ALLIANCE DATA SYSTEMS CORP
Form 10-Q
August 07, 2018
Index

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from to

Commission File Number: 001-15749

ALLIANCE DATA SYSTEMS CORPORATION

(Exact name of registrant as specified in its charter)

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

7500 Dallas Parkway, Suite 700

Plano, Texas 75024

(Address of principal executive office, including zip code)

(214) 494-3000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Emerging growth company
Smaller reporting company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of July 25, 2018, 54,943,591 shares of common stock were outstanding.

Index

ALLIANCE DATA SYSTEMS CORPORATION

INDEX

		Page Number
	Part I FINANCIAL INFORMATION	
Item 1.	Financial Statements (unaudited)	
	Condensed Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017	3
	Condensed Consolidated Statements of Income for the three and six months ended June 30, 2018 and 2017	4
	Condensed Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2018 and 2017	5
	Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2018 and 2017	6
	Notes to Condensed Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	38
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	48
Item 4.	Controls and Procedures	48
	Part II OTHER INFORMATION	
Item 1.	Legal Proceedings	49
Item 1A.	Risk Factors	49
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	49
Item 3.	Defaults Upon Senior Securities	49
Item 4.	Mine Safety Disclosures	49
Item 5.	Other Information	49
Item 6.	Exhibits	50
SIGNATURES		52

Index

PART I

Item 1. Financial Statements.

ALLIANCE DATA SYSTEMS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2018	December 31, 2017
	(In millions, except per share amounts)	
ASSETS		
Cash and cash equivalents	$ 3,449.2	$ 4,190.0
Accounts receivable, net, less allowance for doubtful accounts ($5.7 and $6.7 at June 30, 2018 and December 31, 2017 respectively)	691.6	822.3
Credit card and loan receivables:		
Credit card receivables – restricted for securitization investors	13,524.9	14,293.9
Other credit card and loan receivables	4,460.0	4,319.9
Total credit card and loan receivables	17,984.9	18,613.8
Allowance for loan loss	(1,189.0)	(1,119.3)
Credit card and loan receivables, net	16,795.9	17,494.5
Credit card and loan receivables held for sale	984.2	1,026.3
Inventories, net	233.2	234.1
Other current assets	352.6	348.9
Redemption settlement assets, restricted	574.8	589.5
Total current assets	23,081.5	24,705.6
Property and equipment, net	620.9	613.9
Deferred tax asset, net	82.6	28.1
Intangible assets, net	667.8	800.6
Goodwill	3,857.8	3,880.1
Other non-current assets	640.3	656.5
Total assets	$ 28,950.9	$ 30,684.8
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	$ 532.0	$ 651.2
Accrued expenses	395.4	442.8
Current portion of deposits	6,160.3	6,366.2
Current portion of non-recourse borrowings of consolidated securitization entities	2,477.3	1,339.9
Current portion of long-term and other debt	123.0	131.3
Other current liabilities	291.8	368.7
Deferred revenue	788.9	846.6
Total current liabilities	10,768.7	10,146.7
Deferred revenue	112.0	120.3
Deferred tax liability, net	189.1	211.2
Deposits	4,399.0	4,564.7
Non-recourse borrowings of consolidated securitization entities	5,295.9	7,467.4
Long-term and other debt	5,667.5	5,948.3
Other liabilities	399.4	370.9

Total liabilities		26,831.6		28,829.5
Commitments and contingencies				
Stockholders' equity:				
Common stock, $0.01 par value; authorized, 200.0 shares; issued, 112.9 shares and 112.8 shares at June 30, 2018 and December 31, 2017, respectively		1.1		1.1
Additional paid-in capital		3,132.7		3,099.8
Treasury stock, at cost, 57.9 shares and 57.4 shares at June 30, 2018 and December 31, 2017, respectively		(5,371.7)		(5,272.5)
Retained earnings		4,493.6		4,167.1
Accumulated other comprehensive loss		(136.4)		(140.2)
Total stockholders' equity		2,119.3		1,855.3
Total liabilities and stockholders' equity	$	28,950.9	$	30,684.8

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In millions, except per share amounts)			
Revenues				
Services	$ 609.5	$ 626.5	$ 1,204.6	$ 1,238.1
Redemption, net	147.5	184.5	279.4	435.3
Finance charges, net	1,146.9	1,010.8	2,304.1	2,027.4
Total revenue	1,903.9	1,821.8	3,788.1	3,700.8
Operating expenses				
Cost of operations (exclusive of depreciation and amortization disclosed separately below)	1,001.6	1,014.4	2,015.5	2,056.5
Provision for loan loss	311.9	288.1	649.6	603.2
General and administrative	48.1	42.4	81.2	87.0
Depreciation and other amortization	48.6	45.2	96.3	89.9
Amortization of purchased intangibles	73.4	80.3	147.4	160.4
Total operating expenses	1,483.6	1,470.4	2,990.0	2,997.0
Operating income	420.3	351.4	798.1	703.8
Interest expense				
Securitization funding costs	55.2	36.6	107.3	71.8
Interest expense on deposits	36.8	28.6	72.3	54.6
Interest expense on long-term and other debt, net	73.7	72.3	145.3	136.3
Total interest expense, net	165.7	137.5	324.9	262.7
Income before income taxes	254.6	213.9	473.2	441.1
Provision for income taxes	36.8	76.2	91.4	157.0
Net income	$ 217.8	$ 137.7	$ 381.8	$ 284.1
Net income per share:				
Basic (Note 3)	$ 3.94	$ 2.48	$ 6.90	$ 5.07
Diluted (Note 3)	$ 3.93	$ 2.47	$ 6.87	$ 5.05
Weighted average shares:				
Basic (Note 3)	55.2	55.6	55.3	56.0
Diluted (Note 3)	55.4	55.8	55.5	56.3
Dividends declared per share:	$ 0.57	$ 0.52	$ 1.14	$ 1.04

