Deutsche Bank
Research

Rating
Buy

North America
United States

TMT
Payments, Processors, &
IT Services

Company
Alliance Data Systems

Reuters	Bloomberg	Exchange	Ticker
ADS.N	ADS US	NYS	ADS

Date
19 September 2018

Company Update

Price at 19 Sep 2018 (USD)	247.50
Price target	253.00
52-week range	276.37 - 194.64

Evaluating Strategic Options using SOTP

SOTP range for strategic options

In light of the CEO highlighting potential for strategic optionality at our DB Technology conference last week (refer to our note "CEO Highlights Strategic Optionality"), we look at the different strategic options, namely 1) spin-off of non-card businesses (Epsilon and LoyaltyOne), 2) sale of non-card businesses, 3) sale of pieces/portions of non-card businesses, and 4) no sale/spin-off post an exhaustive review. Our back-of-the-envelope SOTP analysis suggests stock price in the range of $269 to $277 for the first two options, which provides only ~10% upside to the current price. However, we believe the likelihood of the first two actions is low (see details below) and are accordingly keeping our target price at $253 until we receive clarity on the strategic options.

Challenges with strategic optionality

Although the three business units are run relatively independently, it would require significant efforts and operational challenges in splitting these businesses. But more importantly, ADS, which is currently part of the S&P Information Technology index, may have to be reclassified into Financials index and weighting in the overall index could potentially get altered, which could create investor turnover and churn given the passive investor base. Accordingly, we believe ~10% upside may not be sufficient to justify sale or spin-off of non-card businesses. We believe a more likely option to be the sale of portions of the non-card businesses. Potential for no strategic actions post an exhaustive review also cannot be ruled out.

Evaluating potential targets in non-card businesses

Within Epsilon, the key components are 1) Creative agency (HMI), 2) direct mail marketing and Auto (Aspen), 3) ad network (ValueClick/ Conversant), 4) Commission Junction (CJ/ Conversant), 5) CRM (Dotomi/ Conversant), 6) Email marketing (Harmony), 7) Technology platform (Epsilon), and 8) data (Abacus). We believe the data, Technology platform, and CRM have significant customer overlap and are part of the core offerings. Agency has been underperforming given the secular headwinds. Auto is a relatively independent and high growth business with market leadership position. CJ is independent, low growth, higher margin and solid FCF business that could be attractive to private equity investors. Air Miles and Brand Loyalty within LoyaltyOne are relatively independent and could be a potential option as well. Please refer to our June 2016 note " Right-sizing Epsilon/ Conversant Agency Key " for a deep-dive.

Valuation & Risks

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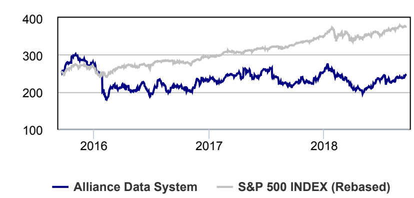
Price/price relative



Performance (%)	1m	3m	12m
Absolute	4.0	5.5	15.1
S&P 500 INDEX	1.9	5.1	15.9

Source: Deutsche Bank

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Next steps

On the 3Q18 earnings call, management plans to provide an update on where the company is headed in terms of the strategic optionality. We believe it's much more likely that the company would announce a decision by the board to look at the strategic options rather than a decision on the strategic option.

TDR and recovery drive improvement in credit metrics but monitoring portfolio sale

TDR roll-off drove improvement in DQ while in-house recovery efforts helped lower net charge-off (NCO). However, given the month over month decline in the period-end receivables which is in contrast to historical seasonality, it's unclear if the company moved Bon-Ton portfolio to held for sale. Although replacing lower balance card portfolios for specialty apparel retailers with higher balance portfolios from home goods, furnishing and Jewellery vertical could drive improving credit metrics in the near-term, we will continue to monitor for implications to credit metrics during downturn.

