UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarter Ended March 31, 2002
OR

o 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.)

17655 Waterview Parkway
Dallas, Texas 75252
(Address of Principal Executive Office, including zip code)

(972) 348-5100
(Registrant’s Telephone Number, Including Area Code)

Indicate by check mark whether the Registrant (i) has filed all reports required to be filed 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 (ii) has been subject to such filing requirements for the past 90 days. Yes ☒ No o

As of April 5, 2002, 74,525,730 shares of the registrant’s common stock, par value $0.01 per share, were outstanding.

ALLIANCE DATA SYSTEMS CORPORATION

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ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(amounts in thousands, except per share amounts)

Part I. – Financial Information
Item 1. Financial Statements

	December 31, 2001	March 31, 2002
ASSETS		
Cash and cash equivalents	$ 117,535	$ 77,287
Due from card associations	46,554	147,939
Trade receivables	88,444	84,568
Credit card receivables and seller's interest	128,793	119,632
Other current assets	82,177	88,207
Total current assets	463,503	517,633
Redemption settlement assets, restricted	150,330	149,404
Property and equipment, net	112,190	115,710
Other non-current assets	43,058	38,098
Due from securitizations	216,140	182,161
Intangible assets, net	491,997	520,235
Total assets	$ 1,477,218	$ 1,523,241
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	$ 82,290	$ 86,924
Accrued expenses	73,135	63,393
Merchant settlement obligations	137,711	195,007
Other liabilities	25,268	31,340
Debt, current portion	111,325	88,525
Total current liabilities	429,729	465,189
Other liabilities	13,112	9,420
Deferred revenue	329,549	334,827
Long-term and subordinated debt	199,100	197,900
Total liabilities	971,490	1,007,336
Stockholders' equity:		
Common stock, $0.01 par value; authorized 200,000 shares; issued and outstanding 73,987 shares as of December 31, 2001, 74,370 shares as of March 31, 2002	740	744
Additional paid-in capital	509,741	516,718
Treasury stock	(6,151)	(6,151)
Retained earnings	8,138	12,597
Accumulated other comprehensive loss	(6,740)	(8,003)
Total stockholders' equity	505,728	515,905
Total liabilities and stockholders' equity	$ 1,477,218	$ 1,523,241

See accompanying notes to unaudited condensed consolidated financial statements

ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(amounts in thousands, except per share amounts)

	For the three months ended March 31,	
	2001 (as restated-see Note 9)	2002
Revenues		

	2001	2002
Transaction and marketing services	$ 107,142	$ 120,960
Redemption revenue	22,343	32,677
Financing charges, net	45,966	51,673
Other income	5,729	5,029
Total revenue	181,180	210,339
Operating expenses		
Cost of operations	143,258	164,781
General and administrative	9,333	14,638
Depreciation and other amortization	6,367	9,271
Amortization of purchased intangibles	11,113	6,837
Total operating expenses	170,071	195,527
Operating income	11,109	14,812
Fair value gain (loss) on interest rate derivative	(5,431)	387
Interest expense	9,635	6,294
Income (loss) before income taxes	(3,957)	8,905
Income tax expense (benefit)	(797)	4,446
Net income (loss)	$ (3,160)	$ 4,459
Income (loss) per share—basic	$ (0.10)	$ 0.06
Income (loss) per share—diluted	$ (0.10)	$ 0.06
Weighted average shares—basic	47,614	73,996
Weighted average shares—diluted	47,614	76,607

See accompanying notes to unaudited condensed consolidated financial statements

ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(amounts in thousands)

	Three months ended March 31, 2001	Three months ended March 31, 2002
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash provided by operating activity before change in merchant settlement activity	$ 18,971	$ 26,310
Net change in merchant settlement activity	(7,974)	(44,089)
Net cash provided by (used in) operating activities	10,997	(17,779)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in redemption settlement assets	(6,164)	926
Net cash paid for corporate acquisition	(18,750)	(26,019)
Purchase of credit card receivables	(76,487)	(93,581)
Proceeds from sale of credit card receivable portfolios	74,258	92,373
Change in seller's interest	11,914	6,980
Change in due from securitizations	(12,797)	35,148
Capital expenditures	(9,149)	(9,582)
Other investing activities	—	(710)
Net cash provided by (used in) investing activities	(37,175)	5,535
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings under debt agreements	171,200	138,200
Repayment of borrowings	(192,986)	(164,088)
Proceeds from issuance of common stock	1,508	4,033
Net cash used in financing activities	(20,278)	(21,855)
Effect of exchange rate changes	(11,729)	(6,149)
Change in cash and cash equivalents	(58,185)	(40,248)
Cash and cash equivalents at beginning of period	116,941	117,535
Cash and cash equivalents at end of period	$ 58,756	$ 77,287
Non cash financing activity:		
Interest paid	$ 9,635	$ 8,926

Income taxes paid	$	10,156	$	7,165

See accompanying notes to unaudited condensed consolidated financial statements

ALLIANCE DATA SYSTEMS CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

The condensed consolidated financial statements included herein have been prepared by Alliance Data Systems Corporation (“ADSC” or, including its wholly owned subsidiaries, 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 have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company’s annual report filed on Form 10-K.

The unaudited condensed consolidated financial statements included herein reflect all adjustments (which include only 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 accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Subsequent to the issuance of the Company’s interim financial statements for the three months ended March 31, 2001 it was determined that an economic hedge on debt related to World Financial Network Credit Card Master Trust did not meet the criteria for hedge accounting under the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 133, as amended. Accordingly, the previously reported financial information for the three months ended Month 31, 2001 have been restated. Such restatement is further discussed in Note 9 to the Company’s financial statements included herein.

2. OTHER COMPREHENSIVE INCOME (LOSS)

The components of other comprehensive income (loss) are as follows:

	Three months ended March 31,	
	2001 (as restated-see Note 9)	2002
	(dollars in thousands)	
Net income (loss)	$ (3,160)	$ 4,459
Cumulative effect of change in accounting for derivatives	323	—
Change in fair value of derivatives	—	810
Reclassifications into earnings	2,281	(131)
Unrealized gain (loss) on securities available-for-sale, net	3	(254)
Foreign currency translation adjustments	(11,121)	(1,688)
Total comprehensive income (loss)	$ (11,674)	$ 3,196

3. EARNINGS PER SHARE

Basic earnings per share is based on the weighted average number of common shares outstanding, excluding any dilutive effects of options or other dilutive securities. Diluted earnings per share is based on the weighted average number of common shares and potentially dilutive common shares, dilutive stock options and other dilutive securities outstanding during the year. However, as the Company generated net losses attributable to common stockholders for the three months ended March 31, 2001 presented below, the weighted average number of common shares including dilutive securities, composed of incremental common shares issuable upon exercise of stock options and warrants and upon conversion of Series A cumulative convertible preferred stock, is not used in determining diluted net income (loss) per share for the period because such shares are anti-dilutive. Such potentially dilutive common shares were 11.4 million shares, primarily related to the preferred stock, in 2001. The following table sets forth the computation of basic and diluted net income (loss) per share for the periods indicated:

	Three months ended March 31,	
	2001 (as restated-see Note 9)	2002
	(in thousands, except per share amounts)	
NUMERATOR		
Income (loss) before extraordinary item	$ (3,160)	$ 4,459
Preferred stock dividends	1,800	—
Net Income (loss) attributable to common stockholders	$ (4,960)	$ 4,459
DENOMINATOR		

Weighted average shares	47,614	73,996
Weighted average effect of dilutive securities:		
Net effect of dilutive stock options and warrants	—	2,611
Net effect of dilutive convertible preferred stock	—	—
Denominator for diluted calculations	47,614	76,607
Income (loss) per share		
Basic	$ (0.10)	$ 0.06
Diluted	$ (0.10)	$ 0.06

