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ADS - Q2 2016 Alliance Data Systems Corp Earnings Call

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OVERVIEW:

Co. reported 2Q16 consolidated revenues of $1.75b and EPS of $3.68. Expects 2016 revenue to be $7.15b and core EPS to be $16.85.

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PRESENTATION

Operator

Good morning, and welcome to the Alliance Data second-quarter 2016 earnings conference call.

(Operator Instructions)

It is now my pleasure to introduce your host, Steve Calk of FTI Consulting. Sir, the floor is yours.

Steve Calk - *FTI Consulting - IR*

Thank you, operator. By now you should have received a copy of the company's second quarter 2016 earnings release. If you have not, please call FTI Consulting at (212) 850-5721.

On the call today, we have Ed Heffernan, President and Chief Executive Officer of Alliance Data; Charles Horn, Chief Financial Officer of Alliance Data; and Melisa Miller, EVP and President of Alliance Data's card services business.

Before we begin, I would like to remind you that some of the comments made on today's call and some of the responses to your questions may contain forward-looking statements. These statements are subject to the risks and uncertainties described in the company's earnings release and other filings with the SEC. Alliance Data has no obligation to update the information presented on the call.

Also on today's call, our speakers will reference certain non-GAAP financial measures, which we believe will provide useful information for investors. Reconciliation of those measures to GAAP will be posted on the Investor Relations website at www.alliancedata.com.

With that, I would like to turn the call over to Ed Heffernan. Ed?

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

Thanks Steve. Joining me today is Charles Horn, our CFO and Melisa Miller, President of Alliance Data Card Services. Charles will update you on the quarter results, Melisa will discuss Card Services and I will wrap-up with a scorecard on Q2 results as well as my updated outlook for full-year 2016.

I will now turn it over to Charles.

Charles Horn - *Alliance Data Systems Corporation - EVP and CFO*

Thanks Ed.

We saw strong acceleration in our growth rates during the second quarter as revenue increased 17 percent to $1.75 billion and core EPS increased 11 percent to $3.68. It was a quarter with many positives-- double-digit growth in revenue and adjusted EBITDA for both LoyaltyOne and card services, a return to positive revenue growth at Epsilon and stable FX rates. Another positive during the quarter was the opportunity to acquire earlier than scheduled the remaining 20% ownership in BrandLoyalty.

It made sense to us as the Company's performance has exceeded all of our expectations, and the opportunity in North America looks very compelling. Accordingly, we acquired the remaining interest effective April 1, 2016 for approximately $259 million in consideration, which was funded by upsizing BrandLoyalty's credit facility.

Now the accounting is a little unique, because the remaining ownership was purchased prior to the 10% tranches scheduled for January 17 and January 18, the consideration paid exceeded the carrying value of the redeemable non-controlling interest on the balance sheet, which would have increased over the next year and a half to roughly equal the purchase price paid. The difference of $68 million is an immediate charge to retain earnings on the balance sheet, but nonetheless is considered in the calculation of EPS, which was reduced by $1.14. Excluding this charge, EPS increased 13% for the second quarter.

What does the early acquisition mean to ADS? From a revenue standpoint, nothing, as we already consolidate 100% of BrandLoyalty's revenue. From a profitability standpoint, it will add a few cents to our EPS and our core EPS for 2016.

Turning to the repurchase program, we've acquired approximately 2.6 million shares under our repurchase program year-to-date. We have approximately $460 million of our Board authorization left, which we expect to use somewhat ratably over the remainder of 2016. Let's go to page 3 and talk about LoyaltyOne.

LoyaltyOne had a very strong second quarter, as revenue increased 17% to $352 million, and adjusted EBITDA increased 20% to $79 million. Negative FX translation rates knocked about 2 points of growth off for the second quarter, but on a positive note, we do not expect any FX drag in the second half of 2016 if current spot rates hold.

AIR MILES revenue increased 6% on a constant-currency basis driven by an 8% increase in miles redeemed. AIR MILES issued declined 3% versus the same quarter last year, which was expected.

As you may recall, we converted Sobeys' legacy reward program into the AIR MILES reward program in the second quarter of 2015. That makes for a difficult year-over-year comparable. In addition, we had less promotional activity in the grocer vertical this year.

AIR MILES redeemed increased 8% compared to the second quarter of 2015, primarily driven by AM Cash, our instant reward option. In particular, we're seeing growth in in-store redemptions, which are popular at our AIR MILES grocery partners.

Moving to BrandLoyalty, revenue increased 44% on a constant-currency basis, driven by an increase in the number of short-term loyalty programs executed during the quarter. Continued expansion into new markets such as South Africa and New Zealand contributed to growth.

The pilot recently executed with a top three grocer in the US finished with very strong results, as pilot stores showed revenue growth approximately 1.5% higher than non-pilot stores. This was accomplished largely through an increased basket sizes.

Plans are currently underway with this grocer to extend the program to the full store network at a later date. Additional pilot programs in the US and Canada are also planned for the back half of this year. Overall, a terrific quarter, and now let's flip over to the next slide and talk about Epsilon.

Epsilon's revenue increased 5% to $519 million for the second quarter, a solid turn from the revenue decline of 2% in the first quarter of 2016. Adjusted EBITDA decreased 9% to $103 million, primarily due to duplicative cost in our India operation and severance costs. We expect these costs to abate during the third quarter, allowing the full flow-through of revenue to EBITDA.

Our digital and technology platforms business is hot, posting a robust 14% growth versus the prior year. This performance was supported by solid contributions from all offerings in this category, with our automotive platform and Conversant CRM business leading the way.