Monitoring impact of Hurricane Florence

Hurricanes Harvey and Irma significantly impacted credit metrics given both Texas and Florida were among the top 5 states and combined accounted for 12% of account and 18% of AR. In contrast, exposure to North and South Carolina is relatively lower; however, we would still expect some impact to the credit metrics from the Hurricane.

Evaluating strategic option scenarios: SOTP analysis

We have evaluated 2 different scenarios, namely spin-off and sale of the non-card businesses. Please see some of the key assumptions below:

Allocation of debt: We estimate ~$5.6bn of debt by the end of the year. We have assumed that the company could fund 10-15% of the receivables using unsecured debt and accordingly, portion of the existing $5.6bn of debt could be allocated to the card business. In case of spin-off, we add 3x leverage on the non-card businesses but believe there is opportunity to lever that business up much higher in the 4x range. In case of sale, we assume the company pays down $2.15bn of debt and uses the rest of the cash for accelerated share repurchase.

Figure 1: Debt allocation scenarios ($ millions)

Debt allocation - Spin-off of non-card businesses	
Total Debt (FY18 est.)	**5,551**
Less cash dividend from bank	574
Non-card leverage	3.0
Less Non-card debt	2,157
Net debt on card business	2,820
percentage of RWA	14.8%

Debt allocation - Sale of non-card businesses	
Total Debt (FY18 est.)	5,551
Less cash dividend from bank	574
Less debt paydown	2,150
Net debt on card business	2,827
percentage of RWA	14.8%

Source: Deutsche Bank estimates

Purchase of servicing unit: Servicing unit for the card businesses reside within the corporate and the banks (Comenity and Comenity Capital) could theoretically purchase the servicing business from the parent company. However, it's unclear to us how the transaction would add equity to the bank. Accordingly, we haven't included that potential optionality in our calculation. However, we estimate Comenity and Comenity Capital banks could potentially lower the liquidity ratio from currently ~18% to ~15%, which would enable them to take out $500-$600m of cash. This would lower the CET1 ratio from currently ~15% to ~12% .

Figure 2: Bank call report - Liquidity and CET1 ratio ($ thousands), 2Q18

Bank Call report	Comenity bank	Comenity Capital bank	Total
Cash	1,910,675	1,320,030	3,230,705
Loans and leases held for investment	11,270,900	6,442,988	17,713,888
Liquidity ratio	17.0%	20.5%	18.2%
Target Liquidity ratio			15%
Liquidity required			2,657,083
Available cash for dividend			**573,622**
Risk Weighted Assets (RWA)	11,679,217	7,361,495	19,040,712
Tier 1 Equity	1,670,048	1,105,525	2,775,573
CET1	**14.3%**	**15.0%**	**14.6%**
Post Cash dividends			2,201,951
CET1 (post cash dividend)			**11.6%**

Source: Call reports

Cost basis: Since the cost basis for non-card businesses is not disclosed, we have assumed $3.6bn of cost basis for non-card businesses, roughly in line with the goodwill for the non-card businesses as of end of 2017. We understand that the cost basis for tax purposes could be completely different than the goodwill recorded for financial reporting.

Figure 3: Goodwill for non-card businesses ($ millions)

Goodwill	
Air Miles	198
BrandLoyalty	533
Epsilon ex-CNVR	1237
Conversant	1650
Total Goodwill	**3618**

Source: ADS 10K

Dis-synergies: In case of spin-off, we split corporate expenses equally between the 2 businesses and assume ~20% dis-synergies from the split. We assume there are no shared development or Sales and marketing costs and mostly corporate G&A expenses. Accordingly, we believe the corporate costs could be higher in case of spin-off since both companies would have to incur independent public company costs. In case of sale, we assume corporate costs with the cards business to be ~80% since it may not be possible to cut the corporate costs drastically.

Interest rate: We have assumed 3% Interest rate since if the banks were spun off, they would technically have no debt and would likely get attractive interest rates.

