we completed our annual assessment of the impairment of goodwill. Based upon this test, the fair value of each of our reporting units exceeded its carrying amount by a satisfactory margin.

Income Tax

For the six months and three months ended June 30, 2004 and 2003, the income tax provision has been calculated based on an estimated effective tax rate for each of the fiscal years. The difference between our effective tax rate and the United States federal statutory rate is primarily the result of state income taxes and tax exempt municipal bond interest.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

(1) GENERAL INFORMATION, continued

Stock Options

We account for stock options granted to employees using the intrinsic value method of APB Opinion No. 25 entitled Accounting for Stock Issued to Employees . All options have been granted at fixed exercise prices at the market price of our common stock at the grant date. Because of that, no stock-based employee compensation cost is reflected in our reported net income. However, the Financial Accounting Standards Board has issued an exposure draft of a pronouncement that, if adopted in its present form, will require stock-based employee compensation to be deducted from net income beginning in 2005. Options vest over a period of up to seven years and expire four to ten years after grant date. The following table illustrates the effects on net income and earnings per share if we had used the fair value method of SFAS No. 123 entitled Accounting for Stock-Based Compensation .

	For the six months ended June 30,		**For the three months ended June 30,**	
	2004	**2003**	**2004**	**2003**
Reported net earnings	$ 90,983	$ 56,735	$ 46,415	$ 32,968
Stock-based compensation using fair value method, net of income tax	(2,453)	(3,871)	(1,233)	(1,932)
Pro forma net earnings	$ 88,530	$ 52,864	$ 45,182	$ 31,036
Reported basic earnings per share	$ 1.41	$ 0.90	$ 0.72	$ 0.52
Fair value stock-based compensation	(0.04)	(0.06)	(0.02)	(0.03)
Pro forma basic earnings per share	$ 1.37	$ 0.84	$ 0.70	$ 0.49
Reported diluted earnings per share	$ 1.39	$ 0.89	$ 0.71	$ 0.52
Fair value stock-based compensation	(0.04)	(0.06)	(0.02)	(0.03)
Pro forma diluted earnings per share	$ 1.35	$ 0.83	$ 0.69	$ 0.49

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

(1) GENERAL INFORMATION, continued

Discontinued Operations

In December 2003, we sold the business of our retail brokerage subsidiary HCC Employee Benefits, Inc. In the fourth quarter of 2003, we began reporting this business as discontinued operations and prior year financial information has been reclassified to reflect this presentation. Summarized financial data for discontinued operations is shown below. Earnings before income tax provision exclude allocated general corporate overhead expenses of $0.8 million and $0.4 million, respectively, for the six months and three months ended June 30, 2003.

	For the six months ended June 30,		For the three months ended June 30,	
	2004	**2003**	**2004**	**2003**
Revenue	$ (197)	$ 10,499	$	$ 6,050
Earnings (loss) before income tax provision	(309)	5,186	71	3,019

Reclassifications

Certain amounts in our 2003 condensed consolidated financial statements have been reclassified to conform to the 2004 presentation. Such reclassifications had no effect on our net earnings, shareholders equity or cash flows.

(2) ACQUISITION

On January 31, 2004, we acquired all of the shares of Surety Associates Holding Co., Inc., the parent company of American Contractors Indemnity Company, a California surety company specializing in court, specialty contract, license and permit bonds. American Contractors Indemnity Company will further expand our diversified financial products segment. We paid $46.9 million in cash. This business combination has been recorded using the purchase method of accounting. The results of operations of American Contractors Indemnity Company have been included in our consolidated financial statements beginning on the effective date of the transaction. We are still in the process of completing the purchase price allocation for this acquisition, as we are still gathering some of the information, including information related to litigation contingencies, needed to make the required calculations. Goodwill resulting from this acquisition will not be deductible for United States federal income tax purposes.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

(2) ACQUISITION, continued

The following table summarizes the combined estimated fair values of assets acquired and liabilities assumed at the acquisition date.

