Zacks Small-Cap Research

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111 North Canal Street • Chicago, IL 60606

# The First Marblehead Corporation (FMD-NYSE)

## FMD: Fine-Tuning Operations - NEUTRAL

| | |
|---|---|
| **Current Recommendation** | **Neutral** |
| Prior Recommendation | N/A |
| Date of Last Change | 06/10/2010 |
| Current Price (07/06/11) | $1.80 |
| **Six- Month Target Price** | **$2.00** |

## OUTLOOK

Our recommendation on The First Marblehead Corporation (FMD) is Neutral. FMD is in the initial stages of a turnaround. It has rolled out its new partnered lending program with two lenders, Sun Trust Bank and Kinecta Federal Credit Union, has added tuition payment services to its product line-up through the recent acquisition of TMS, and recently began using its Union Federal Savings Bank subsidiary to originate private education loans. That said, we believe that any meaningful pickup in revenues will be dependent upon a significant ramp-up in partnered lending loan origination and the re-entry of FMD into the securitization market, in which it has not participated since September 2007. Until that time, FMD continues to lose money, though at a decelerating pace, with our diluted loss per share estimates at $0.81 in fiscal 2011 and $0.52 in fiscal 2012. Fortunately, FMD has strengthened its balance sheet, and has an available cash cushion of about $225 million at present, though it is burning cash at the rate of $12-13 million per quarter.

## SUMMARY DATA

| | |
|---|---|
| **52-Week High** | **$2.84** |
| **52-Week Low** | **$1.40** |
| **One-Year Return (%)** | **-26.23** |
| **Beta** | **2.16** |
| **Average Daily Volume (sh)** | **314,973** |
| **Shares Outstanding (mil)** | **101** |
| **Market Capitalization ($mil)** | **$182** |
| **Short Interest Ratio (days)** | **17.23** |
| **Institutional Ownership (%)** | **40** |
| **Insider Ownership (%)** | **31** |
| **Annual Cash Dividend** | **$0.00** |
| **Dividend Yield (%)** | **0.00** |
| **5-Yr. Historical Growth Rates** | |
| **Sales (%)** | **N/A** |
| **Earnings Per Share (%)** | **N/A** |
| **Dividend (%)** | **N/A** |
| **P/E using TTM EPS** | **N/A** |
| **P/E using 2011 Estimate** | **N/A** |
| **P/E using 2012 Estimate** | **N/A** |
| **Zacks Rank** | **5** |

| | |
|---|---|
| **Risk Level** | **Above Average** |
| **Type of Stock** | **N/A** |
| **Industry** | **Fin-Cons Loans** |
| **Zacks Rank in Industry** | **11 of 11** |

## ZACKS ESTIMATES

**Net Revenue***
(in millions of $)

| | Q1 (Sep) | Q2 (Dec) | Q3 (Mar) | Q4 (Jun) | Year (Jun) |
|---|---|---|---|---|---|
| 2009 | (84.9)A | (86.1)A | (130.6)A | 11.6A | (290.0)A |
| 2010 | 13.5A | 10.1A | (16.8)A | 9.5A | 16.3A |
| 2011 | 5.1A | 9.5A | (14.6)A | 13.9E | 13.9E |
| 2012 | | | | | 59.9E |

**Earnings per Share***
(EPS is operating earnings before nonrecurring items)

| | Q1 (Sep) | Q2 (Dec) | Q3 (Mar) | Q4 (Jun) | Year (Jun) |
|---|---|---|---|---|---|
| 2009 | $(0.94)A | $(0.94)A | $(1.42)A | $(0.36)A | $(3.66)A |
| 2010 | $(0.95)A | $(0.12)A | $(0.30)A | $(0.10)A | $(1.46)A |
| 2011 | $(0.16)A | $(0.10)A | $(0.41)A | $(0.13)E | $(0.81)E |
| 2012 | | | | | $(0.52)E |

*Education finance only in 2011-12
Quarterly EPS may not add to total dues to changes in shares outstanding

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## WHAT'S NEW

FMD has made several announcements over the past week that indicate it continues to fine-tune its operations as the Company forges ahead in its turn-around bid.