Valuation: We have assumed PE multiple of 9x 2019 EPS estimates for the card business, roughly in line with the forward multiple to card companies. SYF is currently trading at ~8x FY19, and DFS and COF are trading at ~9x FY19 EPS (all based on FactSet consensus estimates).

We estimate the non-card businesses to trade at 10x 2019E EV/EBITDA in case of spin-off given low to mid-single digit choppy revenue growth profile but expect much higher 12.5x EV/EBITDA multiple in a take-out scenario, roughly in line with the multiples paid for the Axiom marketing services business in July with net proceeds post taxes of ~11x EV/EBITDA.

IPG paid $2.3bn, or ~13x TTM EBITDA; however, ACXM received only $1.7bn in net cash proceeds, after taxes and fees which lowers the EBITDA multiple to ~10x. IPG received $300m present value of the tax step up, which lowered the multiple to 11.5x 2018E EBITDA.

Figure 4: SoTP Analysis - spin-off of non-card businesses ($ millions)

Spin-off of non-card businesses	2019E	Assumptions
Epsilon EBITDA	522	
LoyaltyOne EBITDA	292	
Corporate expense	-95	50% of total corporate expense with 20% dis-synergies
Non-card EBITDA	719	
EV/EBITDA Multiple	10	
EV	7,190	
Debt	2,157	
Market Cap	**5,033**	
Share price	*94*	
Card services EBITDA	1,637	
Corporate expense	-95	50% of total corporate expense with 20% dis-synergies
D&A	104	2% of revs
EBIT	1,438	
Interest rate	*3%*	
Interest	85	
PTI	1,353	
Net Income	1,042	23% Tax rate
PE	9	
MarketCap	**9,377.99**	
Share price	*175*	
Combined market cap	**14,411**	
Share price	**269**	
Sharecount est. (end of 2019)	53.5	

Source: Deutsche Bank estimates

Figure 5: SoTP Analysis - sale of non-card businesses ($ millions)

Sale of non-card businesses	2019E	Assumptions
Epsilon EBITDA	522	
LoyaltyOne EBITDA	292	
Non-card EBITDA	719	
EV/EBITDA Multiple	12.5	
Proceeds	8,988	
Tax basis	3,618	
Cash taxes	1,235	23% tax rate
Net proceeds	**7,753**	
Use of proceeds		
Debt paydown	2,150	
ASR	5,603	
Share purchase price	275	
Shares repurchased	20	
Card services EBITDA	1,637	
Corporate expense	(126)	80% of total corporate expense is retained
D&A	104	2% of revs
EBIT	1,406	
Interest rate	*3%*	
Interest	85	
PTI	1,321	
Net Income	1,018	23% Tax rate
PE	9	
MarketCap	**9,158**	
Sharecount	33	
Share price	**277**	

Source: Deutsche Bank estimates

Epsilon acquisitions

Please see below list of Epsilon acquisitions and refer to our 12th June 2016 note "Right-sizing Epsilon/ Conversant Agency Key" for deep-dive on Epsilon.

Figure 6: Epsilon acquisitions

Date	Target Name	Price(mil)	Details
09.11.2014	Conversant Inc	2,268.18	
11.09.2012	Hyper Marketing Inc	460	Largest privately held marketing services agency in the United States offering full breadth of ROI-based marketing services through Ryan Partnership, CatapultRPM, SolutionSet and Getmembers.com, including: digital user experience design technology, specializing in websites, social media platforms and mobility; customer relationship marketing; consumer promotions marketing; direct and digital shopper marketing; distributed and local area marketing; and analytical services that include brand planning and consumer insights. HMI had ~1,100 employees.
04.25.2011	Aspen Marketing Services	345	Specializes in a full range of digital and direct marketing services, and advanced analytics to perform data-driven customer acquisition and retention campaigns. The company has deep expertise and heritage in the automotive and telecommunications industries, coupled with diverse Fortune 100 clients in CPG, retail and financial services.
06.02.2010	Equifax-Direct Marketing Svcs	117	Two complementary offerings: database marketing and hosting, and data services including U.S. consumer demographic information. Equifax's DMS division has ~200 employees.
12.28.2006	Abacus	435	Provider of data, data management and analytical services for the retail and catalog industry, as well as other sectors
09.21.2006	CPC Associates Inc	70	Provider of data products used to increase direct-response marketing effectiveness.
02.14.2006	DoubleClick Email Solutions	90	Permission-based email marketing service providers, with operations across North America, Europe and Asia/Pacific. It had ~220 employees. ADS recently rewrote the email marketing engine and rebranded it as Harmony.
10.29.2004	Epsilon	300	Provides services in customer data analysis, marketing database technology, and direct marketing production.