	January 31, 2004
Total investments	$ 87,873
Premium, claims and other receivables	5,665
Reinsurance recoverables	4,715
Other policy related assets	15,118
Goodwill and intangible assets	14,618
All other assets	1,587
Total assets acquired	129,576
Loss and loss adjustment expense payable	15,537
Unearned premium	27,078
Other policy related liabilities	1,729
All other liabilities	38,323
Total liabilities assumed	82,667
Assets acquired in excess of liabilities assumed	$ 46,909

The following unaudited pro forma summary presents information as if this acquisition had occurred at the beginning of 2004 and 2003 after giving effect to certain adjustments, including estimated amortization of intangible assets, presumed interest expense from debt issued to fund the acquisition and income taxes. The pro forma summary is for information purposes only, does not necessarily reflect the actual results that would have occurred, nor is it necessarily indicative of future results of the combined companies. American Contractors Indemnity Company incurred $2.6 million in acquisition related expenses, primarily for bonuses and other incentive compensation and related employment taxes immediately prior to the completion of the acquisition.

	For the six months ended June 30,		For the three months ended June 30,	
Unaudited Pro forma Information	**2004**	**2003**	**2004**	**2003**

Revenue	$599,135	$459,149	$317,270	$249,114
Net earnings	90,007	59,971	46,415	34,398
Basic earnings per share	1.40	0.96	0.72	0.55
Diluted earnings per share	1.37	0.94	0.71	0.54

In the first six months of 2004, we paid $27.7 million related to year end accruals for consideration based on the terms of prior acquisition agreements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data, continued)

(3) REINSURANCE

In the normal course of business our insurance companies cede a portion of their premium to domestic and foreign reinsurers through treaty and facultative reinsurance agreements. Although the ceding of reinsurance does not discharge the primary insurer from liability to its policyholh="20%"> $38.65

$38.26

10/01/2018	12/31/2018	$38.92	$28.99	$32.74
01/02/2019	03/29/2019	$41.33	$31.54	$39.66
04/01/2019*	04/29/2019*	$44.66	$40.99	$44.24

* As of the date of this preliminary terms supplement available information for the second calendar quarter of 2019 includes data for the period from April 1, 2019 through April 29, 2019. Accordingly, the “Quarterly High,” “Quarterly Low” and “Quarterly Close” data indicated are for this shortened period only and do not reflect complete data for the second calendar quarter of 2019.

The graph below illustrates the performance of Applied Materials' common stock for the period indicated, based on information from Bloomberg. The solid line represents a hypothetical trigger price and coupon barrier of $30.79, which is equal to 70.00% of an intra-day price on April 30, 2019. The actual trigger price and coupon barrier will be based on the closing price of Applied Materials' common stock on the trade date. **Past performance of the underlying asset is not indicative of the future performance of the underlying asset.**

What are the Tax Consequences of the Securities?

The U.S. federal income tax consequences of your investment in the Securities are uncertain. There are no statutory provisions, regulations, published rulings or judicial decisions addressing the characterization for U.S. federal income tax purposes of securities with terms that are substantially the same as the Securities. Some

of these tax consequences are summarized below, but we urge you to read the more detailed discussion in the prospectus supplement under "What are the Tax Consequences of the Securities?" and the accompanying product supplement under "Material U.S. Federal Income Tax Consequences — Securities Treated as Prepaid Derivatives or Prepaid Forwards" and to discuss the tax consequences of your particular situation with your tax advisor. This discussion is based upon the Internal Revenue Code of 1986, as amended (the "Code"), final, temporary and proposed U.S. Treasury Department (the "Treasury") regulations, rulings and decisions, in each case, as available and in effect as of the date hereof, all of which are subject to change, possibly with retroactive effect. Tax consequences under state, local and non-U.S. laws are not addressed herein. No ruling from the U.S. Internal Revenue Service (the "IRS") has been sought as to the U.S. federal income tax consequences of your investment in the Securities, and the following discussion is not binding on the IRS.

