ALLIANCE DATA SYSTEMS CORP
Form 10-Q
November 05, 2015

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 September 30, 2015

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 R No £

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

As of October 31, 2015, 61,138,307 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

	September 30, 2015	December 31, 2014
	(In thousands, except per share amounts)	
ASSETS		
Cash and cash equivalents	$977,341	$1,077,152
Trade receivables, less allowance for doubtful accounts ($3,643 and $3,811 at September 30, 2015 and December 31, 2014, respectively)	642,681	743,294
Credit card and loan receivables:		
Credit card receivables – restricted for securitization investors	8,589,282	8,312,291
Other credit card and loan receivables	3,210,737	2,931,589
Total credit card and loan receivables	11,800,019	11,243,880
Allowance for loan loss	(671,246)	(570,171)
Credit card and loan receivables, net	11,128,773	10,673,709
Credit card and loan receivables held for sale	98,709	125,060
Deferred tax asset, net	237,723	218,872
Other current assets	544,069	456,349
Redemption settlement assets, restricted	468,417	520,340
Total current assets	14,097,713	13,814,776
Property and equipment, net	561,300	559,628
Deferred tax asset, net	841	164
Cash collateral, restricted	4,888	22,511
Intangible assets, net	1,268,627	1,515,994
Goodwill	3,835,419	3,865,484
Other non-current assets	531,886	485,420
Total assets	$20,300,674	$20,263,977
LIABILITIES AND EQUITY		
Accounts payable	$382,220	$455,656
Accrued expenses	395,467	457,472
Contingent consideration	—	326,023
Deposits	2,589,313	2,645,995
Non-recourse borrowings of consolidated securitization entities	1,230,000	1,058,750
Current debt	389,146	208,164
Other current liabilities	280,720	306,123
Deferred revenue	703,774	846,370
Deferred tax liability, net	1,719	930
Total current liabilities	5,972,359	6,305,483
Deferred revenue	148,443	166,807
Deferred tax liability, net	642,069	690,175
Deposits	2,633,109	2,127,546
Non-recourse borrowings of consolidated securitization entities	3,743,166	4,133,166
Long-term and other debt	4,710,032	4,001,082
Other liabilities	266,764	207,772
Total liabilities	18,115,942	17,632,031

Commitments and contingencies (Note 12)		
Redeemable non-controlling interest	236,847	235,566
Stockholders' equity:		
Common stock, $0.01 par value; authorized, 200,000 shares; issued, 112,072 shares and 111,686 shares at September 30, 2015 and December 31, 2014, respectively	1,121	1,117
Additional paid-in capital	2,956,814	2,905,563
Treasury stock, at cost, 50,949 shares and 47,874 shares at September 30, 2015 and December 31, 2014, respectively	(3,840,253)	(2,975,795)
Retained earnings	2,948,081	2,540,948
Accumulated other comprehensive loss	(117,878)	(75,453)
Total stockholders' equity	1,947,885	2,396,380
Total liabilities and equity	$20,300,674	$20,263,977

See accompanying notes to unaudited condensed consolidated financial statements.

3

Index

ALLIANCE DATA SYSTEMS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands, except per share amounts)			
Revenues				
Transaction	$83,126	$87,162	$263,195	$251,390
Redemption	220,922	232,464	747,192	744,658
Finance charges, net	737,918	597,892	2,101,360	1,672,339
Marketing services	498,955	353,525	1,435,520	1,021,813
Other revenue	48,196	48,090	143,625	126,991
Total revenue	1,589,117	1,319,133	4,690,892	3,817,191
Operating expenses				
Cost of operations (exclusive of depreciation and amortization disclosed separately below)	901,095	767,415	2,787,501	2,323,210
Provision for loan loss	171,678	114,577	461,944	281,811
General and administrative	40,890	39,169	111,992	101,498
Regulatory settlement	64,563	—	64,563	—
Depreciation and other amortization	36,450	28,070	104,983	79,555
Amortization of purchased intangibles	86,930	48,261	262,131	145,144
Total operating expenses	1,301,606	997,492	3,793,114	2,931,218
Operating income	287,511	321,641	897,778	885,973
Interest expense				
Securitization funding costs	23,143	22,763	71,509	67,974
Interest expense on deposits	13,719	9,064	37,099	25,526
Interest expense on long-term and other debt, net	45,236	29,637	132,212	98,643
Total interest expense, net	82,098	61,464	240,820	192,143
Income before income tax	$205,413	$260,177	$656,958	$693,830
Provision for income taxes	75,031	95,229	231,705	253,946
Net income	$130,382	$164,948	$425,253	$439,884
Less: net income attributable to non-controlling interest	1,952	706	2,927	803
Net income attributable to common stockholders	$128,430	$164,242	$422,326	$439,081
Net income attributable to common stockholders per share:				
Basic	$2.09	$2.84	$6.55	$7.98
Diluted	$2.08	$2.74	$6.51	$6.98
Weighted average shares:				
Basic	61,430	57,742	62,149	54,998
Diluted	61,796	59,908	62,567	62,887

