ALLIANCE DATA SYSTEMS CORP
Form 10-Q
November 05, 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 September 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 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 Exchange Act). Yes £ No R

As of October 31, 2012, 49,855,700 shares of common stock were outstanding.

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PART I

Item 1. Financial Statements.

ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2012	December 31, 2011
	(In thousands, except per share amounts)	
ASSETS		
Cash and cash equivalents	$ 766,317	$ 216,213
Trade receivables, less allowance for doubtful accounts ($4,583 and $2,406 at September 30, 2012 and December 31, 2011, respectively)	287,643	300,895
Credit card receivables:		
Credit card receivables – restricted for securitization investors	5,838,099	4,886,168
Other credit card receivables	741,216	779,843
Total credit card receivables	6,579,315	5,666,011
Allowance for loan loss	(448,542)	(468,321)
Credit card receivables, net	6,130,773	5,197,690
Deferred tax asset, net	183,319	252,303
Other current assets	155,854	121,589
Redemption settlement assets, restricted	495,699	515,838
Assets of discontinued operations	—	2,439
Total current assets	8,019,605	6,606,967
Property and equipment, net	224,018	195,397
Deferred tax asset, net	79,315	43,408
Cash collateral, restricted	62,205	158,727
Intangible assets, net	403,100	383,646
Goodwill	1,458,700	1,449,363
Other non-current assets	165,361	142,741
Total assets	$ 10,412,304	$ 8,980,249
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	$ 236,891	$ 149,812
Accrued expenses	238,489	206,621
Deposits	984,798	642,567
Asset-backed securities debt – owed to securitization investors	1,420,866	1,694,198
Current debt	782,706	19,834
Other current liabilities	104,666	105,888
Deferred revenue	1,031,836	1,036,251
Total current liabilities	4,800,252	3,855,171
Deferred revenue	202,254	190,185
Deferred tax liability, net	191,036	151,746
Deposits	850,854	711,208
Asset-backed securities debt – owed to securitization investors	2,094,250	1,566,089
Long-term and other debt	1,660,739	2,163,640
Other liabilities	120,433	166,244

Total liabilities		9,919,818		8,804,283
Commitments and contingencies				
Stockholders' equity:				
Common stock, $0.01 par value; authorized, 200,000 shares; issued, 94,832 shares and 94,141 shares at September 30, 2012 and December 31, 2011, respectively		948		941
Additional paid-in capital		1,429,936		1,387,773
Treasury stock, at cost, 44,847 shares and 44,311 shares at September 30, 2012 and December 31, 2011, respectively		(2,386,054)		(2,320,696)
Retained earnings		1,469,599		1,131,004
Accumulated other comprehensive loss		(21,943)		(23,056)
Total stockholders' equity		492,486		175,966
Total liabilities and stockholders' equity	$	10,412,304	$	8,980,249

See accompanying notes to unaudited condensed consolidated financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
	(In thousands, except per share amounts)			
Revenues				
Transaction	$ 74,904	$ 74,712	$ 235,150	$ 221,352
Redemption	144,144	141,152	491,795	424,254
Finance charges, net	434,824	365,925	1,188,933	1,040,339
Database marketing fees and direct marketing services	225,303	230,350	658,429	565,324
Other revenue	32,317	32,705	95,239	74,469
Total revenue	911,492	844,844	2,669,546	2,325,738
Operating expenses				
Cost of operations (exclusive of depreciation and amortization disclosed separately below)	499,455	476,993	1,532,815	1,312,768
Provision for loan loss	81,250	70,697	183,129	198,739
General and administrative	24,584	26,242	76,115	68,202
Depreciation and other amortization	18,745	20,304	54,845	53,908
Amortization of purchased intangibles	22,987	22,929	65,009	60,743
Total operating expenses	647,021	617,165	1,911,913	1,694,360
Operating income	264,471	227,679	757,633	631,378
Interest expense				
Securitization funding costs	23,296	30,233	68,143	96,281
Interest expense on deposits	6,753	5,645	18,719	16,832
Interest expense on long-term and other debt, net	44,316	38,478	126,222	111,496
Total interest expense, net	74,365	74,356	213,084	224,609
Income before income tax	$ 190,106	$ 153,323	$ 544,549	$ 406,769
Provision for income taxes	70,561	59,342	205,954	157,389
Net income	$ 119,545	$ 93,981	$ 338,595	$ 249,380
Basic income per share	$ 2.39	$ 1.86	$ 6.76	$ 4.89
Diluted income per share	$ 1.84	$ 1.60	$ 5.33	$ 4.35
Weighted average shares				
Basic	49,939	50,644	50,086	50,948
Diluted	65,038	58,579	63,539	57,377

See accompanying notes to unaudited condensed consolidated financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Net income	$ 119,545	$ 93,981	$ 338,595	$ 249,380
Other comprehensive income, net of tax				
Net unrealized gain on securities available-for-sale, net of tax expense of $142, tax expense of $111 and tax expense of $26, tax expense of $261 for the three and nine months ended September 30, 2012 and 2011, respectively	3,044	13,989	4,880	13,045
Foreign currency translation adjustments	(2,107)	7,281	(3,767)	3,750
Total comprehensive income, net of tax	$ 120,482	$ 115,251	$ 339,708	$ 266,175

See accompanying notes to unaudited condensed consolidated financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 338,595	$ 249,380
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	119,854	114,651
Deferred income taxes	76,356	(221)
Provision for loan loss	183,129	198,739
Non-cash stock compensation	37,605	32,471
Fair value gain on interest-rate derivatives	(22,672)	(23,146)
Amortization of discount on convertible senior notes	60,915	54,574
Change in operating assets and liabilities, net of acquisitions:		
Change in trade accounts receivable	(9,595)	1,188
Change in other assets	20,317	43,402
Change in accounts payable and accrued expenses	134,848	44,739
Change in deferred revenue	(36,364)	15,869
Change in other liabilities	(25,479)	37,411
Excess tax benefits from stock-based compensation	(15,237)	(12,103)
Other	(211)	5,546
Net cash provided by operating activities	862,061	762,500
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in redemption settlement assets	41,885	4,353
Change in restricted cash	(43,892)	98,408
Change in credit card receivables	(418,514)	160,592
Purchase of credit card portfolios	(780,153)	(42,696)
Change in cash collateral, restricted	101,536	(468,690)