4. INTANGIBLE ASSETS, NET

On January 1, 2002, the Company adopted SFAS No. 142 "Goodwill and Other Intangible Assets." SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. The Company has $426.0 million of goodwill that is no longer being amortized. The Company also is required to complete the first step of the transitional impairment test for goodwill within six months of adoption of SFAS No. 142 and to complete the final step of the transitional impairment test by the end of the calendar year. The Company does not expect the results of this assessment to have a material impact on the consolidated financial statements. Pro forma net income and net income per share for the three months ended March 31, 2001, adjusted to eliminate historical amortization of goodwill, net of tax, and comparable amounts for the three months ended March 31, 2002 are as follows:

	Three months ended March 31,	
	2001 (as restated -see Note 9)	2002
	(in thousands, except per share amounts)	
Reported net income (loss)	$ (3,160)	$ 4,459
Add: goodwill amortization, net of tax	3,577	—
Pro forma net income	$ 417	$ 4,459
Reported net income (loss) per share:		
Basic	$ (0.10)	$ 0.06
Diluted	$ (0.10)	$ 0.06
Pro forma net income per share:		
Basic	$ 0.01	$ 0.06
Diluted	$ 0.01	$ 0.06

5. SEGMENT INFORMATION

The Company classifies its businesses into three segments: Transaction Services, Credit Services and Marketing Services.

	Transaction Services	Credit Services	Marketing Services	Other/ Elimination	Total
			(in thousands)		
Three months ended March 31, 2001					
Revenues	$ 117,463	$ 74,299	$ 44,291	$ (54,873)	$ 181,180
Depreciation and amortization	9,972	401	7,107	—	17,480
Operating income (loss)	4,540	8,450	(1,881)	—	11,109
Three months ended March 31, 2002					
Revenues	$ 132,208	$ 82,071	$ 54,649	$ (58,589)	$ 210,339
Depreciation and amortization	10,715	1,441	3,952	—	16,108
Operating income	4,703	7,576	2,533	—	14,812

6. ACQUISITIONS

In January 2002, the Company acquired Frequency Marketing, Inc., a small marketing services firm, adding new products for the Company's loyalty and one-to-one marketing offerings in the U.S. The preliminary purchase price allocation, which equals the total purchase price, net of cash received, of $26.0 million resulted in identifiable intangible assets of $12.2 million, which are being amortized over a 2-5 year period, and goodwill of $17.2 million.

7. RECENT DEVELOPMENTS

On March 15, 2002, the Company further amended its credit agreement to add a short term $50.0 million revolving loan facility, remove a requirement that The Limited maintain ownership of a stated amount of the Company's common stock, and adjust certain other covenants related to leverage ratios, adjusted consolidated net worth, the interest coverage ratio, and allow for prepayment of certain subordinated debt owed to Limited Commerce Corp. and an affiliate of Welsh, Carson, Anderson & Stowe. The Company uses the credit agreement and free cash flow to support its acquisition strategy.

During April 2002, the Company repaid $50.0 million of its subordinated debt held by WCAS Capital Partners II, L.P., an affiliate of Welsh, Carson, Anderson & Stowe, and Limited Commerce Corp. As a result, Limited Commerce Corp. does not hold any of the Company's subordinated debt and an

affiliate of Welsh, Carson, Anderson & Stowe holds the remaining $52 million of the Company's subordinated debt.

8. RECENTLY ISSUED ACCOUNTING STANDARDS

In October 2001, the FASB issued SFAS No. 144, "Impairment or Disposal of Long-Lived Assets", which is applicable for financial statements issued for fiscal years beginning after December 15, 2001. The provisions of this statement provide a single accounting model for impairment of long-lived assets. The Company is in the process of determining the impact, if any, of adopting SFAS No. 144.

9. RESTATEMENT

Subsequent to the issuance of the Company's condensed consolidated financial statements for the three months ended March 31, 2001, the Company determined that an economic hedge on debt related to World Financial Network Credit Card Master Trust did not meet the criteria for hedge accounting under the provisions of SFAS No. 133, as amended, which was adopted on January 1, 2001. In its previously issued interim financial statements for 2001, the Company had designated an interest rate swap agreement as a hedge against its cash flow exposures and included the change in fair value of the interest rate swap in other comprehensive income. These changes should have been included in earnings. Accordingly, the condensed consolidated financial statements for the three months ended March 31, 2001 have been restated. A summary of the significant effects of the restatement is as follows (items that were not changed were not affected by the restatement).

	For the three months ended March 31, 2001	
	As originally reported	As restated
	(in thousands, except per share amounts)	
Revenue	$ 180,692	$ 181,180
Operating expenses	170,071	170,071
Fair value loss on interest rate derivative	—	5,431
Interest expense	9,635	9,635
Income (loss) before income taxes	986	(3,957)
Income tax expense (benefit)	933	(797)
Net income (loss)	$ 53	$ (3,160)
Net income (loss) per share—basic and diluted	$ (0.04)	$ (0.10)

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and related notes thereto presented elsewhere in this document. The Management's Discussion and Analysis of Financial Condition and Results of Operations presented below reflects the restatement of our condensed consolidated financial statements for the three months ended March 31, 2001, as discussed in Note 9 to the condensed consolidated financial statements.

Recent Developments

In January 2002,we acquired Frequency Marketing, Inc., a small marketing services firm, adding new products for our loyalty and one-to-one marketing offerings in the U.S. The preliminary purchase price allocation, which equals the total purchase price, net of cash received, of $26.0 million resulted in identifiable intangible assets of $12.2 million, which are being amortized over a 2-5 year period, and goodwill of $17.2 million.

On March 15, 2002, we further amended our credit agreement to add a short term $50.0 million revolving loan facility, remove a requirement that The Limited maintain ownership of a stated amount of our common stock, and adjust certain other covenants related to leverage ratios, adjusted consolidated net worth, the interest coverage ratio, and allow for prepayment of certain subordinated debt owed to Limited Commerce Corp. and an affiliate of Welsh, Carson, Anderson & Stowe. We use the credit agreement and free cash flow to support our acquisition strategy.

During April 2002, we repaid $50.0 million of our subordinated debt held by WCAS Capital Partners II, L.P., an affiliate of Welsh, Carson, Anderson & Stowe, and Limited Commerce Corp. As a result, Limited Commerce Corp. does not hold any of our subordinated debt and an affiliate of Welsh, Carson, Anderson & Stowe holds the remaining $52 million of our subordinated debt.

Use of EBITDA and operating EBITDA. We evaluate operating performance based on several factors of which the primary financial measure is operating income plus depreciation and amortization, or "EBITDA." EBITDA is presented because it is an integral part of our internal reporting and performance evaluation for senior management. EBITDA eliminates the uneven effect across all segments of considerable amounts of non-cash amortization of purchased intangibles recognized in business combinations accounted for under the purchase method. In addition, we use operating EBITDA to monitor compliance with the financial covenants in our amended credit agreement such as debt-to-operating EBITDA, interest coverage ratios and minimum operating EBITDA .We also use operating EBITDA to measure the performance and liquidity of our reportable segments. EBITDA and operating EBITDA are not intended to be a performance measure that should be regarded as an alternative to, or more meaningful than, either operating income or net income as an indicator of operating performance or to the statement of cash flows as a measure of liquidity. In addition, EBITDA and operating EBITDA are not intended to represent funds available for dividends, reinvestment or other discretionary uses, and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with accounting principles generally accepted in the United States of America. The EBITDA and operating EBITDA measures presented may not be comparable to similarly titled measures presented by other companies.

