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Ed Heffernan at Alliance Data

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ABSTRACT

In 2008, Ed Heffernan, CFO at Alliance Data, found himself at the center of the storm created by the financial crisis and the credit freeze that followed. Yet Heffernan saw in the crisis an opportunity for the company's private label credit division to grow through acquisitions. How would he convince others this was a risk worth taking in an uncertain financial environment?

CONTENTS

Introduction.. 1
ADS Background 2
Senior Management.......................... 3
Retail Services 4
Growth Management at Retail Services.. 5
The Blackstone Deal......................... 6
A New Direction for Retail Services . 7
The Acquisition Plan 9
Exhibits 11

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Introduction

When the global financial system seized up in September 2008 after the fall of Lehman Brothers, Ed Heffernan, Columbia Business School MBA '86, was the chief financial officer at Dallas, Texas–based Alliance Data (ADS). ADS, a multi-billion-dollar company providing a unique hybrid of credit-card processing, loyalty, and marketing solutions, relied heavily on credit markets in every way. The sudden halt in lending forced Heffernan and his team, in triage mode, to direct immediate attention to the company's private label credit division, Alliance Data Retail Services (Retail Services).

Yet the financial crisis also presented a unique opportunity for Heffernan to recommend some aggressive financial moves at a time when most institutions were retreating. As he saw it, Retail Services could follow the rest of the industry and "turtle"—retrench, cut staff and expenses, and ride out the economic shakeout making as few moves as possible. Or it could exploit the crisis and move aggressively on the firm's long-term strategy of acquisitions and growth in private label credit. A risk-taker by nature, Heffernan's choice was clear. But how would Heffernan convince others that decisive action in times of such uncertainty was a risk worth taking?

CFO Ed Heffernan

Upon graduation from Columbia Business School in 1986, Heffernan worked in corporate finance for First Boston and in a variety of merger and acquisition positions at Citicorp and First Data Corporation. He joined ADS in 1998 to lead mergers and acquisitions and was appointed CFO in 2000.

Heffernan made an initial impression as a straight-talking extrovert with a sharp sense of humor. A colleague noted, "Ed is a big athletic guy, with a very outgoing personality." [1] Heffernan described himself as "a boots on the ground" kind of leader. In his role as CFO, he engaged in executive-level strategic discussions as well as conversations with staff workers who were concerned about job security. According to Karen Wald, head of the company's corporate communications, Heffernan earned the trust and respect of all levels of management, though she noted he was a bit of a maverick and not your conventional CFO.

Heffernan valued his ability to remain grounded while holding a senior position at a successful company, commenting, "How many CFOs do you know that rush home to do cannon balls into the pool with their kids?" And he felt no need to call attention to his status: "Everyone knows who I am here; I don't need to go around saying 'I went to Columbia.' In fact, everyone has to check the 'jerk factor' at the door." He was particularly proud of the values at ADS and the low turnover rate of its employees.

[1] This comment is based on an interview with company personnel on January 25, 2010.

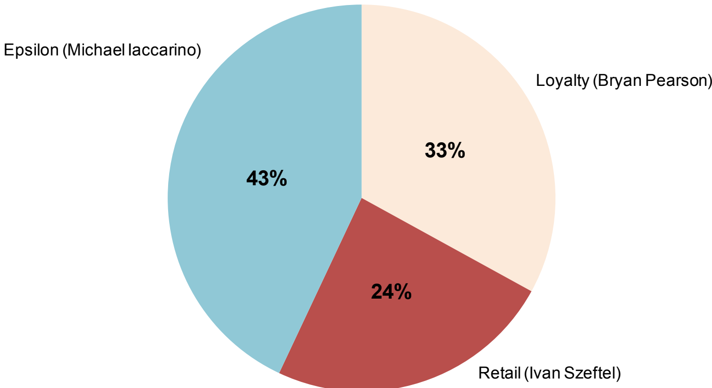
After Lehman's collapse, Heffernan suddenly found himself in the center of the storm created by the credit freeze. As CFO, he faced the daunting task of navigating the company's day-to-day financial operations at a time when the economy was suspended in a state of stunning uncertainty. Accordingly, Heffernan focused much of his attention during this period on the division most directly impacted by the credit crisis: Retail Services.

