

Alliance Data Systems

We have acquired shares of Alliance Data Systems (ADS) at \$233/share. It is currently 9% of our portfolio. We are likely to add more over the next couple of weeks, bringing it to a full 15% position by the end of September.

Alliance Data Systems creates and operates loyalty and marketing campaigns for thousands of consumer-facing companies. It does so via three related, but independent business units: Card Services, Epsilon and LoyaltyOne. All businesses benefit from a shift from traditional mass marketing towards more targeted marketing programs that have a clear and measurable return on investments.

Card Services

This unit provides retailers with private label credit cards combined with a loyalty program that are offered to end-customers. ADS partners with more than 160 retailers, and has an average receivables portfolio of \$100m+ per retailer. Retailers range from traditional such as Victoria's Secret (largest client, together with its affiliates 16% of revenues) and IKEA, Ulta Beauty and pure-play ecommerce retailers such as Wayfair. Over 40% of the credit sales with ADS loyalty programs are done online (vs. 20% of the sales for ADS customer base total footprint).

This unit of ADS does not target major department stores, Amazon or large mass chains such as Walmart. Its main clients are in furniture (Williams-Sonoma, IKEA), jewelry (Signet, Zales), beauty (Ulta) and apparel (Forever21).

Retailers choose ADS because it brings incremental sales (as any credit card company would), but more importantly, ADS loyalty programs capture and process transactional data, which helps the retailer better understand customer behavior and drive further sales. An important point in the era of data-sensitivity: when registering for the loyalty program, end-customer is giving his/her consent to ADS to utilize the SKU-level information to market to the customer solely on behalf of the retailer. With ADS data-driven insights, the retailer learns where its customers shop, what device they use, what time of day they prefer to shop, what are they looking for and the specific message that will spark their interest to purchase an item. ADS tracks the customer anywhere on the web and offers a targeted deal from the online store of the bricks and mortar retailer. Common ID helps ecommerce retailers as well - customers are targeted with personalized offers all over the web rather than only on the website of the retailer. ADS contacts the customer via in-store communication, web, permission-based email, mobile messaging and direct mail. Customers with cards are making more shopping trips and spending 2-3x more than non-card members. ADS helps bricks and mortar move some of the sales online, by leveraging Common ID technology.

In the age of Amazon, all retailers need this expertise, but many are sub-scale to pay for it or develop it in house. ADS offers a convenient solution: by tying the profitable credit card program to the loyalty program, end-customer pays for the insights that retailer uses to boost sales. Additional benefit to the retailer is that ADS cards don't have interchange fee such as Amex, Visa or Mastercard. Much of the fee savings get reinvested into the loyalty program.

End-customers are prime, mostly female and carry a small balance on the card (\$688 on average, less than 20% of a typical credit card balance). They use the cards to access retailer's loyalty program and get discounts on purchases. They pay subprime interest rates (gross yield of 25% in 2017), although they are prime quality (20-year average charge-off net of recoveries has been 6.6% of average receivables; it peaked in the recession at 9.3%). Due to lower credit lines, ADS needs to have five times as many clients default as a typical credit card operator to have the same absolute loss. It is of great comfort to an investor in a credit-

sensitive business that it has operated smoothly, with the same base model, for the past 20 years. Management says that a typical recession would mean a 75bps bump to charge-offs in each of two years. If charge-offs move from normalized 6.5% to 7.25% in 2018 and 8% in 2019, it would be a \$160m and \$350m hit to current estimates, reducing free cash flow by a cumulative \$510m (25%) during those two years. Credit Services is an extremely robust business - at the depths of the recession, ROE of the business was 23.5%.

End-customer doesn't feel like they are paying high rates, as the interest is blended with discounts by the retailer (standard discount is 5% and goes to 30% on promotions). Small balances also help make the rates don't appear prohibitive: end-customer typically doesn't perceive six monthly payments of \$100 for a \$600 product they bought for \$530 as a 28% APR.