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands)			
Net income	$130,382	$164,948	$425,253	$439,884
Other comprehensive income (loss), net of tax:				
Net unrealized gain (loss) on securities available-for-sale, net of tax expense (benefit) of $700, $(228), $572 and $688 for the three and nine months ended September 30, 2015 and 2014, respectively	420	(1,991)	(1,034)	(1,435)
Net unrealized gain (loss) on cash flow hedges, net of tax expense (benefit) of $406, $(34), $(510) and $(34) for the three and nine months ended September 30, 2015 and 2014, respectively	1,415	(104)	(1,466)	(104)
Foreign currency translation adjustments	4,633	(37,956)	(39,925)	(34,480)
Other comprehensive income (loss)	6,468	(40,051)	(42,425)	(36,019)
Total comprehensive income, net of tax	$136,850	$124,897	$382,828	$403,865
Less: comprehensive income attributable to non-controlling interest	2,363	1,251	3,360	1,514
Comprehensive income attributable to common stockholders	$134,487	$123,646	$379,468	$402,351

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months September 30 2015 (In thousands
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income	$425,253
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	367,114
Deferred income tax (benefit) expense	(62,807)
Provision for loan loss	461,944
Non-cash stock compensation	73,343
Amortization of discount on debt	646
Amortization of deferred financing costs	23,489
Change in deferred revenue	(34,168)
Change in contingent consideration	(99,601)
Change in other operating assets and liabilities, net of acquisitions	(82,996)
Originations of credit card and loan receivables held for sale	(4,569,806)
Sales of credit card and loan receivables held for sale	4,556,339
Excess tax benefits from stock-based compensation	(22,952)
Other	(4,566)
Net cash provided by operating activities	1,031,232
CASH FLOWS FROM INVESTING ACTIVITIES:	
Change in redemption settlement assets	(16,374)
Change in cash collateral, restricted	18,000
Change in restricted cash	(369)
Change in credit card and loan receivables	(913,803)
Purchase of credit card portfolios	—
Proceeds from the sale of a credit card portfolio	26,900

Payment for acquired businesses, net of cash	(45,430)
Capital expenditures	(140,091)
Purchases of other investments	(38,772)
Maturities/sales of other investments	7,981
Other	(1,011)
Net cash used in investing activities	(1,102,969)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Borrowings under debt agreements	2,426,443
Repayments of borrowings	(1,528,890)
Proceeds from convertible note hedge counterparties	—
Settlement of convertible note borrowings	—
Payment of acquisition-related contingent consideration	(205,928)
Acquisition of non-controlling interest	(87,376)
Issuances of deposits	2,191,885
Repayments of deposits	(1,743,004)
Non-recourse borrowings of consolidated securitization entities	2,570,000
Repayments/maturities of non-recourse borrowings of consolidated securitization entities	(2,788,750)
Payment of deferred financing costs	(16,396)
Excess tax benefits from stock-based compensation	22,952
Proceeds from issuance of common stock	8,775
Purchase of treasury shares	(856,855)
Other	—
Net cash (used in) provided by financing activities	(7,144)
Effect of exchange rate changes on cash and cash equivalents	(20,930)
Change in cash and cash equivalents	(99,811)
Cash and cash equivalents at beginning of period	1,077,152
Cash and cash equivalents at end of period	$977,341

SUPPLEMENTAL CASH FLOW INFORMATION:	
Interest paid	$223,681
Income taxes paid, net	$225,913

See accompanying notes to unaudited condensed consolidated financial statements.

