

ALLIANCE DATA SYSTEMS CORP

Form 10-Q

August 07, 2006

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

Form 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 30, 2006**
- OR**
- 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
*(State or Other Jurisdiction of
Incorporation or Organization)*

31-1429215
*(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)

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Name of Each Exchange on Which Registered |
|--|--|
| Common Stock, par value \$0.01 per share | New York Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act:

None
(Title of Class)

Indicate by check mark whether the registrant: (1) has filed all reports required 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 (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

As of August 1, 2006, 80,106,147 shares of common stock were outstanding.

ALLIANCE DATA SYSTEMS CORPORATION

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Table of Contents**PART I****Item 1. Financial Statements****ALLIANCE DATA SYSTEMS CORPORATION****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

| | December 31, 2005 | June 30, 2006 |
|--|---|----------------------|
| | (In thousands, except per share amounts) | |
| ASSETS | | |
| Cash and cash equivalents | \$ 143,213 | \$ 151,017 |
| Due from card associations | 58,416 | 15,686 |
| Trade receivables, less allowance for doubtful accounts (\$2,079 and \$2,177 at December 31, 2005 and June 30, 2006, respectively) | 203,883 | 227,047 |
| Seller's interest and credit card receivables, less allowance for doubtful accounts (\$38,415 and \$35,549 at December 31, 2005 and June 30, 2006, respectively) | 479,108 | 357,016 |
| Deferred tax asset, net | 70,221 | 69,679 |
| Other current assets | 87,612 | 95,321 |
| Total current assets | 1,042,453 | 915,766 |
| Redemption settlement assets, restricted | 260,963 | 280,765 |
| Property and equipment, net | 162,972 | 192,970 |
| Due from securitizations | 271,256 | 259,985 |
| Intangible assets, net | 265,000 | 274,569 |
| Goodwill | 858,470 | 922,880 |
| Other non-current assets | 64,968 | 62,923 |
| Total assets | \$ 2,926,082 | \$ 2,909,858 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Accounts payable | \$ 67,384 | \$ 70,198 |
| Accrued expenses | 198,707 | 157,730 |
| Merchant settlement obligations | 127,038 | 118,366 |
| Certificates of deposit | 342,600 | 165,000 |
| Credit facilities and other debt, current | 235,843 | 6,715 |
| Other current liabilities | 76,999 | 76,516 |
| Total current liabilities | 1,048,571 | 594,525 |
| Deferred tax liability, net | 62,847 | 39,080 |
| Deferred revenue | 610,533 | 662,327 |

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| | | |
|--|--------------|--------------|
| Certificates of deposit | 36,500 | 25,100 |
| Long-term and other debt | 222,001 | 552,441 |
| Other liabilities | 24,523 | 13,575 |
| | | |
| Total liabilities | 2,004,975 | 1,887,048 |
| Stockholders' equity: | | |
| Common stock, \$0.01 par value; authorized 200,000 shares; issued 84,765 shares and 86,285 shares at December 31, 2005 and June 30, 2006, respectively | 848 | 863 |
| Unearned compensation | (14,504) | |
| Additional paid-in capital | 743,545 | 791,724 |
| Treasury stock, at cost (4,360 shares and 5,695 shares at December 31, 2005 and June 30, 2006, respectively) | (154,952) | (219,384) |
| Retained earnings | 338,081 | 439,297 |
| Accumulated other comprehensive income | 8,089 | 10,310 |
| | | |
| Total stockholders' equity | 921,107 | 1,022,810 |
| | | |
| Total liabilities and stockholders' equity | \$ 2,926,082 | \$ 2,909,858 |

See accompanying notes to unaudited condensed consolidated financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|------------------|-------------------------|-------------------|
| | June 30, | | June 30, | |
| | 2005 | 2006 | 2005 | 2006 |
| (In thousands, except per share amounts) | | | | |
| Revenues | | | | |
| Transaction | \$ 150,788 | \$ 167,934 | \$ 293,753 | \$ 331,953 |
| Redemption | 67,857 | 84,870 | 130,524 | 163,818 |
| Securitization income and finance charges, net | 93,486 | 141,170 | 207,949 | 302,049 |
| Database marketing fees | 46,304 | 73,994 | 91,174 | 128,283 |
| Other revenue | 12,133 | 22,479 | 23,043 | 41,575 |
| Total revenue | 370,568 | 490,447 | 746,443 | 967,678 |
| Operating expenses | | | | |
| Cost of operations (exclusive of depreciation and amortization disclosed separately below) | 270,628 | 354,353 | 534,783 | 684,672 |
| General and administrative | 18,611 | 21,001 | 42,910 | 40,967 |
| Depreciation and other amortization | 13,881 | 15,849 | 29,211 | 31,066 |
| Amortization of purchased intangibles | 10,101 | 16,062 | 19,943 | 28,383 |
| Total operating expenses | 313,221 | 407,265 | 626,847 | 785,088 |
| Operating income | 57,347 | 83,182 | 119,596 | 182,590 |
| Interest expense, net | 2,353 | 10,059 | 5,114 | 18,596 |
| Income before income taxes | 54,994 | 73,123 | 114,482 | 163,994 |
| Provision for income taxes | 20,611 | 28,328 | 42,917 | 62,778 |
| Net income | \$ 34,383 | \$ 44,795 | \$ 71,565 | \$ 101,216 |
| Net income per share basic | \$ 0.42 | \$ 0.56 | \$ 0.87 | \$ 1.26 |
| Net income per share diluted | \$ 0.40 | \$ 0.55 | \$ 0.84 | \$ 1.24 |
| Weighted average shares basic | 82,750 | 80,074 | 82,540 | 79,987 |
| Weighted average shares diluted | 85,638 | 81,924 | 85,677 | 81,707 |

See accompanying notes to unaudited condensed consolidated financial statements.

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ALLIANCE DATA SYSTEMS CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Six Months Ended June 30, | |
|--|--------------------------------------|-------------|
| | 2005 | 2006 |
| | (In thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 71,565 | \$ 101,216 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 49,154 | 59,449 |
| Deferred income taxes | (2,225) | (7,706) |
| Provision for doubtful accounts | 4,692 | 7,231 |
| Fair value gain on interest only strip | (10,800) | (8,250) |
| Non-cash stock compensation | 3,319 | 19,902 |
| Change in operating assets and liabilities, net of acquisitions: | | |
| Change in trade accounts receivable | (19,822) | 3,278 |
| Change in merchant settlement activity | 4,969 | 34,058 |
| Change in other assets | 10,836 | (1,431) |
| Change in accounts payable and accrued expenses | 4,782 | (24,851) |
| Change in deferred revenue | 17,348 | 27,683 |
| Change in other liabilities | (5,219) | (25,013) |
| Tax benefit of stock option exercises | 10,405 | |
| Excess tax benefits from stock-based compensation | | (12,110) |
| Proceeds from the sale of credit card receivable portfolios to the securitization trusts | | 70,870 |
| Other | 1,305 | 5,899 |
| Net cash provided by operating activities | 140,309 | 250,225 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Change in redemption settlement assets | 529 | (11,143) |
| Payments for acquired businesses, net of cash acquired | (15,344) | (128,118) |
| Net decrease in seller's interest and credit card receivables | 23,505 | 42,596 |
| Change in due from securitizations | 49,523 | 19,833 |
| Capital expenditures | (28,584) | (48,627) |
| Other | 133 | (2,476) |
| Net cash provided by (used in) investing activities | 29,762 | (127,935) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Borrowings under debt agreements | 250,595 | 1,586,742 |
| Repayment of borrowings | (310,261) | (1,488,202) |
| Certificate of deposit issuances | | 73,500 |
| Repayments of certificates of deposits | (92,400) | (262,500) |
| Payment of capital lease obligations | (3,882) | (3,998) |
| Payment of deferred financing costs | | (1,975) |
| Excess tax benefits from stock-based compensation | | 12,110 |
| Proceeds from issuance of common stock | 19,224 | 32,708 |

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| | | |
|--|------------|------------|
| Purchase of treasury shares | (17,102) | (64,432) |
| Net cash used in financing activities | (153,826) | (116,047) |
| Effect of exchange rate changes on cash and cash equivalents | (259) | 1,561 |
| Change in cash and cash equivalents | 15,986 | 7,804 |
| Cash and cash equivalents at beginning of period | 84,409 | 143,213 |
| Cash and cash equivalents at end of period | \$ 100,395 | \$ 151,017 |
| SUPPLEMENTAL CASH FLOW INFORMATION: | | |
| Interest paid | \$ 6,700 | \$ 15,598 |
| Income taxes paid, net of refunds | \$ 33,739 | \$ 76,212 |

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. BASIS OF PRESENTATION**

The unaudited 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 (GAAP) 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/A for the year ended December 31, 2005.

The unaudited condensed consolidated financial statements included herein reflect all adjustments (consisting of 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 GAAP 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.

For purposes of comparability, certain prior period amounts have been reclassified to conform to the current year presentation. Such reclassifications have no impact on previously reported net income.

2. SHARES USED IN COMPUTING NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted net income per share for the periods indicated:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--|-------------|--------------------------------------|-------------|
| | 2005 | 2006 | 2005 | 2006 |
| | (In thousands) | | | |
| Numerator | | | | |
| Net income available to common stockholders | \$ 34,383 | \$ 44,795 | \$ 71,565 | \$ 101,216 |
| Denominator | | | | |
| Weighted average shares, basic | 82,750 | 80,074 | 82,540 | 79,987 |
| Weighted average effect of dilutive securities: | | | | |
| Net effect of unvested restricted stock | 482 | 439 | 427 | 326 |
| Net effect of dilutive stock options | 2,406 | 1,411 | 2,710 | 1,394 |
| Denominator for diluted calculation | 85,638 | 81,924 | 85,677 | 81,707 |

Basic

| | | | | | | | | |
|----------------------|----|------|----|------|----|------|----|------|
| Net income per share | \$ | 0.42 | \$ | 0.56 | \$ | 0.87 | \$ | 1.26 |
|----------------------|----|------|----|------|----|------|----|------|

Diluted

| | | | | | | | | |
|----------------------|----|------|----|------|----|------|----|------|
| Net income per share | \$ | 0.40 | \$ | 0.55 | \$ | 0.84 | \$ | 1.24 |
|----------------------|----|------|----|------|----|------|----|------|

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. ACQUISITIONS**

In February 2006, the Company acquired Toronto-based iCom Information & Communications, Inc. (ICOM), a leading provider of targeted list, marketing data and communications solutions for the pharmaceutical industry in North America. Total consideration paid was approximately \$35.6 million as of the closing date, including approximately \$3.5 million which was placed in escrow for a period of up to 18 months to satisfy potential working capital adjustments and indemnification claims. As a result of this acquisition, the Company acquired approximately \$10.8 million of customer contracts and \$2.3 million of capitalized software. The results of operations for ICOM have been included since the date of acquisition and are reflected in our Marketing Services Segment.

