Nelnet: “The Slowly Amortizing Ice Cube”

Date: 7/13/2021

Current Price (NNI: NYSE): $73.53/share

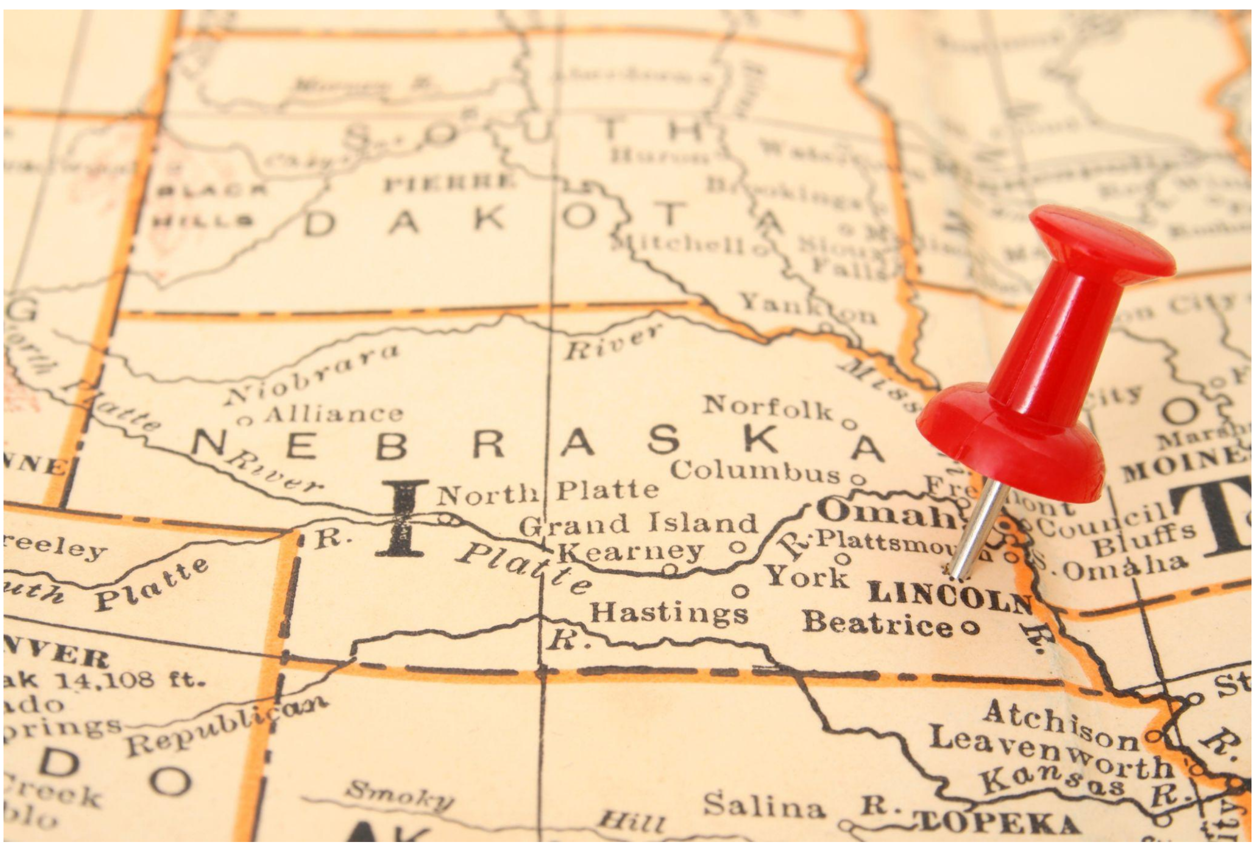

Image source: Getty Images

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What is Nelnet?

Nelnet is a $3 billion conglomerate headquartered in Lincoln, Nebraska that's being fueled by cash flow from a $20 billion federally guaranteed student loan portfolio.

Long-time Chairman Michael Dunlap and CEO Jeffrey Noordhoek have proved themselves to be exceptional stewards of capital by redeploying the company's cash flow into various subsidiaries and private investments at above-market rates of return. To be exact, management has compounded book value per share at 17.3% annually for the last 17 years all while investing in relatively low-risk assets.