Payments for acquired businesses, net of cash	—	(359,076)
Capital expenditures	(77,340)	(48,536)
Investments in marketable securities, net	(1,492)	(68,191)
Investments in the stock of investees	(921)	(17,974)
Other	(9,666)	—
Net cash used in investing activities	(1,188,557)	(741,810)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings under debt agreements	699,500	2,858,500
Repayments of borrowings	(500,428)	(2,524,729)
Issuances of deposits	1,185,049	842,505
Repayments of deposits	(703,173)	(332,600)
Borrowings from asset-backed securities	1,672,962	1,126,921
Repayments/maturities of asset-backed securities	(1,418,133)	(1,703,776)
Payment of capital lease obligations	(16)	(3,920)
Payment of deferred financing costs	(30,930)	(27,366)
Excess tax benefits from stock-based compensation	15,237	12,103
Proceeds from issuance of common stock	15,119	22,942
Purchase of treasury shares	(65,358)	(186,320)
Net cash provided by financing activities	869,829	84,260
Effect of exchange rate changes on cash and cash equivalents	6,771	(4,494)
Change in cash and cash equivalents	550,104	100,456
Cash and cash equivalent at beginning of period	216,213	139,114
Cash and cash equivalents at end of period	$ 766,317	$ 239,570
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	$ 149,076	$ 177,301
Income taxes paid, net	$ 91,055	$ 87,185

See accompanying notes to unaudited condensed consolidated financial statements.

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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.

Effective October 1, 2012, the Company’s subsidiaries World Financial Network Bank and World Financial Capital Bank changed their names to Comenity Bank and Comenity Capital Bank, respectively. These name changes have been reflected in the Notes to the Unaudited Condensed Consolidated Financial Statements.

Recently Issued Accounting Standards

In July 2012, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2012-02, “Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment,” which amends Accounting Standards Codification (“ASC”) 350, “Intangibles – Goodwill and Other.” ASU 2012-02 provides an option to first perform a qualitative assessment in testing an indefinite-lived intangible asset for impairment. If based on the qualitative assessment, the carrying value of the asset is more likely than not greater than the fair value, then the current quantitative impairment test must be performed. ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. ASU 2012-02 only impacts the process of testing indefinite-lived intangible assets, other than goodwill, for impairment. Accordingly, the adoption of the standard in 2013 will have no impact on the Company’s financial condition, results of operations or cash flows.

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

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 September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands, except per share amounts)			
Numerator:				
Net Income	$ 119,545	$ 93,981	$ 338,595	$ 249,380
Denominator:				
Weighted average shares, basic	49,939	50,644	50,086	50,948
Weighted average effect of dilutive securities:				
Shares from assumed conversion of convertible senior notes	9,033	5,138	8,378	4,195
Shares from assumed conversion of convertible note warrants	5,263	1,750	4,317	1,306
Net effect of dilutive stock options and unvested restricted stock	803	1,047	758	928
Denominator for diluted calculations	65,038	58,579	63,539	57,377
Basic net income per share	$ 2.39	$ 1.86	$ 6.76	$ 4.89
Diluted net income per share	$ 1.84	$ 1.60	$ 5.33	$ 4.35

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.

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 nine months ended September 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:

	September 30, 2012	December 31, 2011
	(In thousands)	
Principal receivables	$ 6,260,239	$ 5,408,862
Billed and accrued finance charges	264,106	221,357
Other receivables	54,970	35,792
Total credit card receivables	6,579,315	5,666,011
Less credit card receivables – restricted for securitization investors	5,838,099	4,886,168
Other credit card receivables	$ 741,216	$ 779,843

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

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 $43.3 million for the three months ended September 30, 2012 and 2011, respectively, and $137.5 million and $147.8 million for the nine months ended September 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.

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 September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Balance at beginning of period	$ 432,521	$ 461,015	$ 468,321	$ 518,069
Provision for loan loss	81,250	70,697	183,129	198,739
Change in estimate for uncollectible unpaid interest and fees	—	(5,000)	—	(5,000)
Recoveries	22,088	20,858	74,802	68,600
Principal charge-offs	(87,309)	(93,905)	(277,702)	(326,743)
Other	(8)	(5,000)	(8)	(5,000)
Balance at end of period	$ 448,542	$ 448,665	$ 448,542	$ 448,665

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.

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

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

	September 30, 2012	% of Total	December 31, 2011	% of Total
	(In thousands, except percentages)			
Receivables outstanding – principal	$ 6,260,239	100%	$ 5,408,862	100%
Principal receivables balances contractually delinquent:				
31 to 60 days	96,159	1.5%	78,272	1.4%
61 to 90 days	58,626	0.9	51,709	1.0
91 or more days	109,602	1.8	105,626	2.0
Total	$ 264,387	4.2%	$ 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 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 $113.5 million and $122.2 million, respectively, as a recorded investment in impaired credit card receivables with an associated allowance for loan loss of $41.8 million and $45.3 million, respectively, as of September 30, 2012 and December 31, 2011. These modified credit card receivables represented less than 3% of the Company's total credit card receivables as of September 30, 2012 and December 31, 2011, respectively.

The average recorded investment in the impaired credit card receivables was $111.7 million and $129.0 million for the three months ended September 30, 2012 and 2011, respectively, and $114.3 million and $133.2 million for the nine months ended September 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 $3.0 million and $3.4 million for the three months ended September 30, 2012 and 2011, respectively, and $9.1 million and $10.5 million for the nine months ended September 30, 2012 and 2011, respectively, in interest income associated with modified credit card receivables during the period that such credit card receivables were impaired.