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In millions)			
Net income	$ 217.8	$ 137.7	$ 381.8	$ 284.1
Other comprehensive income:				
Unrealized loss on securities available-for-sale	(2.3)	(2.7)	(5.3)	(2.0)
Tax benefit (expense)	0.3	(0.1)	1.3	(0.1)
Unrealized loss on securities available-for-sale, net of tax	(2.0)	(2.8)	(4.0)	(2.1)
Unrealized gain (loss) on cash flow hedges	1.8	(0.8)	1.7	(1.2)
Tax benefit (expense)	(0.4)	0.2	(0.4)	0.3
Unrealized gain (loss) on cash flow hedges, net of tax	1.4	(0.6)	1.3	(0.9)
Unrealized gain (loss) on net investment hedges	40.8	(38.6)	25.4	(43.7)
Tax benefit (expense)	(9.8)	14.8	(6.1)	16.3
Unrealized gain (loss) on net investment hedges, net of tax	31.0	(23.8)	19.3	(27.4)
Foreign currency translation adjustments	(30.3)	34.5	(12.8)	39.5
Other comprehensive income, net of tax	0.1	7.3	3.8	9.1
Total comprehensive income, net of tax	$ 217.9	$ 145.0	$ 385.6	$ 293.2

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2018	2017
	(In millions)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 381.8	$ 284.1
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	243.7	250.3
Deferred income taxes	(82.0)	(61.0)
Provision for loan loss	649.6	603.2
Non-cash stock compensation	46.3	45.2
Amortization of deferred financing costs	25.5	21.2
Change in deferred revenue	(26.0)	(28.4)
Change in other operating assets and liabilities	(61.1)	(162.7)
Originations of credit card and loan receivables held for sale	(4,743.4)	(3,923.1)
Sales of credit card and loan receivables held for sale	4,791.9	3,920.7
Other	95.5	73.1
Net cash provided by operating activities	1,321.8	1,022.6
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in redemption settlement assets	(39.7)	(181.7)
Change in credit card and loan receivables	(121.2)	(286.4)
Proceeds from sale of credit card portfolio	55.6	—
Capital expenditures	(98.5)	(116.8)
Purchases of other investments	(50.1)	(4.9)
Maturities/sales of other investments	10.6	33.0
Other	7.1	(4.2)
Net cash used in investing activities	(236.2)	(561.0)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings under debt agreements	2,399.1	5,856.9
Repayments of borrowings	(2,678.5)	(5,103.8)
Non-recourse borrowings of consolidated securitization entities	1,475.0	1,465.0
Repayments/maturities of non-recourse borrowings of consolidated securitization entities	(2,510.0)	(1,860.0)
Net (decrease) increase in deposits	(373.2)	332.1
Payment of deferred financing costs	(7.8)	(44.1)
Dividends paid	(63.3)	(58.0)
Purchase of treasury shares	(94.5)	(499.9)
Other	(15.8)	(15.1)
Net cash (used in) provided by financing activities	(1,869.0)	73.1
Effect of exchange rate changes on cash, cash equivalents and restricted cash	(4.1)	3.8
Change in cash, cash equivalents and restricted cash	(787.5)	538.5
Cash, cash equivalents and restricted cash at beginning of period	4,314.7	1,968.5

Cash, cash equivalents and restricted cash at end of period	$ 3,527.2	$ 2,507.0
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	$ 347.5	$ 251.1
Income taxes paid, net	$ 120.6	$ 181.9

See accompanying notes to unaudited condensed consolidated financial statements.

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited condensed consolidated financial statements included herein have been prepared by Alliance Data Systems Corporation ("ADSC" or, including its consolidated subsidiaries and variable interest entities ("VIEs"), the "Company"), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on February 27, 2018.

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

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

For purposes of comparability, certain prior period amounts have been reclassified to conform to the current year presentation in accordance with GAAP. Specifically, certain statement of cash flow reclassifications were made for the adoption of Accounting Standards Update ("ASU") 2016-18, "Restricted Cash." The following table provides a reconciliation of cash and cash equivalents to the total of the amounts reported in the unaudited condensed consolidated statements of cash flows:

	June 30, 2018	June 30, 2017
	(In millions)	
Cash and cash equivalents	$ 3,449.2	$ 1,945.9
Restricted cash included within other current assets (1)	33.8	473.9
Restricted cash included within redemption settlement assets, restricted (2)	44.2	87.2
Total cash, cash equivalents and restricted cash	$ 3,527.2	$ 2,507.0

(1) Includes $433.8 million in principal accumulation at June 30, 2017 for the repayment of non-recourse borrowings of consolidated securitized debt that matured in July 2017.

(2) See Note 8, "Redemption Settlement Assets," for additional information regarding nature of restrictions.

Recently Issued Accounting Standards

In February 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2016-02, "Leases (Topic 842)," that replaces existing lease guidance. The new standard is intended to provide enhanced transparency and comparability by requiring lessees to record right-of-use assets and corresponding lease liabilities on the balance sheet. The new guidance will continue to classify leases as either finance or operating, with classification affecting the pattern of expense recognition in the statements of income. ASU 2016-02 is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption and various optional practical expedients permitted. In July 2018, the FASB issued ASU 2018-11, "Leases (Topic 842): Targeted Improvements" that provides transition relief by removing certain comparative period requirements and recognizing a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption, which is January 1, 2019 for the Company. The new standard may be applied using this additional transition method or a modified retrospective approach. The Company is evaluating the impact that adoption of ASU 2016-02 will have on its consolidated financial statements, but expects an increase in assets and liabilities on its consolidated balance sheets at adoption for the recording of right-of-use assets and corresponding

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

lease liabilities. The Company continues to assess the impact of adoption of the new standard on its existing policies, processes, systems and controls in conjunction with its review of existing lease agreements.

In June 2016, the FASB issued ASU 2016-13, "Measurement of Credit Losses on Financial Instruments." ASU 2016-13 requires entities to utilize a financial instrument impairment model to establish an allowance based on expected losses over the life of the exposure rather than a model based on an incurred loss approach. ASU 2016-13 also expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the allowance. In addition, ASU 2016-13 modifies the impairment model for available-for-sale debt securities and provides for a simplified accounting model for purchased financial assets with credit deterioration since their origination. ASU 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted beginning after December 15, 2018. The Company is evaluating the impact that adoption of ASU 2016-13 will have on its consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, "Targeted Improvements to Accounting for Hedging Activities." ASU 2017-12 expands and refines the hedge accounting model for both financial and non-financial risk components, aligns the recognition and presentation of the effects of hedging instruments and hedged items in the financial statements, and makes certain targeted improvements to simplify the application of hedge accounting guidance related to the assessment of hedge effectiveness. ASU 2017-12 is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. The Company is evaluating the impact that adoption of ASU 2017-12 will have on its consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, "Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." ASU 2018-02 allows for reclassification of stranded tax effects on items resulting from the change in the corporate tax rate as a result of H.R. 1, originally known as the Tax Cuts and Jobs Act of 2017, from accumulated other comprehensive income to retained earnings. Tax effects unrelated to H.R. 1 are permitted to be released from accumulated other comprehensive income using either the specific identification approach or the portfolio approach, based on the nature of the underlying item. ASU 2018-02 is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. The Company is evaluating the impact that adoption of ASU 2018-02 will have on its consolidated financial statements.

