ALLIANCE DATA SYSTEMS CORP
Form 10-Q
August 06, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

R QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2012

OR

£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 001-15749

ALLIANCE DATA SYSTEMS CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	31-1429215
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

7500 Dallas Parkway, Suite 700
Plano, Texas 75024
(Address of principal executive office, including zip code)

(214) 494-3000
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required 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 £ No R

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

As of August 1, 2012, 49,906,953 shares of common stock were outstanding.

ALLIANCE DATA SYSTEMS CORPORATION

INDEX

Index

PART I

Item 1. Financial Statements.

ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2012	December 31, 2011
	(In thousands)	
ASSETS		
Cash and cash equivalents	$ 642,199	$ 216,213
Trade receivables, less allowance for doubtful accounts ($4,718 and $2,406 at June 30, 2012 and December 31, 2011, respectively)	319,292	300,895
Credit card receivables:		
Credit card receivables – restricted for securitization investors	4,891,816	4,886,168
Other credit card receivables	818,885	779,843
Total credit card receivables	5,710,701	5,666,011
Allowance for loan loss	(432,521)	(468,321)
Credit card receivables, net	5,278,180	5,197,690
Deferred tax asset, net	208,022	252,303
Other current assets	553,541	121,589
Redemption settlement assets, restricted	476,234	515,838
Assets of discontinued operations	—	2,439
Total current assets	7,477,468	6,606,967
Property and equipment, net	218,938	195,397
Deferred tax asset, net	54,974	43,408
Cash collateral, restricted	124,895	158,727
Intangible assets, net	347,601	383,646
Goodwill	1,450,284	1,449,363
Other non-current assets	152,754	142,741
Total assets	$ 9,826,914	$ 8,980,249
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	$ 169,938	$ 149,812
Accrued expenses	160,983	206,621
Deposits	809,547	642,567
Asset-backed securities debt – owed to securitization investors	1,634,517	1,694,198
Current debt	22,972	19,834
Other current liabilities	106,202	105,888
Deferred revenue	994,526	1,036,251
Total current liabilities	3,898,685	3,855,171
Deferred revenue	196,634	190,185
Deferred tax liability, net	187,246	151,746
Deposits	843,405	711,208
Asset-backed securities debt – owed to securitization investors	1,803,250	1,566,089
Long-term and other debt	2,405,350	2,163,640
Other liabilities	131,352	166,244
Total liabilities	9,465,922	8,804,283

Commitments and contingencies		
Stockholders' equity:		
Common stock, $0.01 par value; authorized, 200,000 shares; issued, 94,752 shares and 94,141 shares at June 30, 2012 and December 31, 2011, respectively	948	941
Additional paid-in capital	1,412,598	1,387,773
Treasury stock, at cost, 44,797 shares and 44,311 shares at June 30, 2012 and December 31, 2011, respectively	(2,379,728)	(2,320,696)
Retained earnings	1,350,054	1,131,004
Accumulated other comprehensive loss	(22,880)	(23,056)
Total stockholders' equity	360,992	175,966
Total liabilities and stockholders' equity	$ 9,826,914	$ 8,980,249

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
	(In thousands, except per share amounts)			
Revenues				
Transaction	$ 77,502	$ 69,869	$ 160,246	$ 146,640
Redemption	159,185	133,342	347,651	283,102
Finance charges, net	377,794	332,272	754,109	674,414
Database marketing fees and direct marketing services	219,530	182,264	433,126	334,974
Other revenue	32,474	22,711	62,922	41,764
Total revenue	866,485	740,458	1,758,054	1,480,894
Operating expenses				
Cost of operations (exclusive of depreciation and amortization disclosed separately below)	506,455	431,250	1,033,360	835,775
Provision for loan loss	52,552	60,376	101,879	128,042
General and administrative	27,532	21,021	51,531	41,960
Depreciation and other amortization	18,496	16,850	36,100	33,604
Amortization of purchased intangibles	20,907	19,170	42,022	37,814
Total operating expenses	625,942	548,667	1,264,892	1,077,195
Operating income	240,543	191,791	493,162	403,699
Interest expense				
Securitization funding costs	22,518	35,062	44,847	66,048
Interest expense on deposits	6,003	5,494	11,966	11,187
Interest expense on long-term and other debt, net	44,546	38,238	81,906	73,018
Total interest expense, net	73,067	78,794	138,719	150,253
Income before income tax	$ 167,476	$ 112,997	$ 354,443	$ 253,446
Provision for income taxes	63,655	43,974	135,393	98,047
Net income	$ 103,821	$ 69,023	$ 219,050	$ 155,399
Basic income per share	$ 2.07	$ 1.35	$ 4.37	$ 3.04
Diluted income per share	$ 1.63	$ 1.19	$ 3.49	$ 2.74
Weighted average shares				
Basic	50,161	51,070	50,157	51,099
Diluted	63,731	58,145	62,790	56,778

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In thousands)			
Net income	$ 103,821	$ 69,023	$ 219,050	$ 155,399
Other comprehensive income, net of tax				
Net unrealized gain (loss) on securities available-for-sale, net of tax benefit of $(90), tax expense of $146 and tax benefit of $(116), tax expense of $150 for the three and six months ended June 30, 2012 and 2011, respectively	352	3,484	1,836	(944)
Foreign currency translation adjustments	1,406	(387)	(1,660)	(3,531)
Total comprehensive income, net of tax	$ 105,579	$ 72,120	$ 219,226	$ 150,924

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 219,050	$ 155,399
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	78,122	71,418
Deferred income taxes	68,865	9,960
Provision for loan loss	101,879	128,042
Non-cash stock compensation	25,186	20,190
Fair value gain on interest-rate derivatives	(15,184)	(14,603)
Amortization of discount on convertible senior notes	40,050	35,882
Change in operating assets and liabilities, net of acquisitions:		
Change in trade accounts receivable	(43,872)	(19,321)
Change in other assets	26,684	10,941
Change in accounts payable and accrued expenses	(8,570)	(21,599)
Change in deferred revenue	(39,323)	5,113
Change in other liabilities	(19,638)	36,253
Excess tax benefits from stock-based compensation	(13,564)	(11,590)
Other	(2,247)	1,782
Net cash provided by operating activities	417,438	407,867
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in redemption settlement assets	41,440	15,513
Change in restricted cash	(438,665)	16,842
Change in credit card receivables	(61,375)	270,586
Purchase of credit card portfolios	(122,237)	(42,696)
Change in cash collateral, restricted	37,735	(131,172)