In April 2006, the Company acquired DoubleClick Email Solutions (DoubleClick), one of the largest permission-based email marketing service providers, with operations across North America, Europe and Asia/Pacific. Total consideration paid was approximately \$91.1 million. As a result of this acquisition, the Company acquired approximately \$26.8 million of customer contracts, \$2.3 million of capitalized software, and \$0.4 million associated with a non-compete agreement. The results of operations for DoubleClick have been included since the date of acquisition and are reflected in our Marketing Services Segment. The purchase price allocation was as follows:

| | As of June 30, 2006 (In thousands) |
|--------------------------------|---|
| Identifiable intangible assets | \$ 27,200 |
| Capitalized software | 2,300 |
| Goodwill | 55,614 |
| Net assets | 5,996 |
| Purchase price | \$ 91,110 |

4. INTANGIBLE ASSETS AND GOODWILL**Intangible Assets**

Intangible assets consist of the following:

| | June 30, 2006 Accumulated | | |
|-------------------------|--|------------|-------------------------------------|
| Gross Assets | Amortization (In thousands) | Net | Amortization Life and Method |

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| | | | | | |
|--|------------|--------------|------------|------------|---------------------------------|
| Customer contracts and lists | \$ 281,986 | \$ (93,586) | \$ 188,400 | 2-20 years | straight line |
| Premium on purchased credit card portfolios | 74,221 | (19,396) | 54,825 | 5-10 years | straight line or accelerated |
| Collector database | 62,517 | (45,433) | 17,084 | 15% | declining balance |
| Tradename | 12,350 | | 12,350 | | Indefinite life |
| Noncompete agreements | 1,300 | (185) | 1,115 | 2-5 years | straight line |
| Favorable lease | 1,000 | (205) | 795 | 4 years | straight line |
| Total intangible assets | \$ 433,374 | \$ (158,805) | \$ 274,569 | | |

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. INTANGIBLE ASSETS AND GOODWILL (Continued)

| | December 31, 2005 | | Net | Amortization Life and Method |
|---|-------------------|--|------------|------------------------------|
| | Gross Assets | Accumulated Amortization (In thousands) | | |
| Customer contracts and lists | \$ 243,906 | \$ (73,766) | \$ 170,140 | 2-20 years straight line |
| Premium on purchased credit card portfolios | 77,529 | (14,700) | 62,829 | 5-10 years straight line |
| Collector database | 60,186 | (42,292) | 17,894 | 15% declining balance |
| Tradenname | 12,350 | | 12,350 | Indefinite life |
| Noncompete agreements | 2,400 | (1,545) | 855 | 3-5 years straight line |
| Favorable lease | 1,000 | (68) | 932 | 4 years straight line |
| Total intangible assets | \$ 397,371 | \$ (132,371) | \$ 265,000 | |

Goodwill

The changes in the carrying amount of goodwill for the six months ended June 30, 2006 are as follows:

| | Transaction Services | Credit Services | Marketing Services | Total |
|---|----------------------|-----------------|--------------------|------------|
| | (In thousands) | | | |
| Beginning balance | \$ 335,419 | \$ | \$ 523,051 | \$ 858,470 |
| Goodwill acquired during the period | | | 65,464 | 65,464 |
| Effects of foreign currency translation | 405 | | 8,476 | 8,881 |
| Other, primarily final purchase price adjustments | (452) | | (9,483) | (9,935) |
| Ending balance | \$ 335,372 | \$ | \$ 587,508 | \$ 922,880 |

5. DEBT

Debt consists of the following:

| December 31, 2005 | June 30, 2006 |
|----------------------|------------------|
| (In thousands) | |

| | | |
|-------------------------|------------|------------|
| Certificates of deposit | \$ 379,100 | \$ 190,100 |
| Senior notes | | 500,000 |
| Credit facilities | 441,000 | 39,717 |
| Other | 16,844 | 19,439 |
| | 836,944 | 749,256 |
| Less: current portion | (578,443) | (171,715) |
| Long-term portion | \$ 258,501 | \$ 577,541 |

As of June 30, 2006, the certificates of deposit had effective annual fixed rates ranging from 4.3% to 5.6%, and the credit facilities had a weighted average interest rate of 7.4%.

During January 2006, the Company entered into an additional credit agreement to increase its borrowing capacity by an incremental \$300.0 million. This credit agreement included usual and customary negative

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. DEBT (Continued)**

covenants for credit agreements of this type. Payment of amounts due under this credit agreement were secured by guaranties, pledges of the ownership interests of certain of the Company's subsidiaries and pledges of certain intercompany promissory notes. On January 5, 2006, the Company borrowed \$300.0 million under this credit agreement, which the Company used for general corporate purposes, including other debt repayment, repurchases of its common stock in connection with its stock repurchase program, mergers and acquisitions, and working capital expenditures. The Company paid in full the \$300.0 million credit facility on May 16, 2006 with a portion of the proceeds from the senior notes and permitted this credit agreement to terminate pursuant to its terms on its scheduled maturity date, June 30, 2006.

On April 6, 2006, the Company amended its 364-day facility to extend the maturity date from April 6, 2006 to April 5, 2007.

On May 16, 2006, the Company entered into a senior note purchase agreement and issued and sold \$250.0 million aggregate principal amount of 6.00% Series A Notes due May 16, 2009 and \$250.0 million aggregate principal amount of 6.14% Series B Notes due May 16, 2011. The proceeds were used to retire the \$300.0 million credit facility, to repay other debt and for general corporate purposes.

The payment obligations under the senior notes are guaranteed by certain of the Company's existing and future subsidiaries, currently ADS Alliance Data Systems, Inc. The Series A and Series B Notes will accrue interest on the unpaid balance thereof at the rate of 6.00% and 6.14% per annum, respectively, from May 16, 2006, payable semiannually, on May 16 and November 16 in each year, commencing with November 16, 2006, until the principal has become due and payable. The note purchase agreement includes usual and customary negative covenants and events of default for transactions of this type.

The senior notes are unsecured. If, as of September 30, 2006, the Company's senior credit facilities are secured by pledges of the ownership interests of certain of its subsidiaries and pledges of certain intercompany promissory notes, the Company will grant the holders of the senior notes equal and ratable security interests in the same collateral to secure the senior notes.

On April 27, 2006, the Company entered into a treasury rate lock agreement with a notional amount of \$250.0 million to mitigate its exposure to increases in interest rates associated with the placement of the senior notes. Effective April 28, 2006, the treasury lock was terminated and the Company realized a loss of \$0.2 million.

6. DEFERRED REVENUE

A reconciliation of deferred revenue for the AIR MILES® Reward Program is as follows:

| Service | Deferred Revenue Redemption (In thousands) | Total |
|---------|--|-------|
|---------|--|-------|

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| | | | |
|---|------------|------------|------------|
| December 31, 2005 | \$ 184,899 | \$ 425,634 | \$ 610,533 |
| Cash proceeds | 59,981 | 117,312 | 177,293 |
| Revenue recognized | (50,228) | (99,981) | (150,209) |
| Effects of foreign currency translation | 7,323 | 17,387 | 24,710 |
| June 30, 2006 | \$ 201,975 | \$ 460,352 | \$ 662,327 |

7. INCOME TAXES

For the three months and six months ended June 30, 2006, the Company has utilized an effective tax rate of 38.7% and 38.3%, respectively, to calculate its provision for income taxes. Legislation was enacted in Texas

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during May 2006 and in Canada during June 2006 that impacted the effective tax rates. In accordance with Accounting Principles Board Opinion No. 28, Interim Financial Reporting (APB No. 28), the Company's expected annual effective tax rate for calendar year 2006 based on all known variables is estimated to be approximately 37.9% excluding the effect of the change in tax laws.

8. COMPREHENSIVE INCOME

The components of comprehensive income, net of tax effect, are as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--|-------------|--------------------------------------|-------------|
| | 2005 | 2006 | 2005 | 2006 |
| | (In thousands) | | | |
| Net income | \$ 34,383 | \$ 44,795 | \$ 71,565 | \$ 101,216 |
| Unrealized gain (loss) on securities available-for-sale | 1,345 | (807) | 1,112 | (888) |
| Foreign currency translation adjustments ⁽¹⁾ | (424) | 3,614 | (551) | 3,109 |
| Total comprehensive income | \$ 35,304 | \$ 47,602 | \$ 72,126 | \$ 103,437 |

⁽¹⁾ Primarily related to the impact of changes in the Canadian currency exchange rate.

9. SEGMENT INFORMATION

Consistent with prior periods, the Company classifies its businesses into three segments: Transaction Services, Credit Services and Marketing Services.

| | Transaction Services | Credit Services | Marketing Services | Other / Eliminations | Total |
|---|---------------------------------|----------------------------|-------------------------------|---------------------------------|--------------|
| | (In thousands) | | | | |
| Three months ended June 30, 2005 | | | | | |
| Revenues | \$ 168,560 | \$ 130,763 | \$ 145,742 | \$ (74,497) | \$ 370,568 |
| Adjusted EBITDA ⁽¹⁾ | 22,175 | 34,605 | 26,424 | | 83,204 |
| Depreciation and amortization | 13,573 | 1,877 | 8,532 | | 23,982 |
| Stock compensation expense | 625 | 625 | 625 | | 1,875 |
| Operating income | 7,977 | 32,103 | 17,267 | | 57,347 |
| Interest expense, net | | | | 2,353 | 2,353 |

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| | | | | | |
|---|------------|------------|------------|-------------|------------|
| Income before income taxes | 7,977 | 32,103 | 17,267 | (2,353) | 54,994 |
| Three months ended June 30, 2006 | | | | | |
| Revenues | \$ 193,258 | \$ 176,889 | \$ 208,652 | \$ (88,352) | \$ 490,447 |
| Adjusted EBITDA ⁽¹⁾ | 30,428 | 59,821 | 37,442 | | 127,691 |
| Depreciation and amortization | 14,269 | 3,262 | 14,380 | | 31,911 |
| Stock compensation expense | 4,798 | 2,609 | 5,191 | | 12,598 |
| Operating income | 11,361 | 53,950 | 17,871 | | 83,182 |
| Interest expense, net | | | | 10,059 | 10,059 |
| Income before income taxes | 11,361 | 53,950 | 17,871 | (10,059) | 73,123 |

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****9. SEGMENT INFORMATION (Continued)**

| | Transaction Services | Credit Services | Marketing Services (In thousands) | Other / Eliminations | Total |
|---------------------------------------|---------------------------------|----------------------------|--|---------------------------------|--------------|
| Six months ended June 30, 2005 | | | | | |
| Revenues | \$ 336,304 | \$ 282,180 | \$ 283,098 | \$ (155,139) | \$ 746,443 |
| Adjusted EBITDA ⁽¹⁾ | 42,291 | 82,040 | 47,738 | | 172,069 |
| Depreciation and amortization | 28,291 | 3,824 | 17,039 | | 49,154 |
| Stock compensation expense | 1,107 | 1,106 | 1,106 | | 3,319 |
| Operating income | 12,893 | 77,110 | 29,593 | | 119,596 |
| Interest expense, net | | | | 5,114 | 5,114 |
| Income before income taxes | 12,893 | 77,110 | 29,593 | (5,114) | 114,482 |
| Six months ended June 30, 2006 | | | | | |
| Revenues | \$ 384,950 | \$ 376,020 | \$ 385,194 | \$ (178,486) | \$ 967,678 |
| Adjusted EBITDA ⁽¹⁾ | 59,054 | 138,590 | 64,297 | | 261,941 |
| Depreciation and amortization | 27,815 | 5,793 | 25,841 | | 59,449 |
| Stock compensation expense | 7,872 | 3,698 | 8,332 | | 19,902 |
| Operating income | 23,367 | 129,099 | 30,124 | | 182,590 |
| Interest expense, net | | | | 18,596 | 18,596 |
| Income before income taxes | 23,367 | 129,099 | 30,124 | (18,596) | 163,994 |

⁽¹⁾ Adjusted EBITDA is a non-GAAP financial measure equal to net income, the most directly comparable GAAP financial measure, plus stock compensation expense, provision for income taxes, interest expense, net, depreciation and amortization. Adjusted EBITDA is presented in accordance with Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS No. 131) as it is the primary performance metric by which senior management is evaluated.