U.S. Tax Treatment. Pursuant to the terms of the Securities, UBS and you agree, in the absence of a statutory or regulatory change or an administrative determination or judicial ruling to the contrary, to characterize the Securities as pre-paid derivative contracts with respect to the underlying asset. If your Securities are so treated, any contingent coupon that is paid by UBS (including on the maturity date or call settlement date) should be included in your income as ordinary income in accordance with your regular method of accounting for U.S. federal income tax purposes.

In addition, excluding amounts attributable to any contingent coupon, you should generally recognize capital gain or loss upon the taxable disposition of your Securities in an amount equal to the difference between the amount you receive at such time (other than amounts or proceeds attributable to a contingent coupon or any amount attributable to any accrued but unpaid contingent coupon) and the amount you paid for your Securities. Such gain or loss should generally be long-term capital gain or loss if you have held your Securities for more than one year (otherwise such gain or loss would be short-term capital gain or loss if held for one year or less). However, it is possible that the IRS could assert that your holding period in respect of your Securities should end on the date on which the amount you are entitled to receive upon automatic call or maturity of your Securities is determined, even though you may not receive any amounts from the issuer in respect of your Securities prior to the automatic call or maturity of your Securities. In such a case, you may be treated as having a holding period in respect of your Securities prior to the automatic call or maturity of your Securities, and such holding period may be treated as less than one year even if you receive a payment upon the automatic call or maturity of your Securities at a time that is more than one year after the beginning of your holding period. The deductibility of capital losses is subject to limitations. Although uncertain, it is possible that proceeds received from the taxable disposition of your Securities prior to a coupon payment date that are attributable to an expected contingent coupon could be treated as ordinary income. You should consult your tax advisor regarding this risk.

We will not attempt to ascertain whether the underlying asset issuer would be treated as a "passive foreign investment company" (a "PFIC") within the meaning of Section 1297 of the Code or as a "United States real property holding corporation" (a "USRPHC") within the meaning of Section 897 of the Code. If the underlying asset issuer were so treated, certain adverse U.S. federal income tax consequences might apply, to a U.S. holder in the case of a PFIC and to a non-U.S. holder in the case of a USRPHC, upon the taxable disposition of a Security. You should refer to information filed with the SEC or the equivalent governmental authority by the underlying asset issuer and consult your tax advisor regarding the possible consequences to you in the event that such entity is or becomes a PFIC or USRPHC.

In the opinion of our counsel, Cadwalader, Wickersham & Taft LLP, based on certain factual representations received from us, it would be reasonable to treat your Securities in the manner described above. However, because there is no authority that specifically addresses the tax treatment of the Securities, it is possible that your Securities could alternatively be treated for tax purposes as a single contingent payment debt instrument, or pursuant to some other characterization, such that the timing and character of your income from the Securities could differ materially and adversely from the treatment described above, as described further under "Material U.S. Federal Income Tax Consequences — Alternative Treatments for Securities Treated as Any Type of Prepaid Derivative or Prepaid Forward" in the accompanying product supplement. Because of this

uncertainty, we urge you to consult your tax advisor as to the tax consequences of your investment in the Notes.
Notice 2008-2. In 2007, the IRS released a notice that may affect the taxation of holders of the Securities. According to Notice 2008-2, the IRS and the Treasury are actively considering whether the holder of an instrument such as the Securities should be required to accrue ordinary income on a current basis. It is not possible to determine what guidance they will ultimately issue, if any. It is possible, however, that under such guidance, holders of the Securities will ultimately be required to accrue income currently in excess of any receipt of contingent coupons and this could be applied on a retroactive basis. The IRS and the Treasury are also considering other relevant issues, including whether additional gain or loss from such instruments should be treated as ordinary or capital, whether non-U.S. holders of such instruments should be subject to withholding tax on any deemed income accruals, and whether the special "constructive ownership rules" of Section 1260 of the Code should be applied to such instruments. Both U.S. and non-U.S. holders are urged to consult their tax advisor concerning the significance and potential impact of the above considerations.