Payments for acquired businesses, net of cash	—	(359,076)
Capital expenditures	(55,541)	(33,935)
Investments in the stock of investees	(921)	(13,591)
Other	(13,417)	222
Net cash used in investing activities	(612,981)	(277,307)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings under debt agreements	699,500	2,336,500
Repayments of borrowings	(494,691)	(1,876,776)
Issuances of deposits	659,227	138,061
Repayments of deposits	(360,050)	(169,480)
Borrowings from asset-backed securities	897,038	636,500
Repayments/maturities of asset-backed securities	(719,558)	(989,757)
Payment of capital lease obligations	(11)	(3,791)
Payment of deferred financing costs	(25,624)	(24,564)
Excess tax benefits from stock-based compensation	13,564	11,590
Proceeds from issuance of common stock	11,411	20,533
Purchase of treasury shares	(59,032)	(116,661)
Net cash provided by (used in) financing activities	621,774	(37,845)
Effect of exchange rate changes on cash and cash equivalents	(245)	992
Change in cash and cash equivalents	425,986	93,707
Cash and cash equivalent at beginning of period	216,213	139,114
Cash and cash equivalents at end of period	$ 642,199	$ 232,821
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	$ 99,257	$ 118,971
Income taxes paid, net	$ 98,243	$ 58,371

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited condensed consolidated financial statements included herein have been prepared by Alliance Data Systems Corporation ("ADSC" or, including its wholly owned subsidiaries and its consolidated variable interest entities, the "Company"), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report filed on Form 10-K for the year ended December 31, 2011, filed with the SEC on February 27, 2012.

The unaudited condensed consolidated financial statements included herein reflect all adjustments (consisting of normal, recurring adjustments) which are, in the opinion of management, necessary to state fairly the results for the interim periods presented. The results of operations for the interim periods presented are not necessarily indicative of the operating results to be expected for any subsequent interim period or for the fiscal year.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect (1) the reported amounts of assets; (2) liabilities and disclosure of contingent assets and liabilities at the date of the financial statements; and (3) the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. SHARES USED IN COMPUTING NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted net income per share for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In thousands, except per share amounts)			
Numerator:				
Net Income	$ 103,821	$ 69,023	$ 219,050	$ 155,399
Denominator:				
Weighted average shares, basic	50,161	51,070	50,157	51,099
Weighted average effect of dilutive securities:				
Shares from assumed conversion of convertible senior notes	8,435	4,659	8,051	3,724
Shares from assumed conversion of convertible note warrants	4,399	1,537	3,844	1,085
Net effect of dilutive stock options and unvested restricted stock	736	879	738	870
Denominator for diluted calculations	63,731	58,145	62,790	56,778
Basic net income per share	$ 2.07	$ 1.35	$ 4.37	$ 3.04

Diluted net income per share	$	1.63	$	1.19	$	3.49	$	2.74

The Company calculates the effect of its convertible senior notes, consisting of $805.0 million aggregate principal amount of convertible senior notes due 2013 (the “Convertible Senior Notes 2013”) and $345.0 million aggregate principal amount of convertible senior notes due 2014 (the “Convertible Senior Notes 2014”), which can be settled in cash or shares of common stock, on diluted net income per share as if they will be settled in cash as the Company has the intent to settle the convertible senior notes for cash.

Concurrently with the issuance of the Convertible Senior Notes 2013 and the Convertible Senior Notes 2014, the Company entered into hedge transactions that are generally expected to offset the potential dilution of the shares from assumed conversion of convertible senior notes.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

The Company is also party to prepaid forward contracts to purchase 1,857,400 shares of its common stock that are to be delivered over a settlement period in 2014. The number of shares to be delivered under the prepaid forward contracts is used to reduce weighted-average basic and diluted shares outstanding.

For the three and six months ended June 30, 2011, the Company excluded 10.3 million warrants, respectively, from the calculation of net income per share as the effect was anti-dilutive.

3. CREDIT CARD RECEIVABLES

The Company's credit card receivables are the only portfolio segment or class of financing receivables. Quantitative information about the components of total credit card receivables is presented in the table below:

	June 30, 2012	December 31, 2011
	(In thousands)	
Principal receivables	$ 5,451,277	$ 5,408,862
Billed and accrued finance charges	222,735	221,357
Other receivables	36,689	35,792
Total credit card receivables	5,710,701	5,666,011
Less credit card receivables – restricted for securitization investors	4,891,816	4,886,168
Other credit card receivables	$ 818,885	$ 779,843

Allowance for Loan Loss

The Company maintains an allowance for loan loss at a level that is appropriate to absorb probable losses inherent in credit card receivables. The allowance for loan loss covers forecasted uncollectable principal as well as unpaid interest and fees. The allowance for loan loss is evaluated monthly for adequacy.

In estimating the allowance for principal loan losses, management utilizes a migration analysis of delinquent and current credit card receivables. Migration analysis is a technique used to estimate the likelihood that a credit card receivable will progress through the various stages of delinquency and to charge-off. The allowance is maintained through an adjustment to the provision for loan losses. Charge-offs of principal amounts, net of recoveries are deducted from the allowance.

Net charge-offs include the principal amount of losses from credit cardholders unwilling or unable to pay their account balances, as well as bankrupt and deceased credit cardholders, less recoveries and exclude charged-off interest, fees and fraud losses. Charged-off interest and fees reduce finance charges, net while fraud losses are recorded as an expense. Credit card receivables, including unpaid interest and fees, are charged-off at the end of the month during which an account becomes 180 days contractually past due, except in the case of customer bankruptcies or death. Credit card receivables, including unpaid interest and fees, associated with customer bankruptcies or death are charged-off at the end of each month subsequent to 60 days after the receipt of notification of the bankruptcy or death, but in any case, not later than the 180-day contractual time frame.

