August 19, 2016

Alliance Data Systems: If You Don't Like the Answer ... Just Change the Question.

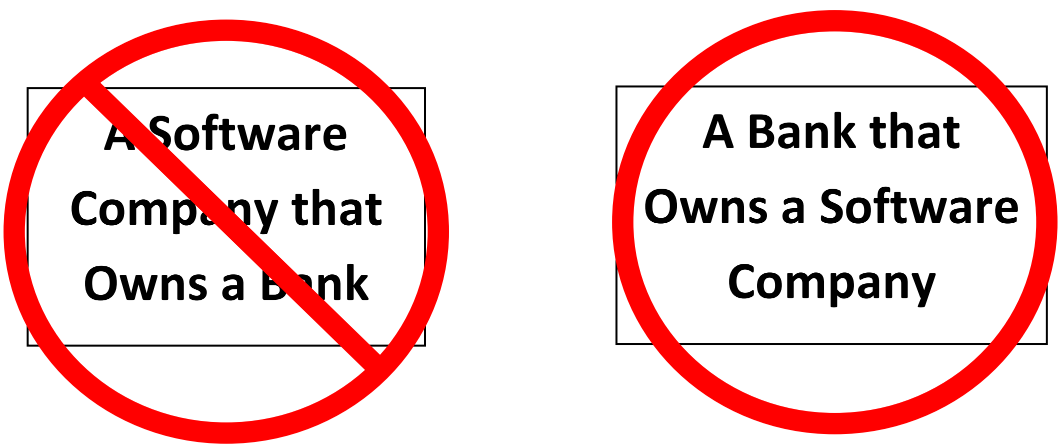
Citron Target on Alliance Data Systems Corp is 50% Near-Term Downside

This month Citron Research celebrates its 15th year of publication -- exposing, for lack of a better term, "market inefficiencies".

This neutral-sounding moniker is occasionally an accident ... but rarely. Most often it exploits the shallowness of Wall Street's "insight" with management's intentional hype, misdirection or just plain fraud. It has become too profitable taking advantage of a bullish market environment to ever let the truth get in the way of a good story.

And then comes Citron Research

In the Case of Alliance Data Systems (NYSE:ADS), Wall Street is just now waking up to the misrepresentations that have been promulgated by ADS management. At best, this is a mis-categorized company which should immediately be priced 40% lower. At worst management is covering up a business that has an entirely different risk profile ... and is one big credit event from derailing into a devastating downward spiral.



What makes this story timely is that it is not just Citron but **Wall Street analysts** who are finally catching up to the story, as reflected in this weeks' note from Credit Suisse, which states:

Alliance Data Closer To a Card Lender Than A Tech Company says Credit Suisse

Alliance Data Systems Corporation (NYSE: ADS) is being increasingly viewed as a lender, and its shares should trade in-line with other credit card lenders. The market would eventually recognize Alliance Data as a lender....

The operations of the company's card services business, which contributes the lion's share of earnings, is at two bank subsidiaries. These two entities are limited by regulatory and capital requirements, which limits the parent company's use of the cash generated by them.

-- Credit Suisse Analyst Paul Condra
August 18, 2016

http://www.benzinga.com/analyst-ratings/analyst-color/16/08/8361854/alliance-data-closer-to-a-card-lender-than-tech-company-

Citron could not have said it better. However, although Credit Suisse DID acknowledge the elephant in the room, they stopped short of driving their verdict to its inevitable valuation conclusion.

"Increasingly Viewed As A Lender"

Let's begin with the background for those who are not familiar with Alliance Data Systems. This is what management CLAIMS they do in their most recent 10-K:

"We are a leading global provider of data-driven marketing and loyalty solutions serving large, consumer-based businesses in a variety of industries. We offer a comprehensive portfolio of integrated outsourced marketing solutions, including customer loyalty programs, database marketing services, end-to-end marketing services, analytics and creative services, direct marketing services and private label and co-brand retail credit card programs."

-- *ADS 10-K Dec 31, 2015*

This would lead most investors, and importantly, indexers, to categorize ADS as a business services company, which deservedly trades on **earnings** rather than **book value**, and be assigned a higher multiple than a bank.

But as Credit Suisse noted, **the lion's share of earnings do in fact come from the banks they operate.** The myth of ADS being a business services company has been widely accepted because the company is in the **S&P 500 Information Technology Sector Index** but **not** the **S&P 500 Financial Sector Index**. Alliance Data Systems has no incentive to correct this obvious mis-categorization; management prefers the higher valuations that are associated with tech companies.

