

ALLIANCE DATA SYSTEMS CORP
Form 10-Q
August 08, 2008
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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, 2008

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)

31-1429215
(I.R.S. Employer)

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Incorporation or Organization)

Identification No.)

17655 Waterview Parkway

Dallas, Texas 75252

(Address of Principal Executive Office, Including Zip Code)

(972) 348-5100

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (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, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act:

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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 5, 2008, 67,279,154 shares of common stock were outstanding.

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

	June 30, 2008	December 31, 2007
	(in thousands)	
ASSETS		
Cash and cash equivalents	\$ 208,236	\$ 219,210
Due from card associations	12,081	
Trade receivables, less allowance for doubtful accounts (\$6,996 and \$6,319 at June 30, 2008 and December 31, 2007, respectively)	214,453	228,582
Seller's interest and credit card receivables, less allowance for doubtful accounts (\$29,488 and \$38,726 at June 30, 2008 and December 31, 2007, respectively)	454,034	652,434
Deferred tax asset, net	94,314	90,515
Other current assets	98,218	100,834
Assets held for sale	107,673	287,610
Total current assets	1,189,009	1,579,185
Redemption settlement assets, restricted	673,076	317,053
Property and equipment, net	188,194	192,759
Deferred tax asset, net	34,959	38,074
Due from securitizations	478,021	379,268
Intangible assets, net	314,002	343,402
Goodwill	1,176,553	1,185,773
Other non-current assets	75,029	68,080
Total assets	\$ 4,128,843	\$ 4,103,594
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	\$ 132,576	\$ 133,857
Accrued expenses	133,732	206,219
Merchant settlement obligations	122,953	
Certificates of deposit	264,800	370,400
Credit facilities and other debt, current	303,855	313,589
Other current liabilities	54,669	52,930
Liabilities held for sale	43,491	254,760
Total current liabilities	1,056,076	1,331,755
Deferred revenue	1,179,274	828,348
Long-term and other debt	900,583	644,061
Other liabilities	113,287	102,464
Total liabilities	3,249,220	2,906,628
Stockholders' equity:		
Common stock, \$0.01 par value; authorized 200,000 shares; issued 88,551 shares and 87,786 shares at June 30, 2008 and December 31, 2007, respectively	886	878
Additional paid-in capital	933,465	898,631
Treasury stock, at cost (16,299 and 9,024 shares at June 30, 2008 and December 31, 2007, respectively)	(858,566)	(409,486)

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Retained earnings	779,191	682,903
Accumulated other comprehensive income	24,647	24,040
Total stockholders' equity	879,623	1,196,966
Total liabilities and stockholders' equity	\$ 4,128,843	\$ 4,103,594

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(in thousands)			
Revenues				
Transaction	\$ 83,096	\$ 95,266	\$ 166,692	\$ 180,452
Redemption	131,621	100,857	248,400	191,400
Securitization income and finance charges, net	138,556	164,589	306,547	342,661
Database marketing fees and direct marketing fees	128,614	109,509	246,117	212,072
Other revenue	25,323	11,599	38,704	21,582
Total revenue	507,210	481,820	1,006,460	948,167
Operating expenses				
Cost of operations (exclusive of depreciation and amortization disclosed separately below)	340,962	319,870	665,773	613,461
General and administrative	14,897	21,216	33,165	44,519
Depreciation and other amortization	17,578	14,919	35,340	28,668
Amortization of purchased intangibles	16,792	17,423	33,979	32,556
Loss on the sale of assets			1,052	
Merger costs	2,804	6,171	4,411	6,171
Total operating expenses	393,033	379,599	773,720	725,375
Operating income	114,177	102,221	232,740	222,792
Interest income	(3,258)	(1,997)	(5,763)	(4,772)
Interest expense	17,200	20,931	36,808	39,506
Income from continuing operations before income taxes	100,235	83,287	201,695	188,058
Provision for income taxes	38,289	31,752	77,047	71,808
Income from continuing operations	61,946	51,535	124,648	116,250
Loss from discontinued operations, net of taxes	(14,977)	(7,446)	(28,360)	(15,301)
Net income	\$ 46,969	\$ 44,089	\$ 96,288	\$ 100,949
Basic income (loss) per share:				
Income from continuing operations	\$ 0.81	\$ 0.66	\$ 1.61	\$ 1.48
Loss from discontinued operations	\$ (0.20)	\$ (0.10)	\$ (0.37)	\$ (0.20)
Net income per share	\$ 0.61	\$ 0.56	\$ 1.24	\$ 1.28
Diluted income (loss) per share:				
Income from continuing operations	\$ 0.79	\$ 0.64	\$ 1.57	\$ 1.44
Loss from discontinued operations	\$ (0.19)	\$ (0.09)	\$ (0.36)	\$ (0.19)
Net income per share	\$ 0.60	\$ 0.55	\$ 1.21	\$ 1.25
Weighted average shares basic	76,619	78,160	77,484	78,591