Results of Operations

Three months ended March 31, 2001 compared to the three months ended March 31, 2002

	Three months ended March 31,					
	Revenue		EBITDA		Operating income (loss)	
	2001	2002	2001	2002	2001	2002
	(amounts in thousands)					
Transaction Services	$ 117,463	$ 132,208	$ 14,512	$ 15,418	$ 4,540	$ 4,703
Credit Services	74,299	82,071	8,851	9,016	8,450	7,576
Marketing Services	44,291	54,649	5,226	6,486	(1,881)	2,533
Other/Eliminations	(54,873)	(58,589)	—	—	—	—
Total	$ 181,180	$ 210,339	$ 28,589	$ 30,920	$ 11,109	$ 14,812

	Three months ended March 31,					
	Percentage of revenue		EBITDA margin		Operating margin	
	2001	2002	2001	2002	2001	2002
Transaction Services	64.8 %	62.9 %	12.4 %	11.7 %	3.9 %	3.6 %
Credit Services	41.0	39.0	11.9	11.0	11.4	9.2
Marketing Services	24.5	26.0	11.8	11.9	(4.2)	4.6
Other/Eliminations	(30.3)	(27.9)	—	—	—	—
Total	100.0 %	100.0 %	15.8 %	14.7 %	6.1 %	7.0 %

Revenue. Total revenue increased $29.1 million, or 16.1%, to $210.3 million for the three months ended March 31, 2002 from $181.2 million for the comparable period in 2001. The increase was principally due to a 12.6% increase in Transaction Services revenue, a 10.5% increase in Credit Services revenue and a 23.4% increase in Marketing Services revenue as follows:

- *Transaction Services.* Transaction Services revenue increased $14.7 million, or 12.6%, due primarily to an increase in the number of statements generated in both Issuer Services and Utility Services and a related increase in revenue per statement. Utility Services revenue increased due to increased statement volume related to Georgia Natural Gas and Puget Sound Energy contracts. Merchant Services continued to grow at a lesser rate than other services and as such is decreasing as a percentage of this segment's revenue.

- *Credit Services.* Credit Services revenue increased $7.8 million, or 10.5%, primarily due to increases in finance charges, net during the three months ended March 31, 2002 over the comparable period in 2001. Merchant fees increased by $1.3 million as a result of a 20.2% increase in private label credit sales. Finance charges, net increased $4.5 million during the three months ended March 31, 2002 from the comparable period in 2001. The increase is largely attributable to lower cost of funds due to the $900.0 million, three year term, asset backed securitization completed in August 2001. Partially offsetting the lower cost of funds, net charge-off rates increased by approximately 50 basis points during the three months ended March 31, 2002 from the comparable period in 2001.

- *Marketing Services.* Marketing Services revenue increased $10.4 million, or 23.4%, primarily due to an increase in reward revenue related to a 60.6% increase in the redemption of AIR MILES® Reward miles. Additionally, services revenue increased 11.9% as a result of the recognition of deferred revenue balances accumulated in connection with the original

issuance of AIR MILES Reward miles. Our deferred revenue balance increased 1.6% to $334.8 million at March 31, 2002 from the balance at December 31, 2001

Operating Expenses. Total operating expenses, excluding depreciation and amortization, increased $26.8 million, or 17.6%, to $179.4 million during the three months ended March 31, 2002 from $152.6 million during the comparable period in 2001. Total EBITDA margin decreased to 14.7% for the three months ended March 31, 2002 from 15.8% for the comparable period in 2001. The decrease in EBITDA margin is due to margin decreases in Transaction Services and Credit Services, partially offset by an increase in the Marketing Services margin.

- *Transaction Services.* Transaction Services operating expenses, excluding depreciation and amortization, increased $13.8 million, or 13.4%, to $116.8 million for the three months ended March 31, 2002 from $103.0 million for the comparable period in 2001, and EBITDA margin decreased to 11.7% for the three months ended March 31, 2002 from 12.4% during the comparable period in 2001. The EBITDA margin decrease is primarily related to the de-conversion of a client.

- *Credit Services.* Credit Services operating expenses, excluding depreciation and amortization, increased $7.6 million, or 11.6%, to $73.1 million for the three months ended March 31, 2002 from $65.4 million for the comparable period in 2001, and EBITDA margin decreased to 11.0% for the three months ended March 31, 2002 from 11.9% during the comparable period in 2001. The decrease in EBITDA margin is the result of the allocated portion of the increase in non-cash compensation expense.

- *Marketing Services.* Marketing Services operating expenses, excluding depreciation and amortization, increased $9.1 million, or 23.3%, to $48.2 million for the three months ended March 31, 2002 from $39.1 million for the comparable period in 2001, and EBITDA margin was relatively constant as compared to the prior year.

- *Depreciation and Amortization.* Depreciation and amortization decreased $1.4 million, or 8.0%, to $16.1 million for the three months ended

March 31, 2002 from $17.5 million for the comparable period in 2001 due primarily to a $4.3 million decrease in the amortization of purchased intangibles relating to the implementation of SFAS No. 142, offset by an increase in depreciation and other amortization of $2.9 million.

Operating Income. Operating income increased $3.7 million, or 33.3%, to $14.8 million for the three months ended March 31, 2002 from $11.1 million during the comparable period in 2001. Operating income increased primarily from revenue gains and a decrease in depreciation and amortization.

Interest Expense. Interest expense decreased $3.3 million, or 34.4%, to $6.3 million for the three months ended March 31, 2002 from $9.6 million for the comparable period in 2001 due to a decrease in average debt outstanding.

Taxes. Income tax expense increased $5.2 million to $4.4 million for the three months ended March 31, 2002 from a $0.8 million benefit in 2001 due to an increase in taxable income. Our effective rate for the three months ended March 31, 2002 was approximately 50%.

Transactions with The Limited. Revenue from The Limited and its affiliates, which includes merchant and database marketing fees, decreased $348,000, or 3.6%, to $9.2 million for the three months ended March 31, 2002 from $9.6 million for the comparable period in 2001, partially as a result of the sale of Lane Bryant by The Limited. Excluding the effect of the Lane Bryant sale, there would have been an increase of $0.6 million. We generate a significant amount of additional revenue (financing charges, net) from our cardholders who are customers of The Limited and its affiliates.

Asset Quality

Our delinquency and net charge-off rates reflect, among other factors, the credit risk of credit card receivables, the average age of our various credit card account portfolios, the success of our collection and recovery efforts, and general economic conditions. The average age of our credit card portfolio affects the stability of delinquency and loss rates of the portfolio. We continue to focus our resources on refining our credit underwriting standards for new accounts and on collections and post charge-off recovery efforts to minimize net losses.

Delinquencies. A credit card account is contractually delinquent if we do not receive the minimum payment by the specified due date on the cardholder’s statement. It is our policy to continue to accrue interest and fee income on all credit card accounts, except in limited circumstances, until the account balance and all related interest and other fees are charged off or paid. When an account becomes delinquent, we print a message requesting payment on the cardholder’s billing statement. After an account becomes 30 days past due, a proprietary collection scoring algorithm automatically scores the risk of the account rolling to a more delinquent status. 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 we are unable to make a collection after exhausting all in-house efforts, we engage collection agencies and outside attorneys to continue those efforts.

The following table presents the delinquency trends of our securitized credit card portfolio:

	December 31, 2001	% of total	March 31, 2002	% of total
	(dollars in thousands)			
Receivables outstanding	$ 2,451,006	100.0%	$ 2,324,443	100.0%
Loan balances contractually delinquent:				
31 to 60 days	59,657	2.4	50,848	2.2
61 to 90 days	34,370	1.4	32,860	1.4
91 or more days	64,175	2.6	63,725	2.7
Total	$ 158,202	6.4%	$ 147,433	6.3%

Net Charge-Offs. Net charge-offs comprise the principal amount of losses from cardholders unwilling or unable to pay their account balances, as well as bankrupt and deceased cardholders, less current period recoveries. Net charge-offs exclude accrued finance charges and fees. The following table presents our net charge-offs for the periods indicated on a securitized basis. Average credit card portfolio outstanding represents the average balance of the securitized receivables at the beginning of each month for the period indicated.