Recently Adopted Accounting Standards

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers," Accounting Standards Codification ("ASC") 606, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. Companies may adopt ASC 606 using a full retrospective or modified retrospective method.

During 2017, the Company completed its evaluation of ASC 606, including the impact on its processes and controls, and differences in the timing and/or method of revenue recognition. As a result, the Company identified changes to and modified certain of its accounting policies and practices. Although there were no significant changes to the Company's accounting systems or controls upon adoption of ASC 606, the Company modified certain of its existing

controls to incorporate the revisions made to its accounting policies and practices.

The Company adopted the standard on January 1, 2018 using the modified retrospective method. The Company's adoption of this standard did not have a material impact on its consolidated results of operations or cash flows. ASC 606 does not apply to financial instruments and other contractual rights or obligations (for example, interest income and late fees from credit card and loan receivables), and therefore, the Company's finance charges, net were not affected by the adoption of the standard. Most revenue streams are recorded consistently under both ASC 605, "Revenue Recognition" and the new standard; however, the Company noted the following impacts:

- Upon the adoption of ASC 606, revenue associated with a database build was changed from recognizing revenue over the expected contract term upon client acceptance to over the build period in which the database is completed, because the Company's performance does not create an asset with an alternative use and the Company has an enforceable right to payment for performance completed to date. The cumulative effect of the changes made to the consolidated January 1, 2018 balance sheet for the adoption of ASC 606 resulted in an

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

increase in unbilled accounts receivable and accrued expenses, a reduction in deferred costs and deferred revenue and a net increase in retained earnings as follows:

Consolidated Balance Sheet	Balance at December 31, 2017	Adjustments due to ASC 606	Balance at January 1, 2018
		(In millions)	
Accounts receivable, net	$ 822.3	$ 22.4	$ 844.7
Other current assets	348.9	(16.6)	332.3
Other non-current assets	656.5	(20.9)	635.6
Total Assets:	1,827.7	(15.1)	1,812.6
Accrued expenses	442.8	3.2	446.0
Other current liabilities	368.7	(14.3)	354.4
Other liabilities	370.9	(13.6)	357.3
Total Liabilities:	1,182.4	(24.7)	1,157.7
Retained earnings	4,167.1	9.6	4,176.7

· Further, ASC 606 impacted the presentation of revenue within the Company’s coalition loyalty program. Upon the adoption of ASC 606, for the fulfillment of certain rewards where the AIR MILES® Reward Program does not control the goods or services before they are transferred to the collector, revenue is recorded on a net basis.

· ASC 606 also requires expanded disclosure regarding the nature, timing, and uncertainty of revenue transactions. See Note 2, “Revenue,” for the Company’s ASC 606 disclosures.

In January 2016, the FASB issued ASU 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities.” ASU 2016-01 requires that equity investments be measured at fair value with changes in fair value recognized in net income. For equity investments without readily determinable fair values, entities have the option to either measure these investments at fair value or at cost adjusted for changes in observable prices minus impairment. Additionally, ASU 2016-01 requires entities that elect the fair value option for financial liabilities to recognize changes in fair value related to instrument-specific credit risk in other comprehensive income. Finally, entities must assess valuation allowances for deferred tax assets related to available-for-sale debt securities in combination with their other deferred tax assets. ASU 2016-01 is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The Company adopted this standard on January 1, 2018, resulting in a cumulative-effect adjustment of $1.5 million that was reclassified from accumulated other comprehensive loss to

retained earnings on the consolidated January 1, 2018 balance sheet.

In August 2016, the FASB issued ASU 2016-15, “Classification of Certain Cash Receipts and Cash Payments.” ASU 2016-15 makes eight targeted changes to how certain cash receipts and cash payments are presented and classified in the statement of cash flows. ASU 2016-15 is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The Company’s adoption of this standard on January 1, 2018 did not have a material impact on its consolidated statements of cash flows.

In November 2016, the FASB issued ASU 2016-18, “Restricted Cash.” ASU 2016-18 requires entities to show the changes in the total of cash, cash equivalents, restricted cash and restricted cash equivalents in the statement of cash flows. ASU 2016-18 is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The Company adopted this standard on January 1, 2018. The effect of the adoption of the standard was to include restricted cash and restricted cash equivalents at the beginning-of-period and end-of-period cash and cash equivalents totals.

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

2. REVENUE

Effective January 1, 2018, the Company adopted ASC 606, "Revenue from Contracts with Customers," applying the modified retrospective method to those contracts that were not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under ASC 606, while prior period amounts have not been adjusted and continue to be reported in accordance with the Company's historic accounting under ASC 605. ASC 606 does not apply to financial instruments and other contractual rights or obligations.

Under ASC 606, revenue is recognized when control of the promised goods or services is transferred to the customer, in an amount that reflects the consideration the Company expects to be entitled to in exchange for those goods or services. The Company's contracts with its customers state the terms of sale, including the description, quantity, and price of the product or service purchased. Payment terms can vary by contract, but the period between invoicing and when payment is due is not significant. Taxes assessed on revenue-producing transactions are excluded from revenues.

