

ALLIANCE DATA SYSTEMS CORP

Form 10-Q

May 11, 2009

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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 March 31, 2009

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)

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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)	

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

As of May 7, 2009, 58,077,074 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**

	March 31, 2009	December 31, 2008
	(In thousands)	
ASSETS		
Cash and cash equivalents	\$ 321,631	\$ 156,911
Trade receivables, less allowance for doubtful accounts (\$7,611 and \$7,172 at March 31, 2009 and December 31, 2008, respectively)	194,304	219,362
Seller's interest and credit card receivables, less allowance for doubtful accounts (\$44,794 and \$40,718 at March 31, 2009 and December 31, 2008, respectively)	678,920	639,573
Deferred tax asset, net	199,273	201,895
Other current assets	139,923	142,661
Redemption settlement assets, restricted	514,318	531,594
Assets held for sale		32,015
Total current assets	2,048,369	1,924,011
Property and equipment, net	160,452	168,847
Due from securitizations	762,656	701,347
Intangible assets, net	284,861	297,776
Goodwill	1,126,423	1,133,790
Other non-current assets	117,356	116,219
Total assets	\$ 4,500,117	\$ 4,341,990
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	\$ 114,050	\$ 108,370
Accrued expenses	102,450	143,656
Certificates of deposit	627,600	433,900
Credit facility and other debt, current	275,392	275,549
Other current liabilities	91,413	106,641
Deferred revenue	816,341	860,455
Liabilities held for sale		20,782
Total current liabilities	2,027,246	1,949,353
Deferred tax liability, net	155,854	123,476
Deferred revenue	129,741	135,179
Certificates of deposit	305,300	255,000
Long-term and other debt	1,355,217	1,215,726
Other liabilities	112,968	115,958
Total liabilities	4,086,326	3,794,692
Stockholders' equity:		
Common stock, \$0.01 par value; authorized 200,000 shares; issued 90,049 shares and 89,029 shares at March 31, 2009 and December 31, 2008, respectively	900	890
Additional paid-in capital	1,118,493	1,115,291
Treasury stock, at cost (30,952 and 26,222 shares at March 31, 2009 and December 31, 2008, respectively)	(1,573,255)	(1,410,339)

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Retained earnings	917,160	889,305
Accumulated other comprehensive loss	(49,507)	(47,849)
Total stockholders' equity	413,791	547,298
Total liabilities and stockholders' equity	\$ 4,500,117	\$ 4,341,990

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 March 31,	
	2009	2008
	(In thousands, except per share amounts)	
Revenues		
Transaction	\$ 95,981	\$ 83,596
Redemption	112,147	116,779
Securitization income and finance charges, net	140,497	167,991
Database marketing fees and direct marketing fees	115,609	117,503
Other revenue	16,022	13,381
Total revenue	480,256	499,250
Operating expenses		
Cost of operations (exclusive of depreciation and amortization disclosed separately below)	321,890	324,811
General and administrative	27,819	18,268
Depreciation and other amortization	15,086	17,762
Amortization of purchased intangibles	14,248	17,187
Loss on the sale of assets		1,052
Merger (income) costs	(580)	1,607
Total operating expenses	378,463	380,687
Operating income	101,793	118,563
Interest expense, net	31,607	17,103
Income from continuing operations before income taxes	70,186	101,460
Provision for income taxes	27,233	38,758
Income from continuing operations	42,953	62,702
Loss from discontinued operations, net of taxes	(15,098)	(13,383)
Net income	\$ 27,855	\$ 49,319
Basic income per share:		
Income from continuing operations	\$ 0.70	\$ 0.80
Loss from discontinued operations	(0.24)	(0.17)
Net income per share	\$ 0.46	\$ 0.63
Diluted income per share:		
Income from continuing operations	\$ 0.69	\$ 0.78
Loss from discontinued operations	(0.24)	(0.17)
Net income per share	\$ 0.45	\$ 0.61
Weighted average shares basic	61,148	78,536
Weighted average shares diluted	61,833	80,589