	Three months ended March 31, 2001	2002
	(dollars in thousands)	
Average credit card portfolio outstanding	$ 2,197,008	$ 2,355,736
Net charge-offs	43,708	43,483
Net charge-offs as a percentage of average loans outstanding (annualized)	8.0%	7.4%

We believe, consistent with our statistical models and other credit analyses, that our securitized net charge-off ratio will continue to fluctuate but generally rise.

Liquidity and Capital Resources

Operating Activities.

	Three months ended March 31, 2001	2002
	(dollars in thousands)	
Cash provided by operating activity before change in merchant settlement activity	$ 18,971	$ 26,310
Net change in merchant settlement activity	(7,974)	(44,089)

Cash provided (utilized) by operations	$ 10,997	$ (17,779)

We generated cash flow from operating activities before change in merchant settlement activity of $26.3 million for the three months ended March 31, 2002 compared to $19.0 million for the comparable period in 2001. The increase in operating cash flows before change in merchant settlement activity is related to improved operating results for the three months ended March 31, 2002, partially offset by working capital movements. Merchant settlement activity fluctuates significantly depending on the day in which the quarter ends. At December 31, 2001, we carried more days of merchant settlement float than at March 31, 2002. We utilize our operating cash flow for ongoing business operations, acquisitions and capital expenditures

Investing Activities. We generated cash flow from investing activities of $5.5 million for the three months ended March 31, 2002 compared to the utilization of $37.2 million for the comparable period in 2001. Significant components of investing activities are as follows:

- *Acquisitions.* Net cash outlays, net of cash received, for acquisitions for the three months ended March 31, 2002 were $26.0 million compared to $18.8 million in the comparable period in 2001. The outlay for acquisitions in 2002 relates to the January 2002 purchase of Frequency Marketing, Inc.

- *Securitizations and Receivables Funding.* We generally fund all private label credit card receivables through a securitization program that provides us with both liquidity and lower borrowing costs. As of March 31, 2002, we had over $2.3 billion of securitized credit card receivables. Securitizations require credit enhancements in the form of cash, spread accounts and additional receivables. The credit enhancements are principally based on the outstanding balances of the private label credit cards in the securitization trust and their related performance. Each year during the period from November to January, we are required to maintain a credit enhancement level of 6% as compared to 4% for the remainder of the year. Accordingly, at December 31, we typically have our highest balance of credit enhancement assets. We intend to utilize our securitization program for the foreseeable future.

Financing Activities. Net cash used in financing activities was $21.9 million for the three months ended March 31, 2002 compared to $20.3 million for the comparable period in 2001. Our financing activities relate primarily to funding working capital requirements and the securitization program.

Liquidity Sources. We have four main sources of liquidity: securitization program, certificates of deposit, credit facility and issuances of equity.

Securitization Program. As of March 31, 2002, we had over $2.3 billion of securitized credit card receivables. Securitizations require credit enhancements in the form of cash, spread accounts and additional receivables. The credit enhancement is principally based on the outstanding balances of the private label credit cards in the securitization trust and their related performance. During the period from November to January, we are required to maintain a credit enhancement level of 6% as compared to 4% for the remainder of the year. Accordingly, at December 31, we typically have our highest balance of credit enhancement assets. We intend to utilize our securitization program for the foreseeable future.

Certificates of Deposit. We utilize certificates of deposit to finance the operating activities of our credit card bank subsidiary, World Financial Network National Bank, and to fund securitization requirements. World Financial Bank issues certificates of deposit in denominations of $100,000 in various maturities ranging between three months and two years and with effective annual fixed rates ranging from 2.8% to 7.5%. As of March 31, 2002, we had $96.8 million of certificates of deposit outstanding. Certificate of deposit borrowings are subject to regulatory capital requirements.

Credit Facility. At March 31, 2002, we had $87.6 million outstanding under our credit facility, consisting of $87.6 million of term loans and no outstanding borrowings under our $100.0 million revolving loan commitment. The term loans mature in installments through July 2005 and the revolving loan commitment matures in July 2003. Our credit facility allows us to borrow up to three times our operating EBITDA. Our borrowing capacity at March 31, 2002 was approximately $512.8 million. With total outstanding borrowings as of March 31, 2002 consisting of credit facility, certificates of deposit, and subordinated debt of $286.4 million, we had additional borrowing capacity of $226.4 million. In addition, we had $77.3 million of cash and cash equivalents as of March 31, 2002. We utilize the credit facility and free cash flow to support our acquisition strategy. During April 2002, we repaid $50.0 million of our subordinated debt that was held by an affiliate of Welsh, Carson, Anderson & Stowe and Limited Commerce Corp. As a result, Limited Commerce Corp. does not hold any of our subordinated debt and an affiliate of Welsh, Carson, Anderson & Stowe holds the remaining $52 million of our subordinated debt.

We believe that our current level of cash and financing capacity, along with future cash flows from operations, will provide sufficient liquidity to meet the needs of our existing businesses for the foreseeable future. However, we may from time to time seek longer-term financing to support additional cash needs, reduce short-term borrowings or raise funds for acquisitions.

Recent Accounting Pronouncements

In August 2001, the FASB issued SFAS No. 144 “Accounting for the Impairment or Disposal of Long-Lived Assets.” SFAS No. 144 supersedes SFAS No. 121 “Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of” and the accounting and reporting provisions of APB Opinion No. 30 “Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions” and amends ARB No. 51 “Consolidated Financial Statements.” SFAS No. 144 retains many of the requirements of SFAS No. 121 and the basic provisions of Opinion 30; however, it establishes a single accounting model for long-lived assets to be disposed of by sale. SFAS No. 144 furthermore resolves significant implementation issues related to SFAS No. 121. The provisions of SFAS No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001 and are to be applied prospectively. We do not anticipate that the adoption of SFAS No. 144 will have a material effect on our financial position or results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk Management

Market Risk

There has been no material change from our annual report on Form 10-K related to the Company’s exposure to market risk from off-balance sheet risk, interest rate risk, credit risk, foreign currency exchange rate risk and redemption reward risk.

FORWARD-LOOKING STATEMENTS

This Form 10-Q and the documents incorporated by reference herein contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements may use words such as "anticipate," "believe," "estimate," "expect," "intend," "predict," "project" and similar expressions as they relate to us or our management. When we make forward-looking statements, we are basing them on our management's beliefs and assumptions, using information currently available to us. Although we believe that the expectations reflected in the forward-looking statements are reasonable, these forward-looking statements are subject to risks, uncertainties and assumptions, including those discussed in the "Risk Factors" section in our 2001 Annual Report on Form10-K.

If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary materially from what we projected. Any forward-looking statements contained in this quarterly report reflect our current views with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. We have no intention, and disclaim any obligation, to update or revise any forward-looking statements, whether as a result of new information, future results or otherwise.

PART II
OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time, we are involved in various claims and lawsuits incidental to our business, including claims and lawsuits alleging breaches of contractual obligations.

On November 16, 2000, in the United States District Court, Southern District of Florida, Miami Division, a group of World Financial Bank cardholders filed a putative class action complaint against World Financial Bank. The plaintiffs, individually and on behalf of all others similarly situated, commenced the action alleging that World Financial Bank engaged in a systematic program of false, misleading, and deceptive practices to improperly bill and collect consumer debts from thousands of cardholders. The suit stems from World Financial Bank's alleged practices involved in calculating finance charges and in crediting cardholder payments on the next business day if received after 6:30 a.m. The plaintiffs contend that such practices are deceptive and result in the imposition of excessive finance charges and other penalties to cardholders. The plaintiffs allege that World Financial Bank, through such practices, has violated the federal Fair Credit Billing Act, the federal Truth-In-Lending Act and breached cardholder contracts. The plaintiffs have not specified an amount of damages, but have requested, individually and on behalf of a putative class, monetary and punitive damages for the alleged stated claims and permanent injunctions for alleged statutory violations. The complaint was subsequently amended to include our subsidiary, ADS Alliance Data Systems, Inc., as a defendant. We believe these allegations are without merit and intend to defend this matter vigorously. We have entered into the discovery phase of the litigation.