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

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

	Three Months Ended September 30, 2012			Nine Months Ended September 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	35,000	$ 31,267	$ 31,248	95,039	$ 85,422	$ 85,316

	Three Months Ended September 30, 2011			Nine Months Ended September 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	36,576	$ 32,665	$ 32,655	119,614	$ 104,483	$ 102,419

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, 2012		Nine Months Ended September 30, 2012	
	Number of Restructurings	Outstanding Balance	Number of Restructurings	Outstanding Balance
	(Dollars in thousands)			
Troubled debt restructurings, defaulted – credit card receivables	12,764	$ 12,363	41,971	$ 40,524

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	Number of Restructurings	Outstanding Balance	Number of Restructurings	Outstanding Balance
	(Dollars in thousands)			
Troubled debt restructurings, defaulted – credit card receivables	18,538	$ 17,850	56,933	$ 56,267

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

Age of Credit Card Receivables

The following table sets forth, as of September 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	3,838	25.7%	$ 1,388,049	22.2%
13-24 Months	1,944	13.0	733,807	11.7
25-36 Months	1,424	9.5	621,926	9.9
37-48 Months	1,139	7.6	565,294	9.0
49-60 Months	944	6.3	436,518	7.0
Over 60 Months	5,668	37.9	2,514,645	40.2
Total	14,957	100.0%	$ 6,260,239	100.0%

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 receivables by obligor credit quality as of September 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(1)	$ 290,008	4.6%
27.1% and higher	257,032	4.1
17.1% - 27.0%	545,755	8.7
12.6% - 17.0%	625,436	10.0
3.7% - 12.5%	2,521,231	40.3
1.9% - 3.6%	1,322,943	21.1
Lower than 1.9%	697,834	11.2
Total	$ 6,260,239	100.0%

(1) Included in the No Score information is The Talbots, Inc. credit card portfolio, whose accounts have yet to be converted to the Company's credit card processing system. The conversion is expected to be completed in the first

quarter of 2013.

Credit Card Portfolio Acquisitions

During the nine months ended September 30, 2012, the Company acquired the following credit card portfolios:

- March 2012 – Pier 1 Imports, for a total purchase price of $97.7 million, which consisted of $96.2 million of credit card receivables and $1.5 million of intangible assets;

- May 2012 – Premier Designs, Inc., for a total purchase price of $24.3 million, which consisted of $22.9 million of credit card receivables and $1.4 million of intangible assets;

- July 2012 – The Bon-Ton Stores, Inc., for a preliminary total purchase price of $494.6 million, which remains subject to customary purchase price adjustments and consists of $444.9 million of credit card receivables and $49.7 million of intangible assets; and

- August 2012 – The Talbots, Inc., for a preliminary total purchase price of $163.6 million, which remains subject to customary purchase price adjustments and consists of $136.5 million of credit card receivables and $27.1 million of intangible assets.

The credit card receivables and intangible assets associated with these portfolios are included in the September 30, 2012 unaudited condensed consolidated balance sheet.

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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 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 nine months ended September 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.

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

	September 30, 2012	December 31, 2011
	(In thousands)	
Total credit card receivables – restricted for securitization investors	$ 5,838,099	$ 4,886,168
Principal amount of credit card receivables – restricted for securitization investors, 90 days or more past due	$ 102,194	$ 94,981

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
	(In thousands)			
Net charge-offs of securitized principal	$ 61,441	$ 65,993	$ 184,886	$ 231,919

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:

	September 30, 2012			December 31, 2011		
	Cost	Unrealized	Unrealized	Cost	Unrealized	Unrealized

		Gains	Losses	Fair Value		Gains	Losses	Fair Value
				(In thousands)				
Cash and cash equivalents	$ 14,420	$ —	$ —	$ 14,420	$ 35,465	$ —	$ —	$ 35,465
Government bonds	5,166	82	—	5,248	4,948	152	—	5,100
Corporate bonds	464,745	11,337	(51)	476,031	468,894	7,416	(1,037)	475,273
Total	$ 484,331	$ 11,419	$ (51)	$ 495,699	$ 509,307	$ 7,568	$ (1,037)	$ 515,838

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

The following tables show the gross unrealized losses and fair value for those investments that were in an unrealized loss position as of September 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:

	September 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)					
Corporate bonds	$ —	$ —	$ 5,039	$ (51)	$ 5,039	$ (51)
Total	$ —	$ —	$ 5,039	$ (51)	$ 5,039	$ (51)

	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)					
Corporate bonds	$ 65,043	$ (444)	$ 18,124	$ (593)	$ 83,167	$ (1,037)
Total	$ 65,043	$ (444)	$ 18,124	$ (593)	$ 83,167	$ (1,037)

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 September 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 September 30, 2012 by contractual maturity are as follows:

	Amortized Cost	Estimated Fair Value
	(In thousands)	
Due in one year or less	$ 91,602	$ 91,935
Due after one year through five years	392,729	403,764
Total	$ 484,331	$ 495,699

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

5. INTANGIBLE ASSETS AND GOODWILL

Intangible Assets

Intangible assets consist of the following:

	September 30, 2012			
	Gross Assets	Accumulated Amortization	Net	Amortization Life and Method
		(In thousands)		
Finite Lived Assets				
Customer contracts and lists	$ 289,500	$ (140,589)	$ 148,911	3 - 12 years—straight line
Premium on purchased credit card portfolios	234,894	(98,574)	136,320	5 - 10 years—straight line, accelerated
Customer database	161,700	(97,825)	63,875	4 - 10 years—straight line
Collector database	71,153	(64,253)	6,900	30 years—15% declining balance
Tradenames	37,644	(9,148)	28,496	5 - 15 years—straight line
Purchased data lists	21,643	(15,395)	6,248	1 - 5 years—straight line, accelerated
Noncompete agreements	—	—	—	2 years—straight line
	$ 816,534	$ (425,784)	$ 390,750	
Indefinite Lived Assets				
Tradenames	12,350	—	12,350	Indefinite life
Total intangible assets	$ 828,884	$ (425,784)	$ 403,100	

	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	

With the credit card portfolio acquisitions made during the nine months ended September 30, 2012, the Company acquired $79.7 million of intangible assets consisting of $42.4 million of customer relationships being amortized over a weighted average life of 5.0 years and $37.3 million of marketing relationships being amortized over a weighted average life of 6.6 years. See Note 3, “Credit Card Receivables,” of the Notes to Unaudited Condensed Consolidated

Financial Statements for additional information related to the credit card portfolio acquisitions.