6

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 consolidated subsidiaries and variable interest entities ("VIEs"), 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, 2014, filed with the SEC on February 27, 2015.

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.

For purposes of comparability, certain prior period amounts have been reclassified to conform to the current year presentation in accordance with GAAP.

Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers," which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. Companies may adopt ASU 2014-09 using a full retrospective approach or report the cumulative effect as of the date of adoption. On July 9, 2015, the FASB voted to defer the effective date by one year to December 15, 2017 for interim and annual reporting periods beginning after that date and permitted early adoption of the standard, but not before the original effective date of December 15, 2016. The Company is evaluating the impact that adoption of ASU 2014-09 will have on its consolidated financial statements.

In February 2015, the FASB issued ASU 2015-02, "Amendments to the Consolidation Analysis," which amends the consolidation requirements in Accounting Standards Codification ("ASC") 810, "Consolidation." ASU 2015-02 makes targeted amendments to the current consolidation guidance for VIEs, which could change consolidation conclusions. ASU 2015-02 is effective for interim and annual periods beginning after December 15, 2015, with early application permitted. The Company does not expect the adoption of this standard to materially impact its consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs." ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. ASU 2015-03 is effective for interim and annual reporting periods beginning after December 15, 2015, with early application permitted. Under ASU 2015-03, unamortized debt issuance costs of $84.9 million would be reclassified from other non-current assets to a reduction of debt as of September 30, 2015.

In April 2015, the FASB issued ASU 2015-05, "Customer's Accounting for Fees Paid in a Cloud Computing Arrangement." ASU 2015-05 provides guidance about whether a cloud computing arrangement includes a software license and is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The Company does not expect the adoption of this standard to materially impact its consolidated financial statements.

7

In July 2015, the FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory." ASU 2015-11 changes the measurement principle for inventory from the lower of cost or market to lower of cost and net realizable value. Net realizable value is defined as the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. ASU 2015-11 is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company does not expect the adoption of this standard to materially impact its consolidated financial statements.

2. EARNINGS PER SHARE

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands, except per share amounts)			
Numerator:				
Net income attributable to common stockholders	$128,430	$ 164,242	$422,326	$439,081
Less: accretion of redeemable non-controlling interest	—	—	15,194	—
Net income attributable to common stockholders after accretion of redeemable non-controlling interest	$128,430	$ 164,242	$407,132	$439,081
Denominator:				
Weighted average shares, basic	61,430	57,742	62,149	54,998
Weighted average effect of dilutive securities:				
Shares from assumed conversion of convertible senior notes	—	—	—	2,816
Shares from assumed exercise of convertible note warrants	—	1,664	—	4,561
Net effect of dilutive stock options and unvested restricted stock	366	502	418	512
Denominator for diluted calculations	61,796	59,908	62,567	62,887
Net income attributable to common stockholders per share:				
Basic	$2.09	$ 2.84	$6.55	$7.98
Diluted	$2.08	$ 2.74	$6.51	$6.98

3. ACQUISITIONS

2014 Acquisitions:

Brand Loyalty Group B.V.

On January 2, 2014, the Company acquired a 60% ownership interest in BrandLoyalty Group B.V. ("BrandLoyalty"), a Netherlands-based, data-driven loyalty marketer. BrandLoyalty designs, organizes, implements and evaluates innovative and tailor-made loyalty programs for food retailers worldwide. The acquisition expands the Company's presence across Europe, Asia and Latin America. The results of BrandLoyalty have been included since the date of acquisition and are reflected in the Company's LoyaltyOne® segment. The initial cash consideration was approximately $259.5 million in addition to the assumption of debt. The goodwill resulting from the acquisition is not deductible for tax purposes.

The following table summarizes the final allocation of consideration and the respective fair values of the assets acquired and liabilities assumed in the BrandLoyalty acquisition as of the date of purchase:

	As of January 2, 2014 (In thousands)
Current assets, net of cash acquired	$246,769
Deferred tax asset	3,509
Property and equipment	19,719
Other non-current assets	3,994
Intangible assets	423,832
Goodwill	565,015
Total assets acquired	1,262,838
Current liabilities	146,559
Current portion of long-term debt	34,180
Deferred tax liability	105,512
Long-term debt (net of current portion)	126,323
Other liabilities	142
Total liabilities assumed	412,716
Redeemable non-controlling interest	341,907
Net assets acquired	$508,215

As part of the initial purchase price allocation, the Company recorded a liability for the earn-out provision included in the BrandLoyalty share purchase agreement of €181.9 million ($248.7 million as of January 2, 2014). The liability was measured at fair value on the date of purchase and subsequent changes in the fair value of the liability were included in operating expenses in the Company's consolidated statements of income. On February 10, 2015, the Company paid €269.9 million ($305.5 million) to settle the contingent liability.