Item 2. Changes in Securities and Use of Proceeds.
None

Item 3. Defaults Upon Senior Securities.
None

Item 4. Submission of Matters to a Vote of Security Holders.
None

Item 5. Other Information.
None

Item 6. Exhibits and Reports on Form 8-K.

(a) *Exhibits*:

EXHIBIT INDEX

Exhibit No.	Description
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant. (Incorporated by reference to Exhibit 3.1 of the Company's Registration Statement on Form S-1, as amended, Registration No. 333-94623)
3.2	Second Amended and Restated Bylaws of the Registrant. (Incorporated by reference to Exhibit 3.2 of the Company's Registration Statement on Form S-1, as amended, Registration No. 333-94623)
3.3	First Amendment to the Second Amended and Restated Bylaws of the Registrant. (Incorporated by reference to Exhibit 3.3 of the Company's Registration Statement on Form S-1, as amended, Registration No. 333-94623)
3.4	Second Amendment to the Second Amended and Restated Bylaws of the Registrant.(Incorporated by reference to Exhibit 3.4 of the Company's 2001 Annual Report on Form 10-K)
* 10.1	Alliance Data Systems Corporation 2002 Incentive Compensation Plan

***** Filed herewith

(b) *Reports on Form 8-K*:

On January 18, 2002, the Company filed with the SEC a Current Report on Form 8-K, dated January 17, 2002. The Current Report on Form 8-K relates to the posting of information on the Company website pursuant to Regulation FD, and such information shall not be deemed filed for purposes of the Securities and Exchange Act of 1934, as amended, nor is it to be incorporated by reference into any other filing by the Company.

On January 31, 2002, the Company filed with the SEC a Current Report on Form 8-K, dated January 30, 2002. The Current Report on Form 8-K relates to the Company's earnings for the fourth quarter of 2001and for the year ended December 31, 2001.

On April 2, 2002, the Company filed with the SEC a Current Report on Form 8-K, dated April 1, 2002. The Current Report on Form 8-K relates to the Company's upward adjustment to final revenue and EBITDA results for the year ended December 31, 2001.

On April l8, 2002, the Company filed with the SEC a Current Report on Form 8-K, dated April 17, 2002. The Current Report on Form 8-K relates to the Company's earnings for the first quarter of 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ALLIANCE DATA SYSTEMS CORPORATION

Date: May 14, 2002

By: /s/ Edward J. Heffernan
Edward J. Heffernan
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer)

Date: May 14, 2002

By: /s/ Michael D. Kubic
Michael D. Kubic
Vice President and Corporate Controller
(Principal Accounting Officer)

EXHIBIT INDEX

Exhibit No.	Description
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant. (Incorporated by reference to Exhibit 3.1 of the Company's Registration Statement on Form S-1, as amended, Registration No. 333-94623
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3.4	Second Amendment to the Second Amended and Restated Bylaws of the Registrant.(Incorporated by reference to Exhibit 3.4 of the Company's 2001 Annual Report on Form 10-K
4	Specimen Certificate for shares of Common Stock of the Registrant. (Incorporated by reference to Exhibit 4 of the Company's Registration Statement on Form S-1, as amended, Registration No. 333-94623
* 10.1	Alliance Data Systems Corporation 2002 Incentive Compensation Plan

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* Filed herewith

EXHIBIT 10.1

Alliance Data Systems

2002
Incentive
Compensation
Plan

Full Plan Description

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Attachment B – Example Individual Expectations Worksheet

Attachment C – 2002 Incentive Compensation Plan Corporate Information Services (CIS)

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Plan Philosophy

The intent of the Alliance Data System's Incentive Compensation (IC) Plan ("Plan") is to:

- Provide incentive compensation to round out an eligible associate's total compensation package to assist Alliance in attracting and retaining high performing associates;
- Improve organizational performance by providing the flexibility for each LOB/BSG to drive financial and individual performance and increase associate satisfaction;
- Improve the alignment between strategic imperatives and initiatives with the Alliance Scorecard; and
- Provide an opportunity for associates to share in the success they help create.

Participation in this plan reflects the importance of an associate's position and the impact that their performance can have on the success of the company. It is very important that associates understand the value incentive compensation has in their total compensation package.

Effective Date

The Plan Year is January 1, 2002 through December 31, 2002.

Eligibility

Associates are covered by this Plan if they are:

- A member of the Alliance Senior Leadership Team, as defined by the title Director through Chairman & CEO.
- In an Exempt position that is designated by Corporate Compensation as IC eligible (currently jobs in pay grades 8-11, 21-23, or 32-35).

- Employed by Alliance Data Systems before October 1, 2002.
- Newly hired associates or associates promoted into IC eligible pay grades for the first time before October 1, 2002.
- On active status on the date of the award distribution or eligible under the guidelines for retirement, disability, or leave of absence.
- Part-time associates working a schedule equal to a minimum of 25 hours per week.

Associates are not eligible if they:

- Are participating in a sales commission or other incentive plan, unless approved by the EVP/President of a Line of Business (LOB) or of a Business Support Group (BSG) and confirmed by Corporate Compensation.
- Are temporary or contract employees.
- Are hired on or after October 1, 2002 or are promoted into an IC eligible pay grade on or after October 1, 2002.
- Are on a documented performance improvement plan.

Base Compensation Used in Calculating Incentive Compensation Payout

Annualized base pay as of October 1, 2002 will be used as part of the incentive compensation calculation. The Incentive Compensation (IC) target percentage(s) will be applied to the October 1, 2002 base salary for purposes of calculating the dollar target amount.

Determining IC Targets

Each participant has an incentive compensation target. The Compensation Committee of the Board of Directors assigns IC targets for the Executive Committee Members. IC targets for other positions are determined by the participant's manager using the guidelines established by Corporate Compensation in the following table:

Grade Level	IC Target (% of 10-01-02 Base Salary)
Executive Committee Member	Determined by the Board's Compensation Committee
(Senior Vice President) 3	35% or 40% or 45%
(Vice President) 4	25% or 30% or 35%
(Director/Senior Director) 5	15% or 20% or 25%
8-10, 21-23, and 33-35	10% or 15%
11 & 32	5% or 10%

IC targets are set in 5% increments. When determining the appropriate target, the following is considered:

- The associate's position relative to those of other participant's in the department;
- The associate's anticipated contribution to the organization's success; and
- Targeted total compensation package that is competitive with similar positions in the appropriate labor market or industry.

IC Targets will be set at the beginning of the plan year or at time of hire and communicated appropriately. If the IC Target percentage changes, managers will explain how the target will be prorated for payout purposes (if appropriate) and whether or not the performance expectations and weightings will change for the current plan year.

Incentive Compensation (IC) Components

All performance goals should be established and communicated at the beginning of the Plan year or within 30 days of becoming a participant in the Plan. The degree to which these performance goals are accomplished may have an impact on the actual incentive earned from the Plan. Alliance Scorecard Measures and strategic imperatives define factors that help the company and the LOB/BSG reach its goals.

Alliance Revenue and EBITDA Targets: Revenue and Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) targets make up 25%-50% of a participant's IC payment (see Standard Weightings Chart below). The Board of Directors of the Company approves the Revenue and EBITDA target to be achieved for minimum, target and maximum payouts.

LOB Revenue and EBITDA Targets: There are a number of financial measures that can be used to determine success for a particular area or individual. Your President or Executive Vice President will determine if sub-measures will be used for your LOB or for you individually. However, it is intended that the Board of Directors approve the achievement of LOB Revenue and EBITDA for payout purposes.