10. STOCK-BASED COMPENSATION

Effective January 1, 2006, the Company adopted the provisions of, and accounted for stock-based compensation in accordance with, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)) which supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). Under the fair value recognition provisions, stock-based compensation expense is measured at the grant date based on the fair value of the award and is recognized ratably over the requisite service period. The Company elected the modified prospective method, under which prior periods are not revised for comparative purposes. The valuation provisions of SFAS No. 123(R) apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation expense estimated for the Statement of Financial Accounting Standards No. 123,

Accounting for Stock-Based Compensation (SFAS No. 123) pro forma disclosures, as adjusted for forfeitures.

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****10. STOCK-BASED COMPENSATION (Continued)**

Total stock-based compensation expense recognized in the Company's consolidated statements of income for the three and six months ended June 30, 2005 and 2006 respectively, is as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------|--|-------------|--------------------------------------|-------------|
| | 2005 | 2006 | 2005 | 2006 |
| | (In thousands) | | | |
| Cost of operations | \$ | \$ 7,299 | \$ | \$ 13,506 |
| General and administrative | 1,875 | 5,299 | 3,319 | 6,396 |
| Total | \$ 1,875 | \$ 12,598 | \$ 3,319 | \$ 19,902 |

Since the amount of stock-based compensation expense recognized is based on awards ultimately expected to vest, the amount recognized in the Company's results of operations has been reduced for estimated forfeitures.

SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on the Company's historical experience. Prior to the adoption of SFAS No. 123(R), the Company accounted for forfeitures as they occurred in accordance with APB No. 25 and did not estimate for forfeitures. As a result, upon adoption of SFAS No. 123(R) the Company recognized a cumulative effect of a change in accounting principle of \$0.8 million, net of tax to reverse compensation expense recognized for those awards not expected to vest.

Prior to the adoption of SFAS No. 123(R), the Company accounted for stock-based awards to employees using the intrinsic value method in accordance with APB No. 25. Under the intrinsic value method, no stock-based compensation expense for employee stock options was recognized in the Company's results of operations as the exercise price equaled the fair market value of the underlying stock at the date of grant. In accordance with the modified prospective transition method, the Company's prior year financial statements have not been restated to reflect the impact of the adoption of SFAS No. 123(R).

The following table sets forth the pro forma amounts of net income and net income per share, for the three months and six months ended June 30, 2005, that would have resulted if the Company had accounted for the stock-based awards under the fair value recognition provisions of SFAS No. 123:

| | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|--|---|---|
| | (In thousands, except per share amounts) | |

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| | | | | |
|--|----|---------|----|---------|
| Net income, as reported | \$ | 34,383 | \$ | 71,565 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | | 1,172 | | 2,074 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all stock option awards, net of related tax effects | | (4,763) | | (8,688) |
| Net income, pro forma | \$ | 30,792 | \$ | 64,951 |
| Net income per share: | | | | |
| Basic-as reported | \$ | 0.42 | \$ | 0.87 |
| Basic-pro forma | \$ | 0.37 | \$ | 0.79 |
| Diluted-as reported | \$ | 0.40 | \$ | 0.84 |
| Diluted-pro forma | \$ | 0.36 | \$ | 0.76 |

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. STOCK-BASED COMPENSATION (Continued)

As of June 30, 2006, there was \$61.1 million of unrecognized expense, adjusted for estimated forfeitures, related to non-vested, stock-based equity awards granted to employees, which is expected to be recognized over a weighted average period of approximately two years.

Stock Options

Stock option awards are granted with an exercise price equal to the market price of the Company's stock. Options typically vest ratably over three years and expire ten years after the date of grant. The fair value of each option award is estimated on the date of grant using a binomial lattice model. The following table indicates the assumptions used in estimating fair value for the six months ended June 30, 2005 and June 30, 2006:

| | Six Months Ended June 30, | |
|--|------------------------------|-------------|
| | 2005 | 2006 |
| Expected dividend yield | | |
| Risk-free interest rate | 2.94%-4.76% | 4.53%-4.65% |
| Expected life of options (years) | 6.4 | 7.1 |
| Assumed volatility | 28.8%-43.6% | 31.9%-37.0% |
| Weighted average grant date fair value | \$16.65 | \$18.46 |

The following table sets forth the summary of option activity under the Company's stock option program for the six months ended June 30, 2006:

| | Outstanding Weighted Average Exercise Price | | Exercisable Weighted Average Exercise Price | |
|-------------------------------------|--|----------|--|----------|
| | Options | Options | Options | Options |
| | (Options in thousands) | | | |
| Balance at December 31, 2005 | 6,680 | \$ 27.19 | 3,319 | \$ 18.01 |
| Granted | 620 | 43.44 | | |
| Exercised | (1,452) | 20.55 | | |
| Cancelled | (238) | 36.46 | | |
| Balance at June 30, 2006 | 5,610 | \$ 30.47 | 3,174 | \$ 23.31 |

The total intrinsic value of options exercised during the six months ended June 30, 2006 was approximately \$44.4 million.

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****10. STOCK-BASED COMPENSATION (Continued)**

The following table summarizes information concerning both outstanding and exercisable stock options at June 30, 2006:

| Range of Exercise Prices | Options | Outstanding | Weighted | | Exercisable | Weighted | |
|--------------------------|---------|-------------|------------------------|---------|-------------|------------------------|---------|
| | | Remaining | Average | Average | Options | Average | Options |
| | | Contractual | Exercise Price | | | Exercise Price | |
| | | Life | (Options in thousands) | | | (Options in thousands) | |
| | | (Years) | | | | | |
| \$ 9.00 to \$12.00 | 608 | 4.1 | \$ | 11.34 | 608 | \$ | 11.34 |
| \$12.01 to \$15.00 | 736 | 4.6 | \$ | 14.96 | 736 | \$ | 14.96 |
| \$15.01 to \$22.00 | 51 | 6.4 | \$ | 18.96 | 51 | \$ | 18.96 |
| \$22.01 to \$29.00 | 779 | 7.0 | \$ | 24.17 | 760 | \$ | 24.07 |
| \$29.01 to \$39.00 | 1,085 | 7.8 | \$ | 32.06 | 553 | \$ | 31.72 |
| \$39.01 to \$47.00 | 2,331 | 8.8 | \$ | 41.78 | 466 | \$ | 41.42 |
| \$47.01 to \$54.00 | 20 | 9.9 | \$ | 53.25 | | | |
| | 5,610 | | | | 3,174 | | |

The aggregate intrinsic value of options outstanding and options exercisable as of June 30, 2006 was approximately \$159.1 million and \$112.7 million, respectively.

Restricted Stock

During 2006, the Company has awarded both time-based and performance-based restricted stock units. Fair value of the restricted stock is estimated on the date of grant. In accordance with SFAS No. 123(R), the Company recognizes the estimated stock-based compensation expense, net of estimated forfeitures, over the applicable service period.

Time-based restricted stock awards typically vest ratably over a three year period. Performance-based restricted stock awards vest if specified performance measures tied to the Company's financial performance are met. The vesting provisions of 86,314 performance-based restricted stock unit awards issued in 2006 to eight employees were modified in March 2006. The vesting provisions, which were dependent on the Company's cash earnings per share (EPS) growth as compared to the S&P 500, were modified such that under the new terms, the vesting provisions are dependent on the Company's year-over-year cash earnings per share growth. The number of shares that vest may range from zero to 200%. A minimum cash EPS growth rate of 10% is necessary for the minimum 50% vesting, 18% cash EPS growth for a 100% vesting, and 36% cash EPS growth (or more) for a maximum 200% vesting. The modification had no impact on the fair value of the award; however, it did result in a change in estimate of the most likely outcome of the

number of shares to vest. The incremental stock-based compensation expense recorded as a result of the change in estimate was not material.

| | Performance- Based | Time- Based | Total |
|-------------------------------------|-------------------------------|------------------------|--------------|
| Balance at December 31, 2005 | | 469,840 | 469,840 |
| Shares granted | 242,015 | 549,765 | 791,780 |
| Shares vested | (8,100) | (35,916) | (44,016) |
| Shares cancelled | (7,741) | (22,079) | (29,820) |
| Balance at June 30, 2006 | 226,174 | 961,610 | 1,187,784 |

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. STOCK-BASED COMPENSATION (Continued)

The weighted average grant-date fair value per share was \$44.04 for restricted stock awards granted during the six months ended June 30, 2006.

Employee Stock Purchase Plan

The Company has an Amended and Restated Employee Stock Purchase Plan (the ESPP), which provides for three month offering periods, commencing on the first trading day of each calendar quarter and ending on the last trading day of each calendar quarter. The purchase price of the common stock is 85% of the fair market value of shares on the applicable purchase date as determined by averaging the high and low trading prices of the last trading day of each quarter. An employee may elect to pay the purchase price of such common stock through payroll deductions. The maximum number of shares that were reserved for issuance under the ESPP is 1,500,000 shares, subject to adjustment as provided in the ESPP. Effective July 1, 2005, employees are required to hold any stock purchased through the ESPP for 180 days prior to any sale or withdrawal of shares. In accordance with SFAS No. 123(R), the Company has recorded compensation expense for the difference between the fair value of the stock and the purchase price of the stock.