In addition, solid traction in the affiliated business and strong net business within our Harmony platform added to the momentum. In particular, Conversant CRM business with industry-leading cross-device recognition and reach had a terrific quarter, with revenue up 66% and a building backlog that should exceed the book of business we want in 2015, with over 20 new clients signed and launched in the first half, including Zales, Beachbody, Justice, and White House Black Market.

Our agency media and services business continues to struggle, as revenue declined 15% versus the prior year. This offering has been weak for several quarters due to a combination of decreased spending by a large customer in our traditional agency, and lower volume of digital media buys from large third-party agencies.

In response, three initiatives were started during the second quarter. The first was to adjust the cost structure commensurate with lower revenue expectations; that is largely complete. The second, which is a longer-term initiative, is to redirect digital agency toward mid-side agencies and maybe direct clients. Third, we have begun pivoting this offering toward data-driven marketing insights, thus creating a CRM-light solution for clients who aren't ready yet for full CRM. Early results are encouraging, as we have begun to gain traction in new verticals such as media and entertainment.

Overall, we see two key market trends that align well with Epsilon's core strategy: demand from CMOs for measurable results and the ongoing shift from traditional marketing channels to digital and data-driven channels. With a highly differentiated digital and off-line data asset, a rich portfolio of services, and a deep marketing advertising technology stack, the business is poised to resume healthy, steady growth.

Top 50 clients are growing at a high single-digit rate and the business has a robust pipeline. Paired with prudent cost-management initiatives currently underway, we expect to see the return to profitable growth in the back half of 2016, and exit the year with a healthier cost structure going into 2017.

I will now turn it over to Melisa to talk about card services.

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

Thank you, Charles. Good morning, everyone. Turning now to page 5.

I'm so pleased to highlight that the card services business had another quarter of strong performance, delivering the 18th consecutive quarter of double-digit revenue growth. Revenues are up 25% over last year, translating to a 10% increase in adjusted EBITDA net of funding costs.

Let's turn now to page 6 and go over some of the key drivers of this strong performance. First, credit sales were up 18% resulting in year-over-year tender share gains of 180 basis points where measurable.

Now, each quarter you hear us comment on tender share, and we do so because it really is a fundamental metric to the success of our programs. And what may be helpful context here is these tender share gains we reference come from our legacy programs and do not include any gains from our newer card programs. Put differently, the tender share gains we reference are a result of increasing the number of trips, spend, and card member retention from those card programs with us prior to 2013.

Importantly, the average tenure of our 12-month active shopper is five years, and the sales distribution of our most tenured card members has been remarkably stable for four years. I mention this because these are highly seasoned relationships, and as such, we have great visibility into their past behavior and that allows us to accurately predict how our card members will behave in the future.

These gains are not a result of any widening, loosening, or lessening of our credit standards. And this consistent increase in tender share is really a result of that data-driven targeted marketing; know more, sell more brand promise, and the increases here are certainly a signal of card members' growing engagement with our brand partners.

Second, as expected, gross yields are normalizing and the year-over-year compression is lessening. And with very good visibility into the remainder of the year, we expect to achieve our annual guidance for gross yields of 25.1% as well.

Third, operating expenses grew 24% this quarter, while improving 40 basis points to 9.5% of our average card receivables. And even with this improvement, we continue to make investments in preparation for the onboarding of several new partners from diverse retail verticals. For example, we deliberately entered the high-growth segment of fast fashion with our recently announced Forever 21 partnership.

We look forward to announcing additional significant partnerships in the coming quarters. And this year as in years past, the new partnerships we will sign represent more than $2 billion in steady-state accounts receivable. Our pipeline remains robust as we continue to identify strong potential partners that are passionate about driving consumer engagement in line with her revolving needs and view the card program as the ultimate loyalty tool.

Fourth, our loss rate for the quarter came in at 5.1%, in line with prior guidance, and we remain confident in achieving our guidance of a 5% loss rate for the full year. We continue to see success in the proven ability to drive stronger engagement and loyalty through our tailored marketing solutions, driven largely by deep data analytics, insights, and innovative capabilities.

Now speaking of engagement, let's spend just a moment to cover off on some of the brands we most recently onboarded. We're super enthusiastic about the progress of our newer partners; they're posting very strong results year-over-year, and I wanted to take just a moment to share two very specific examples.

One partner experienced greater than a 70% increase in application volume and a credit sales jump of 37%; this, driving tender share gains of more than 800 basis points with just a few months post conversion. And another important partner saw tender share gains of 400 basis points, and credit sales increases of 45% post conversion. These gains are really due to our improved tools and stronger multi-channel engagement, and are again testament to the increased spend we generate for our brand partners.

We also know that despite these strong program results, concern still exists in the market around the strength and health of the US consumer. Candidly, we are seeing very few signs of concern.

Our view is that consumer confidence is stable, delinquency trends are within expected parameters, card retention is very strong, and we continue to find success in engaging brands and their customers. We are welcoming new card members to our programs, while the existing card members continue to spend across channels.

If I can comment just a moment about the consumer spend. To be clear, they are spending and they are spending differently. For instance, in some categories, we see our digital credit sales, so those sales outside of the brick-and-mortar environment growing significantly year-over-year.

Specialty retail currently sees digital credit sales over 40%, which is certainly higher than digital sales for the brand and has been steadily climbing. Similarly, 67% of home to core credit sales now come through digital channels, nearly a 10% jump in just two years.