Associate Satisfaction Index: The annual administration of the Associate Survey and the tracking of data (i.e., improvement expectations) are designed to motivate ongoing attention to issues that affect quality of client service, as well as the development and retention of associates. The Associate Satisfaction Index (ASI) is a component of the Associate Survey process. The ASI component is designed to recognize and incent critical non-financial organizational factors that contribute to sustainable business performance and provide competitive advantage in recruiting, developing, and retaining high performing associates. Targets are set at the beginning of each year along with a payout schedule. See Attachment A for more information.

Individual Expectations: The Weightings Chart identifies those participants that have 25% - 50% of their IC payments based upon the achievement of individual expectations or team strategic imperatives (or action steps to accomplish the strategic imperatives) as determined between the participant and his or her manager. A sample worksheet has been provided in Attachment B.

Standard Weightings Chart for IC Components

Incentive Compensation objectives are weighted to allow flexibility for each LOB/BSG to drive financial and individual performance and increase associate satisfaction. Units have the ability to use specific components that closely reflect Alliance Scorecard measurements, such as the CIS example shown in Attachment C. In addition, units may adjust the standard components for SLT members to include measurable financial drivers, such as bad debt or specific client revenue goals, with review and approval by the EVP & CAO and Corporate Compensation. The participant's grade/job level as of October 1, 2002 will be used to determine the overall weightings.

2002 IC Plan
Standard Components and Weightings

		Senior Leadership Team(1)	Exempts with Direct Supervisory Responsibility	All Other Exempts(2)
	LOB EBITDA	**50 %**	**25 %**	**25 %**
LOB	**LOB Revenue**	**25 %**	**25 %**	**25 %**
	Associate Satisfaction(3)	**25 %**	**25 %**	**0 %**
	Individual Expectations(4)	**0 %**	**25 %**	**50 %**
	Alliance EBITDA%	**50 %**	**25 %**	**25 %**
BSG	**Alliance Revenue**	**25 %**	**25 %**	**25 %**
	Associate Satisfaction	**25 %**	**25 %**	**0 %**
	Individual Expectations(4)	**0 %**	**25 %**	**50 %**

(1) The LOB/BSG executive has some flexibility to establish targets — by individual — that are important for the success for their respective area. The Individual Expectations weighting should not be used for SLT members, unless it is used to drive financial performance. Any changes to the standard components, weightings or payout tables should be sent to Corporate Compensation for approval by the EVP & CAO.

(2) The LOB/BSG has some flexibility in reassigning Revenue targets for those associates who fall into an all other eligible exempt category or in unique cases.

(3) Some participants, such as NAMs, may have more emphasis on client relationships than Associate Satisfaction. LOB/BSG executives can determine how they want to distribute the weightings for these positions.

(4) Eligible Exempt associates below the Director level should have Individual Expectations that are based on Alliance Scorecard measures and support strategic imperatives ensuring the success of their LOB/BSG and the company.

Determining Payment Calculations

Attachment A: Associate Satisfaction Index (ASI) Information
Identifies the relationship between level of performance and the percentage to be paid for achievement of 2002 Associate Satisfaction Survey target results. For the ASI component to be paid over 100%, both applicable EBITDA and Revenue targets must be achieved at 100% or greater.

Attachment B: Example Individual Expectations Worksheet
The sample form is provided to facilitate the setting of the Individual Expectations. If a participant is being held accountable for a company-level strategic imperative (or an action item to accomplish the strategic imperative for the LOB/BSG), that form may also be used. **Regardless of the form used, what will be required at the end of 2002 is an overall percentage of achievement of the Individual Expectations component to determine the dollar payment for this IC component.**

Attachment C: 2002 Incentive Compensation Plan Corporate Information Services (CIS)
Corporate Information Services (CIS) IC Plan identifies specific components and weightings for CIS.

Attachment D: Performance/Payout Table for Revenue, EBITDA, and Individual Expectations
Identifies the relationship between level of performance and the percentage to be paid for the achievement of Alliance Revenue and Alliance EBITDA, LOB Revenue and LOB EBITDA, and Individual Expectations targets. A minimum of 80% must be achieved for any payment to be received; performance of 120% or greater receives the maximum payment of 150%. The percentage of objectives achieved is rounded using scientific rounding.

For business support groups, both Alliance EBITDA and Alliance Revenue targets must be achieved at 100% or greater in order for Individual Expectations to be paid above 100% of target. For lines of business, both LOB EBITDA and LOB Revenue targets must be achieved at 100% or greater in order for Individual Expectations to be paid above 100% of target.

Timing of Payment

Incentive compensation earned for the 2002 Plan year is paid in the first quarter of the following year. A participant must be actively employed on the date payment is made to receive their award. Any participant who is on an approved leave of absence or disability, but still on active status, will receive their payment even if they are not actively at work on the date payment is made.

Status Changes That May Affect IC Targets and Payout

Status changes can affect the amount of incentive a participant receives. Status changes include:

- Transfers
- New Hires
- IC Target Changes
- Leaves of Absence
- Terminations

- **Transfers**

The LOB or BSG a participant is assigned to as of October 1, 2002 will be used to determine any payments dependent upon LOB/BSG level of performance (see Standard Weightings Chart). Year-end performance for the LOB/BSG will be used to calculate the incentive amount to be paid for this component. No prorating will be done for the amount of time spent in another LOB/BSG over the Plan year.

For the ASI component, leaders who have moved or transferred during the course of the year, and who could therefore have their compensation tied to different reporting groups, will be reviewed as follows:

- Determine where the associate spent the most time during the action planning cycle;
- Assess where the associate had the greatest opportunity to influence Associate Satisfaction; and
- Before the end of December, the HR Executive makes a report recommendation to Corporate Compensation, which will be approved by the Executive Vice President and Chief Administrative Officer.

- **New Hires**

For associates hired between January 1 and September 30, 2002 into an IC eligible position, the base salary as of October 1, 2002 will be used to calculate the IC dollar target. The dollar target will be prorated as follows:

Hired Between These Dates	Prorated Amount
January 1 – March 31	100%
April 1 – June 30	75%
July 1 – September 30	50%
October 1 – December 31	No IC

For example, if an associate is hired on March 12, the IC dollar target will not be prorated. If an associate is hired on July 4, then the IC dollar target will be prorated by 50%.

New hires within the ASI component will be assigned a report by the HR Executive. In cases where historical data are not available (e.g., new hires as a result of a new acquisition or changes brought about by organizational restructuring), the HR Executive will determine whether there is an existing group in the report plan upon which to base the ASI payout. If not, the current year score will be used to determine payout.

- **IC Target Changes**

For current Alliance associates, if there is a promotion or a grade level change during the plan year and this causes a change in IC target, the incentive will be prorated according to the chart below depending on the associate's **IC eligible effective date**. Note: changes in IC targets after October 1, 2002 will not be used to calculate incentive compensation payout for the current plan year.

IC Eligible Effective Date Between These Dates	Prorated Amount For Old/New IC% Target
January 1 – March 31	0% / 100%
April 1 – June 30	25% / 75%
July 1 – September 30	50% / 50%
October 1 – December 31	100% / 0%

The base salary as of October 1 will always be used to calculate the dollar target, even if there is a corresponding change in base salary at the time of the promotion or IC target change. For example, a grade level change in April results in an IC target change from 5% to 10% and a base salary change from $35,000 to $40,000. The base salary on October 1 is $40,000, so that is the salary used in the calculation. The IC dollar target is then calculated using the following formula:

	10/01 Base	IC	Target	Prorate	Subtotal
Old	$ 40,000	5%	$ 2,000	25%	$ 500
New	$ 40,000	10%	$ 4,000	75%	$ 3,000
TOTAL					$ 3,500

The participant's manager should communicate to the participant the new weightings of financial and individual expectations (if applicable).