ADS Background

ADS was formed in 1996 by the private equity firm Welsh, Carson, Anderson & Stowe (WCAS), which had purchased and then merged JC Penney's transaction-services business and The Limited's credit card bank operation. From there, ADS grew through acquisitions and organic growth to build a portfolio that included a range of marketing, customer loyalty, and private label credit services. See Exhibit 1 for a summary of the company's financial performance.

In third quarter 2008, the company employed more than 7,000 people and consisted of three divisions: Loyalty One™, which primarily managed Canada's AIR MILES® program, a coalition loyalty program in which two thirds of the households in that country actively participated; Epsilon, a marketing agency that provided top-to-bottom strategies to help retailers and other corporations measure, manage, and enhance their relationships with customers; and Retail Services, which provided private-label credit card programs for such retailers as Victoria's Secret, J. Crew, Ann Taylor, and Pottery Barn. The three divisions were independent; there was little overlap in their operations.

FIGURE 1
ADS 2008 REVENUE BY DIVISION: $2,000
(in millions)



Because of ADS's distinctive combination of credit card, loyalty, and marketing services, the firm had never been easy for bankers, analysts, and rating agencies to characterize. Retail Services, the

private-label segment, contributed the largest portion of operating income—leading many observers to view ADS as a credit card company, comparable to a bank. But ADS had always seen itself more as a customer loyalty, marketing, and consulting firm, with Retail Services' private-label business an extension of its core mission to help clients develop and maintain relationships with their customers. Still, the narrow categories Wall Streeters used sometimes made it difficult for ADS to communicate its business model and earn the respect it felt it deserved from the world of high finance. "When you go to an investors' meeting in a ballroom at the Waldorf in Manhattan, and you are standing at the podium, speaking to an audience where 95% of the attendees are relatively young MBA grads, never ran a business, and living in their New York co-ops, it's hard for them to relate to a business model like ours," Heffernan said. "This is a foreign universe to them and our challenge was how to explain it so they see the true value and understand how we have been able generate over a 400% return."[2]

However, the company was well known by the three major rating agencies on the Street: Standard & Poor's, Fitch, and Moody's. The rating agencies were generally comfortable with ADS since its bonds—the company financed its operations mostly through long-term fixed-rate term asset-backed securities—were rated according to collateral that had always been extremely stable. ADS had always made its payments on time, and had a 13-year track record of double- and triple-A ratings.

Senior Management

The company prided itself on maintaining a participatory, collegial environment and a flat hierarchy for the management team. As Heffernan noted, "Our attitude was 'work hard but still have time to get home to your family to attend your kid's football or soccer game.' There are no prima donnas here."

In 2008, ADS's senior management team consisted of Chairman and CEO Mike Parks, an 11-year veteran of the company; CFO Heffernan; Bob Armiak, the treasurer; Michael Iaccarino, president of Epsilon; Bryan Pearson, president of LoyaltyOne; Ivan Szeftel, president of Alliance Retail Data Services; and Alan Utay, the company's general counsel. Nearly all of the top managers had been at ADS for a decade or longer. For example, Pearson had been with LoyaltyOne for 16 years, prior to its acquisition in 1998, and Iaccarino had been at Epsilon since prior to its acquisition in 2004. All were deeply invested in the firm in every way—emotionally, professionally, and financially, thanks to their holdings of company stock and an incentive compensation program that was paid out based on the company's performance.

CEO MIKE PARKS

The senior team was headed by Mike Parks, who had been with the company since its inception. Mike was a down-to-earth Midwestern-style guy, described by a board member as someone who would put his arm around you and ask after the family. Heffernan described Parks as focused on

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[2] This comment and all others from Ed Heffernan are from interviews on December 2, 2009, and January 25, 2010.

growth strategies and employee issues: “He just wanted to build a great company . . . and wanted little to do with Wall Street. So it was like ‘Ed, have a ball with the hedge fund guys.’ He was Mr. Inside and I was Mr. Outside.”

Parks was good at the one-on-one due diligence required when an important decision was to be made. When there was a question of direction, Heffernan noted, “He did a triple check, a gut check before he said ‘This is the way we are going.’” Parks deferred to the executive team in most major decisions, stepping in only when there was a major conflict between key players.

“Mike and I worked well together,” commented Heffernan. “Our offices were next door to each other and we dropped into each other’s offices all the time.” There was little need for formal meetings.