Multi-channel shoppers, so those actively purchasing both in-store and digitally, are our fastest growing segment and they are also the most valuable to our partners. These multi-channel shoppers spend twice as much as digital -- as single channel shoppers. And looking more broadly, nearly 4 out of 10 applications are now completed outside of the store with mobile applications, in particular, the fastest growing channel. This continuing shift to mobile is reflective of consumer behavior, as it is the channel where she increasingly chooses to engage with her favorite brands.

As early adopters in the mobile space, we have been innovating on this trend for many years and believe it will continue to accelerate. As such, our investment strategy remains focused on delivering inventive capabilities that bring the most value to card members and to our brand partners, facilitating deeper loyalty and, ultimately, increased spend. For example, our MyLoyalty app solution continues to help brands cater to, engage with card members as they apply, shop, earn, and redeem, all through a seamless, intuitive, and highly targeted customer experience. And newer capabilities, such as the development of a proprietary mobile application experience that significantly reduces customer time and effort, serves the changing consumer who is looking for every interaction to be effortless.

In summary, card services has delivered another strong quarter, producing results in line with our high expectations. We're confident in our full-year guidance around our loss rates, our yields have stabilized ahead of our expectations, and we remain confident in our consumer outlook and the overall quality and performance of our card members. Our investments in partnerships align to the evolving needs of both our brands customers and the retail landscape overall, thus demonstrating the value we bring to our partners through our broader retail heritage and our experience lends to the market.

Thanks so much and Ed, I will turn this over to you.

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

Great, thanks, Melisa. Why don't we turn to the second-quarter scorecard. We'll try to wrap this up as neatly as we can, and we're going with color-coded circles on the left. We're looking for more green than other colors; that would be a good thing, and as we are midway through the year, looks like we're heading in the right direction.

So to sum it up, on a consolidated basis, $1.75 billion in revs, up 17%; $3.68 on EPS, up 11%. I think for those of you who have been hearing Charles and I talk about how the year would play out, we talked about a Q1, plus 5 top, plus 5 bottom, and in Q2 moving to 8 and 8, and then eventually double digit in the back half.

The fact that we're at 17% in Q2 and 11% on the bottom in Q2 as well essentially means that we are running ahead by a quarter. Essentially, the back half has been accelerated, and that is essentially what you're seeing in Q2. We were -- we had some signs that things that were accelerating, but of course, we wanted to be a little bit more careful until it actually played through.

So I think the easiest way to look at the quarter is it's not unexpected that we are running at double digit; what was unexpected is that we're running a double-digit this early in the year. That certainly takes the risk out of the back half of the year. We're nicely ahead of guidance and in fact we feel comfortable raising guidance at this point for the year. As Charles mentioned, the buyback, we're about halfway through and the year is about halfway through and we will leave it at that.

Now let's turn to card services. Melisa talked extensively about performance, once again, very strong growth in the overall portfolio. And we do talk on and on about tender share because that is so important to us. That's what makes or breaks our model versus other models out there, and essentially, that is the ability of triggering an additional purchase or visit with a purchase by the shopper over and above what she would traditionally do. That is all done through our data-driven marketing and targeting.

And as Melisa talked about, 85% of this tender-share gain is from very mature accounts, folks who have been with us for years and years and years. It's not a function of just pumping more plastic out into the marketplace, and that is something that's important. So the model works.

Probably the biggest surprise for the quarter in terms of good news was that gross yield certainly came in well ahead of expectations. Specifically, if you recall Q1 is where we saw the compression in yields of 210 basis points. We suggested that we thought this would roll off as the year progressed as we anniversaried various programs.

We actually saw a faster burn in, in Q2, and as a result, we picked up a very, very nice chunk of revenues from the gross yield compression being less than expected. Put simply, we went from 200 basis points compression in Q1 all the way down to 80 basis points in Q2, and then we'll trickle ahead for the rest of the year little bit better than that as the final programs burn through. That was probably the first good news surprise for the quarter.

Losses, they're dead on. There is not a lot to talk about there. We talked about a 5% loss rate for the full year way back at the beginning of the year. We are dead on with that number as we look to the back half, so no surprises there.

There is no big cliff heading our way out there; it is pretty straightforward and this is just normal account seasoning. And as Melisa said, there is no distress that we're seeing in the consumer. So very straightforward on the loss side.

And then, obviously, what Melisa and I spent a lot of time on is what does the future look like? The future, again, looks very promising. We've just announced thus far, Boscov's, Forever 21, Children's Place, Bed Bath & Beyond, Hot Topic.

We probably have another half-dozen that are signed, including a couple of biggies, that we will be announcing in the back half of the year. So very, very robust signing season for card services. I think that's it for cards.

We move now onto Epsilon where we have moved from green, yellow, and red to now green and yellow, which I think is a good thing. And I probably would say the second -- if you would call it a piece of good news or a surprise for the quarter, was that we knew Epsilon was turning. And again, Epsilon includes both Epsilon core, as well as the Conversant folks.

In Q1, obviously, it was a disappointing quarter. Revenues were down 2%. Our goal was to swing that to positive a couple of points by Q2 and then hit mid single digits as we move into the back half and accelerate from there.

Again, the news here was that the revenue acceleration occurred faster than we had anticipated. We actually swung from minus 2 to plus 5 between Q1 and Q2, so 7 points growth, change in growth is quite a bit. And needless to say, we were pleased to see that. We expect that type of performance to continue, if not tick up as we go into the back half.

And as Charles mentioned, the good news now is once we have the top line turned, the cost structure should play out as soon as the quarter we're in now, Q3. So essentially, as we have talked to people we had a -- we're in the process over the last year of a very significant ramp up, as we built up our India operation and we had a lot of duplicative costs, et cetera, et cetera, et cetera.