In the first of these on June 30, FMD announced the completion of the $6.9 million sale of a portfolio of contracts with 377 lower cost private, predominantly faith-based primary and secondary schools from its Tuition Management Systems (TMS) subsidiary to FACTS Management Company, a Nelnet subsidiary. While this portfolio accounted for 18% of TMS's revenue in calendar-year 2010, it represented a much higher proportion of contracts at 33% of the total. This sale rids TMS of a less lucrative business and frees up resources that TMS can more profitably devote to higher margin opportunities. We note that TMS will continue to service these schools through the upcoming school year.

On July 5, FMD announced that on July 1 its Union Federal Savings Bank (UFSB) subsidiary began accepting applications for its Union Federal Private Student Loan and prepGATE® Education Loan programs, both based upon First Marblehead's Monogram® product platform, in line with developments announced in May. At that time, FMD made the decision to retain UFSB, which had previously been put up for sale, in an effort to speed growth of its new Monogram-based education lending programs.

In addition to its own UFSB program, FMD has partnered lending programs that began in 2010 with Sun Trust Bank, headquartered in Atlanta and serving the Southeast and mid-Atlantic regions, with more than $170 billion in assets; and Kinecta Federal Credit Union, a California-based federal credit union with over $3.5 billion in assets. Program size is $200 million for Sun Trust and $75 million for Kinecta, with both programs having initial two-year terms that are expected to run through late 2012.

While credit quality metrics of the Sun Trust and Kinecta lending programs appear to be strong based upon preliminary data, we sense that growth is less than FMD had hoped, recognizing that peak demand for education loans typically occurs in the summer months prior to the start of the academic school year. Moreover, adding more financial institutions to FMD's partnered lending roster has been challenging.

Thus, the UFSB program provides FMD the opportunity to grow its asset base through its own national program as well as to make improvements to the Monogram platform based upon its own experience. We note that FMD recently added nine sales people to its national college and university coverage team. The expanded team will be responsible for the national sales and marketing of the both the UFSB private student loan program, as well as its partnered lending programs. In addition, the TMS sales staff is responsible for the national distribution of the prepGATE loan program.

Given UFSB's capital base, it currently has the capacity to originate about $30 million of student loans. Growth in excess of this would require additional capital, possibly in the form of a capital contribution from its Parent, First Marblehead. Much depends upon consumer acceptance of the UFSB loan program and how quickly it can get up to speed.

We expect FMD to report 2011 fiscal fourth quarter and full-year (ending June 30, 2011) results around mid-August. We are maintaining our Neutral recommendation on FMD shares, as well as our loss per share estimates at $0.81 for the fiscal year just ended and at $0.52 for the fiscal 2012 year.

## OVERVIEW

The First Marblehead Corporation (FMD) provides student loan services to financial and education institutions throughout the United States. These services typically consist of helping these institutions design, originate, manage, and finance private education loan programs that further their strategic and financial goals, while also complying with the loan criteria they have established.

FMD offers these services under the Monogram® platform (Monogram), a new product for FMD that was developed over the last few years. Monogram utilizes FMD's proprietary credit risk analytics models, which are based upon data gathered by FMD over 20 years and among the most sophisticated in the industry. Through the partnered lending program based upon Monogram, FMD receives service fees, as well as a portion of the net interest income generated portfolio of program loans for which they provide credit enhancement

Currently, FMD has two clients using Monogram: Sun Trust Bank, headquartered in Atlanta and serving the Southeast and mid-Atlantic regions, with more than $170 billion in assets; and Kinecta Federal Credit Union, a California-based federal credit union with over $3.5 billion in assets. Program size is $200 million for Sun Trust and $75 million for Kinecta, with both programs having initial two-year terms that are expected to run through late 2012.

Other businesses of FMD include the administration of the National Collegiate Student Loan Trusts (NCSLT Trusts), in which FMD has no ownership interests (their residual interests were sold to a third party in 2009), and the administration of certain other loan trusts and portfolios, for which FMD receives a fee of 0.05-0.20% of the principal loan balance.

In addition, with the December 2010 purchase of Tuition Management Systems (TMS) for $47 million, FMD has added a complementary fee-for-service business to its line-up. TMS, one of the nation's largest providers of outsourced tuition planning, billing, counseling, and payment technology services for colleges, universities, and elementary and secondary schools, operates in 47 states and serves over 1,100 school clients, including such prestigious institutions as Duke University, Boston College, University of Chicago, MIT, and Carnegie Mellon. TMS is expected by FMD to add approximately $31 million of total revenues to operating results, and to be cash-flow positive during the first year and accretive to earnings in the second year.