Retail Services

Retail Services was the original nucleus of the company and remained its largest division. It focused on middle-income and affluent female consumers, growing selectively to build a high-quality credit portfolio. In 2008, it had a rotating balance of about $4 billion in receivables from consumers holding its cards, with approximately 11 million active households per month.

Since its inception, Retail Services had competed with what Heffernan called “the three musketeers”—the behemoth financial-services firms GE Capital, HSBC, and Citigroup. But unlike its competitors, who bought existing private-label portfolios from retailers, Retail Services generally started these store-card programs from scratch for merchants that never had the capacity or capital to do it themselves. One reason ADS didn’t like to go head to head with GE, HSBC, and Citi to buy portfolios was that those firms, with their enormous size and unparalleled access to capital, were often willing to pay high premiums for the businesses they wanted. As the little guy in the room, ADS simply didn’t have the resources to match or top their offers. But Heffernan and the rest of the management team were very comfortable with their approach, which was based on nurturing long-term relationships with clients. It was a successful strategy, as proven by the division’s 95% renewal rate and one that fit in with ADS’s company-wide focus on loyalty.

With its main facilities in Texas, Ohio, and Kansas, most of Retail Services’ employees lived and worked far from Wall Street, the epicenter of high finance. Executives described the mindset of associates and managers as “Midwestern”—relaxed and informal but also a bit conservative.

Perhaps even more than ADS’s other divisions, Retail Services valued employee loyalty at all levels. Most of the division’s employees were call-center associates who worked directly with the public. Although this was typically a high-turnover kind of job, Retail Services worked hard to build trust and tenure with its associates; some of the call-center associates had been with the company over five years and the call-center managers 15 or so years. To drive home its commitment, Retail Services made a critical decision around 1999. At the time, most of its competitors were outsourcing their

back-office operations overseas; however, Retail Services decided then that it would not move its call centers to lower-cost countries. Heffernan added that the decision was also based on Retail Services serving a high-end clientele, and wanting to give consumers the confidence that they could call its customer-service lines and avoid language and cultural barriers. “The McKinsey guys started showing up saying, ‘You could save $400 million a year shipping this work overseas,’” Heffernan said, grimacing at the memory. “And we were like, ‘No, you need to leave the building right now.’”

Growth Management at Retail Services

Retail Services President Szeftel, 52, was a native South African who had been in the retail and store-card business most of his working life and had lived through many of the industry’s ups and downs. A certified accountant, he was involved in every aspect of the private-label credit division. Under Szeftel’s command, the division favored a steady approach to growth and focused on building from the ground up. Szeftel’s many years of industry experience lent him credibility when he would say to his co-workers, “This is how we have always done it and it works.”

Szeftel was exceedingly careful both by nature and experience. When he was chief financial officer at Charming Shoppes in the 1980s and 1990s, he had amassed a large stake in that company and held onto it even as the shares dropped way down, wiping out a large percentage of his net worth. At ADS, where he’d worked since 1998, he had millions of dollars tied up in stock and other compensation programs.

Szeftel was well liked among top management and his staff, but he was not the kind of person who engaged in much small talk. He felt his primary responsibility was to deliver his piece of the bottom line. “If times are good,” he would tell his staff, “then our results may have little to do with us. And when times are bad, the same might be true, but it’s still on our heads to deliver.” Not only was Szeftel responsible for delivering the results of his division, he was responsible for nearly 3,000 employees. When, in early 2008, he had to lay off 18 employees, he was quite distressed. A colleague noted, “He commented about this numerous times. He said, ‘You have to understand, this affects not just those who are being laid off, but everyone in my division.’”[3]

Also key to Retail Services’ operations, particularly in times of tight credit, was ADS treasurer Armiak. Armiak was described by his colleagues as a man of few words, unless you were a banker. He was a low-key person, not interested in hierarchy and not into office politics. His focus was on the long-term value of ADS, and his goal was a strong performance for the shareholders. Armiak had developed valuable relationships with a targeted set of banks and had strategically spread out $80 million in ADS’s fees among these banks over the years. As a result, over his 12 years at ADS, Armiak had built up strong ties with the company’s various lenders.

[3] This comment is based on an interview with company personnel on January 25, 2010.

Heffernan and Armiak had started within a year of each other at ADS. Heffernan said, "We grew up together in the organization. I was originally hired to find acquisitions and he had to find the money to buy them, so we worked closely together." According to Heffernan, Armiak was "a bond guy through and through, a capital markets animal," and as CFO, Heffernan came to increasingly rely on him to dig up enough liquidity for Retail Services.