The bottom line is the flow-through will begin in Q3, and that should put us in very good shape for not only the back half, but more importantly, as we go into next year and the following year. That would be what we call the Q3 flip, for lack of a better term. And then I would like to spend just a couple of seconds on Conversant.

So Conversant became part of Alliance at the beginning of last year, and obviously, it was met with a fair amount of skepticism out there. Some of it made a lot of sense, some of it we disagreed with. But at this point, if you looked at the three pieces of Conversant, the traditional Conversant before we went into how we reported today, mashed up with the core Epsilon, you have three pieces.

And the traditional Conversant had about a quarter of the business in agency, and that is probably we're going to run down for the year probably 15% or something like that. Then you have a quarter of the business that's what we call CJ Affiliate, and that's running nicely at mid single digits up, and is a very strong cash flow contributor.

Then you have the biggest piece, half of Conversant, which is the data-driven CRM piece, and that is running between 40% and 50% for the year. That is really the huge piece, and you obviously want your biggest piece to be your fastest grower.

If you put it all together, what you essentially have is in Q2, if you looked at Conversant from a traditional perspective, you would have seen double-digit top consolidated with -- of all three pieces, and double-digit bottom. I raise that because of the fact that, that was our goal.

If you went back to the original thesis behind the acquisition, we knew that the affiliate business is a good business and will chug along. We knew that the agency business would be pressured and we'd need to find a way to distinguish that from other businesses. But primarily the CRM business, we were hoping for the huge cross-sell through the rest of Alliance; that has happened, and as a result, we are seeing this 10% top and bottom that the original deal was based upon.

As far as we're concerned, we hit our goals from the original deal. You look at BrandLoyalty, obviously came out of the gate double digit across the board right from the beginning of the acquisition. So the two deals we've done in the last three, four years have performed quite nicely. Some started a little bit faster than others. But right now, both seem to be producing.

As we move into the LoyaltyOne segment and we talk about BrandLoyalty, we mentioned in Q1 that it is a lumpy business and we have good visibility on full year but quarter by quarter is difficult. But needless to say, Q2 was fairly impressive, with revenue up over 40% and EBITDA up over 100%.

That was obviously a very big quarter for BrandLoyalty. We think we probably don't want to keep that as a run rate going forward, although, I'd love to but I think mid teens top and bottom would be a good set of nums for the year.

Also, as Charles mentioned, the BrandLoyalty US pilot has been completed, has been very successful. We need to be a little careful about chatting about what's next. But we have very high hopes in terms of upcoming activity in the US.

Now let's turn to Canada, and AIR MILES revenue was up 6%, and I believe it was up 5% in Q1. EBITDA for Q2 was up 4% and EBITDA in Q1 was up 11%. I think the bottom line of all of it is that there has been murmurs out there that the Canadian business is too mature and that it's not really going anywhere and that it's very sluggish.

This is a solid mid single-digit top and bottom with very strong cash flow generation. This is a great business, and I think it's going to be around for a long time and that is why we keep it firmly as part of the assets within Alliance. So very pleased with that issuance. Again, jumps by quarter. It was up 5% in Q1, it was down 3% in Q2. I think on a full-year basis, we're still shooting for somewhere around 4% or something like that.

Overall, we did have overperformance versus guidance. It came from three areas. First, on a top-line basis, Epsilon's revenues swung faster than we had anticipated, 7-point swing versus we were looking at more like 4 or 5. Second, in card services, yields came in better than expected as we saw the burn-through of these programs occur faster and that was good news.

Then finally, on the bottom line, it didn't help top line, but on the bottom line, as Charles said, we accelerated the opportunity to take the final 20% of BrandLoyalty and that added a few pennies in addition to the other stuff. Probably those three things drove the overperformance, but in general, really across the board, it was a really good story.

I think on a full-year basis, let's just jump to that. We are raising full-year guidance to revenues of $7.15 billion, up 11%, core EPS of $16.85, up 12%, and the new guidance does reflect the flow-through of the second-quarter [beat] to our guidance. And we'll flow through additional overperformance, if any, if it occurs in the back half of the year.

Essentially, as this year has been playing out, neither Charles nor I want to get too far out and over our skis here, so what we're effectively doing is we'll flow through the over performance when it comes, but let's not go charging down the road too quickly right now. Certainly things are heading in the right direction, there's an upward bias to even the existing guidance. But when it comes, we'll flow it through.

You can think of it almost as a hedge against if foreign-exchange rates start going wonky again, we don't want to have to recut and go through all of that stuff again. But in general, back half looks good, second quarter obviously double/double look very good.

Card services, we still expect double-digit growth, top and bottom for the year. Yield compression, will continue to lessen each quarter and we went from 210 to 80, and it will continue to lessen as the final two quarters play out, which gives us again, from where Melisa and I said, a very nice jump off point for next year.

Principal loss rates -- a lot of chatter out there in the marketplace, losses are going up, they are going up faster, they are going up slower. It's pretty straightforward. We're seeing the seasoning we thought at the beginning of the year; we will do 5% and then the other 50 basis points next year.

We're not seeing any consumer distress and the new vintages that we are signing, we have already completed the $2 billion in signings we needed for the full year this year. So it's only July, but again, a wonderful year.

Epsilon revenue growth rate snapped back to mid single. We expect that to drift up a bit and improve in even Q3 and Q4. As the momentum continues, we expect the revenue flow through to EBITDA starting as soon as Q3 as India is fully ramped up, and again, we'll call it the Q3 flip.

Digital and technology businesses are hot. As Charles mentioned, double-digit growth. It's three quarters of Epsilon and Conversant, so it's by far the largest chunk of it and it is doing extremely well.