The Company's products and services are reported under three segments—LoyaltyOne, Epsilon and Card Services, and are listed below. The following presents revenue disaggregated by major source, as well as geographic region which is based on the location of the subsidiary that generally correlates with the location of the customer:

Three Months Ended June 30, 2018	LoyaltyOne	Epsilon	Card Services	Corporate/ Other	Eliminations	Total
	(In millions)					
Disaggregation of Revenue by Major Source:						
Coalition loyalty program	$ 92.5	$ —	$ —	$ —	$ —	$ 92.5
Short-term loyalty programs	130.3	—	—	—	—	130.3
Technology services	—	255.1	—	—	(5.3)	249.8
Digital Media services	—	179.3	—	—	(1.3)	178.0
Agency services	—	79.8	—	—	(0.9)	78.9
Servicing fees, net	—	—	1.6	—	—	1.6
Other	22.9	—	—	0.2	(0.1)	23.0
Revenue from contracts with customers	$ 245.7	$ 514.2	$ 1.6	$ 0.2	$ (7.6)	$ 754.1
Finance charges, net	—	—	1,146.9	—	—	1,146.9
Investment income	2.9	—	—	—	—	2.9
Total	$ 248.6	$ 514.2	$ 1,148.5	$ 0.2	$ (7.6)	$ 1,903.9

Six Months Ended June 30, 2018	LoyaltyOne	Epsilon	Card Services	Corporate/ Other	Eliminations	Total
	(In millions)					
Disaggregation of Revenue by Major Source:						
Coalition loyalty program	$ 182.4	$ —	$ —	$ —	$ —	$ 182.4
Short-term loyalty programs	244.4	—	—	—	—	244.4
Technology services	—	501.1	—	—	(11.7)	489.4
Digital Media services	—	357.5	—	—	(1.6)	355.9
Agency services	—	165.0	—	—	(1.0)	164.0
Servicing fees, net	—	—	(0.4)	—	—	(0.4)
Other	42.5	—	—	0.3	(0.1)	42.7
Revenue from contracts with customers	$ 469.3	$ 1,023.6	$ (0.4)	$ 0.3	$ (14.4)	$ 1,478.4
Finance charges, net	—	—	2,304.1	—	—	2,304.1
Investment income	5.6	—	—	—	—	5.6
Total	$ 474.9	$ 1,023.6	$ 2,303.7	$ 0.3	$ (14.4)	$ 3,788.1

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Three Months Ended June 30, 2018	LoyaltyOne	Epsilon	Card Services	Corporate/ Other	Eliminations	Total
	(In millions)					
Disaggregation of Revenue by Geographic Region:						
United States	$ 6.3	$ 491.4	$ 1,148.5	$ 0.2	$ (7.4)	$ 1,639.0
Canada	105.4	4.5	—	—	(0.1)	109.8
Europe, Middle East and Africa	91.1	16.2	—	—	(0.1)	107.2
Asia Pacific	28.9	2.1	—	—	—	31.0
Other	16.9	—	—	—	—	16.9
Total	$ 248.6	$ 514.2	$ 1,148.5	$ 0.2	$ (7.6)	$ 1,903.9

Six Months Ended June 30, 2018	LoyaltyOne	Epsilon	Card Services	Corporate/ Other	Eliminations	Total
	(In millions)					
Disaggregation of Revenue by Geographic Region:						
United States	$ 12.0	$ 977.9	$ 2,303.7	$ 0.3	$ (14.2)	$ 3,279.7
Canada	211.0	8.2	—	—	(0.1)	219.1
Europe, Middle East and Africa	188.1	33.0	—	—	(0.1)	221.0
Asia Pacific	45.5	4.5	—	—	—	50.0
Other	18.3	—	—	—	—	18.3
Total	$ 474.9	$ 1,023.6	$ 2,303.7	$ 0.3	$ (14.4)	$ 3,788.1

LoyaltyOne

LoyaltyOne provides coalition and short-term loyalty programs through the Company’s Canadian AIR MILES Reward Program and BrandLoyalty. The AIR MILES Reward Program is a coalition loyalty program for sponsors, who pay LoyaltyOne a fee per AIR MILES reward mile issued, in return for which LoyaltyOne provides all marketing, customer service, rewards and redemption management. BrandLoyalty designs, implements, conducts and evaluates innovative and tailor-made short-term loyalty programs for grocers worldwide.

Total consideration from the issuance of AIR MILES reward miles is allocated to three performance obligations: redemption, service, and brand, based on a relative standalone selling price basis. The estimated standalone selling price for the redemption and the service performance obligations are based on cost plus a reasonable margin. The estimated standalone selling price of the brand performance obligation is determined using a relief from royalty approach. Accordingly, management determines the estimated standalone selling price by considering multiple inputs and methods, including discounted cash flows and available market data in consideration of applicable margins and royalty rates to utilize. The number of AIR MILES reward miles issued and redeemed are factored into the estimates, as management estimates the standalone selling prices and volumes over the term of the respective agreements in order to determine the allocation of consideration to each performance obligation delivered. The redemption performance obligation incorporates the expected number of AIR MILES reward miles to be redeemed, and therefore, the amount of redemption revenue recognized is subject to management's estimate of breakage, or those AIR MILES reward miles estimated to be unredeemed by the collector base.

Redemption revenue is recognized at a point in time, as the AIR MILES reward miles are redeemed. For the fulfillment of certain rewards where the AIR MILES Reward Program does not control the goods or services before they are transferred to the collector, revenue is recorded on a net basis. Service revenue is recognized over time using a time-elapsed output method, the estimated life of an AIR MILES reward mile. Revenue from the brand is recognized over time, using an output method, when an AIR MILES reward mile is issued. Revenue associated with both the service and brand is included in service revenue in the Company's consolidated statements of income.

The amount of revenue recognized in a period is subject to the estimate of breakage and the estimated life of an AIR MILES reward mile. Breakage and the life of an AIR MILES reward mile are based on management's estimate after viewing and analyzing various historical trends including vintage analysis, current run rates and other pertinent factors, such as the impact of macroeconomic factors and changes in the program structure. As of June 30, 2018, the breakage rate was 20% and the estimated life of an AIR MILES reward mile was 38 months.

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

The short-term loyalty programs typically last between 12 and 20 weeks, depending on the nature of the program, with contract terms usually less than one year in length. These programs are tailored for the specific retailer client and are designed to reward key customer segments based on their spending levels during defined campaign periods. Revenue is recognized at the point in time control passes from BrandLoyalty to the retailer.

Contract Liabilities. The Company records a contract liability when cash payments are received in advance of its performance, which applies to the service and redemption of an AIR MILES reward mile and the reward products for its short-term loyalty programs.