Source: FactSet

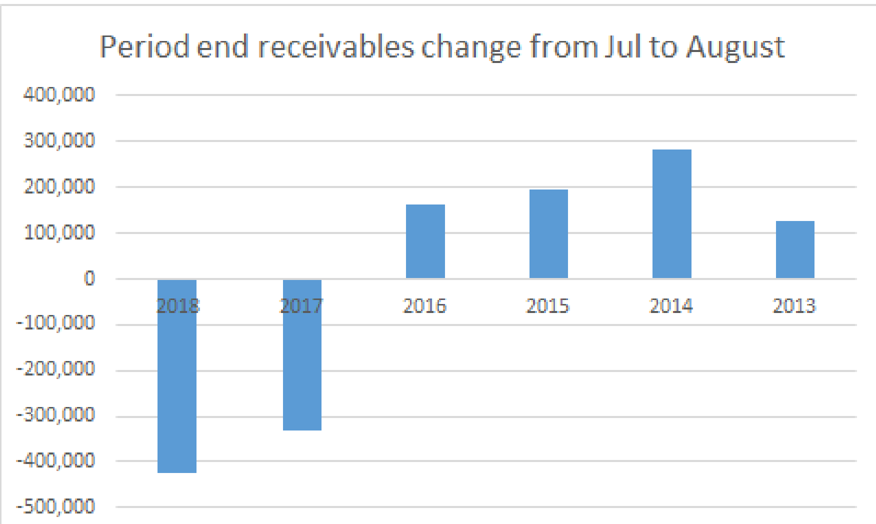
August monthly data

Credit metrics improved in August due to TDR rolling off, improving in-house recovery efforts, and potentially moving portfolios to held for sale, in our view.

Decline in period-end receivables

Year over year increase in DQ improved from +50bps in July to +30bps in August, which the company attributed to TDR rolling off. Average receivables growth improved to 13% in August from 10% in July and the company provided active client receivables growth, which delivered solid high-teens receivables growth. However, period-end receivables growth moderated despite easier comparable. Historically, period-end receivables usually increase ~$200m from July to August; in contrast the period-end receivables declined by ~$400m. Period-end receviables had declined in 2017 as the Healthcare portfolio was moved to held for sale. It's unclear if the Bon-Ton portfolio was moved to held for sale, which could have also benefitted the DQ rate.

Figure 7: Period-end receivables change from Jul to August



Source: Company data

Delinquency rate (DQ) improves

August monthly data was positive as the DQ edged lower sequentially to 5.6% from 5.7% in July and 5.5% in June, which was better than historical seasonality of 10bps increase in DQ from July to August. TDR rolling off and sale of Bon-Ton portfolio could potentially drive further improvement in DQ going forward.