The final piece, the quarter of the business that is agency media and media services, again better than Q1, still have some work to do. We have a number of initiatives underway. I guess the overall way to think about Epsilon and Conversant is that we manage a portfolio of products and services that can range from products that are in decline 15%, 20% to those that are growing over 60%. The goal here is to manage to a weighted average growth rate into the mid to high single digits, and so I think we're back on track there.

On the agency side specifically, we have a number of initiatives underway, specifically a data-driven CRM light, if you want to call it, for clients who don't want to do the full-scale heavy-duty CRM offering. But also potentially looking at maybe a white-label-type approach to the platform offering up to the mid-tier and smaller agencies that can't afford to bring all of that stuff in-house. Again, I think there is a bunch of good stuff going on there that we're still feeling pretty optimistic about it.

Finally, and then we'll take some questions. LoyaltyOne, we expect mid-single-digit growth in revenue on a constant-currency basis. And as I said, this is a -- it's a good business and it continues to get good traction up there. AIR MILES issued, also about 4%, and then of course BrandLoyalty, strong double-digit top- and bottom-line growth as the business continues to expand globally.

Overall, if you were to look at the bigger picture and the longer-term picture, you would see that if you went from the year before the great recession, then including the great recession, and all the way up to last year, this Company has delivered top-line growth averaging 15% a year and then bottom-line growth or core EPS growth of 18% a year again and that includes the great recession.

So it's not all that surprising that we're already back to double-digit top and bottom. Again, I think it's a quarter ahead of schedule, but we are raising guidance and expect to be running at plus 11 and plus 12 for rev and core EPS.

It's the ability to grow our core EPS by double digits despite being in a period of normalization in our card business. So what does that all mean? What it essentially means is we're dumping a whole bunch of P&L expense, not cash expense but P&L expense, into our reserves as losses normalize and as we're growing 20% plus. It's a big drag on our nums. You're talking a couple hundred million.

What that effectively does is that knocks 10 points off of our growth rate, and so even in its big high-growth period with big reserve builds, we're still able to deliver double-digit top and bottom. That's pretty good. And so if we can do plus 11 top, plus 12 bottom, essentially in a period where you're done seasoning and loss rates are stable, that would have been plus 11 and plus 22. That is the order of magnitude here. Our goal is even in a seasoning period, which is what we're in now, we still expect to deliver double top, double bottom.

Okay, so I think that our business outlook looks good, and I think if we don't have anything else here, we might as well just go to Q&A. Obviously, you can tell from our tone that what once was a very heavily weighted backend year is now no longer the case, and we're feeling pretty chipper about it. Why don't we open it up to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

David Togut, Evercore ISI.

David Togut - *Evercore ISI - Analyst*

Thank you and good morning. Nice to see the strong second-quarter results and the increased outlook for the year. Melisa, appreciate the helpful insights into card services. With credit top of mind, could you just remind us what the FICO score ranges are for your customer base? And how these are trending with new customer additions?

Charles Horn - *Alliance Data Systems Corporation - EVP and CFO*

It's a situation, David -- we really don't look at it that way. The underwriting that we do is a combination of internal proprietary data that we use plus bureaus that we [pull] as well, so it's really a combination we use. If you think about the underwriting, David, we've been using the same approach since the early 90s. So it's a very mature -- it's part of our secret sauce. So it's not a case where we purely rely upon bureaus; it is more of a case we use our internal data, which is, as you know extensive, to really find the universe of consumers that meet our profile but they're also a little bit different -- part of the reason we get the growth rates we do. I would say it's what we've always said before: we don't target sub-prime; we're going for a prime consumer, but we don't really rely upon bureaus as 100% of underwriting.

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

David, if I can just add on top of that, we have invested pretty significantly in tools that allow us to look at data sources even beyond that which would be our standard, either from other outside sources or that which we have internally. And we believe that combination is a bit of our secret sauce. It allows us to welcome as many card members to the program that will actually pay us back, but also are really accretive to our brand partners.

David Togut - *Evercore ISI - Analyst*

Understood. Just shifting gears -- ValueAct recently increased its stake to 6.8% of ADS, and they spelled out some objectives in a press release. Can you enlighten us about your dialogue with ValueAct and where you think that will go over time?

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

Sure, I certainly read the press release. I would say that what we can say is that they have known us extremely well for probably a decade, and they've been quite savvy with their bets over the past decade. And the initial discussions we have had were similar to the discussions we'll have with any potential large investor, which is, tell us about the business, the plans, the future. And the belief is just what they said: that they think it's a good value and they think that the noise around the whole credit and how it's going to impact us and everything else is overdone. And that,

that's what we've been told in terms of their position. Anything else -- frankly, I believe they have to file certain papers if they decide to do something else. But frankly, that's all we know at this point.

David Togut - *Evercore ISI - Analyst*

Understood. Finally, just want to confirm that you are reaffirming your free cash flow guidance for the year.

Charles Horn - *Alliance Data Systems Corporation - EVP and CFO*

Yes.

David Togut - *Evercore ISI - Analyst*

Okay, so $1.4 billion?

Charles Horn - *Alliance Data Systems Corporation - EVP and CFO*

Yes.

Operator

Sanjay Sakhrani, KBW.

Sanjay Sakhrani - *Keefe, Bruyette & Woods, Inc. - Analyst*

Thank you. Good morning. And good results. Quick question on some of the initiatives around Epsilon -- redirecting the digital agency toward mid-agencies and the like. How long do you think this takes to really assess whether or not it works or not, Ed?