A reconciliation of contract liabilities for the AIR MILES Reward Program is as follows:

	Deferred Revenue		
	Service	Redemption	Total
	(In millions)		
Balance at January 1, 2018	$ 283.8	$ 683.1	$ 966.9
Cash proceeds	94.7	157.7	252.4
Revenue recognized (1)	(109.5)	(169.3)	(278.8)
Other	—	0.5	0.5
Effects of foreign currency translation	(11.6)	(28.5)	(40.1)
Balance at June 30, 2018	$ 257.4	$ 643.5	$ 900.9
Amounts recognized in the consolidated balance sheets:			
Deferred revenue (current)	$ 145.4	$ 643.5	$ 788.9
Deferred revenue (non-current)	$ 112.0	$ —	$ 112.0

(1) Reported on a gross basis herein.

The deferred redemption obligation associated with the AIR MILES Reward Program is effectively due on demand from the collector base, thus the timing of revenue recognition is based on the redemption by the collector. Service revenue is amortized over the expected life of a mile, with the deferred revenue balance expected to be recognized into revenue in the amount of $86.8 million in 2018, $104.0 million in 2019, $55.1 million in 2020, and $11.5 million in 2021.

Additionally, contract liabilities for the Company’s short-term loyalty programs are recognized in other current liabilities in the Company’s unaudited condensed consolidated balance sheets. The beginning balance as of January 1, 2018 was $87.5 million and the closing balance as of June 30, 2018 was $65.7 million, with the change due to revenue recognized of approximately $190.6 million during the six months ended June 30, 2018, offset in part by cash payments received in advance of program performance.

12

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Epsilon

Epsilon is a leading marketing services firm providing end-to-end, integrated marketing solutions that leverage rich data, analytics, creativity and technology to help clients more effectively acquire, retain and grow relationships with their customers.

The Company assesses the goods and services promised in its contracts with customers and identifies a performance obligation for each good or service that is distinct. Epsilon's product offerings and the associated performance obligations for each product are as follows:

Product	Performance Obligation	Recognition	Basis of Revenue Recognition
Technology services	Professional services	Over time	Recognized over time as the services are performed.
	Email deployment	Point in time	Recognized at deployment.
	Customer lifecycle marketing	Point in time	Recognized at delivery.
Digital Media services	Digital campaign advertisement	Over time	Recognized on an output measure of the digital advertisement.
	Affiliate marketing advertisements	Point in time	Recognized at delivery.
	Data lists	Point in time	Recognized at delivery.
Agency services	Professional services	Over time	Recognized over time as the services are performed.

Epsilon generally enters into multi-year agreements with its customers; however, these contracts provide for termination without penalty with prior written notice. Under ASC 606, this results in a contract term shorter than the stated contractual term.

The Company's contracts with customers may include multiple performance obligations. The transaction price is allocated to the separate performance obligations on a relative standalone selling price basis. If the standalone selling price is not directly observable, the Company estimates the standalone selling price based on either the adjusted market assessment or cost plus a margin approach.

Certain of Epsilon's contracts may provide for returns or cash consideration payable to its customers, which is accounted for as variable consideration. The Company estimates these amounts based on either the expected amount or most likely amount to be provided to the customer to determine the transaction price for the contract. The estimation method is consistent for contracts with similar terms and is applied consistently throughout each contract.

The estimates of variable consideration and determination of whether to include estimated amounts in the transaction price are based largely on an assessment of the anticipated performance and all information that is reasonably available.

The Company generates revenue from commission fees for transactions occurring on the Company's affiliate marketing networks. Commission fee revenue is recognized on a net basis as the Company acts as an agent.

Contract Liabilities. The Company records a contract liability when cash payments are received or due in advance of its performance. Contract liabilities for Epsilon are recognized in other current liabilities and other liabilities in the Company's unaudited condensed consolidated balance sheets. The beginning balance as of January 1, 2018 was $22.8 million and the closing balance as of June 30, 2018 was $23.7 million.

Contract Costs. The Company recognizes an asset for the direct costs incurred to fulfill its contracts with customers to the extent it expects to recover those costs in accordance with ASC 340-40, "Other Assets and Deferred Costs –

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

Contracts with Customers." As of June 30, 2018, the remaining unamortized contract costs were $6.1 million. Contract fulfillment costs are generally deferred and amortized on a straight-line basis through the period in which the future performance obligation is satisfied. No impairment was recognized during the periods presented.

Card Services

Card Services is a provider of branded credit card programs, both private label and co-brand, which drives sales for its brand partners. For these private label and co-brand programs, Card Services provides risk management solutions, account origination, funding, transaction processing, customer care, collections and marketing services.

Finance charges, net. Finance charges, net represents revenue earned on customer accounts owned by the Company, and is recognized in the period in which it is earned. The Company recognizes earned finance charges, interest income and fees on credit card and loan receivables in accordance with the contractual provisions of the credit arrangements. Interest and fees continue to accrue 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. Charge-offs for unpaid interest and fees as well as any adjustments to the allowance associated with unpaid interest and fees are recorded as a reduction to finance charges, net. Pursuant to ASC 310-20, "Receivables - Nonrefundable Fees and Other Costs," direct loan origination costs on credit card and loan receivables are deferred and amortized on a straight-line basis over a one-year period and recorded as a reduction to finance charges, net.

Servicing fees, net. Servicing fees, net represents revenue earned from retailers and cardholders from processing and servicing accounts, and is recognized as such services are performed.

Revenue earned from retailers primarily consists of merchant and interchange fees, which are transaction fees charged to the merchant for the processing of credit card transactions. Merchant and interchange fees are recognized at a point in time upon the cardholder purchase. Our credit card program agreements may also provide for payments to the retailer based on purchased volume or if certain contractual incentives are met, such as if the economic performance of the program exceeds a contractually defined threshold. These amounts are recorded as a reduction of revenue.

Revenue earned from cardholders primarily consists of monthly fees from the purchase of certain payment protection products purchased by our cardholders. The fees are based on the average cardholder account balance, and these products can be cancelled at any time by the cardholder. Revenue is recognized over time using a time-elapsed output method.