Figure 8: DQ Seasonality Analysis 2011 - 2017

DQ	2011	2012	2013	2014	2015	2016	2017
Jan	109%	108%	108%	105%	106%	105%	103%
Feb	106%	106%	107%	108%	105%	101%	103%
Mar	98%	97%	96%	97%	96%	97%	96%
Apr	91%	92%	90%	89%	93%	93%	93%
May	92%	95%	91%	92%	94%	96%	98%
Jun	93%	95%	95%	99%	98%	99%	100%
Jul	99%	98%	101%	101%	100%	103%	102%
Aug	102%	100%	103%	103%	104%	104%	104%
Sep	106%	106%	106%	107%	105%	104%	106%
Oct	105%	104%	107%	104%	104%	104%	102%
Nov	102%	101%	99%	99%	101%	99%	96%
Dec	99%	99%	96%	96%	95%	95%	98%

Source: Company data, Deutsche Bank

Figure 9: DQ 2011 - 2018 YTD

DQ	2011	2012	2013	2014	2015	2016	2017	'17-'16 (Y/Y bps)	2018	'18-'17 (Y/Y bps)
Jan	5.6%	4.5%	4.2%	4.2%	4.2%	4.5%	5.1%	60	5.5%	42
Feb	5.4%	4.4%	4.2%	4.3%	4.2%	4.4%	5.1%	73	5.6%	49
Mar	4.9%	4.0%	3.8%	3.9%	3.9%	4.3%	4.8%	50	5.3%	54
Apr	4.5%	3.8%	3.6%	3.6%	3.8%	4.2%	4.7%	48	5.3%	61
May	4.5%	3.9%	3.7%	3.7%	3.9%	4.4%	4.9%	52	5.4%	48
Jun	4.5%	3.9%	3.9%	4.0%	4.1%	4.6%	5.1%	46	5.5%	42
Jul	4.7%	4.0%	4.2%	4.1%	4.2%	4.8%	5.2%	35	5.7%	51
Aug	4.8%	4.1%	4.3%	4.2%	4.4%	4.9%	5.3%	36	5.6%	28
Sep	4.9%	4.3%	4.5%	4.4%	4.5%	5.0%	5.4%	43		
Oct	4.8%	4.2%	4.6%	4.3%	4.5%	5.1%	5.2%	14		
Nov	4.6%	4.1%	4.3%	4.1%	4.4%	4.9%	5.0%	10		
Dec	4.4%	4.0%	4.2%	4.0%	4.2%	4.8%	5.1%	30		

Source: Company data

NCO - Recovery improvement

Net Charge-off (NCO) of 5.8% decreased m/m from 5.9% in July and 6.6% in June 2018 with ~62bps Y/Y decrease. NCO improved significantly m/m and was lower y-o-y due to relatively easier comps and ramping up of internal recovery efforts. ADS guided NCO to high 5% range in the 3Q18 and mid-5% range in the 4Q18 and reiterated FY18 NCO guidance of 6% as the recovery rate improves.

Figure 10: NCO historical trends

NCO	2011	2012	2013	2014	2015	2016	2017	'17-'16 (Y/Y bps)	2018	'18-'17 (Y/Y bps)
Jan	8.5%	5.6%	4.5%	5.1%	5.0%	5.5%	6.1%	64	6.8%	69
Feb	7.8%	5.2%	4.4%	4.6%	4.8%	5.0%	6.5%	146	6.9%	46
Mar	7.3%	5.0%	4.4%	4.7%	4.9%	5.1%	6.3%	124	6.3%	(8)
Apr	7.4%	5.3%	4.6%	4.6%	4.8%	5.1%	7.4%	231	6.3%	(114)
May	7.2%	4.8%	4.8%	4.5%	4.5%	5.2%	6.4%	120	6.4%	(3)
Jun	6.9%	4.7%	4.5%	4.3%	4.4%	5.0%	4.8%	(19)	6.6%	179
Jul	6.2%	4.7%	4.5%	4.4%	4.6%	5.4%	6.0%	65	5.9%	(12)
Aug	5.9%	3.9%	4.2%	4.1%	4.1%	4.1%	6.4%	234	5.8%	(62)
Sep	5.9%	4.2%	4.3%	3.6%	4.4%	4.7%	4.1%	(57)		
Oct	6.3%	4.7%	5.1%	4.4%	5.0%	5.5%	6.3%	75		
Nov	6.5%	4.7%	5.2%	3.8%	5.0%	5.7%	5.8%	17		
Dec	6.2%	4.7%	5.2%	3.3%	4.1%	5.3%	5.9%	56		

Source: Company data

Sept 19 closing prices of other companies mentioned: Synchrony Financial (SYF, $33.39), Discover Financial (DFS, $78.76), Capital One Financial (COF, $98.96).