- **Leaves of Absence**

If a participant takes a leave of absence in excess of 30 consecutive days, either paid or unpaid, during the Plan year, he or she may be eligible for a prorated award at the discretion of Corporate Compensation and the Executive Committee Member for that LOB/BSG and recommendations should be submitted at the time of the IC payout calculation.

- **Terminations**

If a participant terminates his or her position voluntarily or involuntarily during the Plan year, he or she will **not** be eligible for an IC payment because he or she would not be on active status on the date of the award distribution. If a participant retires, becomes disabled, or dies during the Plan year, he or she may

be eligible for a prorated award at the discretion of Corporate Compensation and the Executive Committee Member for that LOB/BSG. In the event of death, any incentive award is made to the beneficiary named in the company-paid life insurance program.

<u>Other Terms and Conditions</u>

- All decisions by the Company will be final in the interpretation and administration of the Plan and shall lie within the Company's sole and absolute discretion. Decisions shall be final, conclusive, and binding on all parties concerned.

- Participant's rights under the Plan may not be assigned or transferred in any way.

- The Alliance Data System's 2002 Incentive Compensation Plan may be amended, modified, suspended, or terminated by the Company at any time, without prior consent by or prior notice to associates. The Compensation Committee at its sole discretion may change objectives at any time without prior consent by or prior notice to associates.

- The Plan shall be unfunded. The Company shall not be required to establish any special or separate fund or to make other segregation of assets to assure the payment of the amounts under the Plan. Rights to the payment of amounts under the Plan shall be no greater than the rights of the Company's general creditors.

- Texas state law governs the validity, construction, interpretation, administration, and effect of the Plan, and the substantive laws, but not the choice of law rules, of the State of Texas, shall govern rights relating to the Plan.

- All applicable employment and tax deductions plus 401(k) contribution deferrals will be withheld from the incentive payout.

- No associate has the right or is guaranteed the right to participate in the Plan by virtue of being an associate or fulfilling any specific position with Alliance Data Systems. Selection for participation in the Plan is solely within the discretion of the Compensation Committee. Alliance Data Systems may offer participation in the Plan to additional associates or terminate the participation of any Participant in the Plan at any time during the Plan Year.

- Revenues and earnings classified as "windfalls" or business losses may or may not be excluded in whole or in part from the calculation of Revenue and EBITDA at the discretion of the Compensation Committee.

- Notice to participate in the Plan shall not impair or limit the Company's rights to transfer, promote, or demote Plan participants to other jobs or to terminate their employment, nor shall it create any claim or right to receive any payment under the Plan or any right to be retained in the employ of Alliance Data Systems.

- The Plan is established for the current fiscal year. There shall be no obligation on the part of the Company to continue the Plan in the same or a modified form for any future years.

- In the event that a participant has a dispute concerning the administration of this Plan, it shall first be submitted in writing to the Director of Compensation. In the event that the Director of Compensation does not provide a response satisfactory to the participant within 30 business days, the participant may submit the dispute in writing within five business days thereafter to the Executive Vice President and Chief Administrative Officer, whose decision regarding the dispute shall be final and binding on each Participant or person claiming under the Plan.

- The Plan is effective January 1, 2002, and supersedes and replaces all previous Incentive Compensation Plans. All such previous plans, unless earlier terminated, are terminated at midnight, December 31, 2001. If not renewed by the Compensation Committee or their designated representative, this Plan will automatically terminate on December 31, 2002.

- In the event an eligible associate's performance falls below satisfactory standards during the plan year, the associate may receive a reduced incentive compensation payment, at the discretion of the Company, regardless of the performance results of the company, LOB, BSG, or the ASI results (if applicable).

<u>Summary</u>

Participants in this Plan can influence the Company's continued success. Understanding the Incentive Compensation Plan is important to the participant's financial interests, as well as the success of LOB/BSG financial performance and the improvement of associate satisfaction. Questions about this Plan should be addressed to the participant's manager or local human resources professional.

Attachment A

ASSOCIATE SATISFACTION INDEX (ASI) INFORMATION

The Alliance Scorecard views associates as one of three key constituencies (along with clients and shareholders). Research has demonstrated and Alliance believes that satisfied associates provide higher levels of service quality and value creation/delivery, cultivating client retention and loyalty, and in turn providing

greater profitability and growth. The degree to which associates feel valued/satisfied has been shown to be a primary determinant of long-term financial performance. The Associate Satisfaction survey and the resulting Associate Satisfaction Index (ASI) represent an accountability mechanism that puts value on people and "walking the talk" when it comes to Alliance's company values, as well as financials and EBIDTA.

The ASI is intended to drive the company towards Employer of Choice levels of performance and reward progress towards these levels and recognize actual scores. Launched in 2001, the ASI is made up of 18 "core" items, asked and tracked on each annual Associate Survey.

The ASI includes two main components: a progress calculation and a measure of actual scores (current year mean percent favorable score on the 18 items). Scores are evaluated against both progress made since the previous year (as measured by "potential change") and current year scores, and payout is determined by *whichever is higher* (see "Payout Table for Associate Satisfaction Results" on the last page of this Attachment).

Consistent with 2001 are the following elements of the ASI calculation:

- At the company-wide level, the progress target for 2002 remains 16% of potential change. This is consistent with the 3-year plan to achieve external Employer of Choice benchmarks.

- Company-wide and for all subgroups, the goal is to achieve a mean, or average, score on the 18 ASI items of at least 75% Favorable. This level of achievement represents an Employer of Choice threshold and is based on external normative survey data.

- When a group achieves an actual score of 75% or greater, the group is assured at least 100% payout on this IC component, even if regression has occurred since the last survey. For example, if the 2001 mean score is 78% Favorable and the 2002 score is 75% Favorable — indicating regression of -3 percentage points — the group would receive 100% payout because their actual score is greater than 75% Favorable. Groups that exceed 75% will be rewarded according to scales (located below in this Attachment) with a maximum payout of 150% for this IC component.

- In the ASI computation, change is based on *potential change*, not absolute change. Computing scores based on potential change recognizes the increased difficulty of making continued progress as scores get higher. Regressions will be calculated in a similar manner.

In addition, the payout calculation for 2002 is based on the following:

- The scores will be determined using scientific rounding and will continue to be reported in whole integers.

- The payout tables have been modified. Instead of ranges of percent of potential change or ranges of actual scores, appropriate percentage points were determined to provide additional payout points.

- In 2001, ASI was based on a set number of reporting groups, selected to reflect shared accountability. As a continuous improvement effort for 2002, additional reporting groups have been incorporated into the ASI design to better reflect leaders' direct areas of influence and accountability. In consultation with your LOB/BSG HR executive, individual leaders' ASI component has been linked to reporting groups, as defined in the 2001 Associate Survey report plan. The goal of these assignments is to reflect both influence and accountability, and to enhance alignment between the survey process and the ASI design. Prior to the administration of Associate Survey 2002 (by end of July 2002), these assignments will again be reviewed as part of the report planning process led by your HR Executive. This final review will provide an opportunity to review any special cases (e.g., organizational changes) as needed. In any case of significant organizational change that requires a redefinition of a reporting group, targets to achieve 100% payout may change and will be re-communicated to leaders prior to survey administration.

- As in 2001, the targets identified on the next page represent the achievement of 100% payout. As a general rule for 2002, higher performing groups are likely to be paid based on current year scores, while groups with lower scores are likely to be paid based on their ability to make significant progress as measured by their potential change scores. This tendency is reflective of the higher relative "baseline" across the company as a result of the gains made between Associate Surveys 2000 and 2001.