The Company records the actual charge-offs for unpaid interest and fees as a reduction to finance charges, net. Actual charge-offs for unpaid interest and fees were $44.3 million and $48.3 million for the three months ended June 30, 2012 and 2011, respectively, and $93.2 million and $104.5 million for the six months ended June 30, 2012 and 2011, respectively. In estimating the allowance for uncollectable unpaid interest and fees, the Company utilizes historical charge-off trends, analyzing actual charge-offs for the prior three months. The allowance is maintained through an adjustment to finance charges, net.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

In evaluating the allowance for loan loss for both principal and unpaid interest and fees, management also considers factors that may impact loan loss experience, including seasoning, loan volume and amounts, payment rates and forecasting uncertainties. The following table presents the Company's allowance for loan loss for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In thousands)			
Balance at beginning of period	$ 447,483	$ 489,620	$ 468,321	$ 518,069
Provision for loan loss	52,552	60,376	101,879	128,042
Recoveries	23,864	21,876	52,714	47,742
Principal charge-offs	(91,378)	(108,942)	(190,393)	(232,838)
Other	—	(1,915)	—	—
Balance at end of period	$ 432,521	$ 461,015	$ 432,521	$ 461,015

Delinquencies

A credit card account is contractually delinquent if the Company does not receive the minimum payment by the specified due date on the cardholder's statement. It is the Company's policy to continue to accrue interest and fee income on all credit card accounts beyond 90 days, except in limited circumstances, until the credit card account balance and all related interest and other fees are paid or charged off, typically at 180 days delinquent. When an account becomes delinquent, a message is printed on the credit cardholder's billing statement requesting payment. After an account becomes 30 days past due, a proprietary collection scoring algorithm automatically scores the risk of the account becoming further delinquent. The collection system then recommends a collection strategy for the past due account based on the collection score and account balance and dictates the contact schedule and collections priority for the account. If the Company is unable to make a collection after exhausting all in-house collection efforts, the Company will engage collection agencies and outside attorneys to continue those efforts.

The following table presents the delinquency trends of the Company's credit card portfolio:

	June 30, 2012	% of Total	December 31, 2011	% of Total
	(In thousands, except percentages)			
Receivables outstanding – principal	$ 5,451,277	100%	$ 5,408,862	100%
Principal receivables balances contractually delinquent:				
31 to 60 days	77,212	1.4%	78,272	1.4%
61 to 90 days	49,842	0.9	51,709	1.0
91 or more days	87,346	1.6	105,626	2.0
Total	$ 214,400	3.9%	$ 235,607	4.4%

Modified Credit Card Receivables

The Company holds certain credit card receivables for which the terms have been modified. The Company's modified credit card receivables include credit card receivables for which temporary hardship concessions have been granted and credit card receivables in permanent workout programs. These modified credit card receivables include concessions consisting primarily of a reduced minimum payment and an interest rate reduction. The temporary programs' concessions remain in place for a period no longer than twelve months, while the permanent programs remain in place through the payoff of the credit card receivables if the credit cardholder complies with the terms of the program. These concessions do not include the forgiveness of unpaid principal, but may involve the reversal of certain unpaid interest or fee assessments. In the case of the temporary programs, at the end of the concession period, credit card receivable terms revert to standard rates. These arrangements are automatically terminated if the customer fails to make payments in accordance with the terms of the program, at which time their account reverts back to its original terms.

Credit card receivables for which temporary hardship and permanent concessions were granted are collectively evaluated for impairment. Modified credit card receivables are evaluated at their present value with impairment measured as the difference between the credit card receivable balance and the discounted present value of cash flows expected to be collected. Consistent with the Company's measurement of impairment of modified credit card receivables on a pooled basis, the discount rate used for credit card receivables is the average current annual percentage rate the Company applies to non-impaired credit card receivables, which approximates what would have been applied to the pool of modified credit card receivables prior to impairment. In assessing the appropriate allowance for loan loss, these modified credit card receivables are included in the general pool of credit cards with the allowance determined under the contingent loss model of Accounting Standards Codification ("ASC") 450-20, "Loss Contingencies." If the Company applied accounting under ASC 310-40, "Troubled Debt Restructurings by Creditors," to the modified credit card receivables in these programs, there would not be a significant difference in the allowance for loan loss.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

The Company had $107.9 million and $122.2 million, respectively, as a recorded investment in impaired credit card receivables with an associated allowance for loan loss of $40.7 million and $45.3 million, respectively, as of June 30, 2012 and December 31, 2011. These modified credit card receivables represented less than 3% of the Company's total credit card receivables at each of June 30, 2012 and December 31, 2011.

The average recorded investment in the impaired credit card receivables was $111.8 million and $135.0 million for the three months ended June 30, 2012 and 2011, respectively, and $115.6 million and $135.3 million for the six months ended June 30, 2012 and 2011, respectively.

Interest income on these modified credit card receivables is accounted for in the same manner as other accruing credit card receivables. Cash collections on these modified credit card receivables are allocated according to the same payment hierarchy methodology applied to credit card receivables that are not in such programs. The Company recognized $2.9 million and $3.5 million for the three months ended June 30, 2012 and 2011, respectively, and $6.1 million and $7.1 million for the six months ended June 30, 2012 and 2011, respectively, in interest income associated with modified credit card receivables during the period that such credit card receivables were impaired.

The following tables provide information on credit card receivables that entered into a modification program during the specified periods:

	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	Number of Restructurings	Pre-modification Outstanding Principal Balance	Post-modification Outstanding Principal Balance	Number of Restructurings	Pre-modification Outstanding Principal Balance	Post-modification Outstanding Principal Balance
	(Dollars in thousands)					
Troubled debt restructurings – credit card receivables	28,499	$ 25,917	$ 25,839	60,039	$ 54,155	$ 54,068

	Three Months Ended June 30, 2011			Six Months Ended June 30, 2011		
	Number of Restructurings	Pre-modification Outstanding Principal Balance	Post-modification Outstanding Principal Balance	Number of Restructurings	Pre-modification Outstanding Principal Balance	Post-modification Outstanding Principal Balance
	(Dollars in thousands)					
Troubled debt restructurings – credit card receivables	38,966	$ 34,389	$ 34,381	83,038	$ 71,818	$ 69,764

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

The tables below summarize troubled debt restructurings that have defaulted in the specified periods where the default occurred within 12 months of their modification date:

	Three Months Ended June 30, 2012		Six Months Ended June 30, 2012	
	Number of Restructurings	Outstanding Balance	Number of Restructurings	Outstanding Balance
	(Dollars in thousands)			
Troubled debt restructurings, defaulted – credit card receivables	13,187	$ 12,699	29,207	$ 28,161

	Three Months Ended June 30, 2011		Six Months Ended June 30, 2011	
	Number of Restructurings	Outstanding Balance	Number of Restructurings	Outstanding Balance
	(Dollars in thousands)			
Troubled debt restructurings, defaulted – credit card receivables	19,595	$ 19,414	38,395	$ 38,417

Age of Credit Card Receivables

The following table sets forth, as of June 30, 2012, the number of active credit card accounts with balances and the related principal balances outstanding, based upon the age of the active credit card accounts from origination:

Age Since Origination	Number of Active Accounts with Balances	Percentage of Active Accounts with Balances	Principal Receivables Outstanding	Percentage of Receivables Outstanding
	(In thousands, except percentages)			
0-12 Months	3,469	26.5%	$ 1,198,107	22.0%
13-24 Months	1,728	13.2	660,098	12.1
25-36 Months	1,335	10.2	605,357	11.1
37-48 Months	1,023	7.8	504,946	9.2
49-60 Months	851	6.5	396,614	7.3
Over 60 Months	4,683	35.8	2,086,155	38.3
Total	13,089	100.0%	$ 5,451,277	100.0%

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Credit Quality

The Company uses proprietary scoring models developed specifically for the purpose of monitoring the Company's obligor credit quality. The proprietary scoring model is used as a tool in the underwriting process and for making credit decisions. The proprietary scoring model is based on historical data and requires various assumptions about future performance. Information regarding customer performance is factored into these proprietary scoring models to determine the probability of an account becoming 90 or more days past due at any time within the next 12 months. Obligor credit quality is monitored at least monthly during the life of an account. The following table reflects composition of the Company's credit card receivables by obligor credit quality as of June 30, 2012:

Probability of an Account Becoming 90 or More Days Past Due or Becoming Charged off (within the next 12 months)	Total Principal Receivables Outstanding	Percentage of Principal Receivables Outstanding
	(In thousands, except percentages)	
No Score	$ 112,731	2.1%
27.1% and higher	232,278	4.2
17.1% - 27.0%	478,551	8.8
12.6% - 17.0%	551,539	10.1
3.7% - 12.5%	2,197,155	40.3
1.9% - 3.6%	1,236,673	22.7
Lower than 1.9%	642,350	11.8
Total	$ 5,451,277	100.0%

Portfolio Acquisitions

In March 2012, World Financial Network Bank ("WFNB") acquired the existing private label credit card portfolio of Pier 1 Imports. The total purchase price was $97.7 million, which consisted of $96.2 million of credit card receivables and $1.5 million of intangible assets that are included in the unaudited condensed consolidated balance sheets as of June 30, 2012.

In May 2012, World Financial Capital Bank ("WFCB") acquired the existing private label credit card portfolio of Premier Designs, Inc. The preliminary total purchase price, which is subject to customary purchase price adjustments, was $24.5 million and consisted of $22.8 million of credit card receivables and $1.7 million of intangible assets that are included in the unaudited condensed consolidated balance sheets as of June 30, 2012.

Securitized Credit Card Receivables

The Company regularly securitizes its credit card receivables through its credit card securitization trusts, consisting of World Financial Network Credit Card Master Trust, World Financial Network Credit Card Master Note Trust, World Financial Network Credit Card Master Note Trust II and World Financial Network Credit Card Master Trust III (collectively, the "WFN Trusts"), and World Financial Capital Credit Card Master Note Trust (the "WFC Trust"). The Company continues to own and service the accounts that generate credit card receivables held by the WFN Trusts and the WFC Trust. In its capacity as a servicer, each of the respective banks earns a fee from the WFN Trusts and the WFC Trust to service and administer the credit card receivables, collect payments, and charge-off uncollectable receivables. These fees are eliminated and therefore are not reflected in the unaudited condensed consolidated statements of income for the three and six months ended June 30, 2012 and 2011.

The WFN Trusts and the WFC Trust are variable interest entities (“VIEs”) and the assets of these consolidated VIEs include certain credit card receivables that are restricted to settle the obligations of those entities and are not expected to be available to the Company or its creditors. The liabilities of the consolidated VIEs include asset-backed secured borrowings and other liabilities for which creditors or beneficial interest holders do not have recourse to the general credit of the Company.

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

The tables below present quantitative information about the components of total securitized credit card receivables, delinquencies and net charge-offs:

	June 30, 2012	December 31, 2011
	(In thousands)	
Total credit card receivables – restricted for securitization investors	$ 4,891,816	$ 4,886,168
Principal amount of credit card receivables – restricted for securitization investors, 90 days or more past due	$ 78,104	$ 94,981

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In thousands)			
Net charge-offs of securitized principal	$ 60,640	$ 78,623	$ 123,445	$ 165,926

4. REDEMPTION SETTLEMENT ASSETS

Redemption settlement assets consist of cash and cash equivalents and securities available-for-sale and are designated for settling redemptions by collectors of the AIR MILES® Reward Program in Canada under certain contractual relationships with sponsors of the AIR MILES Reward Program. These assets are primarily denominated in Canadian dollars. Realized gains and losses from the sale of investment securities were not material. The principal components of redemption settlement assets, which are carried at fair value, are as follows:

	June 30, 2012				December 31, 2011			
	Cost	Unrealized Gains	Unrealized Losses	Fair Value	Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(In thousands)							
Cash and cash equivalents	$ 6,379	$ —	$ —	$ 6,379	$ 35,465	$ —	$ —	$ 35,465
Government bonds	4,954	104	—	5,058	4,948	152	—	5,100
Corporate bonds	456,346	8,869	(418)	464,797	468,894	7,416	(1,037)	475,273
Total	$ 467,679	$ 8,973	$ (418)	$ 476,234	$ 509,307	$ 7,568	$ (1,037)	$ 515,838

The following tables show the gross unrealized losses and fair value for those investments that were in an unrealized loss position as of June 30, 2012 and December 31, 2011, aggregated by investment category and the length of time that individual securities have been in a continuous loss position:

	June 30, 2012					
	Less than 12 months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Government bonds	$ —	$ —	$ —	$ —	$ —	$ —

Corporate bonds		—		—		4,507		(418)		4,507		(418)
Total	$	—	$	—	$	4,507	$	(418)	$	4,507	$	(418)

	December 31, 2011											
	Less than 12 months				12 Months or Greater				Total			
		Fair Value		Unrealized Losses		Fair Value		Unrealized Losses		Fair Value		Unrealized Losses
	(In thousands)											
Government bonds	$	—	$	—	$	—	$	—	$	—	$	—
Corporate bonds		65,043		(444)		18,124		(593)		83,167		(1,037)
Total	$	65,043	$	(444)	$	18,124	$	(593)	$	83,167	$	(1,037)

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Market values were determined for each individual security in the investment portfolio. When evaluating the investments for other-than-temporary impairment, the Company reviews factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the security's issuer, and the Company's intent to sell the security and whether it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis. The Company typically invests in highly-rated securities with low probabilities of default and has the ability to hold the investments until maturity. As of June 30, 2012, the Company does not consider the investments to be other-than-temporarily impaired.