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

Yes, it's -- what we're seeing on that small piece in the agency side is that the traditional clients we had, the real big agencies, have taken a lot of that work in-house. Because the goal of that part of the business was originally to go out and find inventory and appropriate inventory where we could place the various advertisements and messaging. And so as that has happened and programmatic trading and everything else has come into play, what we're looking at and where we think there is a big opportunity is, there's a lot of clients out there who love the huge CRM-type offering that requires them to give us the SKU-level information both online, off-line. We take that, we churn it through the big machines, we find the right patterns. We go out and place those with the appropriate folks out in the digital space.

But there's also, we believe, a huge chunk of folks, clients out there who don't necessarily want or need the whole soup to nuts that we offer with big CRM, as we call it. So I'm going to call it CRM-light, which is where you will use some data. So for example, a client may say, look, I'm having a big sale, it's going to be in the Southeast region of the country. I want to go out and I want to find those folks who are most likely to visit. Here is my email list. Could you go out, use that data, and let everyone know that's appropriate about the sale and what's going on? And that's a much smaller commitment from the client, and we think that's a good way to get them in the door and hopefully eventually upsell to big CRMs.

So the long-winded answer is, if we can do that along with our partners at, let's say, the mid-tier agencies who can afford to build these massive trading platforms, programmatic-type platforms, that this could be a nice winner and a nice feeder as well into big CRM. We've already started the retraining of our agency sales folks into CRM, and so we expect this thing to start taking root really toward the back half of the year. Hopefully, we'll see some results before we exit this year.

Sanjay Sakhrani - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, great.

And then I have a second question on private label, and maybe it's for Melisa and all of you all. There's obviously always chatter about large renewals for all over the big private label issuers and you guys included. But can you conceptually talk about your confidence in retaining some of your larger customers as they have grown with you? Perhaps anecdotally, maybe you could just talk about if any of those sales, the sales-lift commentary that Melisa had, still apply to these big relationships as your relationship has evolved? Thanks.

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

Yes, Sanjay, good morning.

I'm glad you asked that question, because the sales gains that we talk about are really from those legacy programs. And candidly, we have a high degree of confidence that we will retain those partners where we're like-minded, where they view the card program as the ultimate loyalty tool, where we're both making joint investments into the program. Candidly, tender share increases, increasing spend in retention, is really how our partners measure us and it's the report card that we have for ourselves. We would tell you this: that we have a 100% track record of retaining those important brand partners where we are aligned on the goals of the program. And we intend to approach the future just the same way that we've approached the past.

Operator

Darrin Peller, Barclays.

Darrin Peller - *Barclays Capital - Analyst*

Thanks, guys.

Just want to start off with guidance [via mine]. It's good to see you being on the quarter and raised for the full year by that beat. But just understanding the timing around the quarterly cadence now, your third-quarter guidance suggests a sequential increase from third to fourth quarter to meet your full year, which I think is a little bit more of a ramp than we had initially expected, given fourth quarter often has a drag from reserve build. So can you just give us some color on what the dynamic is between third- and fourth-quarter EPS in terms of the pickup?

Charles Horn - *Alliance Data Systems Corporation - EVP and CFO*

Again, a lot of it comes to timing. I'd say some of it is going to be driven by BrandLoyalty. BrandLoyalty, you saw was revenue was down 10% in Q1, up 40% in Q2. It will likely drop to maybe negative Q3 but then big pop in Q4. As you know, with BrandLoyalty it's a high fixed cost structure, so as its revenue ramps you get a nice flowthrough to earnings. It's just items like that, that have that influence. The CRM business with Conversant -- it is very much a back half-driven around the holiday season; you could get a nice ramp. So, Darrin, it's not one single factor. It's just a number of factors that drive the growth you're looking sequentially Q3, Q4.

Darrin Peller - *Barclays Capital - Analyst*

Okay, all right, thanks.

And then just I want to follow up to some of the questions around the private label of the card services business. Specifically the metrics that got better here more than expected -- the yield, in particular. I know there was some nuances on how you changed some of the program and the way you charge for on time, time payments. Just explain a little more detail, if you don't mind, how that got better versus your expectations. And then, if that trend should continue going forward, what's going to drive that, along with maybe just from a -- really, touch on credit quality one last time, given how many questions all of us have gotten around it. It seems fine, but is there anything you're seeing in any of the delinquency buckets that are any different at all? Maybe either you or Melisa could comment. Thanks.

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

Yes, Darrin, I'll go ahead and answer the question, if I can, in reverse order.

With respect to the consumer behavior, candidly, we're just not seeing the distress in terms of her payment behavior and her shopping behavior that others have discussed. Now she's shopping differently and she is spending differently. And part of the advantage that we have here is, as you know, we've diversified our portfolio a bit. So apparel seems to be the area where we see some weakness. But in terms of her payment behavior and her relationship with us, we have great visibility into where she's been and great visibility into how she's going to continue to behave with us. Again, we feel very comfortable with meeting guidance for the year.

With respect to what has changed from the end of last year, recall that we did make some program changes and the risk mix -- excuse me, the vintage mix -- of our new partners was also influencing what those yields look like. And simply, as Ed said, we are ahead a quarter. The burn-in and the normalization just happened sooner than we expected. And again, with very good visibility into what the future looks like, we feel very, very good about meeting that guidance.

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

Yes, I want to hit the credit thing because there seems to be so much chatter out there that it may be helpful to put it in perspective. And having been in the business for 1,000 years here, going back to the 1990s and the various cycles through where we are today, I think probably the biggest stress test that anyone has ever faced was the great recession. And in the great recession, what actually happened was that, even though private label tends to and always has run a point or so above loss rates in the general purpose arena, what actually happened in the great recession is, we performed a lot better than the general purpose cards. So when it really hit the fan, the general purpose cards -- those portfolios went from 4% or 5% to 10% or 11% loss rates, 600 basis points; we went up 300.