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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 in this quarterly report and the consolidated financial statements and the notes thereto included in our Annual Report filed on Form 10-K/A for the year ended December 31, 2005.

Year in Review Highlights

Our results for the first six months of 2006 included the following significant new and renewed agreements and continued selective execution of our acquisition strategy:

In January 2006, we announced a long-term agreement to provide customer care and comprehensive billing and marketing management services to Green Mountain Energy Company, one of the nation's leading retail providers of cleaner electricity products.

In January 2006, we signed a multi-year renewal agreement with Canada Safeway to continue our partnership in our Canadian AIR MILES Reward Program. As one of our top-ten clients, Canada Safeway has been a partner in our loyalty and marketing program since its inception in 1992.

In February 2006, we signed a multi-year agreement to provide billing and customer care services to WPS Resources Corporation, an energy holding company whose subsidiaries provide electric and natural gas utility service primarily to Michigan and Minnesota consumers.

In February 2006, we acquired iCom Information & Communications, Inc. (ICOM), a leading provider of targeted list, marketing data and communication solutions for the pharmaceutical industry in North America.

In February 2006, we signed a long-term agreement to provide a co-brand credit card program and database marketing services to New York & Company, a leading specialty retailer of women's fashions and accessories.

In February 2006, we signed a long-term contract renewal to continue to provide a comprehensive private-label credit card solution to Goody's, a retailer of moderately priced apparel for women, men and children. Under the expanded terms of agreement, we will also provide an integrated co-brand credit card program and corresponding program servicing.

In March 2006, we announced a multi-year agreement with Citibank, Inc. to provide a comprehensive loyalty solution to support Citi's points-based customer rewards program, the Thank You NetworkSM.

In March 2006, we signed a contract renewal to continue to provide a comprehensive private-label credit card solution to the United Retail Group, Inc., a leading high-growth specialty retailer of plus-size women's fashion apparel.

In April 2006, we signed a multi-year contract renewal to continue to provide a comprehensive private-label credit card solution for Abercrombie & Fitch, a leading men's and women's specialty clothing retailer.

In April 2006, we completed an issuance of \$500.0 million asset-backed notes. The notes were issued through the World Financial Network Credit Card Master Note Trust as part of the securitization program for our private

label credit card banking subsidiary, World Financial Network National Bank.

In May 2006, we announced a multi-year agreement to provide bill print and mail services, electronic bill presentment and prepayment processing for Sacramento Municipal Utility District, the sixth-largest publicly owned utility in the United States with approximately 560,000 residential and commercial accounts in California's Sacramento and Placer counties.

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In May 2006, we signed a multi-year agreement to provide permission-based email marketing services and strategic consulting services to Citicorp Credit Services, Inc., which has more than 120 million credit and charge accounts in North America.

In May 2006, we completed a private placement of \$500.0 million of senior notes to guarantee interest rates and provide additional liquidity.

In May 2006, we signed a multi-year contract renewal to continue to provide database, consulting, and infrastructure services for AARP, one of the nation's largest non-profit organizations.

In May 2006, we signed a contract renewal to continue to provide a comprehensive private-label credit card solution to The Room Place at Harlem Furniture, a multi-channel retailer of high-quality home furniture in the Chicago area.

In June 2006, we signed a long-term contract renewal to continue to provide customer information system services, application management and online bill presentment to Union Gas, a Duke Energy Company.

In June 2006, we signed a multi-year renewal agreement with The Great Atlantic & Pacific Company of Canada (A&P Canada) to continue our partnership in our Canadian AIR MILES Reward Program. As one of our top-ten sponsors, A&P Canada is the second largest food retailer in Ontario.

In June 2006, we signed a multi-year agreement to provide comprehensive private-label credit card services for Bealls Outlet Stores, Inc. and Burke's Outlet Stores, Inc., leading retailers of value-priced apparel, accessories and home furnishings with more than 500 stores across 14 states.

Critical Accounting Policies and Estimates

There have been no material changes to our critical accounting policies and estimates from the information provided in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K/A for the year ended December 31, 2005.

Use of Non-GAAP Financial Measures

Adjusted EBITDA is a non-GAAP financial measure equal to net income, the most directly comparable GAAP financial measure, plus stock compensation expense, provision for income taxes, interest expense, net, depreciation and other amortization and amortization of purchased intangibles. Operating EBITDA is a non-GAAP financial measure equal to adjusted EBITDA less the change in deferred revenue plus the change in redemption settlement assets. We have presented operating EBITDA because we use the financial measure as part of our monitoring of compliance with the financial covenants in our credit facilities and senior notes. For the six months ended June 30, 2006, senior debt-to-operating EBITDA was 1.0x compared to a maximum ratio of 2.50x permitted in our credit facilities and 2.75x permitted in our senior note agreements. Operating EBITDA to interest expense was 18.5x compared to a minimum ratio of 3.5x permitted in our credit facilities and 15.4x compared to a minimum of 3.0x permitted in our senior note agreements. As discussed in more detail in the liquidity section of Management's Discussion and Analysis of Financial Condition and Results of Operations, our credit facilities together with cash flow from operations are the two main sources of funding for our acquisition strategy and for our future working capital needs and capital expenditures. As of June 30, 2006, we had borrowings of \$539.7 million outstanding under the senior notes and credit facilities and had approximately \$475.3 million in unused borrowing capacity. During January 2006, we increased our borrowing capacity by an incremental \$300.0 million through entering into an additional credit

agreement. This credit agreement was paid in full on May 16, 2006 and permitted to terminate pursuant to its terms on its scheduled maturity date, June 30, 2006. During May 2006, we entered into a senior note purchase agreement, pursuant to which we issued and sold \$250.0 million aggregate principal amount of 6.00% Series A Notes and \$250.0 million aggregate principal amount of 6.14% Series B Notes with maturities of May 16, 2009 and May 16, 2011, respectively. We were in compliance with our covenants at June 30, 2006, and we expect to be in compliance with these covenants under these credit facilities and the senior notes during the year ending December 31, 2006.

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We use adjusted EBITDA as an integral part of our internal reporting to measure the performance of our reportable segments and to evaluate the performance of our senior management. Adjusted EBITDA is considered an important indicator of the operational strength of our businesses. Adjusted EBITDA eliminates the uneven effect across all business segments of considerable amounts of non-cash depreciation of tangible assets and amortization of certain intangible assets that were recognized in business combinations. A limitation of this measure, however, is that it does not reflect the periodic costs of certain capitalized tangible and intangible assets used in generating revenues in our businesses. Management evaluates the costs of such tangible and intangible assets, the impact of related impairments, as well as asset sales through other financial measures, such as capital expenditures, investment spending and return on capital. Adjusted EBITDA also eliminates the non-cash effect of stock compensation expense. Stock compensation expense is not included in the measurement of segment adjusted EBITDA provided to the chief operating decision maker for purposes of assessing segment performance and decision making with respect to resource allocations. Therefore, we believe that adjusted EBITDA provides useful information to our investors regarding our performance and overall results of operations. Adjusted EBITDA and operating EBITDA are not intended to be performance measures 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 cash flows from operating activities as a measure of liquidity. In addition, adjusted 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 GAAP. The adjusted EBITDA and operating EBITDA measures presented in this Form 10-Q may not be comparable to similarly titled measures presented by other companies, and may not be identical to corresponding measures used in our various agreements.

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2005 | 2006 | 2005 | 2006 |
| | (In thousands) | | | |
| Net income | \$ 34,383 | \$ 44,795 | \$ 71,565 | \$ 101,216 |
| Stock compensation expense | 1,875 | 12,598 | 3,319 | 19,902 |
| Provision for income taxes | 20,611 | 28,328 | 42,917 | 62,778 |
| Interest expense, net | 2,353 | 10,059 | 5,114 | 18,596 |
| Depreciation and other amortization | 13,881 | 15,849 | 29,211 | 31,066 |
| Amortization of purchased intangibles | 10,101 | 16,062 | 19,943 | 28,383 |
| Adjusted EBITDA | 83,204 | 127,691 | 172,069 | 261,941 |
| Change in deferred revenue | 4,387 | 43,541 | 7,099 | 51,794 |
| Change in redemption settlement assets | 4,748 | (14,371) | 4,436 | (19,802) |
| Operating EBITDA | \$ 92,339 | \$ 156,861 | \$ 183,604 | \$ 293,933 |

Note: Change in deferred revenue and redemption settlement assets are affected by fluctuations in foreign exchange rates. Change in redemption settlement assets is also affected by transfers of cash.

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Three months ended June 30, 2005 compared to the three months ended June 30, 2006

| | Three Months Ended | | Change | |
|---|---------------------------|--------------------------|-------------------|---------------|
| | 2005 | June 30, 2006 | \$ | % |
| (In thousands, except percentages) | | | | |
| Revenue: | | | | |
| Transaction Services | \$ 168,560 | \$ 193,258 | \$ 24,698 | 14.7% |
| Credit Services | 130,763 | 176,889 | 46,126 | 35.3 |
| Marketing Services | 145,742 | 208,652 | 62,910 | 43.2 |
| Other/Eliminations | (74,497) | (88,352) | (13,855) | 18.6 |
| Total | \$ 370,568 | \$ 490,447 | \$ 119,879 | 32.4% |
| Adjusted EBITDA: | | | | |
| Transaction Services | \$ 22,175 | \$ 30,428 | \$ 8,253 | 37.2% |
| Credit Services | 34,605 | 59,821 | 25,216 | 72.9 |
| Marketing Services | 26,424 | 37,442 | 11,018 | 41.7 |
| Total | \$ 83,204 | \$ 127,691 | \$ 44,487 | 53.5% |
| Stock compensation expense: | | | | |
| Transaction Services | \$ 625 | \$ 4,798 | \$ 4,173 | 667.7% |
| Credit Services | 625 | 2,609 | 1,984 | 317.4 |
| Marketing Services | 625 | 5,191 | 4,566 | 730.6 |
| Total | \$ 1,875 | \$ 12,598 | \$ 10,723 | 571.9% |
| Depreciation and amortization: | | | | |
| Transaction Services | \$ 13,573 | \$ 14,269 | \$ 696 | 5.1% |
| Credit Services | 1,877 | 3,262 | 1,385 | 73.8 |
| Marketing Services | 8,532 | 14,380 | 5,848 | 68.5 |
| Total | \$ 23,982 | \$ 31,911 | \$ 7,929 | 33.1% |
| Operating expenses⁽¹⁾: | | | | |
| Transaction Services | \$ 146,385 | \$ 162,830 | \$ 16,445 | 11.2% |
| Credit Services | 96,158 | 117,068 | 20,910 | 21.7 |
| Marketing Services | 119,318 | 171,210 | 51,892 | 43.5 |
| Other/Eliminations | (74,497) | (88,352) | (13,855) | 18.6 |
| Total | \$ 287,364 | \$ 362,756 | \$ 75,392 | 26.2% |
| Operating income: | | | | |

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| | | | | |
|---|--------------|--------------|------------|-------|
| Transaction Services | \$ 7,977 | \$ 11,361 | \$ 3,384 | 42.4% |
| Credit Services | 32,103 | 53,950 | 21,847 | 68.1 |
| Marketing Services | 17,267 | 17,871 | 604 | 3.5 |
| Total | \$ 57,347 | \$ 83,182 | \$ 25,835 | 45.1% |
| Adjusted EBITDA margin ⁽²⁾ : | | | | |
| Transaction Services | 13.2% | 15.7% | 2.5% | |
| Credit Services | 26.5 | 33.8 | 7.3 | |
| Marketing Services | 18.1 | 17.9 | (0.2) | |
| Total | 22.5% | 26.0% | 3.5% | |
| Segment operating data: | | | | |
| Statements generated | 47,239 | 52,193 | 4,954 | 10.5% |
| Credit sales | \$ 1,637,592 | \$ 1,884,168 | \$ 246,576 | 15.1% |
| Average managed receivables | \$ 3,070,988 | \$ 3,556,953 | \$ 485,955 | 15.8% |
| AIR MILES reward miles issued | 816,186 | 963,921 | 147,735 | 18.1% |
| AIR MILES reward miles redeemed | 514,041 | 580,252 | 66,211 | 12.9% |

⁽¹⁾ Operating expenses excludes depreciation, amortization and stock compensation expense.