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended March 31,	
	2009	2008
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 27,855	\$ 49,319
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	29,334	42,941
Deferred income taxes	21,348	2,041
Provision for doubtful accounts	13,288	13,855
Non-cash stock compensation	18,048	6,481
Fair value loss (gain) on interest-only strip	188	(10,400)
Amortization of discount on Convertible Senior Notes	10,354	
Impairment of long-lived assets		15,000
Loss (gain) on the sale of assets	18,018	(3,214)
Change in operating assets and liabilities, net of acquisitions:		
Change in trade accounts receivable	15,262	23,641
Change in merchant settlement activity	(8,987)	(102,713)
Change in other assets	(17,152)	(4,375)
Change in accounts payable and accrued expenses	(56,616)	(83,152)
Change in deferred revenue	(14,890)	11,369
Change in other liabilities	8,933	12,722
Excess tax benefits from stock-based compensation	(528)	339
Other	6,640	(370)
Net cash provided by (used in) operating activities	71,095	(26,516)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in redemption settlement assets	1,581	(629)
Net (increase) decrease in seller's interest and credit card receivables	(55,966)	65,970
Change in due from securitizations	(62,369)	18,752
Capital expenditures	(10,888)	(13,852)
Proceeds from the sale of assets	8,013	5,000
Other	531	(1,931)
Net cash (used in) provided by investing activities	(119,098)	73,310
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings under debt agreements	863,000	933,000
Repayment of borrowings	(727,894)	(871,000)
Certificate of deposit issuances	413,900	95,300
Repayments of certificates of deposits	(169,900)	(183,800)
Payment of capital lease obligations	(5,393)	(4,733)
Payment of deferred financing costs	(1,452)	
Excess tax benefits from stock-based compensation	528	(339)
Proceeds from issuance of common stock	1,658	2,712
Proceeds from sale-leaseback transactions		12,000
Purchase of treasury shares	(159,837)	
Other		(164)
Net cash provided by (used in) financing activities	214,610	(17,024)
Effect of exchange rate changes on cash and cash equivalents	(1,887)	(6,085)

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Change in cash and cash equivalents	164,720	23,685
Cash and cash equivalents at beginning of period	156,911	265,839
Cash and cash equivalents at end of period	\$ 321,631	\$ 289,524
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	\$ 16,088	\$ 10,098
Income taxes paid, net of refunds	\$ 15,078	\$ 39,533

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 for the year ended December 31, 2008, filed with the SEC on March 2, 2009.

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.

On January 1, 2009, the Company adopted Financial Accounting Standards Board (FASB) Staff Position No. APB 14-1, Accounting for Convertible Debt Instruments that May be Settled in Cash Upon Conversion (FSP APB No. 14-1). FSP APB No. 14-1 requires that the liability and equity components of convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) be separately accounted for in a manner that reflects an issuer s nonconvertible debt borrowing rate. The statement requires retrospective application to all periods presented. The adoption of FSP APB No. 14-1 changed the historical accounting for the Company s \$805.0 million aggregate principal amount of convertible senior notes due 2013 (the Convertible Senior Notes). As a result, the Company recorded an additional \$10.4 million of interest expense for the first quarter of 2009. The impact to the Company s consolidated financial statements as of December 31, 2008 is as follows:

	December 31, 2008	
	As Previously Presented	Following the Adoption of FSP APB No. 14-1
	(In thousands)	
Consolidated Balance Sheets		
Liabilities		
Long-term and other debt	\$ 1,451,626	\$ 1,215,726
Total liabilities	3,962,919	3,794,692
Stockholders equity		
Additional paid-in capital	\$ 951,122	\$ 1,115,291
Retained earnings	900,296	889,305
Total stockholders equity	394,120	547,298
Total liabilities and stockholders equity	4,357,039	4,341,990

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

	Year Ended December 31, 2008	
	As Previously Presented	Following the Adoption of FSP APB No. 14-1 (In thousands, except per share amounts)
Consolidated Statements of Income		
Interest expense	\$ 79,249	\$ 96,177
Income from continuing operations before income taxes	396,853	379,925
Provision for income taxes	153,454	147,517
Net income	217,393	206,402
Basic income per share		
Income from continuing operations	\$ 3.40	\$ 3.25
Net income per share	\$ 3.04	\$ 2.89
Diluted income per share		
Income from continuing operations	\$ 3.31	\$ 3.16
Net income per share	\$ 2.95	\$ 2.80

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 March 31,	
	2009	2008
(In thousands, except per share amounts)		
Numerator		
Income from continuing operations	\$ 42,953	\$ 62,702
Loss from discontinued operations	(15,098)	(13,383)
Net income	\$ 27,855	\$ 49,319
Denominator		
Weighted average shares, basic	61,148	78,536
Weighted average effect of dilutive securities:		
Net effect of unvested restricted stock	78	695
Net effect of dilutive stock options	607	1,358
Denominator for diluted calculation	61,833	80,589
Basic		
Income from continuing operations per share	\$ 0.70	\$ 0.80
Loss from discontinued operations per share	(0.24)	(0.17)
Net income per share	\$ 0.46	\$ 0.63