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Weighted average shares	diluted	78,636	80,504	79,496	80,797
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See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Six months ended June 30,	
	2008	2007
	(in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 96,288	\$ 100,949
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	77,310	82,563
Deferred income taxes	(7,835)	8,701
Provision for doubtful accounts	20,724	13,922
Non-cash stock compensation	14,725	24,009
Fair value gain on interest-only strip	(16,400)	(22,050)
Impairment on disposal group	45,400	
Gain on the sale of assets	(41,686)	
Change in operating assets and liabilities, net of acquisitions:		
Change in trade accounts receivable	7,373	(20,240)
Change in merchant settlement activity	(84,232)	35,400
Change in other assets	(6,155)	(26,102)
Change in accounts payable and accrued expenses	(53,958)	(53,566)
Change in deferred revenue	388,925	19,819
Change in other liabilities	6,076	(13,791)
Excess tax benefits from stock-based compensation	(497)	(6,862)
Proceeds from the sale of credit card receivable portfolios to the securitization trusts	91,910	
Other	(5,726)	4,883
Net cash provided by operating activities	532,242	147,635
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in redemption settlement assets	(370,873)	(5,856)
Payments for acquired businesses, net of cash acquired		(437,963)
Net decrease in seller's interest and credit card receivables	80,527	83,613
Change in due from securitizations	(71,500)	21,715
Capital expenditures	(28,531)	(47,532)
Proceeds from the sale of a business	90,307	
Proceeds from the sale of assets	14,098	
Other	(4,006)	(8,866)
Net cash used in investing activities	(289,978)	(394,889)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings under debt agreements	1,903,127	1,227,000
Repayment of borrowings	(1,680,701)	(892,000)
Certificate of deposit issuances	322,700	213,600
Repayments of certificates of deposits	(428,300)	(251,600)
Payment of capital lease obligations	(8,289)	(5,225)
Payment of deferred financing costs	(3,634)	(1,373)
Excess tax benefits from stock-based compensation	497	6,862
Proceeds from issuance of common stock	14,942	19,633
Proceeds from sale-leaseback transactions	34,221	
Purchase of treasury shares	(449,080)	(108,536)
Net cash (used in) provided by financing activities	(294,517)	208,361

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Effect of exchange rate changes on cash and cash equivalents	(3,059)	1,951
Change in cash and cash equivalents	(55,312)	(36,942)
Cash and cash equivalents at beginning of period	265,839	180,075
Cash and cash equivalents at end of period	\$ 210,527	\$ 143,133
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	\$ 35,813	\$ 38,877
Income taxes paid, net of refunds	\$ 89,544	\$ 34,907

See accompanying notes to unaudited condensed consolidated financial statements.

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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 for the year ended December 31, 2007 filed with the SEC on February 28, 2008 and the Company s Current Report on Form 8-K filed with the SEC on May 30, 2008, which re-issued certain items of the Company s Annual Report on Form 10-K.