Over the years, Armiak and Heffernan had whittled down their banking relationships to five or six key banks that were committed to the work and passionate about clients—and that could help them cut through the bureaucracy of the bank as needed. In particular, they looked for a banker who would work closely with the company. One banker who did was the relationship manager for ADS at Barclays Bank PLC (Barclays), a British bank. They had worked with him for some time and he was always helpful. He made dealing with the bank easy. As Heffernan put it, "Our relationship manager [at Barclays] had integrity, and he was passionate about his work. He understood our business and was an advocate for us. He was a pleasure to work with, unlike some bankers, who were clearly absent during the 'Miss Manners' session at school."

Though many financial institutions had "stood tall" with ADS over the years, Heffernan knew that even Armiak's long-standing relationships would be tested during these trying times. Although Armiak loved a challenge, he was wary when it came to risky new initiatives. Heffernan acknowledged that Armiak was his counterbalance: "Whatever I say, he has to say, 'we can do half of that.' He's the reality check."

The Blackstone Deal

As the credit crisis loomed, ADS was also going through a wrenching internal drama. In May 2007, private-equity firm Blackstone agreed to purchase ADS for $7.8 billion, or $81.75 per share. This represented a 30% premium over the shares' most recent closing price. The deal required $6.5 billion in financing and $1.5 billion in equity.

However, as the year unfolded, alarms began sounding about dubious bets banks and hedge funds had made on the subprime lending market, exposing dangerous cracks in the global financial system. Against this backdrop, the Office of the Comptroller of the Currency (OCC), one of two government regulators overseeing ADS's bank subsidiaries (they also fell under the purview of the Federal Deposit Insurance Corporation), became nervous that the company's LBO was too risky in light of the banking world's precarious balance sheets. The OCC wanted to discuss conditions of the deal that essentially required Blackstone to backstop some of the risk for the increased debt, soaring from $1 billion to $6 billion, which ADS would be taking on after the buyout.

Blackstone balked, and Parks and the board of directors became quite focused on either saving the deal or protecting the company from the threat of shareholder lawsuits if the deal fell through, all while managing the normal responsibilities as a board of a large corporation. The board of ADS

included a number of executives who had been directors since its inception as a private company funded by WCAS. The directors, most of whom were in their fifties or sixties, included a number of CEOs and former CEOs of large companies. There were also two WCAS partners, with years of experience in deal-making in private equity and venture capital, who gave the eight-member board a New York feel. The WCAS partners had been on the board since inception. See Exhibit 2 for information on the board. Management described the board as a "diligent" board that "did their homework" and asked a lot of questions when a decision was presented to them. The focus was on making money for shareholders, and the expectations were high. All owned shares in the company.

Early in 2008, at the height of the negotiations, the board was having weekly and sometimes even daily meetings, recalled board member Bruce Anderson: "We were trying to keep the deal together, and keep it at the agreed-upon price."[4] This schedule was a contrast to the quarterly meetings that were the norm for the company.

By February, the Blackstone deal was dead and ADS's share price was falling. At its lowest point, ADS's shares fell to $24 (see Exhibit 3). ADS board members and executives—most of whom held large blocks of shares—saw their net worth drop precipitously. Many long-term investors had sold their holdings on the initial news of the deal and were largely replaced by risk arbitrageurs, traders who bet not on the stock's underlying value or potential, but on short-term price movements. These risk arbs, as they were known, had lost a lot of money on the stock and were anxious to recover what they could.

As the board and Parks were focused on Blackstone, Heffernan continued to focus on keeping ADS on a sound financial basis. The CFO position, always important in a company built on credit, was also the one fielding phone calls from the investment community and the banks.

A New Direction for Retail Services

Because of the company's business model, the credit crisis and the recession hit hard at ADS, particularly in Retail Services since it relied almost entirely on consumer spending and capital markets. Epsilon and Loyalty One had no credit exposure and so were mostly unaffected.