Conversant, Inc.

On December 10, 2014, the Company completed the acquisition of 100% of the common stock of Conversant, Inc. ("Conversant"), a digital marketing services company offering unique end-to-end digital marketing solutions that empower clients to more effectively market to their customers across all channels. The results of Conversant® have been included since the date of the acquisition and are reflected in the Company's Epsilon® segment.

The Company paid total consideration of approximately $2.3 billion, with cash consideration of approximately $936.3 million, net of cash acquired and equity consideration of approximately $1.3 billion through the issuance of approximately 4.6 million shares and the exchange of certain restricted stock awards and stock options. The cash and equity consideration paid and issued were determined in accordance with the terms of the merger agreement, with the value based on the volume weighted average price per share of the Company's common stock for the consecutive period of 15 trading days ending on the close of trading on the second trading day immediately preceding the closing of the merger. The goodwill recognized is attributable to expected synergies and an assembled workforce. The goodwill resulting from the acquisition is not deductible for tax purposes.

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

In the first quarter of 2015, the Company finalized the purchase price allocation, with no changes from the preliminary purchase price allocation disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2014. The following table summarizes the allocation of the consideration and the respective fair values of the assets acquired and liabilities assumed in the Conversant acquisition as of the date of purchase:

	As of December 10, 2014 (In thousands)
Current assets, net of cash acquired	$180,030
Deferred tax asset	11,905
Property and equipment	25,555
Developed technology	182,500
Other non-current assets	1,744
Intangible assets	755,600
Goodwill	1,650,299
Total assets acquired	2,807,633
Current liabilities	177,585
Deferred tax liability	344,081
Other liabilities	26,933
Total liabilities assumed	548,599
Net assets acquired	$2,259,034

The following table presents the Company's unaudited pro forma consolidated revenue and net income for the three and nine months ended September 30, 2014. The unaudited pro forma results include the historical consolidated statements of income of the Company and Conversant, giving effect to the Conversant acquisition and related financing transactions as if they had occurred on January 1, 2013.

	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2014
	(In thousands, except per share amounts)	
Total revenue	$1,457,446	$4,238,797
Net income	$151,921	$411,476
Net income attributable to common stockholders	$151,215	$410,673
Net income attributable to common stockholders per share:		

Basic	$2.43	$6.89
Diluted	$2.34	$6.08

The unaudited pro forma results are not necessarily indicative of the operating results that would have occurred if the Conversant acquisition had been completed as of the date for which the unaudited pro forma financial information is presented. The unaudited pro forma financial information for the three and nine months ended September 30, 2014 includes adjustments that are directly related to the acquisition, factually supportable and expected to have a continuing impact. These adjustments include, but are not limited to, amortization related to fair value adjustments to intangible assets and interest expense on acquisition-related debt. The unaudited pro forma financial information for the three months and nine months ended September 30, 2014 exclude $6.6 million of acquisition costs consisting primarily of advisory, legal and other professional fees.

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

2015 Acquisition:

Edison International Concept & Agencies B.V. and Max Holding B.V.

On August 31, 2015, BrandLoyalty acquired all of the stock of Edison International Concept & Agencies B.V. ("Edison") and Max Holding B.V. ("Merison"), two Netherlands-based loyalty marketers, for consideration of approximately $45.4 million, net of $2.2 million of cash and cash equivalents acquired. The acquisition expands BrandLoyalty's short-term loyalty programs into new markets with new brands. Total net assets acquired were $61.4 million, including $6.7 million of intangible assets and $34.7 million of goodwill, with total liabilities assumed of $16.0 million. The goodwill resulting from the acquisition is not deductible for tax purposes. The results of Edison and Merison have been included since the date of acquisition and are reflected in the Company's LoyaltyOne segment.