Three divisions of ADS must be considered separately when valuing the company:

1	**LoyaltyOne (Tech)**	Runs loyalty programs and leverages the data collected to help design and implement marketing programs.
2	**Epsilon (Tech)**	A comprehensive suite of targeted and data-driven marketing services. A majority of clients do not currently use the full suite of services.
3	**Card Services (Bank)**	Provides a variety of funding and processing services for private label and co-branded credit card programs; leverages the transaction level data to drive multi-channel marketing activities.

So while LoyaltyOne and Epsilon can fairly be valued as members of the Business Services (IT) cohort, ADS is more and more a bank wrapped in the Halloween costume of a business services company.

The Obvious Next Question: What's the Breakdown?

As we can see, 'Card Services' are more often than not discussed last, but is by far the most important division of Alliance Data Systems. The bank-like portion of the business, is almost 2/3rds of the business. From the chart below you can see why ADS would rather be considered a tech services firm than a bank:

Valuation Disparity			
		S&P 2015A	
	Financial Sector	Tech Sector	Tech > Fin
Price / Earnings	14.73	19.16	30.1%
Price / Book Value	1.35	4.13	205.9%
EV / EBIT	13.04	14.35	10.0%
EV / EBITDA	10.76	10.97	2.0%

There aren't too many tech companies out there that report **zero Research and Development costs** ... but it gets even more obvious than that.

What does Alliance Data Systems Really Do? Numbers Don't Lie!

The majority of its income being generated from its banks, ADS is clearly not primarily a technology company. As the operator of Comenity Bank, ADS issues credit cards from Victoria Secret, JCrew, Ulta, and a list of other retailers.

ADS | Business Segment Split 2015

	LoyaltyOne	Epsilon	Card Services	Corporate	Total
Revenue	$1,353	$2,141	$2,974	($28)	$6,440
% of total revenue	*21%*	*33%*	***46%***	*(0%)*	
Adjusted EBITDA, net	$271	$508	$1,069	($119)	$1,728
% of total EBITDA, net	*16%*	*29%*	***62%***	*(7%)*	

*** For those who defend the company claiming it should trade at a premium because their might be synergies between the two business …this is simply UNTRUE. Citron's investigation makes clear that the crossover between clients is statistically insignificant; instances can be counted on one hand. The only ones of note are Express and New York & Co.**

Management Has Promoted This Deception

"In terms of the businesses, and what we worry about, what we're looking at, probably the thing that's important here is free cash flow. I am old school, believe very big in the generation of free cash."

--Ed Heffernan, ADS CEO
Jun 14, 2016 at (William Blair & Company Growth Stock Conference

Meanwhile, the company stopped reporting free cash flow in its Q2 2016 investor presentation (the last time it was not disclosed was Q4 2014).

Generation of free cash is NOT what a bank should be focused on.

More importantly the company is categorized into the Info Tech part of the S&P Index.

https://en.wikipedia.org/wiki/Global_Industry_Classification_Standard

Worse, ADS is explicitly in the "S&P 500 Ex-Financials" Index.

Yet, until now analyst have still been complacent spouting off free cash flow when discussing the financial health. Almost like having a conference call about how fast Usain Bolt can swim: WHO REALLY CARES...?

> "strong free cash flow generation is used to repurchase stock to support EPS growth and the stock price."
>
> *-- RBC Aug 15, 2016*

> "During the quarter, free cash flow was $421 million, with operating cash flow of $474 million and capex of $53 million.
>
> *-- Raymond James Jul 21, 2016*

> "However, we suspect that ValueAct is looking at free cash per share guidance in excess of Core EPS and is interested in two key potential avenues: first, the implementation of a dividend and second, a long-term commitment to prioritizing capital returns over M&A."
>
> *-- JMP Jul 11, 2016*

Plain and Simple:

ADS sells the investment community on **cash flows,** not **Return on Equity** or **Return on Assets**, metrics that a bank would be valued on. Instead they refer to financial metrics that are akin to a technology company.

The Only Intellectually Honest Way To Value ADS

While Credit Suisse got the ball rolling …. Citron now completes and publishes the obviously needed analysis. Because of its two completely different business units, the only way to value ADS is a complete sum of the parts analysis -- looking at the bank and the tech operation separately.

To be fair, we assign the non-bank business a fair multiple of 10x EBIDTA, which is widely accepted for this type of business. This is right in line with Amiya (AIM in Toronto), the largest of all customer loyalty data driven companies.