Historically, ADS generated more than enough cash for operating expenses and to cover its $4 billion in loans to shoppers in part by securitizing the credit card receivables from its private-label business. These were long-term fixed-rate asset-backed bonds sold to major financial institutions; since the company tried to avoid any interest-rate risk, it just rolled over the bonds as they came due. But during the credit freeze, the market for those securities simply dried up. "Our credit facilities were gone; the trillion-dollar asset-backed securities market halted," said Heffernan. "Essentially, it was

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[4] Phone interview with Bruce Anderson, January 4, 2010.

nightmare city. We were thinking, how are we going to keep the doors open when everything is just frozen up?"

Even triple-A-rated companies like General Electric were finding it near impossible to access the capital markets. "We had never faced a situation where blue-chip companies with multi-year records couldn't find money," Heffernan said. "There was no commercial paper market. It was a truly unique moment. We're all looking around at each other, thinking, 'we just don't get it; people aren't acting rationally.'"

Heffernan had to think fast. Management was dealing with employees who had very little interest in high finance and a much keener interest in what the financial crisis might mean for their jobs, their mortgages, and their capability to maintain their families' lifestyles. At this time, ADS competitors like HSBC and Citigroup were firing thousands of workers and selling off business units. In fact, at this time, ADS had sold off two non-core businesses that were not aligned with the company's long-term direction.

ADS was also facing pressure from its bankers. When the crisis hit, most banks pulled back drastically from all corporate customers, afraid to lend even to some of their oldest and best customers. "You could feel the fear when you visited the banks," Heffernan said. He and Armiak had a meeting coming up to review the renewal of the company's credit facility with Barclays. Heffernan knew that two of Barclays's "big dogs," the head of the U.S. corporate banking group and the head of the asset-backed securities group, would attend the meeting in New York. "It was quite clear," Heffernan noted, "they were under pressure and only interested in working with their valuable long-term prospects."

Yet Heffernan began to sense that the crisis was opening up a once-in-a-lifetime opportunity if he could tap the anemic credit markets (no one was lending even though borrowers needed the cash) and scramble together the financing needed to make high-quality acquisitions at bargain prices. This would need to happen even with the substantial share-repurchase program put in place after the end of the Blackstone deal, and without sacrificing the pursuit of new clients. It was a bold recommendation, and Heffernan knew he would face resistance.

At the crux of Heffernan's thinking was the dismal condition of his main competitors, GE Capital, HSBC, and Citigroup. All three had been hobbled by the credit crisis since the fall of Bear Stearns in March 2008. At the same time, retailers who had been managing their own private-label programs, using in-house banks, were also battered by the credit freeze and by increasing customer defaults. They were suddenly desperate to sell their files. "Our competitors were all train wrecks at that point, and the retailers were basically saying, 'I've got to push these things out,'" said Heffernan.

"A $500 million private-label file will throw off $45 million in free cash flow. It's a lucrative business," Heffernan continued. "When times were good and the three musketeers were around, they'd bid for it and pay a $75 to $100 million premium. We only wanted to pay par, so we almost

never did acquisitions in this division. Now we had a chance to get great deals on some big files. That was our play."

Yet this move would be a dramatic departure from Retail Services' usual business model—where people all along the chain of command were unaccustomed to fast or aggressive change.

The Acquisition Plan

After reviewing a handful of acquisition possibilities with the management team, Heffernan was in favor of pursuing the portfolios of Home Shopping Network (HSN) and Charming Shoppes, (having a combined $700 million in receivables), closing the deals preferably within nine months. "We could pick up these things for effectively no purchase price, securitize them and virtually use no capital. They'd throw off combined about $60 million of free cash flow per year against a 10% capital requirement or $70 million," he said. "That's just under a 100% return and growing on our capital—now that's creating shareholder value in my opinion."

However, the plan meant that the parent company ADS would have to tap any and all liquidity—from banks and capital markets as well as non-traditional sources such as new government stimulus programs, like the FDIC's Temporary Liquidity Guarantee Program—in order to pay for the acquisitions. And although many in top management agreed there was an incredible opportunity to pick up high-quality assets, some were less convinced it was worth the financial exposure.

Though ADS had always maintained sterling credit ratings, Heffernan was uncertain how Standard & Poor's, Fitch, and Moody's would look on the company's bonds in the context of the credit crisis. Although the collateralized debt securities ADS issued had held their value, the company was reporting on them more frequently. In Heffernan's and Armiak's experience, Standard & Poor's and Fitch were very interested in the company's view of its treatment of their collateralized debt. It was important to reach beyond the account analysts to the senior people, where reason tended to prevail. Moody's, however, seemed to be in the midst of determining how it would rate collateralized securities. Of the 20 people in the room for any of the agencies, three or four would be the people handling the asset class, credit card receivables, that ADS securitized.