Goodwill

The changes in the carrying amount of goodwill for the nine months ended September 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	8,394	943	—	—	9,337
September 30, 2012	$ 250,091	$ 946,877	$ 261,732	$ —	$ 1,458,700

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

6. DEBT

Debt consists of the following:

Description	September 30, 2012	December 31, 2011	Maturity	Interest Rate
	(Dollars in thousands)			
Deposits:				
Certificates of deposit	$ 1,690,623	$ 1,353,775	Various - October 2012 – September 2019	0.20% to 5.25%
Money market deposits	145,029	—	On demand	0.01% to 0.23%
Total deposits	1,835,652	1,353,775		
Less: current portion	(984,798)	(642,567)		
Long-term portion	$ 850,854	$ 711,208		
Asset-backed securities debt – owed to securitization investors:				
Fixed rate asset-backed term note securities	$ 2,069,515	$ 1,562,815	Various - October 2012 – March 2019	1.68% to 7.00%
Floating rate asset-backed term note securities	588,150	703,500	Various - October 2012 – April 2013	(1)
Conduit asset-backed securities	857,451	993,972	Various - May 2013 – March 2014	1.23% to 1.76%
Total asset-backed securities – owed to securitization investors	3,515,116	3,260,287		
Less: current portion	(1,420,866)	(1,694,198)		
Long-term portion	$ 2,094,250	$ 1,566,089		
Long-term and other debt:				
2011 credit facility	$ —	$ 410,000	May 2016	—%
2011 term loan	891,666	782,594	May 2016 or May 2017	(2)
Senior notes due 2020	500,000	—	April 2020	6.38%
Convertible senior notes due 2013	753,999	711,480	August 2013	1.75%
Convertible senior notes due 2014	297,761	279,365	May 2014	4.75%
Capital lease obligations	19	35	July 2013	7.10%
Total long-term and other debt	2,443,445	2,183,474		
Less: current portion	(782,706)	(19,834)		
Long-term portion	$ 1,660,739	$ 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 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 5.64% at September 30, 2012.

(2) At September 30, 2012, the weighted average interest rate for the 2011 Term Loan was 2.22%.

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

Deposits

Beginning January 1, 2012, Comenity Bank and Comenity Capital Bank, subsidiaries of the Company, offered a demand deposit program through contractual arrangements with securities brokerage firms. As of September 30, 2012, Comenity Bank and Comenity Capital Bank had issued $145.0 million in money market deposits. Money market deposits are redeemable on demand by the customer and, as such, have no scheduled maturity date.

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, are 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.

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

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 September 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:

	September 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	(98,240)	(159,155)
Net carrying value of liability component	$ 1,051,760	$ 990,845
If-converted value of common stock	$ 2,485,284	$ 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 September 30, 2012, is a weighted average period of 1.1 years.

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

	Three Months Ended September 30,	Nine Months Ended September 30,

	2012	2011	2012	2011
	(In thousands, except percentages)			
Interest expense calculated on contractual interest rate	$ 7,619	$ 7,619	$ 22,856	$ 22,856
Amortization of discount on liability component	20,865	18,692	60,915	54,574
Total interest expense on convertible senior notes	$ 28,484	$ 26,311	$ 83,771	$ 77,430
Effective interest rate (annualized)	11.0%	11.0%	11.0%	11.0%

In the third quarter of 2012, the convertible senior notes were convertible at the option of the holder based on the condition that the common stock trading price exceeded 130% of the applicable conversion price. During the third quarter, a de minimis amount were surrendered for conversion and, in each case, either have been or will be settled in cash following the completion of the applicable cash settlement averaging period.

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

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 July 2012, $395.0 million of Class A Series 2009-B asset-backed term notes with a fixed interest rate of 3.79% matured.

In July 2012, World Financial Network Credit Card Master Note Trust issued $433.3 million of term asset-backed securities to investors. The offering consisted of $325.0 million of Class A Series 2012-B asset-backed term notes that have a fixed interest rate of 1.76% per year and mature in July 2017. In addition, the Company retained an aggregate of $108.3 million of subordinated classes of the term asset-backed notes which have been eliminated from the Company's unaudited condensed consolidated financial statements.

In July 2012, World Financial Network Credit Card Master Note Trust issued $266.7 million of term asset-backed securities to investors, which will mature in October 2018. The offering consisted of the following:

- $200.0 million of Class A Series 2012-C asset-backed notes with a fixed interest rate of 2.23% per year;
- $10.0 million of Class M Series 2012-C asset-backed notes with a fixed interest rate of 3.32% per year;
- $12.7 million of Class B Series 2012-C asset-backed notes with a fixed interest rate of 3.57% per year;
- $33.3 million of Class C Series 2012-C asset-backed notes with a fixed interest rate of 4.55% per year; and
- $10.7 million of Class D Series 2012-C asset-backed notes which were retained by the Company and have been eliminated from the Company's unaudited condensed consolidated financial statements.

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.

In September 2012, the Company renewed its $330.0 million 2009-VFC1 conduit facility under World Financial Network Credit Card Master Note Trust III, extending its maturity to September 27, 2013.

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 to manage its exposure to changes in interest rates for certain obligations.

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.”

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 September 30, 2012 and December 31, 2011 in the unaudited condensed consolidated balance sheets:

	September 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	$ 588,150	0.72	$ 703,500	1.37

	September 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	$ 5	Other assets	$ —
Interest rate contracts not designated as hedging instruments	Other current liabilities	$ 15,436	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 nine months ended September 30, 2012 and 2011 recognized in the unaudited condensed consolidated statements of income:

	2012		2011	
For the three months ended September 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	$ 7,488	Securitization funding costs	$ 8,543
For the nine months ended September 30,				
Interest rate contracts not designated as hedging instruments	Securitization funding costs	$ 22,672	Securitization funding costs	$ 23,146

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 September 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 September 30, 2012, these thresholds were not breached and no amounts were held as collateral by the Company.

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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 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	168,367	404,743	573,110
Revenue recognized	(151,492)	(458,324)	(609,816)
Other	—	366	366
Effects of foreign currency translation	13,393	30,601	43,994
September 30, 2012	$ 389,241	$ 844,849	$ 1,234,090
Amounts recognized in the unaudited condensed consolidated balance sheets:			
Current liabilities	$ 186,987	$ 844,849	$ 1,031,836
Non-current liabilities	$ 202,254	$ —	$ 202,254

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. The implementation of AIR MILES Cash did not have a material impact to the Company.