- These targets have not been set by using a flat percentage increase over the average score of the same 18 items from the 2001 survey, but as a percent of the "potential for change". We have set a goal for Alliance Data Systems to increase our associate satisfaction by 16% of potential change a year. Each of the targets in this Attachment was calculated using this same growth percentage. As an example, here is the formula used to determine the 2002 target for the Alliance Consolidated score of 70:

2001 Base Score* = 64

100 – 64 = 36
(100 – 2001 Base Score* = Potential for Change)

36 x 16% = 5.76
(Potential for Change x Alliance Organizational Improvement = Increase Needed)

64 + 6 = 70
(2001 Base Score* + Increase Needed = Target Percent Favorable Score for 2002 Survey)

** Average of 18 items selected to compute Associate Satisfaction Index.*

TARGET SCORES (PERCENT FAVORABLE MEAN) FOR 2002 ASSOCIATE SATISFACTION FOR 100% PAYOUT ON IC COMPONENT

Report Name	2002 Target Score
Alliance Data Systems Consolidated (Mike Parks)	70
Transaction Services	
Transaction Services Consolidated (Mike Beltz)	66
Marketing Services	65
Network Services Consolidated	66
Network Services (Lenexa & Johnson City)	67
Network Services (Lenexa)	73
Network Services (Johnson City)	63
Network Services (Buffalo Grove)	59
Network Services (excluding Johnson City & Lenexa)	64
Utility Services Consolidated	66
Call Center Operations (Atlanta & Walnut St.)	66
Call Center Operations (Atlanta)	65
Call Center Operations & Human Resources — (Walnut St.)	66
Systems Development Consolidated (includes Seattle)	66
Systems Development (Atlanta)	59
Systems Development (HQ2)	74
Systems Development (Seattle)	Payout based on Actual Score
Frequency Marketing	Payout based on Actual Score
Mailbox Corp	Payout based on Actual Score
Corporate Information Services	
Corporate Information Services Consolidated (Steve Walensky)	66
Corporate Information Services (San Antonio)	69
Corporate Information Services (Reynoldsburg)	71
Corporate Information Services (excluding San Antonio & Reynoldsburg)	61
Retail Services	
Retail Services Consolidated (Ivan Szeftel)	73
Bank Operations Consolidated	67
Other Operations Consolidated	66
Retail Information Technology	68
Retail Services (Voorhees)	74
Retail Services (Broad St.)	71
Retail Services (Westerville Call Center)	75
Retail Services (Northglenn)	73
Retail Services (Lenexa)	75
Retail Services (Reno)	75
Retail Services (Other)	73
Corporate Support Services, CFO, & Legal Compliance Audit Services (LCAS)	
Corporate Support Services, Corporate Finance Office, LCAS	73

2001 base line scores can be obtained from your Human Resource Executive.
If a participant has questions about how the 2002 target was set, participants should contact their managers to confirm which target score is applicable.

PAYOUT TABLE FOR ASSOCIATE SATISFACTION RESULTS

There are two ways to determine payout for the ASI Component: Actual Score or the Percent of Target Achieved.

1. Look up the Actual Score first and determine the payout percentage.
2. Then, look up Percent of Target Achieved and determine the payout percentage.
3. Whichever payout percentage is higher will be the one paid, as long as the eligible associate is performing at a satisfactory level as determined by the Company. Payout over 100% for the ASI Component is also contingent upon meeting both the applicable EBITDA and Revenue targets.

Examples:

2001 Base Score:	71	
2002 Target:	76	
2002 Results and Possible Payment		
Actual Score:	75	100% payout
Percent of Target Achieved:	99%	90% payout
Payment would be at higher level = 100%		

2001 Base Score:	55	
2002 Target:	62	
2002 Results and Possible Payment		
Actual Score:	62	35% payout
Percent of Target Achieved:	100%	100% payout
Payment would be at higher level = 100%		

Actual Score (% Favorable Mean)	2002 Payout	Percent of Target Achieved	2002 Payout
56 or Less	**0 %**	89% or Less	**0 %**
57	**10 %**	90%	**10 %**
58	**15 %**	91%	**15 %**
59	**20 %**	92%	**20 %**
60	**25 %**	93%	**30 %**

	61	**30 %**	94 %	**40 %**
	62	**35 %**	95 %	**50 %**
	63	**40 %**	96 %	**60 %**
	64	**45 %**	97 %	**70 %**
	65	**50 %**	98 %	**80 %**
	66	**55 %**	99 %	**90 %**
	67	**60 %**	**100 %**	**100 %** <--Achieving 100% of potential change will result in 100% payout
	68	**65 %**	101 %	**105 %**
	69	**70 %**	102 %	**110 %**
	70	**75 %**	103 %	**115 %**
	71	**80 %**	104 %	**120 %**
	72	**85 %**	105 %	**125 %**
	73	**90 %**	106 %	**130 %**
	74	**95 %**	107 %	**135 %**
75% Favorable Score is the target for 100% payout -->	75	**100 %**	108 %	**140 %**
	76	**110 %**	109 %	**145 %**
	77	**120 %**	110% or more	**150 %**
	78	**130 %**		
	79	**140 %**		
	80 or more	**150 %**		

Attachment B

EXAMPLE INDIVIDUAL EXPECTATIONS WORKSHEET

Name: Target IC (%):

Position Title: Grade Level:

(a) Specific Expectations / Standards of Measure (Deliverables to be Achieved)	(b) Accomplishments / Results (Actual Results Achieved in Performance Period)	Ratings (c) Weighting %	Ratings (d) Actual Perf. %	(e) Overall Perf. Score % (c x d)
1.				
2.				
3.				
4.				
5.				
		100%		

Total Score on Specific Expectations (add column "e") >

Signed by: Associate ______________________ Manager ______________________

Attachment C

2002 INCENTIVE COMPENSATION PLAN
CORPORATE INFORMATION SERVICES (CIS)

Senior Leadership Team and Exempts with Direct Supervisory Responsibility	All Other Eligible Exempts(1)
25% Alliance EBITDA	25% Alliance EBITDA
25% CIS Direct Expenses	25% CIS Direct Expenses
25% Customer Satisfaction	25% Customer Satisfaction

25% Associate Satisfaction	25% Individual Expectations

(1) All other eligible exempt associates should have Individual Expectations that are based on Alliance Scorecard measures and support strategic imperatives ensuring the success of CIS and the company.

Special Payout Provisions

For CIS associates with an ASI component, both Alliance EBITDA and CIS Direct Expense targets must be met at 100% or greater for payout to occur above 100% for the ASI component.

Attachment D

PERFORMANCE/PAYOUT TABLE
FOR REVENUE, EBITDA, AND INDIVIDUAL EXPECTATIONS

	% of Objective(s) Achieved*	% Payout*	
	79% or less	0%	
80% is the threshold for performance achievements to result in a payout.-->	80%	65%	
	81%	67%	
	82%	69%	
	83%	70%	
	84%	72%	
	85%	74%	
	86%	76%	
	87%	77%	
	88%	79%	
	89%	81%	
	90%	83%	
	91%	84%	
	92%	86%	
	93%	88%	
	94%	89%	
	95%	91%	
	96%	93%	
	97%	95%	
	98%	96%	
	99%	98%	
	100%	100%	<-- 100% is the target fpr performance achievments to receive 100% payout
	101%	102.5%	
	102%	105.0%	
	103%	107.5%	
	104%	110.0%	
	105%	112.5%	
	106%	115.0%	
	107%	117.5%	
	108%	120.0%	
	109%	122.5%	
	110%	125.0%	
	111%	127.5%	
	112%	130.0%	
	113%	132.5%	
	114%	135.0%	
	115%	137.5%	
	116%	140.0%	
	117%	142.5%	
	118%	145.0%	
	119%	147.5%	
	120% or greater	150.0%	<-- 150% is the maximum payout level

For business support groups, both Alliance EBITDA and Alliance Revenue targets must be achieved at 100% or greater in order for Individual Expectations to be paid above 100% of target. For lines of business, both LOB EBITDA and LOB Revenue targets must be achieved at 100% or greater in order for Individual Expectations to be paid above 100% of target.