



Rating  
**Buy**

North America  
United States

TMT  
Payments, Processors, &  
IT Services

Company  
**Alliance Data  
Systems**

Reuters ADS.N    Bloomberg ADS US    Exchange NYS    Ticker ADS

Date  
8 July 2018

Results

Price at 6 Jul 2018 (USD)	240.60
Price target	253.00
52-week range	276.37 - 194.64

## Expectations for the DQ Wedge to Close in Jun and 2Q18 EPS Beat

### Bullish sentiment on expectations of wedge closing and 2Q18 earnings beat

After troughing post the disappointing 1Q18 results, ADS stock has rallied over last 2 months due to expectations for the DQ wedge to close in June (tentative reporting date of Jul 16) because of a combination of the Hurricane bubble getting charged-off and easier y-o-y comps. In addition, expectations for a solid earnings beat in 2Q18 and a back-half recovery bode well. Please refer to our May 6, 2018 note, [CFO Highlights Acceleration in All Businesses Going Forward](#), for a detailed discussion.

### Monitoring revenue growth and NCO trajectory

Over the last few years, there have been unexpected disappointments (game of whack-a-mole) and we will continue to monitor for any negative surprises. In particular, expectations are for significant improvement in the NCO rate in 2H18 (roughly mid-5%) from ramping up of in-house recovery, easier comps from Hurricanes, and a mix shift but we will continue to monitor for potential headwinds from credit normalization and anniversary of SIG portfolio. L Brands renewal (expected in 3Q18) could drive higher revenue share. Although we expect 2Q18 earnings to beat consensus estimates, our 2Q18 revenue estimate is below consensus. In addition, consensus and our FY18 revenue estimates are significantly below company revenue guidance and it is unclear if the company will lower its FY18 revenue guidance on the earnings call.

### Widening valuation gap to SYF

ADS is trading at a significant discount to historical valuations; however, P/E multiples have been tied closely to SYF since the retail services business disappointment in 4Q15. ADS's NTM P/E valuation gap versus SYF has widened recently and it is now trading at a ~14% premium to SYF's NTM P/E. On a separate note, we believe the sale of the Acxiom Marketing Solutions business (AMS) to IPG for \$2.3bn valued at 13x TTM EBITDA provides attractive valuation comparables for the Epsilon business and makes it more attractive on a sum-of-the-parts approach.

### NCO/DQ seasonality analysis for Jun 2018

DQ increases seasonally from May to Jun; however, charging off \$30m of hurricane-impacted delinquencies (~20bps benefit) should help sequential improvement in DQ. We expect the DQ rate to improve from 5.4% (48bps Y/Y) in May to 5.3% (+20bps Y/Y) in Jun. Please refer to the seasonality analysis chart in the body for details. Note, DQ increased from a low of +10bps Y/Y in Nov to a

### Valuation & Risks

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### Key changes

EPS (USD)	22.65 to 22.83	↑	0.8%
Revenue (USDm)	8,211.2 to 8,206.6	↓	-0.1%

Source: Deutsche Bank



peak of +60bps Y/Y in April 2018 but we expect the DQ increase to moderate to +20bps Y/Y in Jun 2018 and further improvement going forward.

NCO improves seasonally from May to Jun, which along with ramping-up of in-house recovery bodes well for sequential improvement in NCO; however, charging off \$30m of delinquent receivables could weigh on the gross charge-off. Accordingly, we estimate 6.4% NCO in Jun, in line with 6.4% in May. NCO has tough y-o-y comps in Jun 2018 due to the timing of the sale of charged-off receivables in Jun 2017. Accordingly, we estimate NCO to be up 160bps Y/Y.

Bon-Ton's bankruptcy has weighed on receivables growth, which slowed to 11% in April and May 2018, and we expect the growth to potentially remain in the low-teens in Jun 2018. However, the company still expects receivables growth of mid-teens for 2018 as ramping up of new wins should drive receivables growth in 2H18.

#### 2Q18 - Upside to earnings but keeping an eye on revenues

On 19<sup>th</sup> Jul, we expect ADS to beat 2Q18 EPS consensus estimates. We estimate EPS of \$4.82 compared with consensus of \$4.67 but our revenue estimate of \$1,930m (5.9% Y/Y) is modestly below the street estimate of \$1,940m (6.5% Y/Y). Our LoyaltyOne revenues estimate of \$224m is below the street estimate of \$248m but could potentially surprise to the upside due to a lower-than-expected ASC 606 impact (we estimate \$87.5m) and/or better-than-expected BL growth (we est. 26% Y/Y, 18% cc growth).