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 nine months ended September 30, 2012, the Company acquired a total of 536,241 shares of its common stock for $65.4 million. As of September 30, 2012, the Company has $334.6 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 nine months ended September 30, 2012 and 2011 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Cost of operations	$ 8,343	$ 7,762	$ 23,864	$ 19,672
General and administrative	4,076	4,519	13,741	12,799
Total	$ 12,419	$ 12,281	$ 37,605	$ 32,471

During the nine months ended September 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 nine months ended September 30, 2012, the Company awarded 108,418 service-based restricted stock units with a weighted average grant date fair value per share of $122.10 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.

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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:

	September 30, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In thousands)			
Financial assets				
Cash and cash equivalents	$ 766,317	$ 766,317	$ 216,213	$ 216,213
Trade receivables, net	287,643	287,643	300,895	300,895
Credit card receivables, net	6,130,773	6,130,773	5,197,690	5,197,690
Redemption settlement assets, restricted	495,699	495,699	515,838	515,838
Cash collateral, restricted	62,205	62,205	158,727	158,727
Other investment securities	72,185	72,185	26,772	26,772
Derivative financial instruments	5	5	—	—
Financial liabilities				
Accounts payable	236,891	236,891	149,812	149,812
Deposits	1,835,652	1,856,060	1,353,775	1,372,670
Asset-backed securities debt – owed to securitization investors	3,515,116	3,602,686	3,260,287	3,302,687
Long-term and other debt	2,443,445	3,934,937	2,183,474	3,071,661
Derivative financial instruments	15,436	15,436	38,103	38,103

Fair Value of Assets and Liabilities Held at September 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 for 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 for the same transaction.

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.

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

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 September 30, 2012 and December 31, 2011:

	Fair Value Measurements Using Inputs Considered as					
	Level 1		Level 2		Level 3	
	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011
	(In thousands)					
Government bonds(1)	$ —	$ —	$ 5,248	$ 5,100	$ —	$ —
Corporate bonds(1)	6,200	21,346	469,831	453,927	—	—
Cash collateral, restricted	—	—	—	—	62,205	158,727
Other investment securities(2)	49,094	3,043	23,091	23,729	—	—
Derivative financial instruments(3)	—	—	5	—	—	—
Total assets measured at fair value	$ 55,294	$ 24,389	$ 498,175	$ 482,756	$ 62,205	$ 158,727
Derivative financial instruments(3)	$ —	$ —	$ 15,436	$ 38,103	$ —	$ —
Total liabilities measured at fair value	$ —	$ —	$ 15,436	$ 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.

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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 September 30, 2012 and 2011:

	Cash Collateral, Restricted (In thousands)
June 30, 2012	$ 122,395
Total gains (realized or unrealized):	
Included in earnings	995
Purchases	1,287
Settlements	(62,472)
Transfers in or out of Level 3	—
September 30, 2012	$ 62,205
Gains for the period included in earnings related to assets still held at September 30, 2012	$ 995

	Cash Collateral, Restricted (In thousands)
December 31, 2011	$ 158,727
Total gains (realized or unrealized):	
Included in earnings	5,014
Purchases	1,287
Settlements	(102,823)
Transfers in or out of Level 3	—
September 30, 2012	$ 62,205
Gains for the period included in earnings related to assets still held at September 30, 2012	$ 5,014

	Cash Collateral, Restricted (In thousands)
June 30, 2011	$ 175,826
Total losses (realized or unrealized):	
Included in earnings	(311)
Purchases	11,656
Settlements	(29,457)
Transfers in or out of Level 3	—

September 30, 2011	$	157,714
Losses for the period included in earnings related to assets still held at September 30, 2011	$	(311)

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	147
Purchases	13,947
Settlements	(42,134)
Transfers in or out of Level 3	—
September 30, 2011	$ 157,714
Gains for the period included in earnings related to assets still held at September 30, 2011	$ 147

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 7 to 49 months, with a weighted average term of 21 months. The unobservable input used to calculate the fair value was the discount rate of 3.2%, 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 nine months ended September 30, 2012 and 2011, gains and losses 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 September 30, 2012:

		Fair Value Measurements at September 30, 2012		
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Cash and cash equivalents	$ 766,317	$ 766,317	$ —	$ —
Credit card receivables, net	6,130,773	—	—	6,130,773
Total assets	$ 6,897,090	$ 766,317	$ —	$ 6,130,773
Deposits	$ 1,856,060	$ —	$ 1,856,060	$ —
Asset-backed securities debt - owed to securitization investors	3,602,686	—	3,602,686	—
Long-term and other debt	3,934,937	—	3,934,937	—
Total liabilities	$ 9,393,683	$ —	$ 9,393,683	$ —

10. INCOME TAXES

For the three and nine months ended September 30, 2012, the Company utilized an effective tax rate of 37.1% and 37.8%, respectively, to calculate its provision for income taxes. For the three and nine months ended September 30, 2011, the Company utilized an effective tax rate of 38.7%, in each case, to calculate its provision for income taxes. In accordance with ASC 740-270, “Income Taxes — Interim Reporting,” the Company’s expected annual effective tax rate for calendar year 2012 based on all known variables is 38.1%.

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

11. SEGMENT INFORMATION

The Company operates in three reportable segments: LoyaltyOne, Epsilon and Private Label Services and Credit.

- LoyaltyOne includes the Company’s Canadian AIR MILES Reward Program;
- Epsilon provides integrated direct marketing solutions that combine database marketing technology and analytics with a broad range of direct marketing services; and
- Private Label Services and Credit provides risk management solutions, account origination, funding, transaction processing, customer care and collections services for the Company's private label retail credit card programs.

Effective December 31, 2011, interest expense, net was allocated to each of the respective segments. All prior year segment information has been restated to conform to the current year presentation.

Additionally, corporate and all other immaterial businesses are reported collectively as an “all other” category labeled “Corporate/Other.” Income taxes are not allocated to the segments in the computation of segment operating profit for internal evaluation purposes and have also been included in “Corporate/Other.” Total assets are not allocated to the segments.