ADS collects interest and funds credit card receivables via commercial (customer deposits to be introduced in the near future) deposits from Comenity Bank and Comenity Capital Bank (both in ADS ownership), as well as securitizations. ADS also deals with customer care and collection on delinquent accounts. They charge for those services via a share of interchange fees. When ADS credit card is used, the retailer doesn't pay interchange fees they would typically pay to Visa or Mastercard. The retailer shares those savings with ADS and reinvests them through discounts for its loyal customers.

Combined, the two banks generated on average during the past 15 years a 35% return on equity and grew its book value by 18% p.a. with an average 7x assets/equity ratio (2011 - 2017 average, previous average difficult to be computed due to the change in accounting for securitizations occurred in 2010). Note that the company doesn't show its separate financials for Card Services business.¹

Card Services business grows via three levers: same store sales, tender share (penetration of credit sales vs. cash purchases at existing retail clients) and new customer additions. ADS recently lost customers due to bankruptcies (Bon-Ton). When there is no restructuring or continuation of retailer existence in some form, credit sales are lost. Once the receivables are paid off, the steady state level of receivables is reduced.

ADS has 99% annual retention, as the retailer gets reliant on ADS analytics by giving it the ownership of the data. The switching cost is high. A more plain private label credit card provider such as Synchrony Financial has an average relationship of 17 years, a testament how cumbersome it is to switch card operators. ADS competitive advantage versus Synchrony Financial or Capital One, which translates into lower cycle charge-offs and significantly higher returns on equity, is its retail loyalty program expertise.

As the portfolio transitions toward higher growing businesses (25% share, growing 35% p.a.) from slow growing (75% share, growing 3-4%) and bankrupt ones (Bon-Ton, Gander Mountain and Virgin America that was sold recently are all impacting credit sales growth right now), credit sales will expand from currently reported 2-3% growth to low double digits (would be 17% without the bankrupt accounts), driving receivables growth. Fast-growing accounts will account for more than 50% in about four years at current pace.

Normalized for charge-offs (2018 should be an average year for the cycle), free cash flow of the business (within ADS, more on that below) is c. \$1bn. About 30% of that free cash flow needs to be redeployed into receivables growth to keep growing free cash flow.

¹ Good resource for a more detailed breakdown: <https://cdr.ffiec.gov/public/>

Epsilon

A digital marketing agency, ranked by Ad Age as #1 US agency five years in a row. Epsilon uses data and creates analytics that help its clients more effectively acquire, retain and grow customer relationships. Epsilon offers strategic consulting, customer database technologies, omnichannel marketing, loyalty management, predictive modeling, etc. On behalf of its clients, Epsilon develops highly targeted and personalized marketing programs that reach individual consumers across channels. We take for granted that Amazon offers us a belt that goes with the shoes we've just bought. For most of the other retailers, having that insight is impossible on their own and Epsilon helps them with that.

Epsilon has 1,600 clients, among whom are nine of the top 10 banks, eight of the top 10 retailers, 10 largest pharmaceutical companies and seven of the top 10 automakers.

Epsilon clients allow it to analyze first-party purchase-level data and augment it with its knowledge of digital data about anonymized, segmented consumers: browsing behavior, offline activities, video views, emails, surveys, etc. Epsilon also has capability to do omnichannel analytics and see if the marketing actually resulted in return on investment for the advertiser, even if the return comes via a bricks and mortar store.

Some of the projects Epsilon has done recently: Walgreens loyalty program, revamp of BP loyalty program, consulting on Norwegian Cruise customer acquisition process.

Card Services business uses Epsilon loyalty platform, demographic/psychographic data and digital distribution channels for all of its retail clients. In the past five years, Card Services has developed "mini-Epsilon", with 500 data scientists that is self-sufficient with minimal contracting of Epsilon. This shows willingness to spin/sell Epsilon.

Epsilon CRM tool, which allows for very specific customer segmentation is 25% of revenues and is growing at 15%. Car dealership tool sold to OEMs who push it to dealers that reminds customers to do regular checks is 25% and growing. Big database loyalty programs are another 25% of revenues. Traditional agency work is 15% and has dramatically slowed down.