4. CREDIT CARD AND LOAN RECEIVABLES

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

	September 30, 2015	December 31, 2014
	(In thousands)	
Principal receivables	$11,297,882	$10,762,498
Billed and accrued finance charges	480,315	422,838
Other credit card and loan receivables	21,822	58,544
Total credit card and loan receivables	11,800,019	11,243,880
Less credit card receivables – restricted for securitization investors	8,589,282	8,312,291
Other credit card and loan receivables	$3,210,737	$2,931,589

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 and loan receivables. The allowance for loan loss covers forecasted uncollectible principal as well as unpaid interest and fees. The allowance for loan loss is evaluated monthly for appropriateness.

In estimating the allowance for principal loan losses, management utilizes a migration analysis of delinquent and current credit card and loan receivables. Migration analysis is a technique used to estimate the likelihood that a credit card or loan 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 loss. Charge-offs of principal amounts, net of recoveries are deducted from the allowance. In estimating the allowance for uncollectible 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. 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, seasonality, payment rates and forecasting uncertainties.

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 and loan 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 and loan 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 $88.9 million and $70.9 million for the three months ended September 30, 2015 and 2014, respectively, and $258.2 million and $212.9 million for the nine months ended September 30, 2015 and 2014, respectively.

11

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

The following table presents the Company's allowance for loan loss for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands)			
Balance at beginning of period	$623,316	$483,580	$570,171	$503,169
Provision for loan loss	171,678	114,577	461,944	281,811
Change in estimate for uncollectible unpaid interest and fees	—	1,000	4,500	1,500
Recoveries	48,767	39,074	129,623	115,548
Principal charge-offs	(172,515)	(126,877)	(494,992)	(390,674)
Balance at end of period	$671,246	$511,354	$671,246	$511,354

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 may engage collection agencies and outside attorneys to continue those efforts.

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

	September 30, 2015	% of Total	December 31, 2014	% of Total
		(In thousands, except percentages)		
Receivables outstanding – principal	$11,297,882	100.0%	$10,762,498	100.0%
Principal receivables balances contractually delinquent:				
31 to 60 days	175,018	1.5 %	157,760	1.4 %
61 to 90 days	113,360	1.0	93,175	0.9
91 or more days	225,553	2.0	182,945	1.7
Total	$513,931	4.5 %	$433,880	4.0 %

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.

Index

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

Credit card receivables for which temporary hardship or permanent concessions have been granted are both considered troubled debt restructurings and 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 receivables 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 card receivables with the allowance determined under the contingent loss model of 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 material difference in the allowance for loan loss.

The Company had $155.5 million and $134.9 million, respectively, as a recorded investment in impaired credit card receivables with an associated allowance for loan loss of $39.1 million and $35.2 million, respectively, as of September 30, 2015 and December 31, 2014. These modified credit card receivables represented less than 2% of the Company's total credit card receivables as of both September 30, 2015 and December 31, 2014.

The average recorded investment in impaired credit card receivables was $149.2 million and $114.0 million for the three months ended September 30, 2015 and 2014, respectively, and $141.5 million and $114.2 million for the nine months ended September 30, 2015 and 2014, 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 $3.8 million and $3.3 million for the three months ended September 30, 2015 and 2014, respectively, and $10.7 million and $9.6 million for the nine months ended September 30, 2015 and 2014, 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 are considered troubled debt restructurings as described above, which entered into a modification program during the specified periods:

	Three Months Ended September 30, 2015			Nine Months Ended September 30, 2015		
	Number of Restructurings	Pre-modification Outstanding Balance	Post-modification Outstanding Balance	Number of Restructurings	Pre-modification Outstanding Balance	Post-modification Outstanding Balance
	(Dollars in thousands)					
Troubled debt restructurings – credit card receivables	44,955	$ 48,088	$ 48,048	120,074	$ 129,775	$ 129,661

	Three Months Ended September 30, 2014			Nine Months Ended September 30, 2014		
	Number of Restructurings	Pre-modification Outstanding Balance	Post-modification Outstanding Balance	Number of Restructurings	Pre-modification Outstanding Balance	Post-modification Outstanding Balance
	(Dollars in thousands)					
Troubled debt restructurings – credit card receivables	36,846	$ 37,130	$ 37,100	102,000	$ 101,837	$ 101,750