⁽²⁾ Adjusted EBITDA margin is adjusted EBITDA divided by revenue. Management uses adjusted EBITDA margin to analyze the operating performance of the segments and the impact revenue growth has on operating expenses.

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Revenue. Total revenue increased \$119.9 million, or 32.4%, to \$490.5 million for the three months ended June 30, 2006 from \$370.6 million for the comparable period in 2005. The increase was due to a 14.7% increase in Transaction Services revenue, a 35.3% increase in Credit Services revenue, and a 43.2% increase in Marketing Services revenue as follows:

Transaction Services. Transaction Services revenue increased \$24.7 million, or 14.7%, primarily due to a 10.5% increase in statements generated from our private label and utility businesses. The private label business increase was the result of a ramp up of clients signed during 2005. Revenue for utility services was also positively impacted by the migration of various services for two of our significant clients.

Credit Services. Credit Services revenue increased \$46.1 million, or 35.3%, primarily due to a 51.2% increase in securitization income and finance charges, net offset by a small decrease in Merchant Discount fees. Securitization income and finance charges, net increased \$47.7 million primarily as a result of a 15.8% increase in our average managed receivables, an increase in collected yield, lower charge-offs and a slight improvement in the cost of funds. The improvement of charge-off rates is a continuation of the benefit that we have received this year as a result of the bankruptcy reform legislation which was enacted during the fourth quarter of 2005.

Marketing Services. Marketing Services revenue increased \$62.9 million, or 43.2%, due to growth in the AIR MILES Reward Program and the recent Epsilon Interactive, ICOM and DoubleClick acquisitions. AIR MILES Reward Program growth was driven primarily by an increase in redemption revenue of \$17.1 million related to a 12.9% increase in the redemption of AIR MILES reward miles. Issuance revenue increased \$5.0 million primarily related to growth in issuances of AIR MILES reward miles in recent years from the roll out of major national programs. Correspondingly, our deferred revenue balance increased 7.0% to \$662.3 million at June 30, 2006 from \$618.8 million at March 31, 2006 due to an 18.1% increase in AIR MILES reward miles issued during the three months ended June 30, 2006 over the comparable period in 2005, and changes in foreign currency exchange rates. Changes in the exchange rate of the Canadian dollar accounted for approximately \$12.9 million of the revenue increase. Database marketing fees increased by \$27.9 million primarily related to Epsilon, and its recent acquisitions of Epsilon Interactive, ICOM and DoubleClick.

Operating Expenses. Total operating expenses, excluding depreciation, amortization and stock compensation expense, increased \$75.4 million, or 26.2%, to \$362.8 million during the three months ended June 30, 2006 from \$287.4 million during the comparable period in 2005. Total adjusted EBITDA margin increased to 26.0% for the three months ended June 30, 2006 from 22.5% for the comparable period in 2005 due to increased margins across Transaction Services and Credit Services, offset by a slight decrease in margin for Marketing Services.

Transaction Services. Transaction Services operating expenses, excluding depreciation, amortization and stock compensation expense, increased \$16.4 million, or 11.2%, to \$162.8 million for the three months ended June 30, 2006 from \$146.4 million for the comparable period in 2005, and adjusted EBITDA margin increased to 15.7% for the three months ended June 30, 2006 from 13.2% during the comparable period in 2005. The increase in adjusted EBITDA margin was primarily the result of increases in revenue driven by a 10.5% increase in the segment's key driver, statements generated, and lower corporate overhead charges.

Credit Services. Credit Services operating expenses, excluding depreciation, amortization and stock compensation expense, increased \$20.9 million, or 21.7%, to \$117.1 million for the three months ended June 30, 2006 from \$96.2 million for the comparable period in 2005, and adjusted EBITDA margin increased to 33.8% for the three months ended June 30, 2006 from 26.5% for the same period in 2005. The increased margin is the result of favorable revenue trends from an increase in our average managed receivables, an increase in collected yield, lower net charge-offs, and a slight improvement in the cost of funds. Margin growth also came from leveraging existing infrastructure and lower corporate overhead charges.

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Marketing Services. Marketing Services operating expenses, excluding depreciation, amortization and stock compensation expense, increased \$51.9 million, or 43.5%, to \$171.2 million for the three months ended June 30, 2006 from \$119.3 million for the comparable period in 2005, and adjusted EBITDA margin was relatively flat at 17.9% for the three months ended June 30, 2006 compared to 18.1% for the same period in 2005. The adjusted EBITDA margin was impacted by the timing of marketing expenditures compared to the same period in 2005, as well as lower corporate overhead charges.

Stock compensation expense. Stock compensation expense was \$12.6 million for the three months ended June 30, 2006 compared to \$1.9 million for the comparable period in 2005 due to our adoption of SFAS No. 123(R).

Depreciation and Amortization. Depreciation and amortization increased \$7.9 million, or 33.1%, to \$31.9 million for the three months ended June 30, 2006 from \$24.0 million for the comparable period in 2005 primarily due to a \$6.0 million increase in the amortization of purchased intangibles and an increase of \$1.9 million in depreciation and other amortization.

Operating Income. Operating income increased \$25.8 million, or 45.1%, to \$83.2 million for the three months ended June 30, 2006 from \$57.3 million during the comparable period in 2005. Operating income increased due to the revenue and expense factors discussed above.

Interest Expense. Interest expense increased \$7.7 million, or 327.5%, to \$10.1 million for the three months ended June 30, 2006 from \$2.4 million for the comparable period in 2005. Interest on certificates of deposit increased \$2.6 million due to an increase in on-balance sheet receivables of approximately \$165 million as compared to prior year, which was primarily associated with financing of the Blair portfolio acquisition completed in November 2005. Core debt interest expense increased \$5.6 million as a result of additional borrowings to fund our stock repurchase program and the acquisitions of ICOM and DoubleClick.

Taxes. Income tax expense increased \$7.7 million to \$28.3 million for the three months ended June 30, 2006 from \$20.6 million in 2005 due to an increase in taxable income. Our effective tax rate increased to 38.7% in 2006 compared to 37.5% in 2005 primarily as a result of changes in tax legislation in Texas and Canada.

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Six months ended June 30, 2005 compared to the six months ended June 30, 2006

| | Six Months Ended | | Change | |
|--|---|-------------------|-------------------|---------------|
| | 2005 | 2006 | \$ | % |
| | (In thousands, except percentages) | | | |
| Revenue: | | | | |
| Transaction Services | \$ 336,304 | \$ 384,950 | \$ 48,646 | 14.5% |
| Credit Services | 282,180 | 376,020 | 93,840 | 33.3 |
| Marketing Services | 283,098 | 385,194 | 102,096 | 36.1 |
| Other/Eliminations | (155,139) | (178,486) | (23,347) | 15.0 |
| Total | \$ 746,443 | \$ 967,678 | \$ 221,235 | 29.6% |
| Adjusted EBITDA: | | | | |
| Transaction Services | \$ 42,291 | \$ 59,054 | \$ 16,763 | 39.6% |
| Credit Services | 82,040 | 138,590 | 56,550 | 68.9 |
| Marketing Services | 47,738 | 64,297 | 16,559 | 34.7 |
| Total | \$ 172,069 | \$ 261,941 | \$ 89,872 | 52.2% |
| Stock compensation expense: | | | | |
| Transaction Services | \$ 1,107 | \$ 7,872 | \$ 6,765 | 611.1% |
| Credit Services | 1,106 | 3,698 | 2,592 | 234.4 |
| Marketing Services | 1,106 | 8,332 | 7,226 | 653.3 |
| Total | \$ 3,319 | \$ 19,902 | \$ 16,583 | 499.6% |
| Depreciation and amortization: | | | | |
| Transaction Services | \$ 28,291 | \$ 27,815 | \$ (476) | (1.7)% |
| Credit Services | 3,824 | 5,793 | 1,969 | 51.5 |
| Marketing Services | 17,039 | 25,841 | 8,802 | 51.7 |
| Total | \$ 49,154 | \$ 59,449 | \$ 10,295 | 20.9% |
| Operating expenses⁽¹⁾: | | | | |
| Transaction Services | \$ 294,013 | \$ 325,896 | \$ 31,883 | 10.8% |
| Credit Services | 200,140 | 237,430 | 37,290 | 18.6 |
| Marketing Services | 235,360 | 320,897 | 85,537 | 36.3 |
| Other/Eliminations | (155,139) | (178,486) | (23,347) | 15.0 |
| Total | \$ 574,374 | \$ 705,737 | \$ 131,363 | 22.9% |
| Operating income: | | | | |
| Transaction Services | \$ 12,893 | \$ 23,367 | \$ 10,474 | 81.2% |

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| | | | | |
|---|--------------|--------------|------------|-------|
| Credit Services | 77,110 | 129,099 | 51,989 | 67.4 |
| Marketing Services | 29,593 | 30,124 | 531 | 1.8 |
| Total | \$ 119,596 | \$ 182,590 | \$ 62,994 | 52.7% |
| Adjusted EBITDA margin ⁽²⁾ : | | | | |
| Transaction Services | 12.6% | 15.3% | 2.7% | |
| Credit Services | 29.1 | 36.9 | 7.8 | |
| Marketing Services | 16.9 | 16.7 | (0.2) | |
| Total | 23.1% | 27.1% | 4.0% | |
| Segment operating data: | | | | |
| Statements generated | 94,316 | 104,053 | 9,737 | 10.3% |
| Credit sales | \$ 2,976,814 | \$ 3,378,258 | \$ 401,444 | 13.5% |
| Average managed receivables | \$ 3,104,178 | \$ 3,569,416 | \$ 465,233 | 15.0% |
| AIR MILES reward miles issued | 1,526,948 | 1,820,355 | 293,407 | 19.2% |
| AIR MILES reward miles redeemed | 973,688 | 1,134,563 | 160,875 | 16.5% |

⁽¹⁾ Operating expenses excludes depreciation, amortization and stock compensation expense.