Figure 1: DQ and NCO - Seasonality analysis

DQ	2013	2014	2015	2016	2017		DQ	2015	2016	2017	'17-'16 (Y/Y bps)	2018	'18-'17 (Y/Y bps)
Jan	108%	105%	106%	105%	103%		Jan	4.2%	4.5%	5.1%	60	5.5%	42
Feb	107%	108%	105%	101%	103%		Feb	4.2%	4.4%	5.1%	73	5.6%	49
Mar	96%	97%	96%	97%	96%		Mar	3.9%	4.3%	4.8%	50	5.3%	54
Apr	90%	89%	93%	93%	93%		Apr	3.8%	4.2%	4.7%	48	5.3%	61
May	91%	92%	94%	96%	98%		May	3.9%	4.4%	4.9%	52	5.4%	48
Jun	95%	99%	98%	99%	100%		Jun	4.1%	4.59%	5.1%	46		
Jul	101%	101%	100%	103%	102%		Jul	4.2%	4.82%	5.2%	35		
Aug	103%	103%	104%	104%	104%		Aug	4.4%	4.94%	5.3%	36		
Sep	106%	107%	105%	104%	106%		Sep	4.5%	5.0%	5.4%	43		
Oct	107%	104%	104%	104%	102%		Oct	4.5%	5.1%	5.2%	14		
Nov	99%	99%	101%	99%	96%		Nov	4.4%	4.9%	5.0%	10		
Dec	96%	96%	95%	95%	98%		Dec	4.2%	4.8%	5.1%	30		
NCO	2013	2014	2015	2016	2017		NCO	2015	2016	2017	'17-'16 (Y/Y bps)	2018	'18-'17 (Y/Y bps)
Jan	105%	103%	103%	108%	95%		Jan	5.0%	5.5%	6.1%	64	6.84%	69
Feb	100%	95%	100%	98%	98%		Feb	4.8%	5.0%	6.5%	146	6.94%	46
Mar	100%	100%	103%	100%	95%		Mar	4.9%	5.1%	6.3%	124	6.26%	(8)
Apr	102%	100%	102%	100%	111%		Apr	4.8%	5.1%	7.4%	231	6.28%	(114)
May	105%	100%	96%	102%	96%		May	4.5%	5.2%	6.4%	120	6.37%	(3)
Jun	97%	98%	95%	98%	72%		Jun	4.4%	5.0%	4.8%	(19)		
Jul	96%	105%	100%	105%	90%		Jul	4.6%	5.4%	6.0%	65		
Aug	89%	99%	90%	79%	95%		Aug	4.1%	4.1%	6.4%	234		
Sep	89%	91%	97%	91%	60%		Sep	4.4%	4.7%	4.1%	(57)		
Oct	105%	113%	111%	107%	92%		Oct	5.0%	5.5%	6.3%	75		
Nov	107%	101%	112%	110%	85%		Nov	5.0%	5.7%	5.8%	17		
Dec	104%	93%	92%	103%	85%		Dec	4.1%	5.3%	5.9%	56		

Source: Company data, Deutsche Bank





# ADS 2Q18 preview

## Card services – improving yields to offset declining receivables growth; modest reserve build to drive margin expansion

Despite a decline in receivables growth, we expect expansion in yields to deliver improvement in card service revenue growth. Gross yields have been declining y-o-y over last 4 quarters due to the acquisition, hurricanes, and a potentially higher interest charge-off; however, we expect yields to start expanding (DBe 10bps Y/Y in 2Q18) as the hurricane impact abates and driven by an increase in the prime rate partially offset by the mix shift towards higher balance portfolios. We estimate revenues of \$1,163m (15.7% Y/Y); higher than the street estimate of \$1,145m. On the provision front, we estimate \$314m of provision build driven by \$32m of reserve build (6.75% reserve rate) and 6.4% NCO.

## LoyaltyOne - Strong BL and improving AirMiles issuance

BL growth should accelerate to double-digits as it benefits from the World Cup, easier comps, and FX tailwinds. The Kroger pilot win positions well for an expanding presence in the US market. AirMiles issuance should benefit from promotional activity by the sponsors (particularly BMO, Sobeys and Shell) as well as improved engagement with the collectors.

## Epsilon back-half acceleration

We are modeling 1% growth in Epsilon, modestly below the street estimate of 2.7% Y/Y. Although easier comps should help, we believe the timing of the agency revenues could impact growth in 2Q18. Epsilon's revenues are expected to accelerate in 2H18.

## 2Q18 preview

We estimate ADS 2Q18 revenues of \$1,930m (5.9% Y/Y), below the consensus revenue estimate of \$1,940m and EPS of \$4.82, above consensus EPS of \$4.67. We estimate LoyaltyOne revenues of \$224m (-20% Y/Y), Epsilon revenues of \$550m (1.1% Y/Y), and Card Services revenues of \$1,163m (15.7% Y/Y). We are modeling an adjusted EBITDA margin of 24.2%; modestly above the consensus estimate of 24%.