Three Months Ended September 30, 2012	LoyaltyOne	Epsilon	Private Label Services and Credit	Corporate/ Other	Eliminations	Total
			(In thousands)			
Revenues	$ 215,654	$ 240,820	$ 455,939	$ 80	$ (1,001)	$ 911,492
Adjusted EBITDA(1)	60,334	64,244	214,476	(20,432)	—	318,622
Stock compensation expense	2,408	3,549	2,386	4,076	—	12,419
Depreciation and amortization	4,834	24,821	11,267	810	—	41,732
Operating income (loss)	53,092	35,874	200,823	(25,318)	—	264,471
Interest expense, net	(533)	(10)	29,217	45,691	—	74,365
Income (loss) before income taxes	53,625	35,884	171,606	(71,009)	—	190,106

Three Months Ended September 30, 2011	LoyaltyOne	Epsilon	Private Label Services and Credit	Corporate/ Other	Eliminations	Total
			(In thousands)			
Revenues	$ 209,634	$ 248,405	$ 389,051	$ 211	$ (2,457)	$ 844,844
Adjusted EBITDA(1)	59,920	58,528	187,712	(21,513)	(1,454)	283,193
Stock compensation expense	2,047	3,617	2,098	4,519	—	12,281
Depreciation and amortization	5,130	24,899	8,950	4,254	—	43,233
Operating income (loss)	52,743	30,012	176,664	(30,286)	(1,454)	227,679
Interest expense, net	(151)	(19)	35,708	40,272	(1,454)	74,356
Income (loss) before income taxes	52,894	30,031	140,956	(70,558)	—	153,323

Nine Months Ended September 30, 2012	LoyaltyOne	Epsilon	Private Label Services and Credit	Corporate/ Other	Eliminations	Total
			(In thousands)			
Revenues	$ 703,013	$ 704,228	$ 1,265,782	$ 372	$ (3,849)	$ 2,669,546
Adjusted EBITDA(1)	179,300	152,845	644,956	(62,009)	—	915,092
Stock compensation expense	6,777	10,599	6,488	13,741	—	37,605
Depreciation and amortization	14,920	74,043	28,614	2,277	—	119,854
Operating income (loss)	157,603	68,203	609,854	(78,027)	—	757,633
Interest expense, net	(895)	(47)	83,537	130,489	—	213,084
Income (loss) before income taxes	158,498	68,250	526,317	(208,516)	—	544,549

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

Nine Months Ended September 30, 2011	LoyaltyOne	Epsilon	Private Label Services and Credit	Corporate/ Other	Eliminations	Total
			(In thousands)			
Revenues	$ 630,470	$ 592,545	$ 1,108,679	$ 924	$ (6,880)	$ 2,325,738
Adjusted EBITDA(1)	171,114	131,518	534,713	(54,483)	(4,362)	778,500
Stock compensation expense	5,379	8,765	5,528	12,799	—	32,471
Depreciation and amortization	15,564	65,519	26,818	6,750	—	114,651
Operating income (loss)	150,171	57,234	502,367	(74,032)	(4,362)	631,378
Interest expense, net	(223)	(55)	108,372	120,877	(4,362)	224,609
Income (loss) before income taxes	150,394	57,289	393,995	(194,909)	—	406,769

(1) Adjusted EBITDA is a non-GAAP financial measure equal to net income, the most directly comparable GAAP financial measure, plus stock compensation expense, provision for income taxes, interest expense, net, depreciation and other amortization and amortization of purchased intangibles. Adjusted EBITDA is presented in accordance with ASC 280, "Segment Reporting," as it is the primary performance metric utilized to access performance of the segment.

12. DISCONTINUED OPERATIONS

In November 2009, the Company terminated operations of its credit program for web and catalog retailer VENUE. This has been treated as a discontinued operation under ASC 205-20, "Presentation of Financial Statements — Discontinued Operations." The underlying assets of the discontinued operation for the periods presented in the unaudited condensed consolidated balance sheets are as follows:

	September 30, 2012	December 31, 2011
	(In thousands)	
Assets:		
Credit card receivables, net	$ —	$ 2,439
Assets of discontinued operations	$ —	$ 2,439

13. SUBSEQUENT EVENT

In October 2012, World Financial Network Credit Card Master Note Trust issued $466.7 million of term asset-backed securities to investors, which will mature in June 2019. The offering consisted of the following:

- $350.0 million of Class A Series 2012-D asset-backed notes with a fixed interest rate of 2.15% per year;
- $17.5 million of Class M Series 2012-D asset-backed notes with a fixed interest rate of 3.09% per year;
- $22.2 million of Class B Series 2012-D asset-backed notes with a fixed interest rate of 3.34% per year; and
-

$77.0 million of Class C and Class D Series 2012-D asset-backed notes which were retained by the Company and have been eliminated from the Company's unaudited condensed consolidated financial statements.

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ItemManagement's Discussion and Analysis of Financial Condition and Results of Operations.
2.

The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and related notes thereto presented in this quarterly report and the consolidated financial statements and related notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the Securities and Exchange Commission, or SEC, on February 27, 2012.

Year in Review Highlights

For the nine months ended September 30, 2012, revenue increased 14.8% to $2.7 billion and adjusted EBITDA increased 17.5% to $915.1 million as compared to the prior year period. See below for discussion of operating results for each of our three segments.

LoyaltyOne®

Revenue increased 11.5% to $703.0 million and adjusted EBITDA increased 4.8% to $179.3 million for the nine months ended September 30, 2012 as compared to the same period in 2011.

The LoyaltyOne segment generates revenue primarily from our coalition loyalty program in Canada and, as such, the segment can be impacted by changes in the foreign currency exchange rate between the U.S. dollar and the Canadian dollar. A weaker Canadian dollar negatively impacted the results of operations for the nine months ended September 30, 2012, as the average foreign currency exchange rate was $1.00 as compared to $1.02 in the prior year period, which lowered revenue and adjusted EBITDA by $17.4 million and $4.9 million, respectively.

AIR MILES® reward miles redeemed during the nine months ended September 30, 2012 increased 18.1% compared to the same period in the prior year due to higher collector redemptions. As expected, the introduction of a five-year expiry policy for the AIR MILES Reward Program in December 2011 stimulated redemption activity during the first half of 2012. Redemption activity moderated during the third quarter of 2012 and we believe it will continue to moderate for the remainder of 2012.