The net carrying value and estimated fair value of the securities at June 30, 2012 by contractual maturity are as follows:

	Amortized Cost	Estimated Fair Value
	(In thousands)	
Due in one year or less	$ 93,723	$ 93,831
Due after one year through five years	373,956	382,403
Total	$ 467,679	$ 476,234

5. INTANGIBLE ASSETS AND GOODWILL

Intangible Assets

Intangible assets consist of the following:

	June 30, 2012			
	Gross Assets	Accumulated Amortization	Net	Amortization Life and Method
	(In thousands)			
Finite Lived Assets				
Customer contracts and lists	$ 314,245	$ (157,096)	$ 157,149	3-12 years—straight line
Premium on purchased credit card portfolios	159,395	(92,462)	66,933	5-10 years—straight line, accelerated
Customer database	175,429	(106,600)	68,829	4-10 years—straight line
Collector database	68,854	(61,896)	6,958	30 years—15% declining balance
Tradenames	38,162	(8,922)	29,240	5-15 years—straight line
Purchased data lists	20,639	(14,497)	6,142	1-5 years—straight line, accelerated
Noncompete agreements	300	(300)	—	2 years—straight line
	$ 777,024	$ (441,773)	$ 335,251	
Indefinite Lived Assets				
Tradenames	12,350	—	12,350	Indefinite life
Total intangible assets	$ 789,374	$ (441,773)	$ 347,601	

	December 31, 2011			
	Gross Assets	Accumulated Amortization	Net	Amortization Life and Method

	(In thousands)			
Finite Lived Assets				
Customer contracts and lists	$ 314,245	$ (140,622)	$ 173,623	3-12 years—straight line
Premium on purchased credit card portfolios	156,203	(82,988)	73,215	5-10 years—straight line, accelerated
Customer database	175,377	(96,363)	79,014	4-10 years—straight line
Collector database	68,652	(61,091)	7,561	30 years—15% declining balance
Tradenames	38,155	(7,411)	30,744	5-15 years—straight line
Purchased data lists	23,776	(16,712)	7,064	1-5 years—straight line, accelerated
Noncompete agreements	1,045	(970)	75	2 years—straight line
	$ 777,453	$ (406,157)	$ 371,296	
Indefinite Lived Assets				
Tradenames	12,350	—	12,350	Indefinite life
Total intangible assets	$ 789,803	$ (406,157)	$ 383,646	

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Goodwill

The changes in the carrying amount of goodwill for the six months ended June 30, 2012 are as follows:

	LoyaltyOne®	Epsilon®	Private Label Services and Credit	Corporate/ Other	Total
			(In thousands)		
December 31, 2011	$ 241,697	$ 945,934	$ 261,732	$ —	$ 1,449,363
Effects of foreign currency translation	680	241	—	—	921
June 30, 2012	$ 242,377	$ 946,175	$ 261,732	$ —	$ 1,450,284

6. DEBT

Debt consists of the following:

Description	June 30, 2012	December 31, 2011	Maturity	Interest Rate
	(Dollars in thousands)			
Deposits:				
Certificates of deposit	$ 1,514,944	$ 1,353,775	Various - July 2012 – April 2019	0.20% to 5.25%
Money market deposits	138,008	—	On demand	0.01% to 0.26%
Total deposits	1,652,952	1,353,775		
Less: current portion	(809,547)	(642,567)		
Long-term portion	$ 843,405	$ 711,208		
Asset-backed securities debt – owed to securitization investors:				
Fixed rate asset-backed term note securities	$ 1,929,415	$ 1,562,815	Various - July 2012 – March 2019	1.68% to 7.00%
Floating rate asset-backed term note securities	645,825	703,500	Various - July 2012 – April 2013	(1)
Conduit asset-backed securities	862,527	993,972	Various - September 2012 – March 2014	1.20% to 1.70%
Total asset-backed securities – owed to securitization investors	3,437,767	3,260,287		
Less: current portion	(1,634,517)	(1,694,198)		
Long-term portion	$ 1,803,250	$ 1,566,089		
Long-term and other debt:				
2011 credit facility	$ —	$ 410,000	May 2016	—%
2011 term loan	897,403	782,594	May 2016 or May 2017	(2)

Senior notes due 2020	500,000	—	April 2020	6.38%
Convertible senior notes due 2013	739,484	711,480	August 2013	1.75%
Convertible senior notes due 2014	291,411	279,365	May 2014	4.75%
Capital lease obligations	24	35	July 2013	7.10%
Total long-term and other debt	2,428,322	2,183,474		
Less: current portion	(22,972)	(19,834)		
Long-term portion	$ 2,405,350	$ 2,163,640		

(1) Interest rates include those for certain of the Company's asset-backed securities – owed to securitization investors where floating rate debt is fixed through interest rate swap agreements. The interest rate for the floating rate debt is equal to the London Interbank Offered Rate ("LIBOR") plus a margin of 0.1% to 2.5%, each as defined in the respective agreements. The weighted average interest rate of the fixed rate achieved through interest rate swap agreements is 5.70% at June 30, 2012.

(2) At June 30, 2012, the weighted average interest rate for the 2011 Term Loan was 2.25%.

At June 30, 2012, the Company was in compliance with its covenants.

Deposits

Beginning January 1, 2012, World Financial Network Bank and World Financial Capital Bank, subsidiaries of the Company, offered a demand deposit program through contractual arrangements with securities brokerage firms. As of June 30, 2012, WFNB and WFCB had issued $138.0 million in money market deposits. Money market deposits are redeemable on demand by the customer and, as such, have no scheduled maturity date.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Credit Agreement

The Company, as borrower, and ADS Alliance Data Systems, Inc., ADS Foreign Holdings, Inc., Alliance Data Foreign Holdings, Inc., Epsilon Marketing Services, LLC, Epsilon Data Management LLC, Comenity LLC and Alliance Data FHC, Inc., as guarantors, is party to a credit agreement that originally provided for a $792.5 million term loan (the “2011 Term Loan”) and a $792.5 million revolving line of credit (the “2011 Credit Facility”).

In March 2012, the Company entered into a second amendment (the “Second Amendment”) to its credit agreement, dated May 24, 2011 (the “Credit Agreement”), through which the Company increased its 2011 Credit Facility by $125.0 million to $917.5 million. In addition, in March 2012, the Company borrowed additional term loans in the aggregate principal amount of $125.5 million, increasing the 2011 Term Loan to $903.1 million.