Epsilon segment generated LTM revenues of \$2.3bn, EBITDA of \$451m and pre-tax FCF of c. \$344m.

Valuation: Epsilon closest peer, Acxiom Marketing Solutions was sold for \$2.3bn to IPG on 2nd July 2018 (3.5x EV/Sales, 14x EV/EBITDA). This would imply a range on EV of Epsilon between \$6.2bn to \$8bn.

LoyaltyOne

LoyaltyOne does design and implementation of loyalty programs. LoyaltyOne uses information gathered through the loyalty program to help clients create effective marketing programs.

LoyaltyOne owns and operates AIR MILES, a Canadian coalition loyalty program founded in 1992. The coalition program has 200 sponsors (Sobeys, Shell, Amex, Bank of Montreal, etc.), 400 suppliers and a presence in two thirds of Canadian households (10m), enabling customers ("collectors") to collect points on everyday purchases. As a typical coalition loyalty program, sponsors pay a fee to AIR MILES per point issued to the collectors. AIR MILES uses the data that sponsors share to help them with marketing. An advantage to using AIR MILES for the sponsor rather than having their own program, is that AIR MILES sees what collectors are doing at 200+ sponsors, enriching the knowledge for each individual sponsor. An advantage for the collector is that accumulation of miles is multiple times faster than participating in many loyalty programs.

AIR MILES provides all marketing, customer service and redemption management for the program. When a collector redeems points at one of the suppliers, AIR MILES pays the suppliers. AIR MILES makes a spread between what the sponsors paid it for the point and what it paid the suppliers. Breakage, points that are forgotten by clients and never redeemed, present another source of profits. The company estimates breakage of 20%. Finally, a coalition operator benefits from investment income it has from the float (an estimated 38-month mismatch in duration between the time of purchase of a point and a redemption of a point). Most of the float is invested in corporate bonds. AIR MILES is a program owned and operated by ADS, rather than a program where Epsilon is a service provider, which is typical for the US, where companies prefer not to share data and want to run their own loyalty program.

AIR MILES went through a rough patch recently as it played its hand overly aggressively. In 2012, it announced it will cancel miles older than five years, effective January 1st 2017. In December 2016, a month before the plan was supposed to be activated, it caused backlash in Canada. In 2016, miles redeemed were 22% larger (and +60% year on year) than miles issued, an effective unwind of the float and a show of lack of trust in the program. The expiration plan was cancelled last-minute in December 2016 and subsequent regulation was introduced to prohibit mile cancellation in the future.

In 2017, the business got back to the normal levels of activity, with miles issued 21% larger than miles redeemed and miles issued back to pre-2016 levels. Renewal of contract with Bank of Montreal, the biggest sponsor (20+% of revenues), in 2017 was a big vote of confidence for the continued success of the program. In 2017, this business maintained its mid-20s EBITDA margins and extraordinary cash flow profile. As breakage rate assumptions decreased from 26% to 20% in 2017, we suspect the profitability of the program was maintained with modest points inflation.

Due to the remarkable penetration rate, this business can be expected to grow in-line with the rate of nominal GDP. Revenue for 2017 was \$743m and at a 24% EBITDA margin, yielded \$180m in EBITDA.

As a side note, in 2006 creation of a Canadian income trust for Air Miles was discussed at a \$1.7bn valuation, at a time that EBITDA was c. \$100m.

BrandLoyalty is a loyalty platform that sets up short-term loyalty programs for grocers in Europe, Asia and Canada. It does 200+ programs per year. The data obtained from the program is used to understand the customer base. It has traditionally operated in Europe. It has recently signed a pilot with Kroger, their first US deal (US loyalty coalitions failed three times so far). 60% of BrandLoyalty was acquired in 2014, 10% in 2015 and 30% in 2016 for a total of \$750m (\$1.3bn based on the valuation of the final 20%). This business has grown 10% p.a. historically.