Figure 2: ADS 2Q18 preview

	2Q18		
	Consensus	DB est	Updated DB est
LoyaltyOne	248	219	224
Y/Y Growth	-11.5%	-21.9%	-20.0%
Epsilon	559	564	550
Y/Y Growth	2.7%	3.7%	1.1%
Card Services	1145	1150	1163
Y/Y Growth	13.9%	14.5%	15.7%
<b>Adj. Revenue</b>	<b>1,940</b>	<b>1926</b>	<b>1930</b>
Y/Y Growth	6.5%	5.7%	5.9%
<b>Adjusted EBITDA</b>			
LoyaltyOne	64.0	55.1	56.8
margins	25.8%	25.2%	25.4%
Epsilon	110.4	108.2	108.5
margins	19.8%	19.2%	19.7%
Card Services, net	349.9	324.3	340.3
margins	30.6%	28.2%	29.3%
Adj. EBITDA Margins, net	24.0%	23.3%	24.2%
Tax Rate		25.0%	25.0%
<b>EPS</b>	<b>\$4.67</b>	<b>\$4.57</b>	<b>\$4.82</b>
growth	21.7%	16.8%	25.4%

Source: Deutsche Bank estimates, FactSet, Company data

#### FY18 estimates vs. guidance

For FY18, we are estimating revenues at \$8,207m (6.3% Y/Y), which is roughly in line with the consensus estimate of \$8,204m (6.3% Y/Y), adj. EBITDA of \$2,128m, which is above the consensus estimate of \$2,110m, and EPS of \$22.83, which is above the consensus estimate of \$22.58.

Figure 3: FY18 estimates vs. consensus

	FY18 Guidance			
	Consensus	DB Est.	Updated DB est	Current Guidance
LoyaltyOne	1099.2	1061.7	1029.4	
Y/Y Growth	-15.7%	-18.6%	-21.0%	
Epsilon	2357.9	2375.0	2360.9	
Y/Y Growth	3.8%	4.5%	3.9%	
Card Services	4768.1	4802.4	4844.2	
Y/Y Growth	14.3%	15.1%	16.2%	
<b>Total Revenues</b>	<b>\$8,204</b>	<b>\$8,211</b>	<b>\$8,207</b>	<b>\$8,350</b>
Y/Y Growth	6.3%	6.4%	6.3%	8%
Adj EBITDA	\$2,110	\$2,114	\$2,128	
Adj EBITDA margins	25.7%	25.8%	25.9%	
<b>EPS</b>	<b>\$22.58</b>	<b>\$22.65</b>	<b>\$22.83</b>	<b>\$22.50-\$23</b>

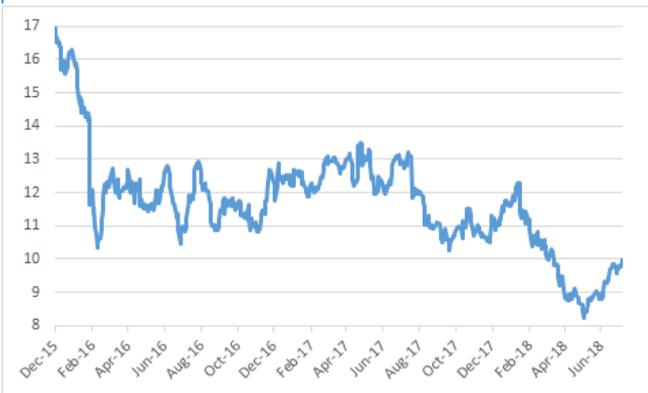
Source: Deutsche Bank estimates, FactSet, Company data



# Valuations compared with SYF

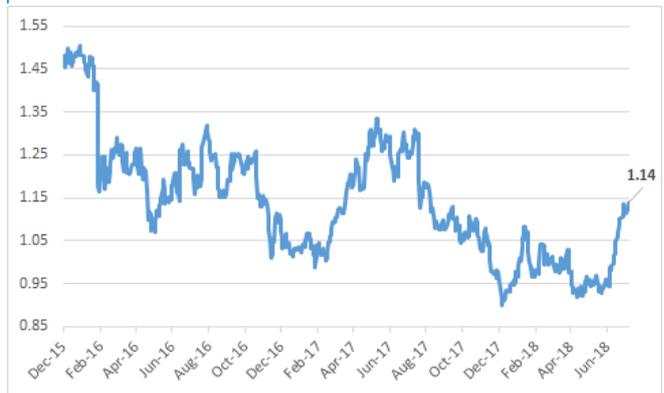
ADS's NTM P/E multiples dropped from ~17x in late 2015 after the card services business disappointed in 4Q15, and credit data have disappointed since with the non-card businesses also choppy. ADS's NTM P/E multiples troughed at ~8x in early May and have started to move up closer to 10x. We believe there is further upside to the street estimate and potential opportunity for some modest multiple expansion. However, over the last ~2 years, ADS has traded within a -15% to +25% valuation premium to SYF on NTM P/E estimates. ADS is currently trading at 14% premium to SYF and we will continue to monitor the valuation gap.