The Second Amendment, among other things, (i) extends the maturity date of certain term loans under the Credit Agreement from May 24, 2016 to May 24, 2017, (ii) creates a mechanism by which in the future non-extending term loan lenders may extend their term loans to May 24, 2017, (iii) reflects the additional term loans and the increase in the revolving credit commitments and (iv) provides for aggregate principal payments equal to 5% of the extended term loan amount in the additional year of the extended term loans, payable in equal quarterly installments. Total availability under the 2011 Credit Facility at June 30, 2012 was $917.5 million.

Senior Notes Due 2020

In March 2012, the Company issued and sold $500 million aggregate principal amount of 6.375% senior notes due April 1, 2020 (the “Senior Notes due 2020”). The Senior Notes due 2020 accrue interest on the principal amount at the rate of 6.375% per annum from March 29, 2012, payable semiannually in arrears, on April 1 and October 1 of each year, beginning on October 1, 2012.

The payment obligations under the Senior Notes due 2020 are governed by an indenture dated March 29, 2012 with Wells Fargo Bank, N.A., as trustee. The Senior Notes due 2020 are unsecured and are guaranteed on a senior unsecured basis by certain of the Company’s existing and future domestic subsidiaries that guarantee its Credit Agreement, initially ADS Alliance Data Systems, Inc., ADS Foreign Holdings, Inc., Alliance Data Foreign Holdings, Inc., Epsilon Marketing Services, LLC, Epsilon Data Management LLC, Comenity LLC and Alliance Data FHC, Inc. The indenture includes usual and customary negative covenants and events of default for transactions of this type.

Convertible Senior Notes

The Company has outstanding $1.15 billion of convertible senior notes, consisting of $805.0 million scheduled to mature on August 1, 2013 and $345.0 million scheduled to mature on May 15, 2014. The table below summarizes the carrying value of the components of the convertible senior notes:

	June 30, 2012	December 31, 2011
	(In thousands)	
Carrying amount of equity component	$ 368,678	$ 368,678
Principal amount of liability component	$ 1,150,000	$ 1,150,000
Unamortized discount	(119,105)	(159,155)

Net carrying value of liability component	$ 1,030,895	$ 990,845
If-converted value of common stock	$ 2,363,602	$ 1,818,048

The discount on the liability component will be amortized as interest expense over the remaining life of the convertible senior notes which, at June 30, 2012, is a weighted average period of 1.3 years.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Interest expense on the convertible senior notes recognized in the Company's unaudited condensed consolidated statements of income for the three and six months ended June 30, 2012 and 2011 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In thousands, except percentages)			
Interest expense calculated on contractual interest rate	$ 7,618	$ 7,618	$ 15,237	$ 15,237
Amortization of discount on liability component	20,300	18,187	40,050	35,882
Total interest expense on convertible senior notes	$ 27,918	$ 25,805	$ 55,287	$ 51,119
Effective interest rate (annualized)	11.0%	11.0%	11.0%	11.0%

Asset-backed Securities – Owed to Securitization Investors

Asset-backed Term Notes

In April 2012, World Financial Network Credit Card Master Note Trust issued $550.0 million of term asset-backed securities to investors. The offering consisted of $412.5 million of Class A Series 2012-A asset-backed term notes that have a fixed interest rate of 3.14% per year and mature in March 2019. In addition, the Company retained an aggregate of $137.5 million of subordinated classes of the term asset-backed notes which have been eliminated from the Company's unaudited condensed consolidated financial statements.

In August 2009, World Financial Network Credit Card Master Note Trust issued $395.0 million of Class A Series 2009-B asset-backed term notes that have a fixed interest rate of 3.79% per year and mature in July 2012. Pursuant to the indenture supplement applicable to these securities, as of June 30, 2012, the Company has collected $395.0 million of principal payments made by its credit cardholders during the accumulation period. The cash is restricted to the securitization investors and is reflected in other current assets in the Company's unaudited condensed consolidated financial statements as of June 30, 2012.

Conduit Facilities

In June 2012, the Company renewed its $1.2 billion 2009-VFN conduit facility under World Financial Network Credit Card Master Note Trust, extending its maturity to March 5, 2014. Also, in June 2012, the Company renewed its 2009-VFN conduit facility under World Financial Capital Master Note Trust, extending the maturity to May 31, 2013 and increasing the total capacity from $275.0 million to $375.0 million.

Derivative Financial Instruments

As part of its interest rate risk management program, the Company may enter into derivative financial instruments with institutions that are established dealers and manage its exposure to changes in fair value of certain obligations attributable to changes in LIBOR.

The credit card securitization trusts enter into derivative financial instruments, which include both interest rate swaps and an interest rate cap, to mitigate their interest rate risk on a related financial instrument or to lock the interest rate on a portion of their variable asset-backed securities debt.

These interest rate contracts involve the receipt of variable rate amounts from counterparties in exchange for the Company making fixed rate payments over the life of the agreement without the exchange of the underlying notional amount. These interest rate contracts are not designated as hedges. Such contracts are not speculative and are used to manage interest rate risk, but do not meet the specific hedge accounting requirements of ASC 815, “Derivatives and Hedging.”

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

The following tables identify the notional amount, fair value and classification of the Company’s outstanding interest rate contracts at June 30, 2012 and December 31, 2011 in the unaudited condensed consolidated balance sheets:

	June 30, 2012		December 31, 2011	
	Notional Amount	Weighted Average Years to Maturity	Notional Amount	Weighted Average Years to Maturity
	(Dollars in thousands)			
Interest rate contracts not designated as hedging instruments	$ 645,825	0.92	$ 703,500	1.37

	June 30, 2012		December 31, 2011	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
	(In thousands)			
Interest rate contracts not designated as hedging instruments	Other assets	$ 8	Other assets	$ —
Interest rate contracts not designated as hedging instruments	Other current liabilities	$ 22,927	Other current liabilities	$ 4,739
Interest rate contracts not designated as hedging instruments	Other liabilities	$ —	Other liabilities	$ 33,364

The following table summarizes activity related to and identifies the location of the Company’s outstanding interest rate contracts for the three and six months ended June 30, 2012 and 2011 recognized in the unaudited condensed consolidated statements of income:

	2012		2011	
For the three months ended June 30,	Income Statement Location	Gain on Derivative Contracts	Income Statement Location	Gain on Derivative Contracts
	(In thousands)			
Interest rate contracts not designated as hedging instruments	Securitization funding costs	$ 8,172	Securitization funding costs	$ 4,711
For the six months ended June 30,				
Interest rate contracts not designated as hedging	Securitization	$ 15,184	Securitization funding costs	$ 14,603

instruments	funding costs

The Company limits its exposure on derivatives by entering into contracts with institutions that are established dealers who maintain certain minimum credit criteria established by the Company. At June 30, 2012, the Company does not maintain any derivative contracts subject to master agreements that would require the Company to post collateral or that contain any credit-risk related contingent features. The Company has provisions in certain of the master agreements that require counterparties to post collateral to the Company when their credit ratings fall below certain thresholds. At June 30, 2012, these thresholds were not breached and no amounts were held as collateral by the Company.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