Contract Costs. The Company recognizes an asset for the incremental costs of obtaining or fulfilling a contract with the retailer for a credit card program agreement to the extent it expects to recover those costs, in accordance with ASC 340-40. As of June 30, 2018, the remaining unamortized contract costs were $386.8 million and are included in other current assets and other non-current assets in the Company's unaudited condensed consolidated balance sheets. Contract costs are deferred and amortized on a straight-line basis over the respective term of the agreement, which represents the period of service. Depending on the nature of the contract costs, the amortization is recorded as a reduction to revenue, or costs of operations, in the Company's unaudited condensed consolidated statements of income. Amortization of contract costs recorded as a reduction to revenue totaled $15.4 million and $32.6 million for the three and six months ended June 30, 2018, respectively. Amortization of contract costs recorded to cost of

operations expense totaled $2.1 million and $4.6 million for the three and six months ended June 30, 2018, respectively. No impairment was recognized during the periods presented.

Practical Expedients

The Company does not disclose the value of unsatisfied performance obligations for (i) contracts with an original expected length of one year or less and (ii) contracts for which we recognize revenue at the amount to which the Company has the right to invoice for services performed.

The Company has elected the practical expedient from ASC 340-40 with respect to contract costs, and expenses the incremental costs as incurred for those costs that would otherwise be recognized with an amortization period of one year or less. These costs are primarily related to sales commissions, and such expensed incremental costs are recorded to cost of operations expense in the Company's unaudited condensed consolidated statements of income.

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

3. EARNINGS PER SHARE

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In millions except per share amounts)			
Numerator:				
Net income	$ 217.8	$ 137.7	$ 381.8	$ 284.1
Denominator:				
Weighted average shares, basic	55.2	55.6	55.3	56.0
Weighted average effect of dilutive securities:				
Net effect of dilutive stock options and unvested restricted stock	0.2	0.2	0.2	0.3
Denominator for diluted calculation	55.4	55.8	55.5	56.3
Basic net income per share	$ 3.94	$ 2.48	$ 6.90	$ 5.07
Diluted net income per share	$ 3.93	$ 2.47	$ 6.87	$ 5.05

For the three and six months ended June 30, 2018 and 2017, a de minimis amount of restricted stock units was excluded from each calculation of weighted average dilutive common shares as the effect would have been anti-dilutive.

4. ACQUISITIONS

2017 Acquisitions:

On October 20, 2017, the Company acquired credit card receivables and the associated accounts and assumed a portion of an existing customer care operation, including a facility sublease agreement and approximately 250 employees, from Signet Jewelers Limited (“Signet”) for cash consideration of approximately $945.6 million. This acquisition increases the Company’s presence in the jewelry vertical. The Company determined these acquired activities and assets constituted a business under ASC 805, “Business Combinations,” based on the nature of the inputs, processes and outputs acquired from the transaction. In addition, the parties entered into a long-term agreement under which the Company became the primary issuer of private-label credit cards and related marketing services for Signet. The Company obtained control of the assets and assumed the liabilities on October 20, 2017, and the results of operations have been included since the date of acquisition in the Company’s Card Services segment.

The Company engaged a third party specialist to assist it in the measurement of the fair value of the assets acquired. The fair value of the assets acquired exceeded the cost of the acquisition. Consequently, the Company reassessed the recognition and measurement of the identifiable assets acquired and liabilities assumed and concluded that the

valuation procedures and resulting measures were appropriate. The excess value of the net assets acquired over the purchase price of $7.9 million was recorded as a bargain purchase gain, which was included in cost of operations in the Company’s consolidated statement of income for the year ended December 31, 2017.

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

The following table summarizes the fair values of the assets acquired and the liabilities assumed in the Signet acquisition as of October 20, 2017:

	As of October 20, 2017 (In millions)
Credit card receivables	$ 906.3
Intangible assets	52.3
Total assets acquired	958.6
Other liabilities	0.2
Deferred tax liability	4.9
Total liabilities assumed	5.1
Net assets acquired	$ 953.5
Total consideration paid	945.6
Gain on business combination	$ 7.9

5. CREDIT CARD AND LOAN RECEIVABLES

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

	June 30, 2018	December 31, 2017
	(In millions)	
Principal receivables	$ 17,072.4	$ 17,705.1
Billed and accrued finance charges	871.2	887.0
Other	41.3	21.7
Total credit card and loan receivables	17,984.9	18,613.8
Less: Credit card receivables – restricted for securitization investors	13,524.9	14,293.9
Other credit card and loan receivables	$ 4,460.0	$ 4,319.9

Allowance for Loan Loss

The Company maintains an allowance for loan loss at a level that is appropriate to absorb probable losses inherent in credit card and loan receivables. The allowance for loan loss covers forecasted uncollectible principal as well as

unpaid interest and fees. The allowance for loan loss is evaluated monthly for appropriateness.

In estimating the allowance for principal loan losses, management utilizes a migration analysis of delinquent and current credit card and loan receivables. Migration analysis is a technique used to estimate the likelihood that a credit card or loan receivable will progress through the various stages of delinquency and to charge-off. The allowance is maintained through an adjustment to the provision for loan loss. Charge-offs of principal amounts, net of recoveries are deducted from the allowance. In estimating the allowance for uncollectible unpaid interest and fees, the Company utilizes historical charge-off trends, analyzing actual charge-offs for the prior three months. The allowance is maintained through an adjustment to finance charges, net. In evaluating the allowance for loan loss for both principal and unpaid interest and fees, management also considers factors that may impact loan loss experience, including seasoning and growth, account collection strategies, economic conditions, bankruptcy filings, policy changes, payment rates and forecasting uncertainties.

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In millions)			
Balance at beginning of period	$ 1,169.3	$ 1,020.2	$ 1,119.3	$ 948.0
Provision for loan loss	311.9	288.1	649.6	603.2
Allowance associated with credit card and loan receivables transferred to held for sale	(5.2)	—	(11.8)	—
Change in estimate for uncollectible unpaid interest and fees	(5.0)	5.0	10.0	10.0
Recoveries	48.8	53.9	80.1	101.8
Principal charge-offs	(330.8)	(297.9)	(658.2)	(593.7)
Balance at end of period	$ 1,189.0	$ 1,069.3	$ 1,189.0	$ 1,069.3

Net charge-offs include the principal amount of losses from credit cardholders unwilling or unable to pay their account balances, as well as bankrupt and deceased credit cardholders, less recoveries and exclude charged-off interest, fees and fraud losses. Charged off interest and fees reduce finance charges, net while fraud losses are recorded as an expense. Credit card and loan receivables, including unpaid interest and fees, are charged-off in the month during which an account becomes 180 days contractually past due, except in the case of customer bankruptcies or death. Credit card and loan receivables, including unpaid interest and fees, associated with customer bankruptcies or death are charged-off in 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 $182.0 million and $160.7 million for the three months ended June 30, 2018 and 2017, respectively, and $381.5 million and $317.3 million for the six months ended June 30, 2018 and 2017, respectively.