Except to the extent otherwise required by law, UBS intends to treat your Securities for U.S. federal income tax purposes in accordance with the treatment described above and under "Material U.S. Federal Income Tax Consequences — Securities Treated as Prepaid Derivatives or Prepaid Forwards with Associated Contingent Coupons" in the accompanying product supplement unless and until such time as the IRS and the Treasury determine that some other treatment is more appropriate.

Medicare Tax on Net Investment Income. U.S. holders that are individuals, estates, and certain trusts are subject to an additional 3.8% tax on all or a portion of their "net investment income", which may include any income or gain realized with respect to the Securities, to the extent of their net investment income that when added to their other modified adjusted gross income, exceeds $200,000 for an unmarried individual, $250,000 for a married taxpayer filing a joint return (or a surviving spouse), or $125,000 for a married individual filing a separate return. The 3.8% Medicare tax is determined in a different manner than the income tax. U.S. holders should consult their tax advisors as to the consequences of the 3.8% Medicare tax to an investment in the Securities.

Specified Foreign Financial Assets. U.S. holders may be subject to reporting obligations with respect to their Securities if they do not hold their Securities in an account maintained by a financial institution and the aggregate value of their Securities and certain other "specified foreign financial assets" (applying certain attribution rules) exceeds an applicable threshold. Significant penalties can apply if a U.S. holder is required to disclose its Securities and fails to do so.

Non-U.S. Holders. The U.S. federal income tax treatment of the contingent coupons is unclear. Subject to the discussions below with respect to Section 871(m) of the Code and FATCA (as defined below), our counsel is of the opinion that contingent coupons paid to a non-U.S. holder that provides us (and/or the applicable withholding agent) with a fully completed and validly executed applicable IRS Form W-8 should not be subject to U.S. withholding tax and we do not intend to withhold any tax on contingent coupons. However, it is possible that the IRS could assert that such payments are subject to U.S. withholding tax, or that another withholding agent may otherwise determine that withholding is required, in which case such other withholding agent may withhold up to 30% on such payments (subject to reduction or elimination of such withholding tax pursuant to an applicable income tax treaty). We will not pay any additional amounts in respect of such withholding. Subject to Section 871(m) of the Code, discussed below, gain from the taxable disposition of the Securities generally should not be subject to U.S. tax unless (i) such gain is effectively connected with a trade or business conducted by the non-U.S. holder in the U.S., (ii) the non-U.S. holder is a non-resident alien individual and is present in the U.S. for 183 days or more during the taxable year of such taxable disposition and certain other conditions are satisfied or (iii) the non-U.S. holder has certain other present or former connections with the U.S.

Section 871(m). A 30% withholding tax (which may be reduced by an applicable income tax treaty) is imposed under Section 871(m) of the Code on certain "dividend equivalents" paid or deemed paid to a non-U.S. holder with respect to a "specified equity-linked instrument" that references one or more dividend-paying U.S. equity securities. The withholding tax can apply even if the instrument does not provide for payments that reference dividends. Treasury regulations provide that the withholding tax applies to all dividend equivalents paid or deemed paid on specified equity-linked instruments that have a delta of one (“delta one specified equity-linked instruments”) issued after 2016 and to all dividend equivalents paid or deemed paid on all other specified equity-linked instruments issued after 2018. However, the IRS has issued guidance that states that the Treasury and the IRS intend to amend the effective dates of the Treasury regulations to provide that withholding on dividend equivalents paid or deemed paid will not apply to specified equity-linked instruments that are not delta one specified equity-linked instruments and are issued before January 1, 2021.