⁽²⁾ Adjusted EBITDA margin is adjusted EBITDA divided by revenue. Management uses adjusted EBITDA margin to analyze the operating performance of the segments and the impact revenue growth has on operating expenses.

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Revenue. Total revenue increased \$221.2 million, or 29.6%, to \$967.7 million for the six months ended June 30, 2006 from \$746.4 million for the comparable period in 2005. The increase was due to a 14.5% increase in Transaction Services revenue, a 33.3% increase in Credit Services revenue, and a 36.1% increase in Marketing Services revenue as follows:

Transaction Services. Transaction Services revenue increased \$48.6 million, or 14.5%, primarily due to a 10.3% increase in statements generated from our private label and utility businesses. The private label business increase was the result of a ramp up of clients signed during 2005. Revenue for utility services was also positively impacted by the migration of various services for two of our significant clients.

Credit Services. Credit Services revenue increased \$93.8 million, or 33.3%, primarily due to a 45.3% increase in securitization income and finance charges, net offset by a small decrease in Merchant Discount fees. Securitization income and finance charges, net increased \$94.0 million primarily as a result of a 15.0% increase in our average managed receivables, an increase in collected yield, lower charge-offs and a slight improvement in the cost of funds. The improvement of charge-off rates is a continuation of the benefit that we have received this year as a result of the bankruptcy reform legislation which was enacted during the fourth quarter of 2005.

Marketing Services. Marketing Services revenue increased \$102.1 million, or 36.1%, due to growth in the AIR MILES Reward Program and the recent Epsilon Interactive, ICOM and DoubleClick acquisitions. AIR MILES Reward Program growth was driven primarily by an increase in redemption revenue of \$33.4 million related to a 16.5% increase in the redemption of AIR MILES reward miles. Issuance revenue increased \$8.9 million primarily related to growth in issuances of AIR MILES reward miles in recent years from the roll out of major national programs. Correspondingly, our deferred revenue balance increased 8.5% to \$662.3 million at June 30, 2006 from \$610.5 million at December 31, 2005 due to a 19.2% increase in AIR MILES reward miles issued during the six months ended June 30, 2006 over the comparable period in 2005, and changes in foreign currency exchange rates. Changes in the exchange rate of the Canadian dollar accounted for approximately \$19.7 million of the revenue increase. Database marketing fees increased by \$37.7 million primarily related to Epsilon, and its recent acquisitions of Epsilon Interactive, ICOM and DoubleClick.

Operating Expenses. Total operating expenses, excluding depreciation, amortization and stock compensation expense, increased \$131.4 million, or 22.9%, to \$705.7 million during the six months ended June 30, 2006 from \$574.4 million during the comparable period in 2005. Total adjusted EBITDA margin increased to 27.1% for the six months ended June 30, 2006 from 23.1% for the comparable period in 2005 due to increased margins across Transaction Services and Credit Services, offset by a slight decrease in margin for Marketing Services.

Transaction Services. Transaction Services operating expenses, excluding depreciation, amortization and stock compensation expense, increased \$31.9 million, or 10.8%, to \$325.9 million for the six months ended June 30, 2006 from \$294.0 million for the comparable period in 2005, and adjusted EBITDA margin increased to 15.3% for the six months ended June 30, 2006 from 12.6% during the comparable period in 2005. The increase in adjusted EBITDA margin was primarily the result of increases in revenue driven by a 10.3% increase in the segment's key driver, statements generated, and lower corporate overhead charges.

Credit Services. Credit Services operating expenses, excluding depreciation, amortization and stock compensation expense, increased \$37.3 million, or 18.6%, to \$237.4 million for the six months ended June 30, 2006 from \$200.1 million for the comparable period in 2005, and adjusted EBITDA margin increased to 36.9% for the six months ended June 30, 2006 from 29.1% for the same period in 2005. The increased margin is the result of favorable revenue trends from an increase in our average managed receivables, an increase in collected yield, lower net charge-offs, and a slight improvement in the cost of funds. Margin growth also came from leveraging existing infrastructure and lower corporate overhead charges.

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Marketing Services. Marketing Services operating expenses, excluding depreciation, amortization and stock compensation expense, increased \$85.5 million, or 36.3%, to \$320.9 million for the six months ended June 30, 2006 from \$235.4 million for the comparable period in 2005, and adjusted EBITDA margin was relatively flat at 16.7% for the six months ended June 30, 2006 from 16.9% for the comparable period in 2005. The adjusted EBITDA margin was impacted by the timing of marketing expenses incurred during the first half of the year, as well as lower corporate overhead charges.

Stock compensation expense. Stock compensation expense was \$19.9 million for the six months ended June 30, 2006 compared to \$3.3 million for the comparable period in 2005 due to our adoption of SFAS No. 123(R).

Depreciation and Amortization. Depreciation and amortization increased \$10.3 million, or 20.9%, to \$59.4 million for the six months ended June 30, 2006 from \$49.2 million for the comparable period in 2005 primarily due to a \$8.4 million increase in the amortization of purchased intangibles and an increase of \$1.9 million in depreciation and other amortization.

Operating Income. Operating income increased \$63.0 million, or 52.7%, to \$182.6 million for the six months ended June 30, 2006 from \$119.6 million during the comparable period in 2005. Operating income increased due to the revenue and expense factors discussed above.

Interest Expense. Interest expense increased \$13.5 million, or 263.6%, to \$18.6 million for the six months ended June 30, 2006 from \$5.1 million for the comparable period in 2005. Interest on certificates of deposit increased \$5.8 million due to an increase in on-balance sheet receivables of approximately \$165.2 million as compared to prior year, which was primarily associated with financing of the Blair portfolio acquisition completed in November 2005. Core debt interest expense increased \$9.0 million as a result of additional borrowings to fund our stock repurchase program and the acquisitions of ICOM and DoubleClick.

Taxes. Income tax expense increased \$19.9 million to \$62.8 million for the six months ended June 30, 2006 from \$42.9 million in 2005 due to an increase in taxable income. Our effective tax rate increased to 38.3% in 2006 compared to 37.5% in 2005 primarily as a result in changes of tax legislation in Texas and Canada.

Asset Quality

Our delinquency and net charge-off rates reflect, among other factors, the credit risk of our private label credit card receivables, the average age of our various private label credit card account portfolios, the success of our collection and recovery efforts, and general economic conditions. The average age of our private label 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.

An older private label credit card portfolio generally equates to a more stable performance of the portfolio. At June 30, 2006, 57.2% of securitized accounts with balances and 60.8% of securitized receivables were for accounts with origination dates greater than 24 months old.

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 beyond 90 days delinquent. When an account becomes delinquent, we print a message on the cardholder's billing statement requesting payment. 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.

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

| | December 31, | % of | June 30, | % of |
|--|-------------------------------|--------------|-----------------|--------------|
| | 2005 | Total | 2006 | Total |
| | (Dollars in thousands) | | | |
| Receivables outstanding | \$ 3,714,548 | 100.0% | \$ 3,619,840 | 100.0% |
| Receivables balances contractually delinquent: | | | | |
| 31 to 60 days | 59,018 | 1.6 | 55,706 | 1.5 |
| 61 to 90 days | 35,342 | 1.0 | 34,322 | 0.9 |
| 91 or more days | 69,343 | 1.9 | 65,389 | 1.8 |
| Total | \$ 163,703 | 4.4% | \$ 155,417 | 4.3% |

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 managed basis. Average managed receivables represent the average balance of the cardholder receivables at the beginning of each month in the period indicated.

| | Three Months Ended | | Six Months Ended | |
|---|-------------------------------|--------------|-------------------------|--------------|
| | June 30, | | June 30, | |
| | 2005 | 2006 | 2005 | 2006 |
| | (Dollars in thousands) | | | |
| Average managed receivables | \$ 3,070,988 | \$ 3,556,953 | \$ 3,104,178 | \$ 3,569,416 |
| Net charge-offs | 49,138 | 42,438 | 95,610 | 79,475 |
| Net charge-offs as a percentage of average managed receivables (annualized) | 6.4% | 4.8% | 6.2% | 4.5% |

Liquidity and Capital Resources

Operating Activities. We have historically generated cash flows from operations, although that amount may vary based on fluctuations in working capital and the timing of merchant settlement activity. Our operating cash flow is seasonal, with cash utilization peaking at the end of December due to increased activity in our Credit Services segment related to holiday retail sales.

| | Six Months Ended | |
|--|-------------------------|-------------|
| | June 30, | |
| | 2005 | 2006 |
| | (In thousands) | |
| Cash provided by operating activities before proceeds from the sale of credit card portfolios and change in merchant settlement activity | \$ 135,340 | \$ 145,297 |

| | | |
|---|------------|------------|
| Proceeds from the sale of credit card portfolios to the securitization trusts | | 70,870 |
| Net change in merchant settlement activity | 4,969 | 34,058 |
| Cash provided by operating activities | \$ 140,309 | \$ 250,225 |

We generated cash flow from operating activities before proceeds from the sale of credit card portfolios and change in merchant settlement activity of \$145.3 million for the six months ended June 30, 2006 as compared to \$135.3 million for the comparable period in 2005. The increase in operating cash flows before changes in merchant settlement activity is related to improved operating results for the six months ended June 30, 2006 offset in part by the classification of the tax benefits associated with the exercise of stock options and related stock-based compensation. Merchant settlement activity fluctuates significantly depending on the day in which the quarter ends. We utilize our cash flow from operations for ongoing business operations, acquisitions and capital expenditures.

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Investing Activities. Cash used in investing activities was \$127.9 million for the six months ended June 30, 2006 compared to \$29.8 million of cash provided for the comparable period in 2005. Significant components of investing activities are as follows:

Acquisitions. Cash outlays, net of cash received, for acquisitions for the six months ended June 30, 2006 was \$128.1 million compared to \$15.3 million for the comparable period in 2005. The outlay for acquisitions in 2006 relates primarily to the purchase of ICOM, a leading provider of targeted list, marketing data and communications solutions for the pharmaceutical industries in North America and DoubleClick, one of the largest permission-based email marketing service providers, with operations across North America, Europe and Asia/Pacific.