We will add that to the value of the banks, assigning them a 2x book value, which is the same as Synchrony Financial, the gold standard of private label credit cards.

***NOTE:** The corporate debt must be assigned to the loyalty business. Due to Section 23 of the Federal Reserve Banking Regs, banks cannot hold corporate debt. **They certainly can't raise debt to buy back shares.** This concern is acknowledged in the GS research report on ADS.

Because its more than half a bank, not a tech firm, the valuation models of Alliance are miles from reality!

P/E Analysis

ADS | Valuation by P/E	
Non-Financials Business EBITDA (2015A)	$779
EV / EBITDA	10.0x
Implied Non-Financial Business Value	$7,789
Less: Net Debt	$6,483
Implied Non-Financial Business Value (less debt)	$1,306
Implied Non-Financial Business Value (less debt) - per share	$22.32
Earnings from bank (2015A)	$10.50
Price / Earnings	10.0x
Implied Value of Banks (per share)	$105.00
Implied Market Capitalization	$7,452
Shares outstanding	58.5
Implied Share Price	**$127.32**
Current Share Price	**$203.71**
Downside	**(37.5%)**

Price to Book Analysis:

ADS | Valuation	
Non-Financials Business EBITDA (2015A)	$779
EV / EBITDA	10.0x
Implied Non-Financial Business Value	$7,789
Less: Net Debt	$6,483
Implied Non-Financial Business Value (less debt)	$1,306
Comenity Bank	$1,497
Comenity Capital Bank	$707
Book Value of Banks	$2,204
P / Book	2.0x
Implied Value of Banks	$4,408
Implied Market Capitalization	$5,714
Shares outstanding	58.5
Implied Share Price	**$97.63**
Current Share Price	**$203.71**
Downside	**(52.1%)**

Realigning Perceptions and Reality

In a best-case scenario, ADS should trade at $100 per share -- $125 tops -- which is more than fair. Worst case scenario, it could go much lower with a credit event. While this story does need to explain what could happen, investors would be foolish not to pay attention to a lender with more red flags than the Beijing Olympics…..**ALL WHICH COULD TRIGGER A CREDIT EVENT AND SEND THE STOCK LOWER THAN OUR PROJECTIONS**

The Single Most Disturbing Data Point about ADS:

ADS **DOES NOT disclose FICO scores of their borrowers**. They are the **only credit company in the S&P 500** that does not … this is beyond disturbing, because they intentionally cater to a lower than prime client. See the "Shopping Cart Trick" below.

And the other Red Flags:

Many of ADS private label credit cards purposely do not offer an auto pay feature, which enables them to earn a higher ROE from late fees charged. This has already been the target of the FDIC and could go to the CFPB.

Comenity bank already has history of run-ins with regulators, and has been fined. CFPB is always a threat. http://www.creditcards.com/credit-card-news/comenity-bank-fdic-fine-refund-1282.php

ADS is possibly the only bank on the S&P 500 that **does not disclose** Return on Equity or Return on Assets.

ADS is the rare financial institution on the S&P 500 that has > $5 billion of debt and no credit rating.

The sub-prime book is becoming more apparent -- you can see the connection to Lending Club of page 9 of their most recent 10-K.

Charge-offs are growing:

Table 1: ADS Private Label Monthly Metrics

	Mar-16	Apr-16	May-16	Jun-16	July-16
Net Principal Charge-off (Managed)	*5.1%*	*5.1%*	*5.2%*	*5.0%*	*5.4%*
Y/Y Change in Charge Offs	*+20bps*	*+30bps*	*+70bps*	*+60bps*	*+80bps*
Net Principal Charge Off (Master Trust)	5.9%	6.3%	6.5%	5.9%	7.1%
Gross Defaults (Master Trust)	8.6%	8.5%	8.2%	8.3%	9.0%
Gross Defaults - 6 Month Lag (Master Trust)	9.2%	9.0%	8.2%	7.7%	8.8%
% of Receivables 30+ Days Delinquent (Master Trust)	*4.5%*	*4.5%*	*4.9%*	*5.1%*	*5.5%*
% of Receivables 30+ Days Delinquent (Managed)	*4.3%*	*4.2%*	*4.4%*	*4.6%*	*4.8%*
Portfolio Growth (y/y)	*29%*	*25%*	*24%*	*23%*	*23%*

Source: Company reports and JPM calculations

Lastly, and the Biggest Red Flag of them All, is Comenity's Prominent Use of the “Shopping Cart Trick”

Citron believes that a big part of the online credit card business of Comenity is based on a widely known trick amongst the subprime community which allows consumers to get credit, especially high fee retail-branded credit cards**, without a credit request ever getting put on your credit records or lowering your FICO score**. Comenity is well aware of this credit loophole; you will be amazed of how popular it has become with the subprime community.