The number of AIR MILES reward miles issued impacts the number of future AIR MILES reward miles available to be redeemed. This can also impact our future revenue recognized with respect to the number of AIR MILES reward miles redeemed and the amount of breakage for those AIR MILES reward miles expected to go unredeemed. AIR MILES reward miles issued during the nine months ended September 30, 2012 increased 5.8% compared to the same period in the prior year due to positive growth in consumer credit card spending and increased promotional activity in the gas and grocer sectors. We expect mid-single digit year-over-year issuance growth for the remainder of 2012.

In December 2011, we introduced a new program option to issue AIR MILES reward miles called 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. We launched our fifth participating redemption sponsor in June 2012 and currently have approximately 850,000 collectors in the program. AIR MILES reward mile issuance in AIR MILES Cash continues to meet our expectations; however, such issuances are not a material part of total AIR MILES reward mile issuances. We plan to expand the program to as many as seven sponsors by the end of 2012, with a focus on high-frequency retail sponsors. The timing of the expansion is somewhat dependent on our sponsors as it requires point-of-sale programming changes on their part. The implementation of AIR MILES Cash did not have a material impact for the nine months ended September 30, 2012 nor is it expected to have a material impact for the remainder of 2012.

During the nine months ended September 30, 2012, LoyaltyOne announced a new agreement with Michaels of Canada to issue AIR MILES reward miles across multiple Canadian provinces. We also announced a new multi-year agreement with Toys “R” Us, Canada to issue AIR MILES reward miles in all Toys “R” Us and Babies “R” Us locations across Canada.

Further, CBSM-Companhia Brasileira De Servicos De Marketing, operator of Brazil’s dotz coalition loyalty program, or dotz, in which we have a 37% ownership, continues to roll-out its coalition loyalty program into additional regions. We announced the rollout of dotz into the Sao Paulo State interior in April 2012 and into Fortaleza in July 2012. We anticipate that dotz will enter into two additional Brazilian markets by the end of 2012. In June 2012, we acquired an additional 8% ownership interest in Direxions Global Solutions Private Ltd., a leading loyalty, CRM solutions and data analytics provider in India, bringing our total ownership interest to 34%. We expect to incur losses of approximately $15 million associated with these international initiatives in 2012.

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Epsilon®

Revenue increased 18.8% to $704.2 million and adjusted EBITDA increased 16.2% to $152.8 million for the nine months ended September 30, 2012 as compared to the same period in 2011. These increases were driven by the acquisition of Aspen Marketing Holdings, Inc., or Aspen, in May 2011 as well as growth in marketing technology with the expansion of services to existing clients and new client signings for the nine months ended September 30, 2012. In the third quarter of 2012, Epsilon's revenue decreased 3.1% due to weakness in the pharmaceutical vertical and a decline in the direct marketing of customer acquisition production programs from one of our top clients. We expect continued softness in the pharmaceutical vertical in the fourth quarter and anticipate that revenue will be flat. However, we expect continued double-digit growth in adjusted EBITDA in the fourth quarter, with expansion in our adjusted EBITDA margin.

During the nine months ended September 30, 2012, Epsilon announced a new multi-year agreement with Guideposts, a leading publisher of inspirational magazines and digital content, to provide comprehensive database marketing services. Additionally, Epsilon announced the expansion of its relationship with Jaguar Land Rover for global customer relationship management and marketing services. Epsilon announced a new multi-year agreement with Northwestern Mutual Life Insurance Company to manage and deploy their permission-based email newsletters and email marketing initiatives. Epsilon also announced that The Container Store, a leading retailer of storage and organization products, has enlisted Epsilon for comprehensive data and database marketing services. Epsilon also announced a new multi-year agreement with Canadian Tire Corporation, one of Canada's largest general and sporting goods retailers, to host the electronic platform for Canadian Tire Corporation's customer rewards program.

In addition, Epsilon also announced a multi-year renewal agreement with Brookstone, a nationwide specialty retailer of consumer products, to continue to host and manage Brookstone's customer database and continue to provide list processing and list rental fulfillment. Patagonia, a leading designer of sport-related apparel and accessories, has renewed its long-standing partnership with Epsilon where Epsilon will continue to provide comprehensive database marketing services.

Private Label Services and Credit

Revenue increased 14.2% to $1.3 billion and adjusted EBITDA increased 20.6% to $645.0 million for the nine months ended September 30, 2012 as compared to the same period in 2011.

For the nine months ended September 30, 2012, average credit card receivables increased 15.2% as compared to the same period in the prior year as a result of increased credit sales and stabilized payment rates. Credit sales increased 26.2% for the nine months ended September 30, 2012 due to strong core credit cardholder spending, recent new client signings and recent credit card portfolio acquisitions.

Delinquency rates improved to 4.2% of principal receivables at September 30, 2012, down from 4.9% at September 30, 2011. The principal net charge-off rate was 4.8% for the nine months ended September 30, 2012 as compared to 7.0% in the prior year period.

In March 2012, we acquired the existing credit card portfolio of Pier 1 Imports for a total purchase price of $97.7 million. In May 2012, we acquired the existing private label credit card portfolio of Premier Designs, Inc for a total purchase price of $24.3 million. In July 2012, we purchased the existing private label credit card portfolio of The Bon-Ton Stores, Inc. for a preliminary purchase price of $494.6 million, which is subject to customary purchase price adjustments. We do not expect the acquisition of the credit card portfolio to provide any accretion to earnings per share in 2012, but it is expected to be accretive to 2013. In September 2012, we acquired the existing private label credit card portfolio of The Talbots, Inc. for a preliminary purchase price of $163.6 million, which is subject to customary purchase price adjustments.

During the nine months ended September 30, 2012, we also announced the signing of multi-year renewal agreements to continue providing private label credit card services to Samuels Jewelers, Inc., a leading retailer of diamonds and fine jewelry; Stage Stores, Inc., a leading retailer of brand name apparel; and Gordmans Stores, Inc., a national department store retailer. We also signed long-term extension agreements with Reed Jewelers, a leading multichannel jewelry retailer; The Buckle, Inc., a leading multichannel retailer of private label and brand name apparel, accessories and footwear; Gardner-White Furniture, a Michigan-based multichannel retailer of home furnishings and electronics; and Little Switzerland, Inc., a leading multi-channel retailer of duty-free merchandise, providing for the continuation of credit, loyalty and multi-channel marketing services.