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 (1) the reported amounts of assets and liabilities; (2) disclosure of contingent assets and liabilities at the date of the financial statements; and (3) 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. The Company s unaudited condensed consolidated financial statements have been presented with our merchant and utility services businesses as discontinued operations. All historical statements have been restated to conform to this presentation.

2. TERMINATION OF MERGER

On May 17, 2007, the Company entered into an Agreement and Plan of Merger by and among the Company, Aladdin Solutions, Inc. (f/k/a Aladdin Holdco, Inc., Parent) and Aladdin Merger Sub, Inc. (Merger Sub and together with Parent, the Blackstone Entities) (the Merger Agreement), pursuant to which the Company was to be acquired by affiliates of The Blackstone Group L.P. (the Merger).

On January 25, 2008, Parent informed the Company in a written notice that it did not anticipate the condition to closing the Merger relating to obtaining approvals from the Office of the Comptroller of the Currency would be satisfied.

On January 30, 2008, the Company filed a lawsuit against the Blackstone Entities in the Delaware Court of Chancery, seeking specific performance to compel the Blackstone Entities to comply with their obligations under the Merger Agreement, including their covenants to obtain required regulatory approvals and to consummate the Merger. On February 8, 2008, the Company filed a motion to dismiss this lawsuit without prejudice in response to the Blackstone Entities confirmation of their commitment to work to consummate the Merger.

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED

CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

On March 17, 2008, the Company notified the Blackstone Entities that they were in breach of the Merger Agreement and demanded that the Blackstone Entities cure the breaches including, among other things, obtaining required regulatory approvals from the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

On April 18, 2008, Parent repudiated the Merger Agreement by sending the Company a notice purporting to terminate the contract. The Company believes that the notice of termination was ineffective because the Merger Agreement cannot be terminated under the relevant termination provision by a party that is in breach. Subsequently, on April 18, 2008, the Company terminated the Merger Agreement because of the Blackstone Entities' repudiation and their refusal to timely cure their breaches and perform their covenants and agreements, thereby causing specified closing conditions not to be satisfied.

Pursuant to the Merger Agreement, if the Company terminates the Merger Agreement as a result of Parent's or Merger Sub's breach or failure to perform that causes specified closing conditions not to be satisfied, Parent is required to pay, or cause to be paid, to the Company a fee of \$170.0 million (the Business Interruption Fee). Blackstone Capital Partners V L.P. (BCP V) provided a limited guarantee pursuant to which, among other things, BCP V guarantees payment of the Business Interruption Fee and up to \$3.0 million of other amounts for which the Blackstone Entities are liable under the Merger Agreement. The Company has demanded that Parent pay the Business Interruption Fee, and commenced litigation on April 18, 2008 seeking full and timely payment of this fee by BCP V, as guarantor of the fee, in the New York State Supreme Court (the New York action).

On April 21, 2008, the Blackstone Entities filed an action for declaratory judgment in the Delaware Court of Chancery against Alliance Data seeking an order declaring that, among other things, the Blackstone Entities are not in breach of the Merger Agreement and that they are not obligated to pay the Business Interruption Fee (the Delaware declaratory judgment action).

On May 30, 2008, the Company filed a breach of contract action in the Delaware Court of Chancery against BCP V, Parent and Merger Sub seeking payment of the Business Interruption Fee (the Delaware contract action).

Pursuant to the parties' agreement, the New York action was stayed pending completion of the Delaware contract action, and the Blackstone Entities voluntarily dismissed the Delaware declaratory judgment action. The Company filed an amended complaint in the Delaware contract action on June 25, 2008, asserting the same claims seeking payment of the Business Interruption Fee, though Merger Sub was dropped as a defendant. The remaining defendants, BCP V and Parent, filed a motion to dismiss the amended complaint on July 14, 2008. Pursuant to an agreed-to briefing schedule, the Company's opposition brief is due on or before August 13, 2008, and defendants' reply brief is due within 14 days after the opposition brief is filed.