The three agencies had not only failed to anticipate the subprime mortgage collapse but actually helped create it by giving high ratings to what turned out to be incredibly risky, low-quality securities. They responded to the first signs of the meltdown by downgrading many of the bonds they had previously helped prop up. Since its collateral was still very stable, Heffernan was cautiously optimistic that ADS's asset-backed securities would not be downgraded. Yet he was planning a trip with Armiak to meet with the agencies—where he knew their plans would be closely scrutinized and their direction challenged. In fact, Heffernan was prepared to pack his bags and head for New York every week if it might help preserve the company's ratings.

“It was all about credit, and we wanted to not only expand and extend our footprint in credit, but its credit that’s 100 percent relying on retail just as the economy’s sunk into a recession,” Heffernan said. “So you can imagine putting those two puppies together, and that dog didn’t hunt too well.” He knew his strategy was a risky one and that it might be a tough sell to both company insiders and industry onlookers.

Exhibits

Exhibit 1

Financial performance, 2007–8

ADS Income Summary Income Statement

(in $ 000s)	FY 2008	FY 2007	
Total Revenue	**2,025.3**	**1,962.2**	
Cost Of Goods Sold	1,342.0	1,304.6	
Gross Profit	**683.2**	**657.5**	
Selling General & Admin Exp.	82.8	80.9	
Depreciation & Amort.	135.8	127.0	
Other Operating Exp., Total	**218.6**	**207.9**	
Operating Income	**464.6**	**449.6**	
Net Interest Exp.	**(63.6)**	**(69.4)**	
EBT Excl. Unusual Items	**401.0**	**380.2**	
EBT Incl. Unusual Items	**396.9**	**351.8**	
Income Tax Expense	153.5	137.4	
Earnings from Cont. Ops.	**243.4**	**214.4**	
Earnings of Discontinued Ops.	(26.0)	(50.4)	
Net Income	**217.4**	**164.1**	-
Per Share Items			
Basic EPS	$3.04	$2.093	
Basic EPS Excl. Extra Items	3.404	2.735	
Weighted Avg. Basic Shares Out.	71.5	78.4	

Exhibit 1 (continued)

Alliance Data Balance Sheet
(in $000s)

	As of 12/31/08	As of 12/31/07
Cash and cash equivalents	156.9	219.2
Seller's interest and credit card receivables	632.7	652.4
Redemption settlement assets	531.6	317.1
Intangible assets, net	304.6	343.4
Goodwill	1,133.8	1,185.8
Total Assets	**4,300.0**	**4,103.6**
Deferred revenue	995.6	828.3
Certificates of deposit	688.9	370.4
Core debt*	1,670.0	921.0
Total liabilities	**3,905.9**	**2,906.6**
Stockholders' equity	**394.1**	**1,197.0**

*Core debt excludes certificates of deposit and capital leases and other debt

Source: Company data and Capital IQ.

Exhibit 2

Alliance Data Board of Directors

Bruce K. Anderson, co-founder of Welsh, Carson, Anderson & Stowe; general partner since 1979. Director since 1996.

Roger H. Ballou, CEO of CDI Corporation, a public company providing staffing and outsourcing services. Director since 2001.

Lawrence M. Benveniste, Dean of Goizueta Business School at Emory University. Director since 2004.

D. Keith Cobb, consultant. Spent 32 years as a practicing C.P.A. for KPMG, LLP, including as the National Managing Partner – Financial Services, and senior member of the firm's management committee. Mr. Cobb was vice chairman and chief executive officer of Alamo Rent-a-Car Inc. Director since 2004.

E. Linn Draper Jr., Chairman of the board of American Electric Power Company from 1993 until retirement in 2004. Director since 2005.