The reason behind that is why I guess we don't share the concern that others do about private label and everything else, is the fact that for sure it's a card that doesn't have the utilization of a general-purpose card. But that's great in terms of when times get stretched, because of the fact that you do not have a big open-to-buy line and you do not have the ability to go use it to buy food and put gas in the car and then go bankrupt. What you're seeing is, there may be lots of cards out there, but as you go down the credit spectrum, you bring down your credit lines. And so you may have $100 credit line on someone with a thin file. That ability to manage or open to buy in your credit lines across 40 million households is what allowed us to really manage to a very modest hit during the great recession. And that's why I think we don't expect to see any spike, because we are very active in terms of managing credit lines.

Darrin Peller - *Barclays Capital - Analyst*

That's helpful. Just a quick follow-up and then I'll turn it back to the queue.

On the buyback front, I know there was a lot last quarter. You paid out for BrandLoyalty this quarter. Is that why there was a little bit of a slowdown in buyback? Should we expect that to resume next quarter and going forward? Thanks, guys.

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

Obviously, we can't tell you exactly what we're going to do, but it shouldn't change the general thinking for the year. I would look at it as simply as we're halfway through the year, we've spent half the money.

Darrin Peller - *Barclays Capital - Analyst*

Great; thanks, guys.

Operator

Ramsey El-Assal with Jefferies.

Ramsey El-Assal - *Jefferies & Co. - Analyst*

Hi guys. So you mentioned that you pulled forward the purchase of BrandLoyalty. On the EPS line, what did that add in the quarter and in the guide?

Charles Horn - *Alliance Data Systems Corporation - EVP and CFO*

It probably added about $0.03 to the quarter, and for the year if they continue to meet expectations, Ramsey, it will probably add an incremental $0.05 compared to what we started the year thinking. What we'll do with that, Ramsey, is, as it comes through on a quarterly basis, then you'd see us flow it through to our guidance.

Ramsey El-Assal - *Jefferies & Co. - Analyst*

Got it, OK.

On BrandLoyalty, how should we think about the kind of -- how can I put this? This sales cadence or where you're at in the sales cycle with this program? In other words, especially in North America, you seem to have some success in the programs. Are you waiting to dial-up the sales resources you stack against rolling this program out? Are you still consider yourself in test-and-learn mode? Or is there some inflection point we should be waiting for when you put the pedal to the metal? Or is it more going to be just a gradual cross-sell or build over time?

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

It's a great question.

I think in North America if you look at where we started, we started up in Canada. Obviously, it made sense, since we had all of those relationships with the big grocers. Pedal is to the metal in Canada and that is bringing in $40 million, $50 million a year of incremental revenue since we started there probably 18 months ago. So Canada is fully spooled up, and so you're left with the US, which is 10 times in terms of the market size of Canada, which gets us obviously pretty excited. We were very deliberate in the pilots that we've been running. All that we can say at this point is that the results were quite good and the results, we expect that the client is hopefully as excited as we are. And hopefully we'll have some bigger news before the end of the year. That is, unfortunately, all we can say at this point, but once that happens then we press the accelerator a little bit more.

Ramsey El-Assal - *Jefferies & Co. - Analyst*

Lastly for me -- on the regulatory front, I heard a little chatter in the quarter about the CFPB looking at deferred interest promotions. Are there any other acute areas of risk in the business at this point? How are you thinking about regulation over the next, call it, 12, 18 months?

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

Ramsey, here's what we would say. We have been thriving in a very heavily regulated environment for many years. We obviously stay very close to pending points of view to any actions that are taken out there. For us on the deferred side, it is not a significant portion of our business, and so we would respond accordingly if there was any feedback that was given. For us, next to our partners and our consumers, we take our reputation with the regulators very, very seriously. So we build strong relationships and build our business accordingly.

Ramsey El-Assal - *Jefferies & Co. - Analyst*

Okay, thanks for your comments.

Operator

Bob Napoli, William Blair.

Bob Napoli - *William Blair & Company - Analyst*

Melisa, maybe a follow-up on the regulatory question.

Obviously, regulatory has been a big challenge for anybody in the financial services industry, and as you guys are getting larger, you may have a different regulatory body reviewing you. You may already have that happening. But what are you looking at? Are there areas of concern as new regulators, as you grow, take a different look at Alliance Data Systems? Is there anything -- what should we be worried about or concerned about?

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

Bob, we would tell you that this growth, as you well know, has been very purposeful, very planned. Like all of the other institutions, we have been dramatically strengthening our areas of compliance, compliance management systems. And, candidly, the FDIC and the CFPB have had strong collaboration for some amount of time. The consumer protection laws that are written by the CFPB are currently laws we already abide by, and so we feel very good that there shouldn't be any big surprises. Will there be some nuances to the relationship? Potentially; but sitting here today, we don't expect something large or ominous to come our way.

Bob Napoli - *William Blair & Company - Analyst*

OK, and then.

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

(Inaudible) is given.

Bob Napoli - *William Blair & Company - Analyst*

On the credit side, if you, typically cards across the credit card industry, credit weakens in the back half of the year seasonally. I think that's -- if you look back historically in ADS, that's not necessarily always the case. But is there, why are -- you're right at your target for the year in the first half of the year with the potential for seasonal weakening in the back half. Why are you so confident on hitting your target on the credit side for the year?