For the six months ended June 30, 2008, the Company recorded merger costs of approximately \$4.4 million consisting of legal, accounting and other costs associated with the Merger. In July 2008, the Company received \$3.0 million from the Blackstone Entities for reimbursement of certain costs related to the Blackstone Entities' financing of the proposed merger.

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED****CONSOLIDATED FINANCIAL STATEMENTS CONTINUED****3. 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		Six Months Ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
	(in thousands, except per share amounts)			
Numerator				
Income from continuing operations	\$ 61,946	\$ 51,535	\$ 124,648	\$ 116,250
Loss from discontinued operations	(14,977)	(7,446)	(28,360)	(15,301)
Net income	\$ 46,969	\$ 44,089	\$ 96,288	\$ 100,949
Denominator				
Weighted average shares, basic	76,619	78,160	77,484	78,591
Weighted average effect of dilutive securities:				
Net effect of unvested restricted stock	733	753	691	667
Net effect of dilutive stock options	1,284	1,591	1,321	1,539
Denominator for diluted calculation	78,636	80,504	79,496	80,797
Basic				
Income from continuing operations per share	\$ 0.81	\$ 0.66	\$ 1.61	\$ 1.48
Loss from discontinued operations per share	\$ (0.20)	\$ (0.10)	\$ (0.37)	\$ (0.20)
Net income per share	\$ 0.61	\$ 0.56	\$ 1.24	\$ 1.28
Diluted				
Income from continuing operations per share	\$ 0.79	\$ 0.64	\$ 1.57	\$ 1.44
Loss from discontinued operations per share	\$ (0.19)	\$ (0.09)	\$ (0.36)	\$ (0.19)
Net income per share	\$ 0.60	\$ 0.55	\$ 1.21	\$ 1.25

4. DISPOSITIONS

In March 2008, the Company determined that its merchant and utility services businesses were not aligned with the Company's long-term strategy and committed to a plan of disposition and began exploring the potential sale of these businesses. In accordance with the provisions of Statement of Financial Accounting Standards No. 144, Accounting for Impairment or Disposal of Long-Lived Assets, these businesses have been reported as discontinued operations in this Quarterly Report on Form 10-Q. The results of operations for all periods presented have been reclassified to reflect these businesses as discontinued operations.

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In May 2008, the Company entered into an agreement with Heartland Payment Systems, Inc. (Heartland) to sell the merchant services business for approximately \$77.5 million, of which \$1.5 million was held in escrow. The sale was completed on May 30, 2008 and the Company received net proceeds of approximately \$90.3 million, which included approximately \$14.3 million for the payment of net working capital. In connection with the sale, the Company recognized a pre-tax gain of approximately \$29.4 million, which has been included in the loss from discontinued operations. In connection with the sale, the Company's private label credit card banking subsidiary World Financial Network National Bank entered into an interim transition services agreement for a period of nine months to provide card processing and certain other services to Heartland.

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED****CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

In July 2008, the Company entered into a definitive agreement with VTX Holdings Limited, and its subsidiaries Vertex U.S. Holdings II Inc. and Vertex Canada Holdings II Limited, to sell the majority of the utility services business (excluding certain retained assets and liabilities) for approximately \$50.0 million in cash, subject to certain adjustments. The sale was completed on July 25, 2008. The Company still retains one disposal group associated with our utility services business and is currently exploring its potential sale, which is expected to be completed by March 2009.

Based on the estimated enterprise value of these businesses, for the six months ended June 30, 2008, the Company recorded a pre-tax impairment charge of \$45.4 million, which has been included in the loss from discontinued operations.