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 September 30, 2015		Nine Months Ended September 30, 2015	
	Number of Restructurings	Outstanding Balance	Number of Restructurings	Outstanding Balance
	(Dollars in thousands)			
Troubled debt restructurings that subsequently defaulted – credit card receivables	20,212	$ 21,436	55,940	$ 57,995

13

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

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	Number of Restructurings	Outstanding Balance	Number of Restructurings	Outstanding Balance
	(Dollars in thousands)			
Troubled debt restructurings that subsequently defaulted – credit card receivables	14,047	$ 14,037	44,545	$ 44,009

Age of Credit Card and Loan Receivables Accounts
The following tables set forth, as of September 30, 2015 and 2014, the number of active credit card and loan receivables accounts with balances and the related principal balances outstanding, based upon the age of the active credit card and loan receivables accounts from origination:

	September 30, 2015			
Age of Accounts Since Origination	Number of Active Accounts with Balances	Percentage of Active Accounts with Balances	Principal Receivables Outstanding	Percentage of Principal Receivables Outstanding
	(In thousands, except percentages)			
0-12 Months	5,881	29.8 %	$ 2,994,083	26.5 %
13-24 Months	3,014	15.3	1,783,846	15.8
25-36 Months	2,085	10.6	1,266,628	11.2
37-48 Months	1,509	7.6	917,319	8.1
49-60 Months	1,107	5.6	676,015	6.0
Over 60 Months	6,148	31.1	3,659,991	32.4
Total	19,744	100.0 %	$ 11,297,882	100.0 %

	September 30, 2014			
Age of Accounts Since Origination	Number of Active Accounts with Balances	Percentage of Active Accounts with Balances	Principal Receivables Outstanding	Percentage of Principal Receivables Outstanding
	(In thousands, except percentages)			
0-12 Months	4,869	28.2 %	$ 2,220,148	25.1 %
13-24 Months	2,554	14.8	1,282,695	14.5
25-36 Months	1,781	10.3	937,043	10.6
37-48 Months	1,283	7.4	701,808	7.9
49-60 Months	969	5.6	557,911	6.3
Over 60 Months	5,828	33.7	3,149,984	35.6
Total	17,284	100.0 %	$ 8,849,589	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 models are used as a tool in the underwriting process and for making credit decisions. The proprietary scoring models are based on historical data and require 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 and loan receivables by obligor credit quality as of September 30, 2015 and 2014:

	September 30, 2015		September 30, 2014	
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	Total Principal Receivables Outstanding	Percentage of Principal Receivables Outstanding
	(In thousands, except percentages)			
No Score	$176,379	1.6 %	$180,003	2.0 %
27.1% and higher	607,856	5.4	430,333	4.9
17.1% - 27.0%	944,270	8.3	829,208	9.4
12.6% - 17.0%	1,140,013	10.1	955,459	10.8
3.7% - 12.5%	4,413,422	39.1	3,613,024	40.8
1.9% - 3.6%	2,405,329	21.3	1,837,713	20.8
Lower than 1.9%	1,610,613	14.2	1,003,849	11.3
Total	$11,297,882	100.0%	$8,849,589	100.0 %

Transfer of Financial Assets
The Company originates loans under an agreement with one of its clients, and after origination, these loan receivables are sold to the client at par value plus accrued interest. These transfers qualify for sale treatment as they meet the conditions established in ASC 860-10, "Transfers and Servicing." Following the sale, the client owns the loan receivables, bears the risk of loss in the event of loan defaults and is responsible for all servicing functions related to the loan receivables. The loan receivables originated by the Company that have not yet been sold to the client were $62.2 million and $48.9 million at September 30, 2015 and December 31, 2014, respectively, and are included in credit card and loan receivables held for sale in the Company's unaudited condensed consolidated balance sheets and carried at the lower of cost or fair value. The carrying value of these loan receivables approximates fair value due to the short duration between the date of origination and sale. Originations and sales of these loan receivables held for sale are reflected as operating activities in the Company's unaudited condensed consolidated statements of cash flows. Upon the client's purchase of the originated loan receivables, the Company is obligated to purchase a participating interest in a pool of loan receivables that includes the loan receivables originated by the Company. Such interest participates on a pro rata basis in the cash flows of the underlying pool of loan receivables, including principal repayments, finance charges, losses and recoveries. The Company bears the risk of loss related to its participation interest in this pool.
During the nine months ended September 30, 2015 and 2014, the Company purchased $227.7 million and $181.8 million, respectively, of loan receivables under these agreements.
The total outstanding balance of these loan receivables was $193.6 million and $160.6 million as of September 30, 2015 and December 31, 2014, respectively, and was included in other credit card and loan receivables in the Company's unaudited condensed consolidated balance sheets.
Portfolios Held for Sale