FMD also owns a small federally chartered thrift, Union Federal Savings Bank of New Providence, Rhode Island (acquired in November 2006), that offers residential and commercial mortgage loans, and retail savings, money market and time deposit products. FMD had been exploring strategic alternatives for this business, but now intends to retain Union Federal as a vehicle for originating Monogram-based private education loans beginning in early fiscal 2012.

Financial statements were considerably altered with the beginning of the fiscal 2011 year (ending June 30, 2011), following the adoption of new accounting standards, which required the consolidation of 14 securitizations trusts that had previously been accounted for off balance sheet. Thus, $8.2 billion of securitized loan receivables from the trusts were added to FMD's balance sheet, along with $9.0 billion of nonrecourse debt issued by the trusts. This occurred even though FMD has no ownership interest in, or liability or responsibility for the loans and debt of 11 of these trusts (FMD does have an ownership interest in a small $300 million portfolio of loans, related to the Guaranteed Access to Education—GATE—Trusts).

Because of this change, FMD now reports two business segments: education financing, which encompasses the fee-for-service operations of the Company, as well as Union Federal Savings; and securitization trusts, which include the 11 NCSLT Trusts and 3 GATE Trusts. The results for the education financing segment are generally comparable to the financial reporting used by the Company prior to this fiscal year. Given this, in this report we will be focusing on the education financing operations.

## VALUATION

FMD's stock valuation metrics are depressed. Although FMD is in the initial stages of a turnaround and we are encouraged by the progress made to date, the outlook remains somewhat murky. Moreover, FMD continues to lose money, though at a decelerating pace, with our diluted loss per share estimates at $0.81 in fiscal 2011 and $0.52 in fiscal 2012.

This is reflected in FMD's stock price. FMD shares have declined 17.1% year to date, compared to a median increase of 14.3% for financial services companies in the Zacks small-cap index, as shown in the following table. The shares had been down almost 36% when FMD hit a recent low of $1.40 on June 13, but have reversed that decline and are now trading at over $1.80.

Turning to Price/Book Value, FMD is valued at 0.66X, well below the industry median of 1.46X. It is also below FMD's average Price/Book Value of 0.83X for the past year or so.

Applying the 0.83X ratio to our estimated book value for FMD six months out results in a price target of approximately $2.00. This is a bit above FMD's current stock price. Therefore, we recommend a Neutral on FMD shares.

## Industry Comparables- Small-cap Financial Services

| | | Price / Earnings Ratios | | | | | Return on Equity | | Return on Assets | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Pr Chg YTD | TTM* EPS | 2011E | 2012E | 5-Yr Avg | Price/ Book | TTM* | 5-Yr Avg | TTM* | 5-Yr Avg | Div Yld |
| **First Marblehead** | **(17.1)** | | | | | **0.66** | **Neg** | **Neg** | **Neg** | **Neg** | **-----** |
| **S&P 500** | **6.8** | **18.3** | **14.0** | **12.9** | **17.9** | **3.7** | **26.1** | | **8.96** | | **1.8** |
| **Median** | **14.3** | **14.3** | **11.0** | **9.1** | **12.1** | **1.46** | **12.5** | **14.56** | **3.24** | **5.3** | **-----** |
| Average | 8.1 | 19.7 | 11.6 | 8.9 | 15.5 | 2.5 | 3.0 | 8.26 | 0.93 | 3.3 | 1.3 |
| High | 56.1 | 100.3 | 31.6 | 12.9 | 65.1 | 10.5 | 36.5 | 33.52 | 17.28 | 12.5 | 10.9 |
| Low | (65.6) | 4.3 | 3.6 | 3.7 | 7.4 | 0.5 | (114.3) | (67.03) | (75.42) | (14.2) | ----- |