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. Securitized credit card receivables were over \$3.3 billion as of June 30, 2006. Securitizations require credit enhancements in the form of cash, spread accounts and additional receivables. The credit enhancement is partially funded through the use of certificates of deposit issued through our subsidiary, World Financial Network National Bank. Cash flow from securitization activity as well as on-balance sheet credit card receivables was \$62.4 million for the six months ended June 30, 2006 and \$73.0 million for the comparable period in 2005. We intend to utilize our securitization program for the foreseeable future.

Capital Expenditures. Our capital expenditures for the six months ended June 30, 2006 were \$48.6 million compared to \$28.6 million for the comparable period in 2005. We anticipate capital expenditures to be approximately 5% of annual revenue for the foreseeable future.

Financing Activities. Net cash used in financing activities was \$116.0 million for the six months ended June 30, 2006 compared to a net use of cash of \$153.8 million in the comparable period in 2005. Our financing activities during the six months ended June 30, 2006 relate primarily to borrowings and repayments of debt, the repurchase of 1,335,152 shares of our common stock under our stock repurchase program and the issuance and repayment of certificates of deposit.

Liquidity Sources. In addition to cash generated from operating activities, we have four main sources of liquidity: our securitization program, certificates of deposit issued by World Financial Network National Bank and World Financial Capital Bank, our credit facilities and issuances of equity and debt securities. We believe that internally generated funds and existing sources of liquidity are sufficient to meet current and anticipated financing requirements during the next 12 months.

Securitization Program and Off-Balance Sheet Transactions. Since January 1996, we have sold, sometimes through WFN Credit Company, LLC and WFN Funding Company II, LLC, substantially all of the credit card receivables owned by our credit card bank subsidiary, World Financial Network National Bank, to World Financial Network Credit Card Master Trust, World Financial Network Credit Card Master Note Trust, World Financial Network Credit Card Master Trust II and World Financial Network Credit Card Master Trust III, which we refer to as the WFN Trusts, as part of our securitization program. This securitization program is the primary vehicle through which we finance our private label credit card receivables.

Our securitization of credit card receivables involves sales to the WFN Trusts. We remove credit card receivables from our Consolidated Balance Sheets for those asset securitizations that qualify as sales in accordance with Statement of Financial Accounting Standard No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities a replacement of FASB Statement No. 125 (SFAS No. 140). For the six months ended June 30, 2006, we recognized \$2.5 million in gains related to the securitization of new credit card receivables

accounted for as sales. We record gains or losses on the securitization of credit card receivables on the date of the sale based on cash received, the estimate of fair value of assets sold and retained, and liabilities incurred in the sale.

In April 2006, World Financial Network Credit Card Master Note Trust issued \$395.0 million of Class A Series 2006-A asset backed notes that have an interest rate not to exceed one-month LIBOR plus 0.13% per year and that will mature in April 2013, \$18.8 million of Class M Series 2006-A asset backed notes that have

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an interest rate not to exceed one-month LIBOR plus 0.21% per year that will mature in April 2013, \$23.8 million of Class B Series 2006-A asset backed notes that have an interest rate not to exceed one-month LIBOR plus 0.35% per year that will mature in April 2013 and \$62.5 million of Class C Series 2006-A asset backed notes that have an interest rate not to exceed one-month LIBOR plus 0.60% per year that will mature in April 2013. The notes are rated AAA through BBB, or its equivalent, by each of Standard and Poor's, Moody's, and Fitch Ratings. In connection with the transaction, World Financial Network Credit Card Master Note Trust also entered into interest rate swaps that effectively fix the interest rate on the notes starting at 5.53% over the seven-year term of the interest rate swaps. The 2006 Series A Notes were pre-funded, with \$450.0 million of the proceeds invested in a guaranteed investment contract in order to minimize negative carrying costs until receivables are purchased by World Financial Network Credit Card Master Note Trust later this year.

As of June 30, 2006, the WFN Trusts had over \$3.3 billion of securitized credit card receivables. Securitizations require credit enhancements in the form of cash, spread deposits and additional receivables. The credit enhancement is principally based on the outstanding balances of the series issued by the WFN Trusts and by the performance of the private label credit cards in the securitization trust. During the period from November to January, the WFN Trusts are required to maintain a credit enhancement level of between 6% and 10% of securitized credit card receivables. Certain of the WFN Trusts are required to maintain a level of between 4% and 9% for the remainder of the year.

If World Financial Network National Bank were not able to regularly securitize the receivables it originates, our ability to grow or even maintain our credit services business would be materially impaired as we would be severely limited in our financing ability. World Financial Network National Bank's ability to effect securitization transactions is impacted by the following factors, some of which are beyond our control:

conditions in the securities markets in general and the asset-backed securitization market in particular; and

conformity in the quality of credit card receivables to rating agency requirements and changes in those requirements; and

our ability to fund required over collateralizations or credit enhancements, which we routinely utilize in order to achieve better credit ratings to lower our borrowing costs.

We believe that the conditions to securitize private label receivables are favorable for us. We plan to continue using our securitization program as our primary financing vehicle.

Once World Financial Network National Bank securitizes receivables, the agreement governing the transaction contains covenants that address the receivables' performance and the continued solvency of the retailer where the underlying sales were generated. In the event one of those or other similar covenants is breached, an early amortization event could be declared, in which case the trustee for the securitization trust would retain World Financial Network National Bank's interest in the related receivables, along with the excess interest income that would normally be paid to World Financial Network National Bank, until such time as the securitization investors are fully repaid. The occurrence of an early amortization event would significantly limit, or even negate, our ability to securitize additional receivables.

Certificates of Deposit. We utilize certificates of deposit to finance the operating activities and fund securitization enhancement requirements of our credit card bank subsidiaries, World Financial Network National Bank and World Financial Capital Bank. World Financial Network National Bank and World Financial Capital Bank issue 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 4.3% to 5.6%. As of June 30, 2006, we had \$190.1 million of certificates of deposit outstanding. Certificate of deposit borrowings are subject to regulatory capital requirements.

Credit Facilities. During January 2006, we entered into an additional credit agreement to increase our borrowing capacity by an incremental \$300.0 million. This credit agreement included usual and customary negative covenants for credit agreements of this type. Payment of amounts due under this credit agreement

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were secured by guaranties, pledges of the ownership interests of certain of our subsidiaries and pledges of certain intercompany promissory notes. On January 5, 2006, we borrowed \$300.0 million under this credit agreement, which we used for general corporate purposes, including other debt repayment, repurchases of our common stock in connection with our stock repurchase program, mergers and acquisitions, and working capital expenditures. We paid in full the \$300.0 million credit facility on May 16, 2006 with a portion of the proceeds from the senior notes and permitted this credit agreement to terminate pursuant to its terms on its scheduled maturity date, June 30, 2006.

On April 6, 2006, we amended our 364-day facility to extend the maturity date from April 6, 2006 to April 5, 2007.

Advances under all of our credit facilities are in the form of either base rate loans or Eurodollar loans. The interest rate on base rate loans fluctuates based upon the higher of (1) the interest rate announced by the administrative agent as its prime rate and (2) the Federal funds rate plus 0.5%, in each case with no additional margin. The interest rate on Eurodollar loans fluctuates based upon the rate at which Eurodollar deposits in the London interbank market are quoted plus a margin of 0.5% to 1.0% based upon the ratio of total debt under the credit facilities to consolidated Operating EBITDA, as each term is defined in the credit facilities. All of our credit facilities are secured by pledges of stock of certain of our subsidiaries and pledges of certain intercompany promissory notes.

We utilize our credit facilities, senior notes and excess cash flows from operations to support our acquisition strategy and to fund working capital, our stock buyback program and capital expenditures. We were in compliance with our covenants under our credit facilities and senior notes at June 30, 2006.

Senior Notes. On May 16, 2006, we entered into a senior note purchase agreement and issued and sold \$250.0 million aggregate principal amount of 6.00% Series A Notes due May 16, 2009 and \$250.0 million aggregate principal amount of 6.14% Series B Notes due May 16, 2011. The proceeds were used to retire the \$300.0 million credit facility, to repay other debt and for general corporate purposes.

The payment obligations under the senior notes are guaranteed by certain of our existing and future subsidiaries, currently ADS Alliance Data Systems, Inc. The Series A and Series B Notes will accrue interest on the unpaid balance thereof at the rate of 6.00% and 6.14% per annum, respectively, from May 16, 2006, payable semiannually, on May 16 and November 16 in each year, commencing with November 16, 2006, until the principal has become due and payable. The note purchase agreement includes usual and customary negative covenants and events of default for transactions of this type.

The senior notes are unsecured. If, as of September 30, 2006, our senior credit facilities are secured by pledges of the ownership interests of certain of our subsidiaries and pledges of certain intercompany promissory notes, we will grant the holders of the senior notes equal and ratable security interests in the same collateral to secure the senior notes.

At June 30, 2006, we had borrowings of \$39.7 million outstanding under our credit facilities (with an average interest rate of 7.4%), \$500.0 million under our senior notes, no letters of credit outstanding, and we had available unused borrowing capacity of approximately \$475.3 million. These credit facilities limit our aggregate outstanding letters of credit to \$50.0 million.

Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS No. 155) which amends Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133) and SFAS No. 140. SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the

whole instrument on a fair value basis. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided we have not yet issued financial statements,

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including for interim periods, for that fiscal year. We do not expect the adoption of SFAS No. 155 to have a material impact on our consolidated financial position, results of operations or cash flows.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets (SFAS No. 156). SFAS No. 156 amends SFAS No. 140 with respect to the accounting for separately-recognized servicing assets and liabilities. SFAS No. 156 addresses the recognition and measurement of separately-recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting. The standard is effective for fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided we have not yet issued financial statements, including for interim periods, for that fiscal year. We do not expect the adoption of SFAS No. 156 to have a material impact on our consolidated financial position, results of operations or cash flows.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS No. 109). FIN No. 48 prescribes a financial statement recognition threshold and measurement attribute of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition classification, interest and penalties, accounting in interim periods, disclosure and transition. The provisions of FIN No. 48 are effective for fiscal years beginning after December 15, 2006. We are currently in the process of evaluating the effect the adoption of FIN No. 48 will have on our consolidated financial position, results of operations or cash flows.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market Risk

There has been no material change from our Annual Report on Form 10-K/A for the year ended December 31, 2005 related to our exposure to market risk from off-balance sheet risk, credit risk, and redemption reward risk.