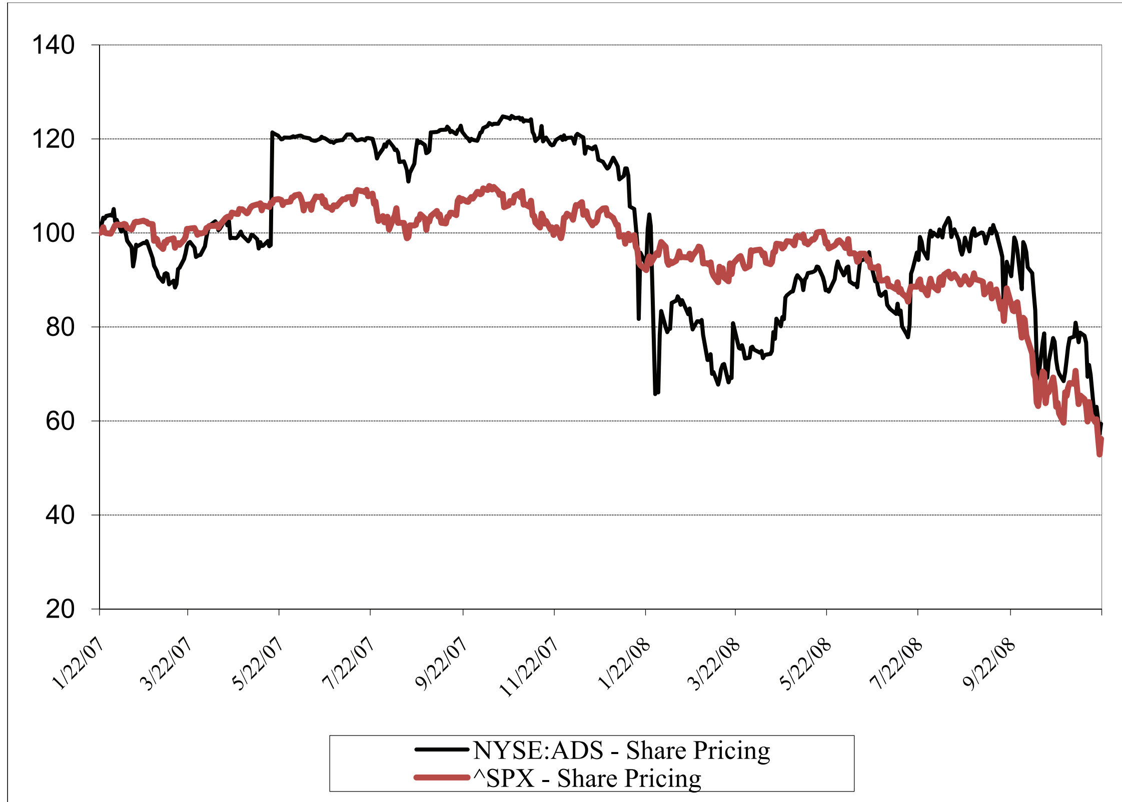
Kenneth R. Jensen, consultant. Former director and CFO of Fiserv Inc., a company engaged in data processing outsourcing. Director since 2001.

Robert A. Minicucci, general partner Welsh, Carson, Anderson & Stow, since joining the firm in 1993. Director since 1996.

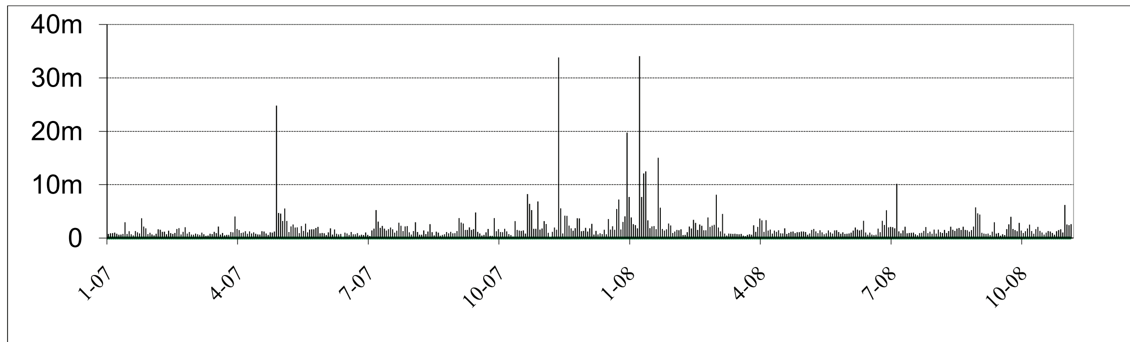
J. Michael Parks, chairman and CEO of Alliance Data since 1997.

Exhibit 3

Alliance Data Systems Stock Performance (2007–8)



Alliance Data Systems Trading Volume (2007–8)



Source: Capital IQ.