Delinquencies

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

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

	June 30, 2018	% of Total		December 31, 2017	% of Total	
	(In millions, except percentages)					
Receivables outstanding - principal	$ 17,072.4	100.0	%	$ 17,705.1	100.0	%
Principal receivables balances contractually delinquent:						
31 to 60 days	304.3	1.8	%	301.5	1.7	%
61 to 90 days	210.9	1.2		191.3	1.1	
91 or more days	419.9	2.5		409.6	2.3	
Total	$ 935.1	5.5	%	$ 902.4	5.1	%

Index

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 each considered troubled debt restructurings and are collectively evaluated for impairment. Modified credit card receivables are evaluated at their present value with impairment measured as the difference between the credit card 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 card receivables with the allowance determined under the contingent loss model of ASC 450-20, "Loss Contingencies." If the Company applied accounting under ASC 310-40, "Troubled Debt Restructurings by Creditors," to the modified credit card receivables in these programs, there would not be a material difference in the allowance for loan loss.

The Company had $347.9 million and $260.2 million, respectively, as a recorded investment in impaired credit card receivables with an associated allowance for loan loss of $97.3 million and $56.1 million, respectively, as of June 30, 2018 and December 31, 2017. These modified credit card receivables represented less than 2% of the Company's total credit card receivables as of both June 30, 2018 and December 31, 2017.

The average recorded investment in impaired credit card receivables was $423.3 million and $219.2 million for the three months ended June 30, 2018 and 2017, respectively, and $359.8 million and $216.7 million for the six months ended June 30, 2018 and 2017, 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 $9.3 million and $4.8 million for the three months ended June 30, 2018 and 2017, respectively, and $15.3 million and $9.5 million for the six months ended June 30, 2018 and 2017, respectively, in interest income associated with modified credit card receivables during the period that such credit card receivables were impaired.

18

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

The following tables provide information on credit card receivables that are considered troubled debt restructurings as described above, which entered into a modification program during the specified periods:

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
	Number of Restructurings	Pre-modification Outstanding Balance	Post-modification Outstanding Balance	Number of Restructurings	Pre-modification Outstanding Balance	Post-modification Outstanding Balance
	(Dollars in millions)					
Troubled debt restructurings – credit card receivables	70,236	$ 101.8	$ 101.6	350,308	$ 414.3	$ 413.8

	Three Months Ended June 30, 2017			Six Months Ended June 30, 2017		
	Number of Restructurings	Pre-modification Outstanding Balance	Post-modification Outstanding Balance	Number of Restructurings	Pre-modification Outstanding Balance	Post-modification Outstanding Balance
	(Dollars in millions)					
Troubled debt restructurings – credit card receivables	47,624	$ 60.9	$ 60.9	92,872	$ 119.6	$ 119.5

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

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2018	
	Number of Restructurings	Outstanding Balance	Number of Restructurings	Outstanding Balance
	(Dollars in millions)			
Troubled debt restructurings that subsequently defaulted – credit card receivables	174,835	$ 192.5	203,595	$ 227.5

	Three Months Ended June 30, 2017		Six Months Ended June 30, 2017	
	Number of Restructurings	Outstanding Balance	Number of Restructurings	Outstanding Balance
	(Dollars in millions)			
Troubled debt restructurings that subsequently defaulted – credit card receivables	24,060	$ 29.5	50,681	$ 61.6

Age of Credit Card and Loan Receivable Accounts

The following tables set forth, as of June 30, 2018 and December 31, 2017, the number of active credit card and loan receivable accounts with balances and the related principal balances outstanding, based upon the age of the active credit card and loan receivable accounts from origination:

	June 30, 2018				
Age of Accounts Since Origination	Number of Active Accounts with Balances	Percentage of Active Accounts with Balances		Principal Receivables Outstanding	Percentage of Principal Receivables Outstanding	
	(In millions, except percentages)					
0-12 Months	6.4	26.8	%	$ 3,735.3	21.9	%
13-24 Months	4.2	17.9		3,049.4	17.9	
25-36 Months	2.8	11.9		2,243.3	13.1	
37-48 Months	2.3	9.6		1,948.9	11.4	
49-60 Months	1.5	6.5		1,276.9	7.5	
Over 60 Months	6.5	27.3		4,818.6	28.2	
Total	23.7	100.0	%	$ 17,072.4	100.0	%

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

	December 31, 2017			
Age of Accounts Since Origination	Number of Active Accounts with Balances	Percentage of Active Accounts with Balances	Principal Receivables Outstanding	Percentage of Principal Receivables Outstanding
	(In millions, except percentages)			
0-12 Months	7.4	27.3 %	$ 4,110.0	23.2 %
13-24 Months	4.5	16.4	3,011.3	17.0
25-36 Months	3.2	11.7	2,357.1	13.3
37-48 Months	2.4	8.8	1,837.0	10.4
49-60 Months	1.7	6.3	1,280.8	7.2
Over 60 Months	8.1	29.5	5,108.9	28.9
Total	27.3	100.0 %	$ 17,705.1	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, which the Company updates periodically. Information regarding customer performance is factored into these proprietary scoring models to determine the probability of an account becoming 91 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 the composition of the Company’s credit card and loan receivables by obligor credit quality as of June 30, 2018 and December 31, 2017:

	June 30, 2018		December 31, 2017	
Probability of an Account Becoming 91 or More Days Past Due or Becoming Charged-off (within the next 12 months)	Total Principal Receivables Outstanding	Percentage of Principal Receivables Outstanding	Total Principal Receivables Outstanding	Percentage of Principal Receivables Outstanding
	(In millions, except percentages)			
No Score	$ 174.6	1.0 %	$ 210.6	1.2 %
27.1% and higher	1,409.3	8.3	1,330.5	7.5
17.1% - 27.0%	833.0	4.9	850.5	4.8
12.6% - 17.0%	1,106.0	6.5	1,137.7	6.4
3.7% - 12.5%	6,953.3	40.7	7,449.7	42.1
1.9% - 3.6%	3,125.4	18.3	3,286.9	18.6
Lower than 1.9%	3,470.8	20.3	3,439.2	19.4