*Trailing twelve months

# The First Marblehead Corporation

**Income Statement and Balance Sheet**

*(Dollars in millions, except per share data)*

| | 06/06 | 06/07 | 06/08 | 06/09 | 06/10 | 06/11 E | 06/12 E |
|---|---|---|---|---|---|---|---|
| Net interest income | 5.5 | 9.4 | 25.6 | 25.1 | 9.9 | 1.1 | 4.6 |
| Non-interest revenue | 566.1 | 871.3 | (54.0) | (315.1) | 6.4 | 12.8 | 55.3 |
| Total net revenue | 571.6 | 880.7 | (28.4) | (290.0) | 16.3 | 13.9 | 59.9 |
| Loan loss provision | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.3 | 0.1 |
| Non-interest expense | 187.8 | 253.0 | 358.5 | 260.8 | 232.1 | 94.1 | 110.2 |
| Income tax expense (credit) | 147.8 | 256.4 | (151.8) | (187.8) | (70.3) | 0.9 | 2.5 |
| **Education financing net income before NRI** | **236.0** | **371.3** | **(235.1)** | **(363.0)** | **(145.5)** | **(81.4)** | **(52.9)** |
| Securitization trusts net income & eliminations | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | (127.3) | (144.0) |
| Zacks adjusted net income before NRI | 236.0 | 371.3 | (235.1) | (363.0) | (145.5) | (208.7) | (196.9) |
| GAAP net income | 236.0 | 371.3 | (235.1) | (363.0) | (145.5) | (202.7) | (196.9) |
| **Education financing EPS** | **2.45** | **3.92** | **(2.46)** | **(3.66)** | **(1.46)** | **(0.81)** | **(0.52)** |
| Reported EPS | 2.45 | 3.92 | (2.46) | (3.66) | (1.46) | (2.01) | (1.95) |
| Dividends per share | 0.32 | 0.58 | 0.40 | 0.00 | 0.00 | 0.00 | 0.00 |
| | | | | | | | |
| Cash & short-term investments | 143.0 | 234.9 | 221.1 | 181.5 | 385.5 | 269.3 | 217.3 |
| Restricted cash & GICs | 0.0 | 0.0 | 0.0 | 0.0 | 1.0 | 100.0 | 100.0 |
| Loans | 0.0 | 37.1 | 508.1 | 360.5 | 113.6 | 7.0 | 17.0 |
| Receivables | 551.6 | 809.7 | 411.2 | 233.9 | 73.3 | 30.0 | 30.0 |
| Other assets | 75.7 | 132.8 | 60.5 | 45.4 | 60.0 | 80.0 | 78.0 |
| **Total education financing assets** | **770.3** | **1,214.5** | **1,200.9** | **821.3** | **633.4** | 486.3 | 442.3 |
| Securitization trusts assets & eliminations | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 7,191.5 | 6,551.5 |
| Total assets | 770.3 | 1,214.5 | 1,200.9 | 821.3 | 633.4 | 7,677.8 | 6,993.8 |
| | | | | | | | |
| Deposits | 0.0 | 53.5 | 244.1 | 154.5 | 108.7 | 58.1 | 58.3 |
| Restricted funds due to clients | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 100.0 | 100.0 |
| Short-term borrowings | 0.0 | 0.0 | 242.9 | 230.1 | 218.1 | 0.0 | 0.0 |
| Long-term borrowings | 8.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other liabilities | 185.3 | 318.4 | 76.3 | 31.2 | 36.8 | 67.6 | 76.3 |
| Education financing shareholders' equity | 576.2 | 842.6 | 637.6 | 405.5 | 269.8 | 260.6 | 207.7 |
| **Education financing liabilities and equity** | **770.3** | **1,214.5** | **1,200.9** | **821.3** | **633.4** | 486.3 | 442.3 |
| Securitization trusts liabilities & eliminations | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 8,314.8 | 7,818.8 |
| Securitization trusts equity & eliminations | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | (1,123.3) | (1,267.3) |
| Total liabilities and equity | 770.3 | 1,214.5 | 1,200.9 | 821.3 | 633.4 | 7,677.8 | 6,993.8 |