Interest Rate Risk. Interest rate risk affects us directly in our lending and borrowing activities. Our total interest incurred was approximately \$91.3 million for the first six months of 2006, which includes both on- and off-balance sheet transactions. Of this total, \$18.6 million of the interest expense, net was attributable to on-balance sheet indebtedness and the remainder to our securitized credit card receivables, which are financed off-balance sheet. To manage our risk from market interest rates, we actively monitor the interest rates and the interest sensitive components both on- and off-balance sheet to minimize the impact that changes in interest rates have on the fair value of assets, net income and cash flow. We manage our exposure to fluctuations in market interest rates by matching asset and liability repricings and through the use of fixed-rate debt instruments to the extent that reasonably favorable rates are obtainable with such arrangements. In addition, we enter into derivative financial instruments such as interest rate swaps and treasury locks to mitigate our interest rate risk on a related financial instrument or to lock the interest rate on a portion of our variable debt. We do not enter into derivative or interest rate transactions for trading or other speculative purposes. At June 30, 2006, we had \$4.4 billion of debt, including \$3.7 billion of off-balance sheet debt from our securitization program.

At June 30, 2006, 83.8% of our \$4.4 billion of debt was fixed or effectively fixed through interest rate swap agreements.

At June 30, 2006, 69.8% of our total debt, comprised entirely of 84.0% of our off-balance sheet debt, was locked at a current effective interest rate of 4.11% through interest rate swap agreements with notional amounts totaling \$3.1 billion. Of the remaining 16.0% of our off-balance sheet debt, we have variable rate private label

credit cards that are equal to or greater than the variable rate debt.

At June 30, 2006, approximately 14.0% of our total debt, comprised entirely of 82.6% of our on-balance sheet debt, was subject to fixed rates with a weighted average interest rate of 5.7%.

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The approach we use to quantify interest rate risk is a sensitivity analysis which we believe best reflects the risk inherent in our business. This approach calculates the impact on pretax income from an instantaneous and sustained increase in interest rates of 1.0%. For the six-month period ended June 30, 2006, a 1.0% increase in interest rates would have resulted in an annual decrease to pretax income of approximately \$1.9 million. Conversely, a corresponding decrease in interest rates would result in a comparable increase to pretax income. Our use of this methodology to quantify the market risk of financial instruments should not be construed as an endorsement of its accuracy or the accuracy of the related assumptions.

Foreign Currency Exchange Risk. We are exposed to fluctuations in the exchange rates primarily between the U.S. and the Canadian dollar through our significant Canadian operations. We do not hedge our net investment exposure in our Canadian subsidiary.

Item 4. Controls and Procedures

Evaluation

As of June 30, 2006, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2006, our disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and include controls and procedures designed to ensure that information we are required to disclose in such reports is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Our evaluation of and conclusion on the effectiveness of internal control over financial reporting as of December 31, 2005 did not include the internal controls of Epsilon Interactive, ICOM, and DoubleClick because of the timing of these acquisitions, which were completed in September 2005, February 2006, and April 2006 respectively. As of December 31, 2005, these entities constituted \$147.7 million of total assets and an immaterial amount of revenues and net income for the year then ended. In the fourth quarter of 2006, we will expand our evaluation of the effectiveness of the internal controls over financial reporting to include Epsilon Interactive. As part of our integration of Epsilon Interactive, we are in the process of converting their legacy general ledger platform to the platform used by our existing business units.

There have been no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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 Annual Report on Form 10-K/A for the year ended December 31, 2005.

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

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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

Item 1. Legal Proceedings.

From time to time, we are involved in various claims and lawsuits arising in the ordinary course of our business that we believe will not have a material adverse affect on our business or financial condition, including claims and lawsuits alleging breaches of contractual obligations.

Item 1A. Risk Factors.

There has been no material change from our Annual Report on Form 10-K/A for the year ended December 31, 2005 related to our exposure to market risk from off-balance sheet risk, credit risk, and redemption reward risk.

We are updating the risk factor below to provide more information regarding our interest rate risk as of June 30, 2006.

Interest Rate increases could significantly reduce the amount we realize from the spread between the yield on our assets and our cost of funding.

An increase in market interest rates could reduce the amount we realize from the spread between the yield on our assets and our cost of funding. A rise in market interest rates may indirectly impact the payment performance of consumers or the value of, or the amount we could realize from the sale of interest-only strips. At June 30, 2006, we had \$4.4 billion of debt, including \$3.7 billion of off-balance sheet debt from our securitization program.

At June 30, 2006, 83.8% of our \$4.4 billion of debt was fixed or effectively fixed through interest rate swap agreements.

At June 30, 2006, 69.8% of our total debt, comprised entirely of 84.0% of our off-balance sheet debt, was locked at a current effective interest rate of 4.11% through interest rate swap agreements with notional amounts totaling \$3.1 billion. Of the remaining 16.0% of our off-balance sheet debt, we have variable rate private label credit cards that are equal to or greater than the variable rate debt.

At June 30, 2006, approximately 14.0% of our total debt, comprised entirely of 82.6% of our on-balance sheet debt, was subject to fixed rates with a weighted average interest rate of 5.7%.

Assuming we do not take any counteractive measures, a 1.0% increase in interest rates would result in a decrease to pretax income of approximately \$1.9 million related to our on-balance sheet debt for the six-month period ended June 30, 2006. The foregoing sensitivity analysis is limited to the potential impact of an interest rate increase of 1.0% on cash flows and fair values, and does not address default or credit risk.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On June 8, 2005, our Board of Directors authorized a stock repurchase program to acquire up to an aggregate of \$80.0 million of our outstanding common stock through June 2006. At the expiration date of the program, we had acquired the full amount allowable under this program. On October 27, 2005, our Board of Directors authorized a new stock repurchase program to acquire up to an additional \$220.0 million of our outstanding common stock through

October 2006. As of June 2006, we have acquired \$133.2 million under this program. In total, we have repurchased 5,277,252 shares of our common stock for approximately \$213.2 million as of June 30, 2006 under the above two programs. Additionally, the administrator of our 401(k) and Retirement Savings Plan purchased shares of our common stock for the benefit of the employees who participated in that portion of the plan during the second quarter of 2006.

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The following table presents information with respect to those purchases of our common stock made during the three months ended June 30, 2006:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares |
|---------------------------------------|---|------------------------------------|--|--|
| | | | | That May Yet be Purchased Under the Plans or Programs (1) (2) (In millions) |
| During the second quarter of 2006: | | | | |
| April | 93,976 | \$ 46.30 | 92,452 | \$ 117.3 |
| May | 536,199 | 53.34 | 534,200 | 88.8 |
| June | 46,080 | 53.11 | 38,300 | 86.8 |
| Total | 676,255 | \$ 52.35 | 664,952 | \$ 86.8 |

(1) On June 8, 2005, our Board of Directors authorized a stock repurchase program to acquire up to an aggregate of \$80.0 million of our outstanding common stock through June 2006. As of the expiration of the program, we have acquired the full amount available under this program. On October 27, 2005, our Board of Directors authorized a new stock repurchase program to acquire up to an additional \$220.0 million of our outstanding common stock through October 2006.

(2) Debt covenants in our credit facilities restrict the amount of funds that we have available for repurchases of our common stock in any calendar year.

Item 3. Defaults Upon Senior Securities.

None

Item 4. Submission of Matters to a Vote of Security Holders.

On June 6, 2006, the Annual Meeting of Stockholders (Annual Meeting) was held at our corporate headquarters at 17655 Waterview Parkway, Dallas, Texas 75252. A total of 76,864,712 of our shares of common stock were present or represented by proxy at the Annual Meeting. This represented more than 95% of our shares outstanding. Two management proposals were voted upon at the Annual Meeting and each was approved. Each of Robert A. Minicucci and J. Michael Parks was re-elected as a Class III director to serve until our 2009 annual meeting of stockholders and until his successor is duly elected and qualified, and the selection of Deloitte & Touche LLP as our independent registered public accounting firm for 2006 was ratified and approved by the stockholders.

The results of the tabulation of the votes cast at the Annual Meeting are as follows:

| | For (#) | Withhold (#) |
|-----------------------------------|----------------|---------------------|
| Proposal 1 Election of Directors: | | |
| Robert A. Minicucci | 76,291,607 | 573,105 |
| J. Michael Parks | 76,115,161 | 749,551 |

| | For (#) | Against (#) | Abstain (#) | No Vote (#) |
|--|----------------|--------------------|--------------------|--------------------|
| Proposal 2 Ratification of Deloitte & Touche LLP as our independent registered public accounting firm for 2006 | 76,534,211 | 327,428 | 3,073 | 0 |

Item 5. Other Information.

(a) None

(b) None

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| Exhibit No. | Description |
|------------------------|--|
| 3.1 | Second Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit No. 3.1 to our Registration Statement on Form S-1 filed with the SEC on March 3, 2000, File No. 333-94623). |
| 3.2 | Second Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit No. 3.2 to our Registration Statement on Form S-1 filed with the SEC on March 3, 2000, File No. 333-94623). |
| 3.3 | First Amendment to the Second Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit No. 3.3 to our Registration Statement on Form S-1 filed with the SEC on May 4, 2001, File No. 333-94623). |
| 3.4 | Second Amendment to the Second Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit No. 3.4 to our Annual Report on Form 10-K, filed with the SEC on April 1, 2002, File No. 001-15749). |
| 4 | Specimen Certificate for shares of Common Stock of the Registrant (incorporated by reference to Exhibit No. 4 to our Quarterly Report on Form 10-Q filed with the SEC on August 8, 2003, File No. 001-15749). |
| 10.1 | Note Purchase Agreement, dated as of May 1, 2006, by and among Alliance Data Systems Corporation and the Purchasers party thereto (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K, filed with the SEC on May 18, 2006, File No. 001-15749). |
| 10.2 | Subsidiary Guaranty, dated as of May 1, 2006, by ADS Alliance Data Systems, Inc. in favor of the holders from time to time of the Notes (incorporated by reference to Exhibit 10.2 to our Current Report on Form 8-K, filed with the SEC on May 18, 2006, File No. 001-15749). |
| +10.3 | Alliance Data Systems Corporation Non-Employee Director Deferred Compensation Plan (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K, filed with the SEC on June 9, 2006, File No. 001-15749). |
| *31.1 | Certification of Chief Executive Officer of Alliance Data Systems Corporation pursuant to Rule 13a-14 (a) promulgated under the Securities Exchange Act of 1934, as amended. |
| *31.2 | Certification of Chief Financial Officer of Alliance Data Systems Corporation pursuant to Rule 13a-14(a) promulgated under the Securities Exchange Act of 1934, as amended. |
| *32.1 | Certification of Chief Executive Officer of Alliance Data Systems Corporation pursuant to Rule 13a-14(b) promulgated under the Securities Exchange Act of 1934, as amended, and Section 1350 of Chapter 63 of Title 18 of the United States Code. |
| *32.2 | Certification of Chief Financial Officer of Alliance Data Systems Corporation pursuant to Rule 13a-14(b) promulgated under the Securities Exchange Act of 1934, as amended, and Section 1350 of Chapter 63 of Title 18 of the United States Code. |

* Filed herewith.

+ Management contract, compensatory plan or arrangement.

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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

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

Date: August 7, 2006

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

Date: August 7, 2006

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