7. DEFERRED REVENUE

Because management has determined that the earnings process is not complete at the time an AIR MILES reward mile is issued, the recognition of revenue on all fees received at issuance is deferred. The Company allocates the proceeds from the issuance of AIR MILES reward miles into two components as follows:

Redemption element. The redemption element is the larger of the two components. Revenue related to the redemption element is based on the estimated fair value. For this component, revenue is recognized at the time an AIR MILES reward mile is redeemed, or for those AIR MILES reward miles that are estimated to go unredeemed by the collector base, known as "breakage," over the estimated life of an AIR MILES reward mile, or a period of 42 months. The Company's estimate of breakage is 28%.

Service element. The service element consists of marketing and administrative services. Revenue related to the service element is determined in accordance with Accounting Standards Update ("ASU") 2009-13, "Multiple Deliverable Revenue Arrangements." It is initially deferred and then amortized pro rata over the estimated life of an AIR MILES reward mile. With the adoption of ASU 2009-13, the residual method will no longer be utilized for new sponsor agreements entered into on or after January 1, 2011 or existing sponsor agreements that are materially modified subsequent to that date; for these agreements, the Company will measure the service element at its estimated selling price.

Under certain of the Company's contracts, a portion of the proceeds is paid to the Company upon the issuance of an AIR MILES reward mile and a portion is paid at the time of redemption and therefore, the Company does not have a redemption obligation related to these contracts. Revenue is recognized at the time of redemption and is not reflected in the reconciliation of the redemption obligation detailed below. Under such contracts, the proceeds received at issuance are initially deferred as service revenue and revenue is recognized pro rata over the estimated life of an AIR MILES reward mile. Amounts for revenue related to the redemption element and service element are recorded in redemption revenue and transaction revenue, respectively, in the unaudited condensed consolidated statements of income.

A reconciliation of deferred revenue for the AIR MILES Reward Program is as follows:

	Deferred Revenue		
	Service	Redemption	Total
	(In thousands)		
December 31, 2011	$ 358,973	$ 867,463	$ 1,226,436
Cash proceeds	113,589	269,083	382,672
Revenue recognized	(99,323)	(323,062)	(422,385)
Other	—	385	385
Effects of foreign currency translation	907	3,145	4,052
June 30, 2012	$ 374,146	$ 817,014	$ 1,191,160
Amounts recognized in the unaudited condensed consolidated balance sheets:			
Current liabilities	$ 177,512	$ 817,014	$ 994,526
Non-current liabilities	$ 196,634	$ —	$ 196,634

Effective from December 31, 2011, LoyaltyOne implemented an expiry policy, with all existing and future AIR MILES reward miles having an expiry of five years.

In December 2011, LoyaltyOne introduced a new program option, AIR MILES Cash, to which collectors, beginning in the first quarter of 2012, can allocate some or all of their future AIR MILES reward miles collected. Effective March 2012, AIR MILES Cash enabled collectors to instantly redeem their AIR MILES reward miles collected in this new program in-store towards purchases at participating sponsors.

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

8. STOCKHOLDERS’ EQUITY

Stock Repurchase Program

On December 13, 2011, the Company’s Board of Directors authorized a stock repurchase program to acquire up to $400.0 million of the Company’s outstanding common stock from January 1, 2012 through December 31, 2012, subject to any restrictions pursuant to the terms of the Company’s credit agreements or otherwise.

For the six months ended June 30, 2012, the Company acquired a total of 486,241 shares of its common stock for $59.0 million. As of June 30, 2012, the Company has $341.0 million available under the stock repurchase program.

Stock Compensation Expense

Total stock-based compensation expense recognized in the Company’s unaudited condensed consolidated statements of income for the three and six months ended June 30, 2012 and 2011 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In thousands)			
Cost of operations	$ 7,954	$ 6,007	$ 15,521	$ 11,910
General and administrative	4,926	5,099	9,665	8,280
Total	$ 12,880	$ 11,106	$ 25,186	$ 20,190

During the six months ended June 30, 2012, the Company awarded 328,759 performance-based restricted stock units with a weighted average grant date fair value per share of $120.00 as determined on the date of grant. The performance restriction on the awards will lapse upon determination by the Board of Directors or the Compensation Committee of the Board of Directors that the Company’s earnings before taxes for the period from January 1, 2012 to December 31, 2012 met certain pre-defined vesting criteria that permit a range from 50% to 150% of such performance-based restricted stock units to vest. Upon such determination, the restrictions will lapse with respect to 33% of the award on February 21, 2013, an additional 33% of the award on February 21, 2014 and the final 34% of the award on February 23, 2015, provided that the participant is employed by the Company on each such vesting date.

During the six months ended June 30, 2012, the Company awarded 94,626 service-based restricted stock units with a weighted average grant date fair value per share of $120.16 as determined on the date of grant. Service-based restricted stock units typically vest ratably over three years provided that the participant is employed by the Company on each such vesting date.

9. FINANCIAL INSTRUMENTS

In accordance with ASC 825, “Financial Instruments,” the Company is required to disclose the fair value of financial instruments for which it is practical to estimate fair value. To obtain fair values, observable market prices are used if available. In some instances, observable market prices are not readily available and fair value is determined using present value or other techniques appropriate for a particular financial instrument. These techniques involve judgment and as a result are not necessarily indicative of the amounts the Company would realize in a current market exchange. The use of different assumptions or estimation techniques may have a material effect on the estimated fair value amounts.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Fair Value of Financial Instruments — The estimated fair values of the Company's financial instruments are as follows:

	June 30, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In thousands)			
Financial assets				
Cash and cash equivalents	$ 642,199	$ 642,199	$ 216,213	$ 216,213
Trade receivables, net	319,292	319,292	300,895	300,895
Credit card receivables, net	5,278,180	5,278,180	5,197,690	5,197,690
Redemption settlement assets, restricted	476,234	476,234	515,838	515,838
Cash collateral, restricted	124,895	124,895	158,727	158,727
Other investment securities	469,215	469,215	26,772	26,772
Derivative financial instruments	8	8	—	—
Financial liabilities				
Accounts payable	169,938	169,938	149,812	149,812
Deposits	1,652,952	1,670,748	1,353,775	1,372,670
Asset-backed securities debt – owed to securitization investors	3,437,767	3,502,028	3,260,287	3,302,687
Long-term and other debt	2,428,322	3,779,796	2,183,474	3,071,661
Derivative financial instruments	22,927	22,927	38,103	38,103

Fair Value of Assets and Liabilities Held at June 30, 2012 and December 31, 2011

The following techniques and assumptions were used by the Company in estimating fair values of financial instruments as disclosed herein:

Cash and cash equivalents, trade receivables, net and accounts payable — The carrying amount approximates fair value due to the short maturity and the relatively liquid nature of these assets and liabilities.