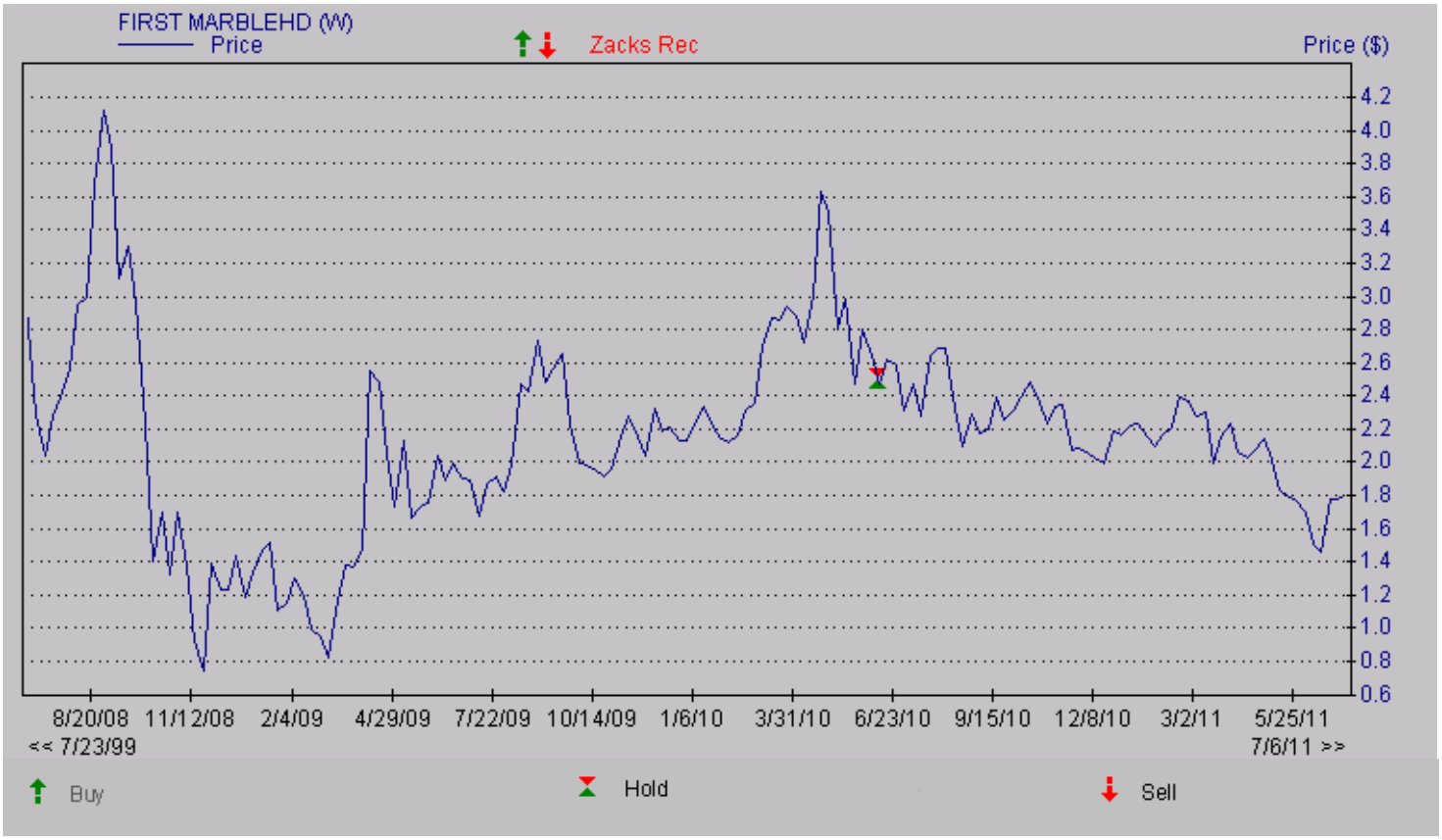
# The First Marblehead Corporation

**Income Statement and Balance Sheet**

*(Dollars in millions, except per share data)*

| | 2010 | | | | 2011 | | | |
|---|---|---|---|---|---|---|---|---|
| | **Q1 A** | **Q2 A** | **Q3 A** | **Q4 A** | **Q1 A** | **Q2 A** | **Q3 A** | **Q4 E** |
| Net interest income | 4.4 | 1.5 | 0.7 | 3.3 | 0.1 | 0.2 | 0.4 | 0.4 |
| Non-interest revenue | 9.1 | 8.6 | (17.5) | 6.2 | 5.0 | 9.3 | (15.0) | 13.5 |
| Total net revenue | 13.5 | 10.1 | (16.8) | 9.5 | 5.1 | 9.5 | (14.6) | 13.9 |
| Loan loss provision | (0.1) | 0.0 | 0.0 | 0.0 | 0.1 | 0.2 | 0.0 | 0.1 |
| Non-interest expense | 150.3 | 31.2 | 28.0 | 22.7 | 20.0 | 19.5 | 27.2 | 27.2 |
| Income tax expense (credit) | (42.6) | (9.4) | (15.4) | (2.8) | 1.1 | (0.0) | (0.1) | (0.0) |
| **Education financing net income before NRI** | **(94.1)** | **(11.7)** | **(29.4)** | **(10.4)** | **(16.1)** | **(10.2)** | **(41.7)** | **(13.4)** |
| Securitization trusts net income & eliminations | 0.0 | 0.0 | 0.0 | 0.0 | (48.9) | (29.3) | 2.4 | (51.5) |
| Zacks adjusted net income before NRI | (94.1) | (11.7) | (29.4) | (10.4) | (65.0) | (39.5) | (39.3) | (64.9) |
| GAAP net income | (94.1) | (11.7) | (29.4) | (10.4) | (65.0) | (33.4) | (39.3) | (64.9) |
| **Education financing EPS** | **(0.95)** | **(0.12)** | **(0.30)** | **(0.10)** | **(0.16)** | **(0.10)** | **(0.41)** | **(0.13)** |
| Reported EPS | (0.95) | (0.12) | (0.30) | (0.10) | (0.64) | (0.33) | (0.39) | (0.64) |
| Dividends per share | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| | | | | | | | | |
| Cash & short-term investments | 187.7 | 456.0 | 430.0 | 385.5 | 332.9 | 297.8 | 282.3 | 217.3 |
| Restricted cash & GICs | 0.0 | 0.0 | 0.0 | 1.0 | 0.0 | 147.0 | 97.4 | 100.0 |
| Loans | 241.3 | 111.4 | 108.1 | 113.6 | 8.6 | 8.0 | 6.9 | 17.0 |
| Receivables | 230.0 | 75.0 | 56.0 | 73.3 | 34.1 | 14.6 | 32.0 | 30.0 |
| Other assets | 77.7 | 65.6 | 73.5 | 60.0 | 50.0 | 114.1 | 72.8 | 78.0 |