The Company has certain credit card portfolios held for sale, which are carried at the lower of cost or fair value, and were $36.5 million and $76.2 million as of September 30, 2015 and December 31, 2014, respectively. In June 2015, the Company sold one credit card portfolio previously classified as held for sale for cash proceeds of $26.9 million and recognized a de minimis gain.

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

Securitized Credit Card Receivables
The Company regularly securitizes its credit card receivables through its credit card securitization trusts, consisting of the World Financial Network Credit Card Master Trust, World Financial Network Credit Card Master Note Trust ("Master Trust I") and World Financial Network Credit Card Master Trust III ("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 uncollectible receivables. These fees are eliminated and therefore are not reflected in the Company's unaudited condensed consolidated statements of income for the three and nine months ended September 30, 2015 and 2014.
The WFN Trusts and the WFC Trust are 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 non-recourse secured borrowings and other liabilities for which creditors or beneficial interest holders do not have recourse to the general credit of the Company.
The tables below present quantitative information about the components of total securitized credit card receivables, delinquencies and net charge-offs:

	September 30, 2015	December 31, 2014
	(In thousands)	
Total credit card receivables – restricted for securitization investors	$8,589,282	$8,312,291
Principal amount of credit card receivables – restricted for securitization investors, 90 days or more past due	$172,524	$145,768

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands)			
Net charge-offs of securitized principal	$94,130	$75,092	$290,585	$240,754

5. INVENTORIES
Inventories of $230.4 million and $220.5 million at September 30, 2015 and December 31, 2014, respectively, consist of finished goods primarily to be utilized as rewards in the Company's loyalty programs and are included in other current assets in the Company's unaudited condensed consolidated balance sheets.
Inventories are stated at the lower of cost or market and valued primarily on a first-in-first-out basis. The Company records valuation adjustments to its inventories if the cost of inventory exceeds the amount it expects to realize from the ultimate sale or disposal of the inventory. These estimates are based on management's judgment regarding future market conditions and an analysis of historical experience.

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

6. OTHER INVESTMENTS

Other investments consist of restricted cash, marketable securities and U.S. Treasury bonds and are included in other current assets and other assets in the Company's unaudited condensed consolidated balance sheets. The principal components of other investments, which are carried at fair value, are as follows:

	September 30, 2015				December 31, 2014			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(In thousands)							
Restricted cash	$23,414	$ —	$ —	$23,414	$22,611	$ —	$ —	$22,611
Marketable securities	125,672	851	(1,007)	125,516	95,669	520	(1,322)	94,867
U.S. Treasury bonds	100,051	893	—	100,944	100,072	66	(33)	100,105
Total	$249,137	$ 1,744	$ (1,007)	$249,874	$218,352	$ 586	$ (1,355)	$217,583

The following tables show the unrealized losses and fair value for those investments that were in an unrealized loss position as of September 30, 2015 and December 31, 2014, aggregated by investment category and the length of time that individual securities have been in a continuous loss position:

	September 30, 2015					
	Less than 12 months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Marketable securities	$18,913	$ (153)	$35,783	$ (854)	$54,696	$ (1,007)
Total	$18,913	$ (153)	$35,783	$ (854)	$54,696	$ (1,007)

	December 31, 2014					
	Less than 12 months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Marketable securities	$8,757	$ (27)	$48,961	$ (1,295)	$57,718	$ (1,322)
U.S. Treasury bonds	75,043	(33)	—	—	75,043	(33)
Total	$83,800	$ (60)	$48,961	$ (1,295)	$132,761	$ (1,355)

The amortized cost and estimated fair value of the marketable securities and U.S. Treasury bonds at September 30, 2015 by contractual maturity are as follows:

	Amortized Cost	Fair Value
	(In thousands)	
Due in one year or less	$31,638	$31,672
Due after one year through five years	75,042	75,901
Due after five years through ten years		