Additionally, we signed new multi-year agreements to provide private label credit card services for Westgate Resorts, a premier operator of time share and destination accommodations; True Value, a leading cooperative of retail locations offering home improvement, hardware products and garden supplies; and Ideal Image, a leader among laser hair removal centers. We also signed a new multi-year agreement to create and manage a new private label credit card program for Blue Nile, Inc., a leading online retailer of diamonds and fine jewelry.

Effective October 1, 2012, our subsidiaries, World Financial Network Bank and World Financial Capital Bank, changed their names to Comenity Bank and Comenity Capital Bank, respectively.

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Critical Accounting Policies and Estimates

There have been no material changes to our critical accounting policies and estimates from the information provided in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," included in our Annual Report filed on Form 10-K for the fiscal year ended December 31, 2011.

Recent Accounting Pronouncements

See "Recently Issued Accounting Standards" under Note 1, "Summary of Significant Accounting Policies," of the Notes to Unaudited Condensed Consolidated Financial Statements for a discussion of certain accounting standards that have been issued during 2012.

Use of Non-GAAP Financial Measures

Adjusted EBITDA is a non-GAAP financial measure equal to net income, the most directly comparable financial measure based on accounting principles generally accepted in the United States of America, or GAAP, plus stock compensation expense, provision for income taxes, interest expense, net, depreciation and other amortization and amortization of purchased intangibles.

We use adjusted EBITDA as an integral part of our internal reporting to measure the performance of our reportable segments and to evaluate the performance of our senior management. Adjusted EBITDA is considered an important indicator of the operational strength of our businesses. Adjusted EBITDA eliminates the uneven effect across all business segments of considerable amounts of non-cash depreciation of tangible assets and amortization of certain intangible assets that were recognized in business combinations. A limitation of this measure, however, is that it does not reflect the periodic costs of certain capitalized tangible and intangible assets used in generating revenues in our businesses. Management evaluates the costs of such tangible and intangible assets, as well as asset sales through other financial measures, such as capital expenditures, investment spending and return on capital and therefore the effects are excluded from adjusted EBITDA. Adjusted EBITDA also eliminates the non-cash effect of stock compensation expense. Stock compensation expense is not included in the measurement of segment adjusted EBITDA provided to the chief operating decision maker for purposes of assessing segment performance and decision making with respect to resource allocations. Therefore, we believe that adjusted EBITDA provides useful information to our investors regarding our performance and overall results of operations. Adjusted EBITDA is not intended to be a performance measure that should be regarded as an alternative to, or more meaningful than, either operating income or net income as an indicator of operating performance or to cash flows from operating activities as a measure of liquidity. In addition, adjusted EBITDA is not intended to represent funds available for dividends, reinvestment or other discretionary uses, and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with GAAP.

The adjusted EBITDA measure presented in this Quarterly Report on Form 10-Q may not be comparable to similarly titled measures presented by other companies, and may not be identical to corresponding measures used in our various agreements.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Net income	$ 119,545	$ 93,981	$ 338,595	$ 249,380
Stock compensation expense	12,419	12,281	37,605	32,471
Provision for income taxes	70,561	59,342	205,954	157,389

Interest expense, net	74,365	74,356	213,084	224,609
Depreciation and other amortization	18,745	20,304	54,845	53,908
Amortization of purchased intangibles	22,987	22,929	65,009	60,743
Adjusted EBITDA	$ 318,622	$ 283,193	$ 915,092	$ 778,500

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Results of Operations

Three months ended September 30, 2012 compared to the three months ended September 30, 2011

	Three Months Ended September 30,		Change	
	2012	2011	$	%
	(In thousands, except percentages)			
Revenue:				
LoyaltyOne	$ 215,654	$ 209,634	$ 6,020	2.9%
Epsilon	240,820	248,405	(7,585)	(3.1)
Private Label Services and Credit	455,939	389,051	66,888	17.2
Corporate/Other	80	211	(131)	(62.1)
Eliminations	(1,001)	(2,457)	1,456	nm*
Total	$ 911,492	$ 844,844	$ 66,648	7.9%
Adjusted EBITDA(1):				
LoyaltyOne	$ 60,334	$ 59,920	$ 414	0.7%
Epsilon	64,244	58,528	5,716	9.8
Private Label Services and Credit	214,476	187,712	26,764	14.3
Corporate/Other	(20,432)	(21,513)	1,081	(5.0)
Eliminations	—	(1,454)	1,454	nm*
Total	$ 318,622	$ 283,193	$ 35,429	12.5%
Stock compensation expense:				
LoyaltyOne	$ 2,408	$ 2,047	$ 361	17.6%
Epsilon	3,549	3,617	(68)	(1.9)
Private Label Services and Credit	2,386	2,098	288	13.7
Corporate/Other	4,076	4,519	(443)	(9.8)
Total	$ 12,419	$ 12,281	$ 138	1.1%
Depreciation and amortization:				
LoyaltyOne	$ 4,834	$ 5,130	$ (296)	(5.8)%
Epsilon	24,821	24,899	(78)	(0.3)
Private Label Services and Credit	11,267	8,950	2,317	25.9
Corporate/Other	810	4,254	(3,444)	(81.0)
Total	$ 41,732	$ 43,233	$ (1,501)	(3.5)%
Operating income:				
LoyaltyOne	$ 53,092	$ 52,743	$ 349	0.7%
Epsilon	35,874	30,012	5,862	19.5
Private Label Services and Credit	200,823	176,664	24,159	13.7
Corporate/Other	(25,318)	(30,286)	4,968	(16.4)
Eliminations	—	(1,454)	1,454	nm*
Total	$ 264,471	$ 227,679	$ 36,792	16.2%
Adjusted EBITDA margin(2):				
LoyaltyOne	28.0%	28.6%	(0.6)%	
Epsilon	26.7	23.6	3.1	
Private Label Services and Credit	47.0	48.2	(1.2)	
Total	35.0%	33.5%	1.5%	
Segment operating data:				
Private label statements generated	43,050	35,286	7,764	22.0%
Credit sales	$ 3,149,420	$ 2,245,718	$	