Based on our determination that the Securities are not “delta-one” with respect to the underlying asset, our counsel is of the opinion that the Securities should not be delta one specified equity-linked instruments and thus should not be subject to withholding on dividend equivalents. Our determination is not binding on the IRS, and the IRS may disagree with this determination. Furthermore, the application of Section 871(m) of the Code will depend on our determinations made upon issuance of the Securities. If withholding is required, we will not make payments of any additional amounts.

Nevertheless, after issuance, it is possible that your Securities could be deemed to be reissued for tax purposes upon the occurrence of certain events affecting the underlying asset or your Securities, and following such occurrence your Securities could be treated as delta one specified equity-linked instruments that are subject to withholding on dividend equivalents. It is also possible that withholding tax or other tax under Section 871(m) of the Code could apply to the Securities under these rules if you enter, or have entered, into certain other transactions in respect of the underlying asset or the Securities. If you enter, or have entered, into other transactions in respect of the underlying asset or the Securities, you should consult your tax advisor regarding the application of Section 871(m) of the Code to your Securities in the context of your other transactions.

Because of the uncertainty regarding the application of the 30% withholding tax on dividend equivalents to the Securities, you are urged to consult your tax advisor regarding the potential application of Section 871(m) of the Code and the 30% withholding tax to an investment in the Securities.

Foreign Account Tax Compliance Act. The Foreign Account Tax Compliance Act (“FATCA”) was enacted on March 18, 2010, and imposes a 30% U.S. withholding tax on “withholdable payments” (i.e., certain U.S.-source payments, including interest (and original issue discount), dividends, other fixed or determinable annual or periodical gain, profits, and income, and on the gross proceeds from a disposition of property of a type which can produce U.S.-source interest or dividends) and “passthru payments” (i.e., certain payments attributable to withholdable payments) made to certain foreign financial institutions (and certain of their affiliates) unless the payee foreign financial institution agrees (or is required), among other things, to disclose the identity of any U.S. individual with an account of the institution (or the relevant affiliate) and to annually report certain information about such account. FATCA also requires withholding agents making withholdable payments to certain foreign entities that do not disclose the name, address, and taxpayer identification number of any substantial U.S. owners (or do not certify that they do not have any substantial U.S. owners) to withhold tax at a rate of 30%. Under certain circumstances, a holder may be eligible for refunds or credits of such taxes.

Pursuant to final and temporary Treasury regulations and other IRS guidance, the withholding and reporting requirements under FATCA will generally apply to certain “withholdable payments” made on or after July 1, 2014, certain gross proceeds on a taxable disposition occurring after December 31, 2018, and certain foreign passthru payments made after December 31, 2018 (or, if later, the date that final regulations defining the term “foreign passthru payment” are published). If withholding is required, we (or the applicable paying agent) will not be required to pay additional amounts with respect to the amounts so withheld. Foreign financial institutions and non-financial foreign entities located in jurisdictions that have an intergovernmental agreement with the U.S. governing FATCA may be subject to different rules.

Investors should consult their tax advisors about the application of FATCA, in particular if they may be classified as financial institutions (or if they hold their Securities through a foreign entity) under the FATCA rules.

Proposed Legislation. In 2007, legislation was introduced in Congress that, if it had been enacted, would have required holders of Securities purchased after the bill was enacted to accrue interest income over the term of the Securities despite the fact that there may be no interest payments over the entire term of the Securities.

Furthermore, in 2013, the House Ways and Means Committee released in draft form certain proposed legislation relating to financial instruments. If it had been enacted, the effect of this legislation generally would have been to require instruments such as the Securities to be marked to market on an annual basis with all gains and losses to be treated as ordinary, subject to certain exceptions.

It is not possible to predict whether any similar or identical bills will be enacted in the future, or whether any such bill would affect the tax treatment of your Securities. You are urged to consult your tax advisor regarding the possible changes in law and their possible impact on the tax treatment of your Securities.