Credit card receivables, net — The carrying amount of credit card receivables, net approximates fair value due to the short maturity, and the average interest rates approximate current market origination rates.

Redemption settlement assets, restricted — Redemption settlement assets, restricted consists of cash and cash equivalents and marketable securities. The fair value for securities is based on quoted market prices for the same or similar securities.

Cash collateral, restricted — The spread deposits are recorded at their fair value based on discounted cash flow models. The Company uses a valuation model that calculates the present value of estimated cash flows for each asset. The fair value is based on the term of the underlying securities and a discount rate. The carrying amount of excess funding deposits approximates its fair value due to the relatively short maturity period and average interest rates, which approximate current market rates.

Other investment securities — Other investment securities consist primarily of restricted cash and marketable securities. The fair value is based on quoted market prices for the same or similar securities.

Deposits — The fair value is estimated based on the current observable market rates available to the Company for similar deposits with similar remaining maturities.

Asset-backed securities debt – owed to securitization investors — The fair value is estimated based on the current observable market rates available to the Company for similar debt instruments with similar remaining maturities or quoted market prices of the same transaction.

Long-term and other debt — The fair value is estimated based on the current observable market rates available to the Company for similar debt instruments with similar remaining maturities or quoted market prices of the same transaction.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Derivative financial instruments —The valuation of these instruments is determined using a discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and option volatility.

Financial Assets and Financial Liabilities Fair Value Hierarchy

ASC 825 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include:

Level 1, defined as observable inputs such as quoted prices in active markets;

Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and

Level 3, defined as unobservable inputs where little or no market data exists, therefore requiring an entity to develop its own assumptions.

Financial instruments are considered Level 3 when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 financial instruments also include those for which the determination of fair value requires significant management judgment or estimation. The use of different techniques to determine fair value of these financial instruments could result in different estimates of fair value at the reporting date.

The following table provides information for the assets and liabilities carried at fair value measured on a recurring basis as of June 30, 2012 and December 31, 2011:

	Fair Value Measurements Using Inputs Considered as					
	Level 1		Level 2		Level 3	
	June 30, 2012	December 31, 2011	June 30, 2012	December 31, 2011	June 30, 2012	December 31, 2011
	(In thousands)					
Government bonds (1)	$ —	$ —	$ 5,058	$ 5,100	$ —	$ —
Corporate bonds (1)	14,158	21,346	450,639	453,927	—	—
Cash collateral, restricted	2,500	—	—	—	122,395	158,727
Other investment securities (2)	443,793	3,043	25,422	23,729	—	—
Derivative financial instruments (3)	—	—	8	—	—	—
	$ 460,451	$ 24,389	$ 481,127	$ 482,756	$ 122,395	$ 158,727

Total assets measured at fair value						
Derivative financial instruments (3)	$ —	$ —	$ 22,927	$ 38,103	$ —	$ —
Total liabilities measured at fair value	$ —	$ —	$ 22,927	$ 38,103	$ —	$ —

(1) Amounts are included in redemption settlement assets in the unaudited condensed consolidated balance sheets.

(2) Amounts are included in other current assets and other non-current assets in the unaudited condensed consolidated balance sheets.

(3) Amounts are included in other assets, other current liabilities and other liabilities in the unaudited condensed consolidated balance sheets.

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

The following tables summarize the changes in fair value of the Company's assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as defined in ASC 825 as of June 30, 2012 and 2011:

	Cash Collateral, Restricted (In thousands)
March 31, 2012	$ 141,866
Total gains (realized or unrealized):	
Included in earnings	2,330
Purchases	—
Settlements	(21,801)
Transfers in or out of Level 3	—
June 30, 2012	$ 122,395
Gains for the period included in earnings related to assets still held at June 30, 2012	$ 2,330

	Cash Collateral, Restricted (In thousands)
December 31, 2011	$ 158,727
Total gains (realized or unrealized):	
Included in earnings	4,019
Purchases	—
Settlements	(40,351)
Transfers in or out of Level 3	—
June 30, 2012	$ 122,395
Gains for the period included in earnings related to assets still held at June 30, 2012	$ 4,019

	Cash Collateral, Restricted (In thousands)
March 31, 2011	$ 179,333
Total gains (realized or unrealized):	
Included in earnings	126
Purchases	—
Settlements	(3,633)
Transfers in or out of Level 3	—
June 30, 2011	$ 175,826

Gains for the period included in earnings related to assets still held at June 30, 2011	$	126

Index

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

	Cash Collateral, Restricted (In thousands)
December 31, 2010	$ 185,754
Total gains (realized or unrealized):	
Included in earnings	458
Purchases	2,291
Settlements	(12,677)
Transfers in or out of Level 3	—
June 30, 2011	$ 175,826
Gains for the period included in earnings related to assets still held at June 30, 2011	$ 458

The spread deposits included in cash collateral, restricted are recorded at their fair value based on discounted cash flow models, utilizing the respective term of each instrument which ranged from 1 to 52 months, with a weighted average term of 14 months. The unobservable input used to calculate the fair value was the discount rate of 3.3%, which was based on an interest rate curve that is observable in the market as adjusted for a credit spread. Significant increases (decreases) in the term or the discount rate would result in a lower (higher) fair value.

For the three and six months ended June 30, 2012 and 2011, gains included in earnings attributable to cash collateral, restricted are included in interest in the unaudited condensed consolidated statements of income.

Financial Instruments Disclosed but Not Carried at Fair Value

The following table provides assets and liabilities disclosed but not carried at fair value as of June 30, 2012:

		Fair Value Measurements at June 30, 2012		
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Cash and cash equivalents	$ 642,199	$ 642,199	$ —	$ —
Credit card receivables, net	5,278,180	—	—	5,278,180
Total assets	$ 5,920,379	$ 642,199	$ —	$ 5,278,180