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## Deal to Make Sallie Mae a Big Debtor

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Sallie Mae has long profited from making loans to college students. Now, the company will be saddling itself with debt in an effort to generate even more lucrative returns. Yesterday, Sallie Mae, as the [SLM Corporation](#) is known, agreed to be taken private for \$25 billion amid a private equity wave that has swept Wall Street and as calls are heard in Washington to reduce federal subsidies for [student loans](#).

As the largest buyout of a financial services company, the deal has the potential to not only transform Sallie Mae but shake up the entire lending industry.

The buyout will put the company in the hands of two private equity investors, J. C. Flowers and Friedman Fleischer & Lowe, and two banking giants, [Bank of America](#) and [JPMorgan Chase](#).

Although the buyers are investing a total of \$8.8 billion of their own money, the remaining \$16.2 billion will be financed with debt. Together, the two buyout firms will control 50.2 percent of the company, while the banks will provide Sallie Mae with up to \$200 million in backup financing and own the remaining stake.

The complex transaction is expected to close late this year, but is bound to face intense scrutiny. The deal comes as debate is renewed on Capitol Hill over how heavily the government should subsidize and guarantee student loans made by Sallie Mae and smaller rivals.

“The student loan business is transforming,” said Charles A. Gabriel Jr., an analyst with the Prudential Equity Group. “This gives the industry’s critics ammunition to say there are outside profits and excess subsidies.”

Yet shares of Sallie Mae surged nearly 18 percent yesterday. The stock closed up \$8.29, to \$55.05 — still shy of the \$60 a share the four buyers are offering, which is a nearly 50 percent premium over Sallie Mae's battered share price before news of a potential buyout was reported in The New York Times last week.

“Some of the savviest minds on Wall Street believe that even in the face of a Congressional debate over subsidies, there is room for a 50 percent premium,” Mr. Gabriel said.

Shares of other lenders soared on the belief that that more private equity deals could be coming. Shares of Nelnet, a smaller student loan company, jumped nearly 15 percent, while shares of the [Student Loan Corporation](#) rose 5 percent.

The deal for Sallie Mae also appeared to prompt investors to reconsider whether other financial companies — once thought too big and too debt-averse for private equity — could become targets. Shares of CIT rose 5 percent and shares of [Countrywide Financial](#) were up 7 percent.

For Sallie Mae, whose \$142 billion portfolio makes it the nation's largest provider of student loans, the deal represents a chance to escape the public limelight at a time when its business model is under attack.

Democratic lawmakers and President Bush are threatening to cut the federal subsidies that guarantee lenders a certain level of profit and help insure them against default. Regulatory investigations and media scrutiny of suspected deceptive sales practices are casting a harsh light on Sallie Mae's fastest-growing and most lucrative business: high-interest private loans to bridge the gap between tuition costs and federal aid.

Some analysts say that the deal represents a bet by private investors that Sallie Mae can survive, and even thrive, in spite of the intense legislative pressure.

If Congress were to take away part of the lender subsidies, Sallie Mae's low operating costs would still give it an advantage over smaller rivals. That could help expand its 36

percent share of the \$197 billion in outstanding federally guaranteed loans, according to [Citigroup](#) analysts.

Sallie Mae could also become a bigger player in the origination of private loans, a lucrative market ranging from \$17 billion to \$25 billion, where it already has as much as a 40 percent share. That business does not depend on the government and is currently fueling the company's growth.

"The underlying business is very strong from a growth perspective since education costs are growing at twice the rate of inflation," said Richard Hoffmann, a financial analyst for CreditSights in New York. "You can simply look at the enrollment of high school students and see what the growth rate is."

It is also a chance for Sallie Mae executives to cash out. Albert L. Lord, Sallie Mae's chairman, took home pay worth more than \$228 million before stepping down in 2005, according to an Equilar analysis. Its current chief executive, Thomas J. Fitzpatrick, has accumulated nearly \$180 million in total compensation. On top of that, the deal could prompt a change-of-control payout, accelerating more than \$31.6 million in stock and options. Mr. Fitzpatrick and the rest of the Sallie Mae management team are expected stay on as part of the deal.

Of course, the deal also poses the same risks that have prevented other financial firms from being taken over by private equity investors.

Piling on billions of dollars in debt at a company like Sallie Mae is a tricky endeavor, especially when interest margins are tight. But Sallie Mae appears ready to walk away from issuing high-grade bonds and into the edge of junk-bond territory.

Yesterday, all three major credit rating agencies — Fitch, Moody's, and Standard & Poor's — either lowered Sallie Mae's ratings or put the company on watch.

Analysts say that Sallie Mae will try to offset that risk in two ways. First, it can rely on the steady stream of cash that is thrown off by the guaranteed federal student loans in its portfolio. And in the event that its access to capital becomes limited, Bank of America

and JPMorgan Chase have arranged to provide as much as \$200 million in backup financing to guarantee that the company can make low-cost loans.

While all four investors are lured by the lucrative returns, Bank of America and JPMorgan may expect additional strategic benefits. For one, it also gives them access to college students, with whom they seek lifelong relationships. Moreover, they can expect to make income and fees from the deal. And analysts say teaming up with a buyout firm allows the banks to expand their student loan business without making a deal that could reduce earnings.

The banks' close relationship with Sallie Mae could now give them a cost advantage. Both big banks have existing student-lending businesses, which they insist will remain independent. But Sallie Mae said the agreement allows the two banks to let it package their private loans, their faster-growing and more profitable business, at potentially lower rates.

Several analysts expect Bank of America and JPMorgan to begin moving away from existing loan packagers, like First Marblehead, and to Sallie Mae. Even though both banks are locked into their contracts until they expire, First Marblehead shares lost more than a fifth of their value yesterday.

On Capitol Hill, some lawmakers used the Sallie Mae buyout to criticize the use of government funds to support private student lenders.

Senator [Edward M. Kennedy](#), the Massachusetts Democrat who is chairman of the education committee, said it was "more urgent than ever to enact reforms to our student loan system to ensure that students, not profits, are our top priority."