Valuation: AIR MILES is a rare business where cash flow from operations is consistently substantially higher than EBITDA, due to a three year long negative working capital cycle. Fair multiple for this business could be 10x EBITDA, for an EV of \$1.8bn.

BrandLoyalty performance was less than satisfactory in 2017 (revenue -12% in 2017) and could be worth less than what it was paid between 2014 and 2016 (total price \$753m). I assume an EV of \$500m (7x EBITDA, 1x revenue), although the company expects double digit revenue and EBITDA growth to continue starting 2018.

Getting ADS free cash flow to zero - stress testing

- 1) Credit cycle turns for the worse with losses double the typical recession and equal to the Great Recession (6% -> 9%)
\$419m provision hit in one chunk
- 2) Down-cycle bankrupts 20% of their retailer customers and leads to a 20% drop in receivables
- 3) Interest cost jump from 2.4% blended to 3.5% blended... with APR flat. Interest cost \$439m -> \$805m. (note that the numbers are pro-forma for spin-off and debt pro-ration)
- 4) Opex doesn't move a dime
= Card Services business is close to FCF breakeven (= \$17m by my math)
- 5) Simultaneous cut in marketing budgets deducts 15% of revenue from LO, Epsilon... at 61% incremental FCF margin

FCF of the whole company would be c. \$0

Management

Ed Heffernan has been with the company since 1998, in CFO capacity and since 2009, as CEO. He came along with the ex-CEO, Mike Parks, from First Data Corp. He owns \$50m of stock. Bruce Anderson, has been on the board since IPO and is from the founding PE firm. He owns a personal account stake worth \$200m. Two other board members own \$20m+.

ValueAct owns 10.6% of the company (15% of their US equity portfolio) and has Kelly Barlow (ex-Adobe board member) on the board since 2017. Other notable holders of stock are Brave Warriors (16% of the US equity portfolio, 3% of the company), Arlington Value (14% of the US equity portfolio and 1.5% of the company).

Capital allocation

Management deserves praise for buying back 9% of the stock in 2008 and 22% of the stock in 2009 at a cumulative average of \$63/share. In the past three years they bought back \$2.3bn of stock (9.5m, 17% of current shares outstanding) at an average of \$243/share. They have indicated that a more aggressive repurchase will continue at current levels. Balance sheet has been financed increasingly via deposits (from 16% of gross receivables in 2010 to 56% of gross receivables in 2017).

Valuation - putting ADS together

Combined businesses will do \$1.5bn in free cash flow in 2018, of which \$115m goes to dividend and about \$350m goes to support growth of the credit card receivable portfolio at a 12-15% pace. This leaves \$1bn in free cash flow that is set to grow 10% per year. At 12x FCF (pre-dividend), we are paying an attractive price for a collection of superior businesses. At current prices, we expect most of the cash flows to be deployed towards buybacks.

Valuation - pulling ADS apart

We think that the logic for the spin-off is a sound one and that the value hidden in the Card Services could be unlocked by showing its true economics and allowing it to repurchase its

own stock in the market. We'd rather own Card Services than Epsilon, especially if it is at a 30% of the multiple of Epsilon.

Selling/spinning off LoyaltyOne for \$2.3bn and Epsilon for \$7bn, a combined enterprise value of \$9.3bn (equity of \$6.5bn, after accounting for pro-rata (for revenue) \$2.8bn in debt), would leave the credit card business priced at \$5.6bn, at 6x P/normalized 2019 FCF and 2x P/B. This is extremely cheap for a 35% ROE business that can keep growing free cash flow at low double digits for years. Fair multiple for this business is 15x FCF.

Reaching the fair multiple and having a normalized economy would lead to 40% annual returns for the five years between 2019 and 2023. The only rational deployments of capital are buybacks (share count can be reduced by 26% over five years if the share price compounds at 40%) and investing to support the growth of the credit card receivables portfolio. In a no-lose scenario, a lower pace of share price appreciation is more than fine with us. If the price per share doesn't move, the business can retire 70% of the shares within five years, ending 2023 trading at 1x P/FCF.