Below are just 3 but there are literally hundreds of sites and videos dedicated to this Comenity “loophole". Folks this is the Holy Grail of subprime lending:

How to Perform the Shopping Cart Trick

1. Go online to the store's website for the card you want.
2. Register for their website or loyalty program. You will want to provide your personal information. Providing your address is a must because it allows them to send promotions to your address.
3. Add a couple of items to your shopping cart.
4. Continue the check-out process until you reach the final page. If you have not received an offer, then you will have try again or try another website. Again, you do not have to purchase anything. The process of going to the final checkout page increases your chance of an offer to pop up.
5. Accept the offer and complete the application.

Note: Be sure to enter the same information that is on your credit report when you're applying for the credit card. If they cannot verify your identity, then you will not be eligible for the card.

http://www.bankcheckingsavings.com/shopping-cart-trick/

Other links documenting the **same nonsensical sleight-of-hand --** an engraved invitation to sub-prime customers:

http://shoppingcarttrick.net
http://theshoppingcarttrick.com

So Why Do Investors Own ADS???

Simple: Investors buy ADS as a yield name as it boasts 10% free cash flow yields. Yet, using this metric for a bank instead of its price to book is like asking Ryan Lochte how his night was. You'll get an answer; it's just that reality might be a different story.

The company has said numerous times in SEC filings that in 2015 they generated $1.3 billion in free cash flow. **This is not only misleading – in our opinion this is borderline fraudulent.**

In a time where we all increasingly struggle to understand or delineate **GAAP vs. non-GAAP** figures, the SEC has attempted to add clarity with Regulation G. This regulation forces companies to "show their homework" when disclosing any non-GAAP financial measures, in this case when disclosing cash flows – Alliance Data Systems should show investors how they were calculated. They should provide a reconciliation of Free Cash Flow to provided GAAP figures (as free cash flow is a non-GAAP figure). But Alliance Data Systems does not do this.

Worse- they have changed their own definition of free cash flows.	
Q1 2013 Earnings Call	Q4 2014 Earnings Call
Edward Heffernan (CEO): *"One of the key things is free cash flow… everyone seems to define free cash flow differently. I keep it real simple, which is how much is left in the bank account at the end of the year, which means how much after you pay for CapEx and interest and taxes and working capital and bank capital and everything else."* (source)	Edward Heffernan (CEO): *"Then finally, free cash flow, if we are going to do around $1.8 billion or so of net EBITDA, if you take out CapEx and cash interest and cash taxes, we will probably be around $1.3 billion of free cash flow"* (source)

Research done by numerous accountant and industry experts has concluded that the actual free cash flow of ADS is less than HALF of what is disclosed, just $539 million … and here is the homework.

2015 Free Cash Flow Reconciliation	
GAAP Net Income	$605
Stock Based Compensation	$91
Depreciation & Amortization	$492
Non-cash interest expense and derivative MTM Gain	$24
Non-Cash Items	**$607**
Capex (non-card services only)	($156)
Change in net working capital	($53)
Cash items not captured in net income	**($209)**
Adjusted EBITDA	($1,219)
Interest expense on deposits	$54
Securitization funding costs	$97
Regulatory settlement	$65
Stock based compensation	$15
Taxes	$354
Remove card services impact to GAAP net income	**($634)**
Dividends	$225
Infusions	($55)
Free cash flow from banks (CB and CCB)	**$170**
Free cash flow available to shareholders	**$539**

While ADS wants investors to believe that free cash flow = EBITDA less taxes, capex, interest – in reality and in their own former calculation it is… Net dividends from the two banks to the parent plus the free cash flow of the non bank businesses.

DUH!!! Everyone knows that EBITDA is the most useless metric when looking at a bank ... Everyone except maybe ADS.

Conclusion

Citron has attempted to present this story as simply as possible. Goldman Sachs already understands the mispricing of ADS, and reports even its Sum of The Parts analysis is significantly lower than the stock's current lofty levels. Now Credit Suisse is on board. Pretty soon, all of Wall Street will wake up and understand that **AT BEST- Alliance Data Systems is a $100 stock. And if we see a recession or other threat to consumer credit default rates, the floor becomes the ceiling ... overnight.**

Cautious Investing to All