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

Well, there are a couple of things that contribute to that, Bob. The first is, again, as we mentioned, these customers that are 12-month active have been with us for many years. So we have great visibility into where she has been and how she'll behave in the future. For us, although some of our brands admittedly are seeing weakness, we generally continue to deliver that 3 times the brand growth. We saw that play out in Q1 and Q2. And so said differently, in times of brand weakness, the card programs are actually the bright spot, because they are the most loyal card members. And so this is where that multi-channel approach comes into play. We'll talk with her more. We'll ensure that she has the right motivation to either get online or get back into the store. But we are confident in our sales projections for the year.

Bob Napoli - *William Blair & Company - Analyst*

But on the credit side -- on the sales side, are you seeing the same payment rates? Are you looking -- what are you looking at that gives you that very high confidence that you'll hit your 5% charge-off?

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

Well, what we're confident in is that we are seeing the delinquency follow normal seasonal trends. We are seeing our charge-offs follow normal seasonal trends. And no, we're not worried about our payment rates. Our payment rates are commensurate with the balances that our card members carry, so we're not concerned about that.

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

I think if I could pile on a little bit.

Essentially, delinquency flows -- how we're carrying those delinquency flows, recovery rates, personal bankruptcies, open to buy -- all the stuff that goes into figuring out the flow-through in the visibility, we have been spot on since the guide at the beginning of the year, where we gave it by quarter. And based on all of the flows we are seeing, the losses, they're not going up in the back half versus the front half. We're going to be right at that 5% by the end of the year.

Bob Napoli - *William Blair & Company - Analyst*

Last question,

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

We -- I'm sorry, go ahead.

Bob Napoli - *William Blair & Company - Analyst*

I was just going to say, last question: the differentiation of your card business versus your competitors' or Synchrony and the marketing side of your business -- I thought The Children's Place was a good example. But are you seeing, when you're talking to potential clients, how often or how important, how would you differentiate yourself? And is your differentiation today the same as it has been in the past? And are you seeing competitors invest more in their marketing capabilities to narrow that competitive gap?

Melisa Miller - *Alliance Data Systems Corporation - EVP and President, Retail Credit Services*

It's certainly a crowded, competitive field right now, Bob. And what we would tell you is, our newest brand partners as well as our legacy brand partners, are our very best selling tools. So if you think about the two examples that I just called out, these are brand-new partners that have had very, very long-standing programs with other issuers. So the card member didn't suddenly change overnight and the brand didn't suddenly change overnight. What changed, perhaps, are the new tools that we make available, the way that we move out new value propositions to really resonate with the card members; and candidly, the way that we go about segmenting a client customer base so that we can get her back into the store. So we believe that our history speaks for itself. In all humility, we earn business every day. But we have a proven track record of delivering larger, more meaningful programs to the market we serve.

Charles Horn - *Alliance Data Systems Corporation - EVP and CFO*

We will take one more question.

Operator

Tim Willi, Wells Fargo.

Tim Willi - *Wells Fargo Securities, LLC - Analyst*

Hopefully I can sneak two in here real quick.

First one is, Ed, just going back to the free cash flow and thinking about that nominal number versus how you allocate that, and truly what's there for the repurchase program, which you have executed on. But obviously, you're growing the bank and the receivables. And if you look at some of the regulatory reports, you're actually putting capital into one of the banks. So I was just wondering if you could walk through, maybe explain a bit what's going on with the bank capital infusion relative to free cash flow relative to other priorities for that free cash flow. And then I just had a follow-up on Epsilon real quick.

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

Yeah, I will give it to you at a high level and Charles can put any detail that he wants. But at a very high level, when I look at capital allocation and capital resources for any given year, I start with our general definition of EBITDA, net of funding cost, net of corporate interest expense, net of CapEx. You add back the delta between the provision and what our actual cash losses are and you come up with about $1.4 billion. Of that amount, if cards is growing, the file $3 billion a year or something like that, we're going to need $450 million to $550 million of capital to support that.

You take that out of the $1.4 billion, you're down to $900,000, and that essentially is what we have to play with without increasing the leverage a lot. But that $900,000 is what we play with, and that either goes toward buyback or it goes towards M&A. The M&A could be at the bank level with the portfolio. In that case we would keep a little bit more down at the bank. Or it could be M&A for an Epsilon or LoyaltyOne. In that case, we would upstream it to the parents. That's essentially the breakdown of our free cash.

Tim Willi - *Wells Fargo Securities, LLC - Analyst*

Great, thank you. And then just a quick follow-up on Epsilon, and I apologize if this was addressed earlier. I hopped off.

But in terms of that agency business -- I think mid or early second quarter -- I think there was a study or a paper written by a trade group around the ad agency and the inventory and things of that nature, basically saying there was not a lot of transparency between the big ad agencies and their consumer products customers in terms of the services they provide in kickbacks and discounts and things like that. It showed a conflict maybe with some of the insourcing that was going on at those big agencies.

Again, maybe I'm just going way down the wrong path here, but I'm just curious if that development is something that actually potentially could benefit your agency business even just incrementally, as maybe the end customer, that big consumer product Company or whatever, says, I need more transparency and objective execution around my services versus just giving it all to you in house. Is there anything there to think about or no?

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

I would certainly -- I think I'll just leave it at, it doesn't hurt us, that is for sure.

Tim Willi - *Wells Fargo Securities, LLC - Analyst*

Fair enough, that's all I had. Thanks.

Ed Heffernan - *Alliance Data Systems Corporation - President, CEO and Director*

Thank you, everyone. We look forward to a great summer, good Q3, and a strong end to the year. So thank you and we'll talk to you later. Bye.

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.