Appendix 1

Important Disclosures

*Other information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Alliance Data Systems	ADS.N	247.50 (USD) 19 Sep 2018	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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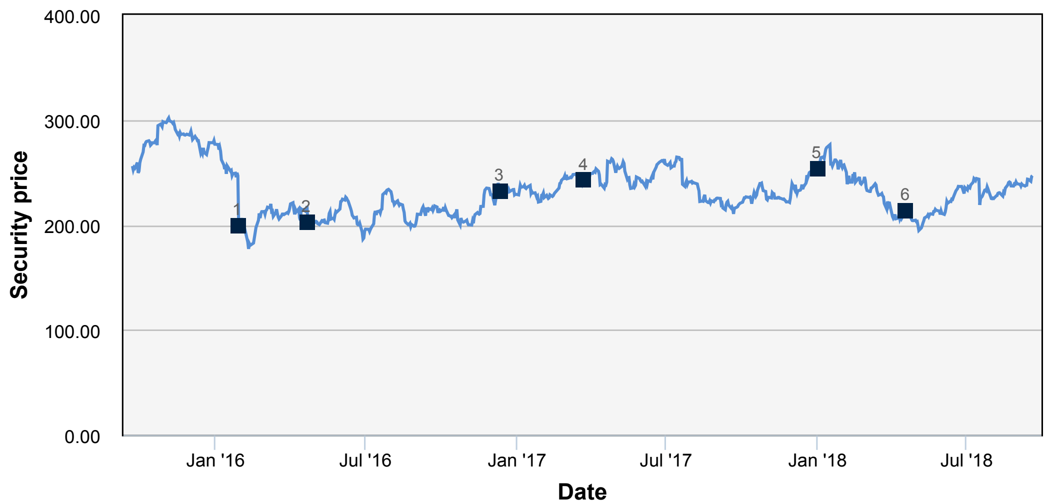
Historical recommendations and target price. Alliance Data Systems (ADS.N)

(as of 09/19/2018)



Current Recommendations
Buy
Hold
Sell
Not Rated
Suspended Rating

** Analyst is no longer at Deutsche Bank

1.	01/29/2016	Buy, Target Price Change USD 291.00 Ashish Sabadra
2.	04/22/2016	Buy, Target Price Change USD 246.00 Ashish Sabadra
3.	12/12/2016	Buy, Target Price Change USD 263.00 Ashish Sabadra
4.	03/24/2017	Buy, Target Price Change USD 278.00 Ashish Sabadra
5.	01/02/2018	Buy, Target Price Change USD 298.00 Ashish Sabadra
6.	04/19/2018	Buy, Target Price Change USD 253.00 Ashish Sabadra

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Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock.
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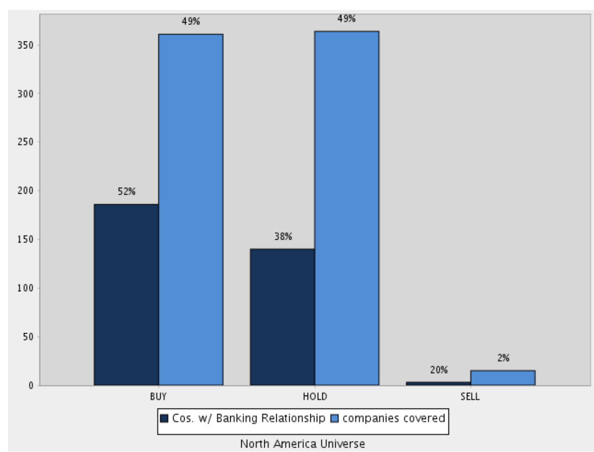
Equity rating dispersion and banking relationships



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