Figure 4: NTM P/E Valuation for ADS



Source: FactSet, Deutsche Bank

Figure 5: NTM P/E Valuation for ADS compared with SYF



Source: FactSet, Deutsche Bank



# Appendix 1

## Important Disclosures

\*Other information available upon request

Disclosure checklist			
Company	Ticker	Recent price*	Disclosure
Alliance Data Systems	ADS.N	240.60 (USD) 6 Jul 2018	1, 7, 8

\*Prices are current as of the end of the previous trading session unless otherwise indicated and are sourced from local exchanges via Reuters, Bloomberg and other vendors. Other information is sourced from Deutsche Bank, subject companies, and other sources. For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at <https://research.db.com/Research/Disclosures/CompanySearch>. Aside from within this report, important risk and conflict disclosures can also be found at <https://research.db.com/Research/Topics/Equities?topicId=RB0002>. Investors are strongly encouraged to review this information before investing.

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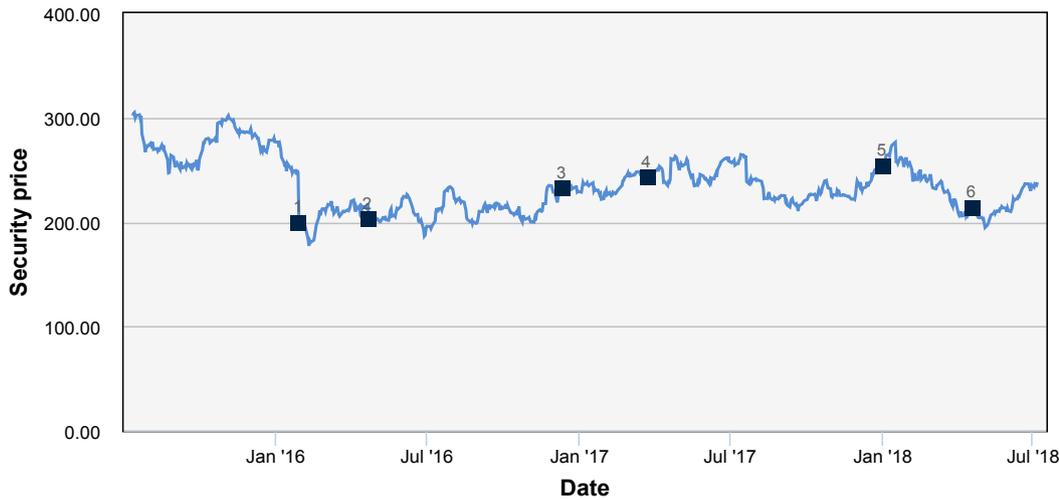
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Historical recommendations and target price. Alliance Data Systems (ADS.N)

(as of 07/06/2018)



Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

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2.	04/22/2016	Buy, Target Price Change USD 246.00	Ashish Sabadra	5.	01/02/2018	Buy, Target Price Change USD 298.00	Ashish Sabadra
3.	12/12/2016	Buy, Target Price Change USD 263.00	Ashish Sabadra	6.	04/19/2018	Buy, Target Price Change USD 253.00	Ashish Sabadra

Equity Rating Key

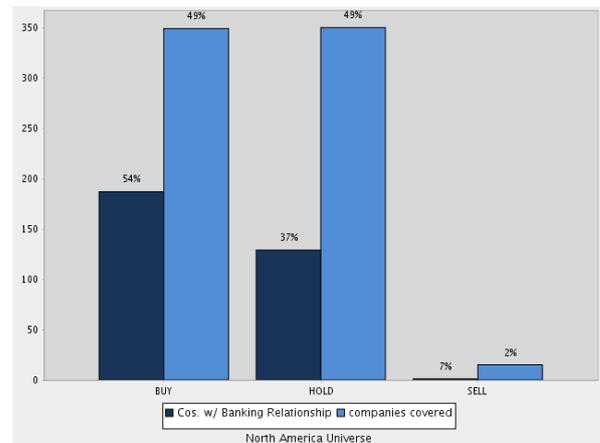
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