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Diluted		
Income from continuing operations per share	\$ 0.69	\$ 0.78
Loss from discontinued operations per share	(0.24)	(0.17)
Net income per share	\$ 0.45	\$ 0.61

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ALLIANCE DATA SYSTEMS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

At March 31, 2009, the Company excluded 10.3 million warrants, 1.0 million restricted stock units, and 1.7 million stock options from the calculation of earnings per share as the effect was anti-dilutive.

3. DISPOSITIONS

In February 2009, the Company completed the sale of the remainder of its utility services business, including the termination of a services agreement and the resolution of certain contractual disputes, to a former utility client and recognized a pre-tax loss of approximately \$18.0 million, which has been included in loss from discontinued operations in the unaudited condensed consolidated statements of income. In addition, the Company entered into transition services and co-location agreements to provide such former utility client with certain services or access to certain facilities for varying terms through the fourth quarter of 2010.

The sale of the remainder of the utility services business completed the plan of disposition which began in March 2008.

The assets and liabilities of the discontinued operations are presented in the unaudited condensed consolidated balance sheets as 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:

	March 31, 2009	December 31, 2008
	(In thousands)	
Assets:		
Trade receivables, net	\$	\$ 30,663
Other assets		1,307
Property and equipment, net		45
Assets held for sale	\$	\$ 32,015
Liabilities:		
Accrued expenses	\$	\$ 18,738
Other liabilities		2,044
Liabilities held for sale	\$	\$ 20,782

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

	Three Months Ended March 31, 2009	2008
	(In thousands)	
Revenue	\$ 4,659	\$ 75,487
Loss before provision for income taxes	(23,122)	(20,451)
Benefit from income taxes	(8,024)	(7,068)
Loss from discontinued operations	\$ (15,098)	\$ (13,383)

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Intangible assets consist of the following:

	Gross Assets	March 31, 2009 Accumulated Amortization (In thousands)	Net	Amortization Life and Method
<i>Finite Lived Assets</i>				
Customer contracts and lists	\$ 186,428	\$ (102,711)	\$ 83,717	5-10 years straight line
Premium on purchased credit card portfolios	84,344	(38,800)	45,544	3-10 years straight line, accelerated
Collector database	55,514	(45,857)	9,657	30 years 15% declining balance
Customer database	160,013	(43,789)	116,224	4-10 years straight line
Noncompete agreements	2,403	(1,647)	756	3-5 years straight line
Favorable lease	1,000	(955)	45	4 years straight line
Tradenames	11,517	(2,677)	8,840	4-10 years straight line
Purchased data lists	13,658	(5,930)	7,728	1-5 years straight line, accelerated
	\$ 514,877	\$ (242,366)	\$ 272,511	
<i>Indefinite Lived Assets</i>				
Tradenames	12,350		12,350	Indefinite life
Total intangible assets	\$ 527,227	\$ (242,366)	\$ 284,861	

	Gross Assets	December 31, 2008 Accumulated Amortization (In thousands)	Net	Amortization Life and Method
<i>Finite Lived Assets</i>				
Customer contracts and lists	\$ 186,428	\$ (96,435)	\$ 89,993	5-10 years straight line
Premium on purchased credit card portfolios	84,344	(35,925)	48,419	3-10 years straight line, accelerated
Collector database	57,528	(47,096)	10,432	30 years 15% declining balance
Customer database	160,103	(41,194)	118,909	4-10 years straight line
Noncompete agreements	2,425	(1,554)	871	3-5 years straight line
Favorable lease	1,000	(886)	114	4 years straight line
Tradenames	11,542	(2,361)	9,181	4-10 years straight line
Purchased data lists	12,994	(5,487)	7,507	1-5 years straight line, accelerated
	\$ 516,364	\$ (230,938)	\$ 285,426	
<i>Indefinite Lived Assets</i>				
Tradenames	12,350		12,350	Indefinite life

Total intangible assets	\$ 528,714	\$ (230,938)	\$ 297,776
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The changes in the carrying amount of goodwill for the three months ended March 31, 2009 are as follows:

	Loyalty Services	Epsilon Marketing Services	Private Label Services	Private Label Credit	Corporate/ Other	Total
	(In thousands)					
December 31, 2008	\$ 204,507	\$ 667,551	\$ 261,732	\$	\$	\$ 1,133,790
Goodwill acquired during the period						
Effects of foreign currency translation	(6,763)	(477)				(7,240)
Other, primarily final purchase price adjustments	(127)					(127)
March 31, 2009	\$ 197,617	\$ 667,074	\$ 261,732	\$	\$	\$ 1,126,423

5. SECURITIZATION OF CREDIT CARD RECEIVABLES

As part of a securitization program, the Company regularly sells its credit card receivables to the World Financial Network Credit Card Master Trust, World Financial Network Credit Card Master Note Trust and World Financial Network Credit Card Master Trust III (collectively the WFN Trusts) and the World Financial Capital Credit Card Master Note Trust (the WFC Trust).

The following table shows the maturities of borrowing commitments as of March 31, 2009 for the WFN Trusts and the WFC Trust by year:

	2009	2010	2011	2012	2013 & Thereafter	Total
	(In millions)					
Public notes	\$ 652.8	\$ 72.2	\$ 450.0	\$	\$ 500.0	\$ 1,675.0
Private conduits ⁽¹⁾	2,097.6	666.6				2,764.2
Total	\$ 2,750.4	\$ 738.8	\$ 450.0	\$	\$ 500.0	\$ 4,439.2

⁽¹⁾ Amount represents borrowing capacity, not outstanding borrowings.

Seller's interest and credit card receivables, less allowance for doubtful accounts included in the unaudited condensed consolidated balance sheets consists of seller's interest, credit card receivables, other receivables and an allowance for doubtful accounts. Seller's interest is recorded at the allocated carrying amount based on relative fair value. Changes in the fair values of our seller's interest are recorded through securitization income and finance charges, net in the unaudited condensed consolidated statements of income.

The Company is required to maintain minimum interests ranging from 4% to 10% of the securitized credit card receivables. This requirement is met through seller's interest and is supplemented through the excess funding deposits.

Due from securitizations included in the unaudited condensed consolidated balance sheets consists of spread deposits, interest-only strips, retained interest in securitization trusts and excess funding deposits.

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The spread deposits and interest-only strips are recorded at their fair value. Fair value is determined by computing the present value of the estimated cash flows, using the dates that such cash flows are expected to be

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released to the Company, at a discount rate considered to be commensurate with the risks associated with the cash flows. The amounts and timing of the cash flows are estimated after considering various economic factors including payment rates, delinquency, default and loss assumptions. Interest-only strips, seller's interest and other interests retained are periodically evaluated for impairment based on the fair value of those assets.

Fair values of interest-only strips and other interests retained are based on a review of actual cash flows and on the factors that affect the amounts and timing of the cash flows from each of the underlying credit card receivable pools. Based on this analysis, assumptions are validated or revised as deemed necessary, the amounts and the timing of anticipated cash flows are estimated and fair value is determined. The Company has one collateral type, credit card receivables, which is comprised of both private label and co-brand retail credit card receivables.

Retained interest in securitization trusts represents the Company's investment in subordinated notes sold by the WFN Trusts and the WFC Trust. These investments are classified as available-for-sale, and changes in fair value are recorded through other comprehensive (loss) income.

At March 31, 2009, key economic assumptions and the sensitivity of the current fair value of residual cash flows to an immediate 10% and 20% adverse change in the assumptions are as follows:

	Assumptions	Impact on Fair Value of 10% Change (In thousands)	Impact on Fair Value of 20% Change
Fair value of interest-only strips	\$ 168,890		
Weighted average life	9.5 11 months	\$ (13,140)	\$ (24,071)
Discount rate	18.8% 22.0%	(920)	(1,822)
Expected yield, net of dilution	28.5% 29.4%	(42,319)	(84,224)
Base rate ⁽¹⁾	0.5% 1.1%	(574)	(1,148)
Net charge-off rate	9.5% 11.5%	(14,051)	(28,245)

⁽¹⁾ Base rate assumptions do not factor any changes in spreads with respect to future refinancing.

At March 31, 2009, key economic assumptions and the sensitivity of the current fair value of the Company's seller's interest and retained interest of the subordinated notes to an immediate 10% and 20% adverse change in the assumptions are as follows:

Assumptions	Impact on Fair Value of 10% Change	Impact on Fair Value of 20% Change
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