| **Total education financing assets** | **736.7** | **708.0** | **667.6** | **633.4** | **425.6** | **581.5** | **491.4** | 442.3 |
| Securitization trusts assets & eliminations | 0.0 | 0.0 | 0.0 | 0.0 | 7,824.8 | 7,504.1 | 7,347.8 | 6,551.5 |
| Total assets | 736.7 | 708.0 | 667.6 | 633.4 | 8,250.4 | 8,085.6 | 7,839.2 | 6,993.8 |
| | | | | | | | | |
| Deposits | 156.4 | 145.0 | 127.4 | 108.7 | 79.5 | 55.9 | 57.3 | 58.3 |
| Restricted funds due to clients | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 147.0 | 94.7 | 100.0 |
| Short-term borrowings | 229.5 | 228.9 | 227.9 | 218.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Long-term borrowings | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | (0.0) | 0.0 | 0.0 |
| Other liabilities | 38.7 | 32.3 | 38.3 | 36.8 | 28.6 | 64.1 | 65.4 | 76.3 |
| Education financing shareholders' equity | 312.1 | 301.8 | 274.0 | 269.8 | 317.5 | 314.5 | 274.0 | 207.7 |
| **Education financing liabilities and equity** | **736.7** | **708.0** | **667.6** | **633.4** | **425.6** | **581.5** | **491.4** | 442.3 |
| Securitization trusts liabilities & eliminations | 0.0 | 0.0 | 0.0 | 0.0 | 8,869.6 | 8,578.2 | 8,419.6 | 7,818.8 |
| Securitization trusts equity & eliminations | 0.0 | (0.0) | (0.0) | 0.0 | (1,044.8) | (1,074.1) | (1,071.8) | (1,267.3) |
| Total liabilities and equity | 736.7 | 708.0 | 667.6 | 633.4 | 8,250.4 | 8,085.6 | 7,839.2 | 6,993.8 |

## HISTORICAL ZACKS RECOMMENDATIONS




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The current distribution of Zacks Ratings is as follows on the 1032 companies covered: Buy/Outperform- 14.5%, Hold/Neutral- 79.1%, Sell/Underperform – 5.2%. Data is as of midnight on the business day immediately prior to this publication.

The current distribution of Zacks Ratings is as follows on the 1027 companies covered: Buy/Outperform- 14.5%, Hold/Neutral- 78.3%, Sell/Underperform – 5.8%. Data is as of midnight on the business day immediately prior to this publication.