Both U.S. and non-U.S. holders are urged to consult their tax advisors concerning the application of U.S. federal income tax laws to their particular situation, as well as any tax consequences of the purchase, beneficial ownership and disposition of the Securities (including possible alternative treatments and the issues presented by Notice 2008-2) arising under the laws of any state, local, non-U.S. or other taxing jurisdiction.

Supplemental Plan of Distribution (Conflicts of Interest); Secondary Markets (if any)

We will agree to sell to UBS Securities LLC and UBS Securities LLC will agree to purchase, all of the Securities at the issue price to the public less the underwriting discount indicated on the cover of the final terms supplement, the document that will be filed pursuant to Rule 424(b) containing the final pricing terms of the Securities. UBS Securities LLC will agree to resell all of the Securities to UBS Financial Services Inc. at a discount from the issue price to the public equal to the underwriting discount indicated on the cover of the final terms supplement.

Conflicts of Interest - Each of UBS Securities LLC and UBS Financial Services Inc. is an affiliate of UBS and, as such, has a "conflict of interest" in this offering within the meaning of FINRA Rule 5121. In addition, UBS will receive the net proceeds (excluding the underwriting discount) from the initial public offering of the Securities and, thus creates an additional conflict of interest within the meaning of FINRA Rule 5121. Consequently, the offering is being conducted in compliance with the provisions of Rule 5121. Neither UBS Securities LLC nor UBS Financial Services Inc. is permitted to sell Securities in the offering to an account over which it exercises discretionary authority without the prior specific written approval of the account holder.

UBS Securities LLC and its affiliates may offer to buy or sell the Securities in the secondary market (if any) at prices greater than UBS' internal valuation - The value of the Securities at any time will vary based on many factors that cannot be predicted. However, the price (not including UBS Securities LLC's or any affiliate's customary bid-ask spreads) at which UBS Securities LLC or any affiliate would offer to buy or sell the Securities immediately after the trade date in the secondary market is expected to exceed the estimated initial value of the Securities as determined by reference to our internal pricing models. The amount of the excess will decline to zero on a straight line basis over a period ending no later than 1 month after the trade date, provided that UBS Securities LLC may shorten the period based on various factors, including the magnitude of purchases and other negotiated provisions with selling agents. Notwithstanding the foregoing, UBS Securities LLC and its affiliates are not required to make a market for the Securities and may stop making a market at any time. For more information about secondary market offers and the estimated initial value of the Securities, see "Key Risks - Fair value considerations" and "Key Risks - Limited or no secondary market and secondary market price considerations" in this preliminary terms supplement.

Prohibition of Sales to EEA Retail Investors — The Securities are not intended to be offered, sold or otherwise made available to and should not be offered, sold or otherwise made available to any retail investor in the European Economic Area ("EEA"). For these purposes, a retail investor means a person who is one (or more) of: (i) a retail client as defined in point (11) of Article 4(1) of Directive 2014/65/EU, as amended ("MiFID II"); (ii) a customer within the meaning of Directive 2002/92/EC, as amended, where that customer would not qualify as a professional client as defined in point (10) of Article 4(1) of MiFID II; or (iii) not a qualified investor as defined in Directive 2003/71/EC, as amended. Consequently no key information document required by Regulation (EU) No 1286/2014 (as amended, the "PRIIPs Regulation") for offering or selling the Securities or otherwise making them available to retail investors in the EEA has been prepared and therefore offering or selling the Securities or otherwise making them available to any retail investor in the EEA may be unlawful under the PRIIPs Regulation.

You should rely only on the information incorporated by reference or provided in this preliminary terms supplement, the accompanying prospectus supplement, the accompanying product supplement or the accompanying prospectus. We have not authorized anyone to provide you with different information. We are not making an offer of these Securities in any state where the offer is not permitted. You should not assume that the information in this preliminary terms supplement is accurate as of any date other than the date on the front of the document.

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(To Prospectus Supplement dated November 1, 2018,

Product Supplement dated October 31, 2018 and

Prospectus dated October 31, 2018)

UBS Investment Bank

UBS Financial Services Inc.