The assets and liabilities of the discontinued operations are presented in the condensed consolidated balance sheets under the captions Assets held for sale and Liabilities held for sale. The underlying assets and liabilities of the discontinued operations for the periods presented are as follows:

	June 30, 2008	December 31, 2007
	(in thousands)	
Assets:		
Cash and cash equivalents	\$ 2,291	\$ 46,630
Due from card associations		21,456
Trade receivables	55,364	78,410
Other assets	11,120	15,016
Property and equipment, net	31,313	56,030
Intangible assets, net	7,585	20,493
Goodwill		49,575
Assets held for sale	\$ 107,673	\$ 287,610
Liabilities:		
Accounts payables	\$ 369	\$ 933
Accrued expenses	25,867	21,892
Merchant settlement obligations		216,560
Capital lease obligations	4,642	2,455
Other liabilities	12,613	12,920
Liabilities held for sale	\$ 43,491	\$ 254,760

The following table summarizes the operating results of the discontinued operations.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2008	2007	2008	2007
	(amounts in thousands)			
Revenue	\$ 64,510	\$ 81,978	\$ 139,996	\$ 164,789

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Loss before provision for income taxes	(10,015)	(11,393)	(30,466)	(23,411)
Provision for (benefit) from income taxes	4,962	(3,947)	(2,106)	(8,110)
Loss from discontinued operations	\$ (14,977)	\$ (7,446)	\$ (28,360)	\$ (15,301)

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED****CONSOLIDATED FINANCIAL STATEMENTS CONTINUED****5. SELLER'S INTEREST AND CREDIT CARD RECEIVABLES**

In June 2008, the Company sold a portfolio of credit card receivables to our securitization trusts. The Company sold a net principle balance of \$100.7 million, for which we received cash of \$91.9 million and retained \$8.8 million in a spread deposit account that is included in Due from Securitizations in the condensed consolidated balance sheet. The gain on the sale was approximately \$5.0 million, of which \$2.2 million was included in the gain on the interest-only strip and \$2.8 million was associated with the write-off of the allowance and other assets. The total gain is included in Securitization income and finance charges, net in our condensed consolidated statement of income.

6. INTANGIBLE ASSETS AND GOODWILL*Intangible Assets*

Intangible assets consist of the following:

	Gross Assets	June 30, 2008 Accumulated Amortization (in thousands)	Net	Amortization Life and Method
<i>Finite Lived Assets</i>				
Customer contracts and lists	\$ 186,428	\$ (83,883)	\$ 102,545	5-10 years straight line
Premium on purchased credit card portfolios	68,432	(31,375)	37,057	5-10 years straight line, accelerated
Collector database	68,554	(55,080)	13,474	30 years 15% declining balance
Customer databases	161,699	(30,922)	130,777	4 -10 years straight line
Noncompete agreements	2,160	(1,693)	467	2-5 years straight line
Favorable lease	1,000	(750)	250	4 years straight line
Tradenames	11,260	(1,758)	9,502	4 -10 years straight line
Purchased data lists	11,326	(3,746)	7,580	1 -5 year accelerated basis, straight line
	\$ 510,859	\$ (209,207)	\$ 301,652	
<i>Indefinite Lived Assets</i>				
Tradenames	12,350		12,350	Indefinite life
Total intangible assets	\$ 523,209	\$ (209,207)	\$ 314,002	

Table of Contents**ALLIANCE DATA SYSTEMS CORPORATION****NOTES TO UNAUDITED CONDENSED****CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

	December 31, 2007				
	Gross Assets	Accumulated Amortization (in thousands)	Net	Amortization Life and Method	
<i>Finite Lived Assets</i>					
Customer contracts and lists	\$ 186,428	\$ (71,330)	\$ 115,098	5-10 years	straight line
Premium on purchased credit card portfolios	70,664	(29,203)	41,461	5-10 years	straight line, accelerated
Collector database	71,358	(56,093)	15,265	30 years	15% declining balance
Customer databases	161,713	(20,096)	141,617	4 -10 years	straight line
Noncompete agreements	2,160	(1,308)	852	2-5 years	straight line
Favorable lease	1,000	(614)	386	4 years	straight line
Tradenames	11,262	(1,154)	10,108	4 -10 years	straight line
Purchased data lists	8,656	(2,391)	6,265	1 -5 year	accelerated basis, straight line
	\$ 513,241	\$ (182,189)	\$ 331,052		
<i>Indefinite Lived Assets</i>					
Tradenames					