Total	$ 17,072.4	100.0 %	$ 17,705.1	100.0 %

Transfer of Financial Assets

The Company originates loans under an agreement with one of its clients, and after origination, these loan receivables are sold to the client at par value plus accrued interest. These transfers qualify for sale treatment as they meet the conditions established in ASC 860-10, "Transfers and Servicing." Following the sale, the client owns the loan receivables, bears the risk of loss in the event of loan defaults and is responsible for all servicing functions related to the loan receivables. The loan receivables originated by the Company that have not yet been sold to the client were $78.8 million and $126.9 million at June 30, 2018 and December 31, 2017, respectively, and are included in credit card and loan receivables held for sale in the Company's unaudited condensed consolidated balance sheets and carried at the lower of cost or fair value. The carrying value of these loan receivables approximates fair value due to the short duration between the date of origination and sale. Originations and sales of these loan receivables held for sale are reflected as operating activities in the Company's unaudited condensed consolidated statements of cash flows. Effective July 2, 2018, the Company no longer originates loan receivables for this client.

Portfolios Held for Sale

The Company has certain credit card portfolios held for sale, which are carried at the lower of cost or fair value, of $905.4 million and $899.4 million as of June 30, 2018 and December 31, 2017, respectively.

In the first quarter of 2018, the Company transferred one credit card portfolio totaling approximately $82.4 million out of credit card and loan receivables held for sale and into credit card and loan receivables, and transferred one credit card portfolio totaling approximately $90.1 million into credit card and loan receivables held for sale. The portfolio was transferred into credit card and loan receivables held for sale at the net carrying amount, inclusive of the related reserves for losses, as the fair value was estimated to be greater than the net carrying amount, and such amount will be the measurement basis until the sale of the portfolio.

In the second quarter of 2018, the Company transferred one credit card portfolio totaling approximately $54.6 million into credit card and loan receivables held for sale. The portfolio was transferred at the net carrying amount, inclusive of the related reserves for losses, as the fair value was estimated to be greater than the net carrying amount, and which was the measurement basis until the portfolio was sold in June 2018. The Company received preliminary cash consideration of approximately $55.6 million from the sale of the credit card portfolio, and the Company recognized a de minimis gain on the transaction.

Additionally, for the three and six months ended June 30, 2018, the Company recorded valuation adjustments of $14.2 million and $35.9 million, respectively, to reduce the value of certain portfolios within credit card and loan receivables held for sale. The Company carries its credit card and loan receivables held for sale at the lower of cost or fair value.

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 ("Master Trust I") and World Financial Network Credit Card Master Trust III ("Master Trust III") (collectively, the "WFN Trusts"), and World Financial Capital Credit Card Master Note Trust (the "WFC Trust"). The Company continues to own and service the accounts that generate credit card receivables held by the WFN Trusts and the WFC Trust. In its capacity as a servicer, each of the respective banks earns a fee from the WFN Trusts and the WFC Trust to service and administer the credit card receivables, collect payments and charge-off uncollectible receivables. These fees are eliminated and therefore are not reflected in the Company's unaudited condensed consolidated statements of income for the three and six months ended June 30, 2018 and 2017.

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

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

	June 30, 2018	December 31, 2017
	(In millions)	
Total credit card receivables – restricted for securitization investors	$ 13,524.9	$ 14,293.9
Principal amount of credit card receivables – restricted for securitization investors, 91 days or more past due	$ 307.2	$ 295.0

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In millions)			
Net charge-offs of securitized principal	$ 240.3	$ 176.4	$ 485.3	$ 362.4

21

Index

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)

6. INVENTORIES, NET

Inventories, net of $233.2 million and $234.1 million at June 30, 2018 and December 31, 2017, respectively, primarily consist of finished goods to be utilized as rewards in the Company's loyalty programs. Inventories, net are stated at the lower of cost and net realizable value and valued primarily on a first-in-first-out basis. The Company records valuation adjustments to its inventories if the cost of inventory exceeds the amount it expects to realize from the ultimate sale or disposal of the inventory. These estimates are based on management's judgment regarding future market conditions and an analysis of historical experience.

7. OTHER INVESTMENTS

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

	June 30, 2018				December 31, 2017			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(In millions)							
Marketable securities	$ 245.8	$ —	$ (7.4)	$ 238.4	$ 207.3	$ 0.2	$ (2.5)	$ 205.0
U.S. Treasury bonds	50.0	—	(0.2)	49.8	50.0	—	(0.1)	49.9
Total	$ 295.8	$ —	$ (7.6)	$ 288.2	$ 257.3	$ 0.2	$ (2.6)	$ 254.9

The following tables show the unrealized losses and fair value for those investments that were in an unrealized loss position as of June 30, 2018 and December 31, 2017, aggregated by investment category and the length of time that individual securities have been in a continuous loss position:

	June 30, 2018					
	Less than 12 months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In millions)					
Marketable securities	$ 148.8	$ (4.6)	$ 57.5	$ (2.8)	$ 206.3	$ (7.4)
U.S. Treasury bonds	24.8	(0.2)	—	—	24.8	(0.2)
Total	$ 173.6	$ (4.8)	$ 57.5	$ (2.8)	$ 231.1	$ (7.6)

	December 31, 2017					
	Less than 12 months		12 Months or Greater		Total	

	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In millions)					
Marketable securities	$ 104.5	$ (0.9)	$ 67.3	$ (1.6)	$ 171.8	$ (2.5)
U.S. Treasury bonds	49.9	(0.1)	—	—	49.9	(0.1)
Total	$ 154.4	$ (1.0)	$ 67.3	$ (1.6)	$ 221.7	$ (2.6)

The amortized cost and estimated fair value of the marketable securities and U.S. Treasury bonds at June 30, 2018 by contractual maturity are as follows:

	Amortized Cost	Fair Value
	(In millions)	
Due in one year or less	$ 79.3	$ 79.1
Due after one year through five years	2.6	2.6
Due after five years through ten years	—	—
Due after ten years	213.9	206.5
Total	$ 295.8	$ 288.2

ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)