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Nelnet's Corporate Performance vs. the S&P 500

Annual Percentage Change

	Nelnet Per Share Book Value With Dividends Included	Nelnet Per Share Market Value With Dividends Included	S&P 500 With Dividends Included
2004	49.2%	20.2%	10.9%
2005	41.5%	51.1%	4.9%
2006	6.3%	(32.7)%	15.8%
2007	(1.6)%	(52.5)%	5.5%
2008	6.6%	13.3%	(37.0)%
2009	21.0%	20.7%	26.5%
2010	23.7%	41.6%	15.1%
2011	22.6%	4.9%	2.1%
2012	16.7%	27.5%	16.0%
2013	26.1%	42.8%	32.4%
2014	21.1%	10.9%	13.7%
2015	16.0%	(26.6)%	1.4%
2016	15.4%	52.7%	12.0%
2017	8.8%	9.1%	21.8%
2018	9.9%	(3.2)%	(4.4)%
2019	6.2%	12.7%	31.5%
2020	15.6%	23.7%	18.4%
CAGR	**17.3%**	**8.4%**	**9.6%**

Source: Nelnet Investor Relations Featured Presentation

How We Got Here

Nelnet got its start in 1978 as a student loan servicer for two local Nebraska banks. For anyone unacquainted with the loan servicing process, bear with us for a quick explainer.

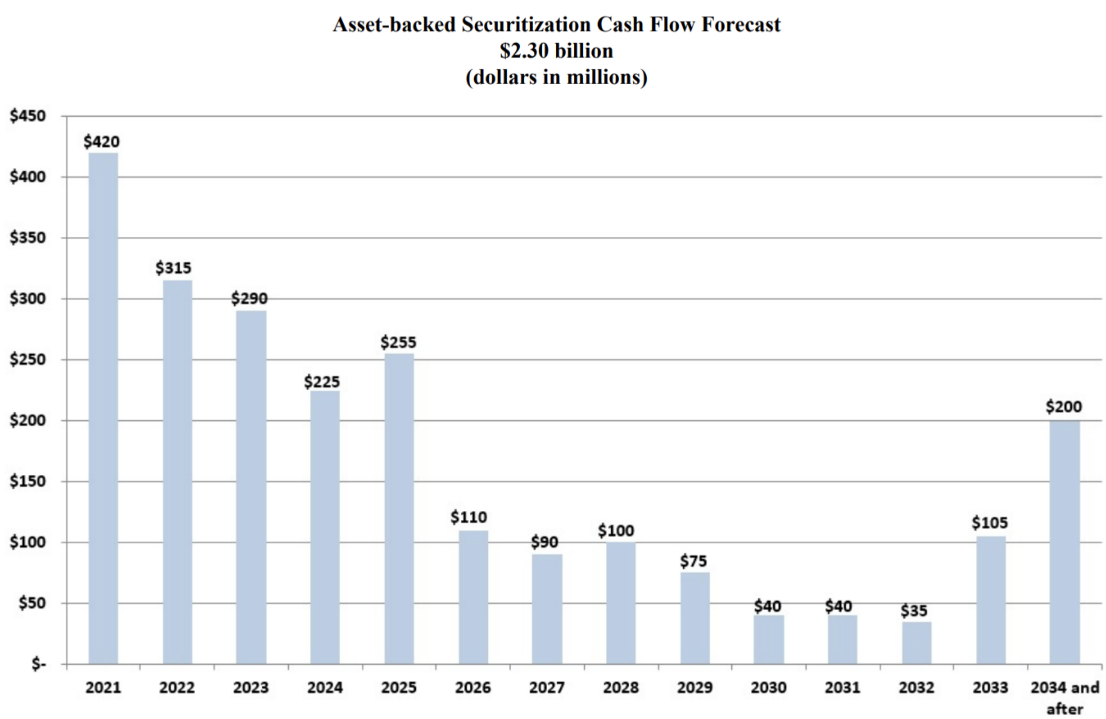
When a lender lends money to a borrower, there's a layer of work being done under the hood that tends to go unnoticed. This layer includes the actual distribution and collection of money, maintenance of financial records, and a central dashboard for borrowers to interface with during the payback period. This layer is what's referred to as loan servicing and Nelnet does a lot of it.

With servicing at its core, Nelnet was able to successfully expand into student loan originations and began lending through the Federal Family Education Loan Program (FFELP). However, after 14 years of successful underwriting, the federal government enacted the Health Care and Education Reconciliation Act of 2010 and took the program in-house. While this threw a wrench in Nelnet's day-to-day operations, the company still had billions of dollars worth of existing loans on its balance sheet, some of which it still carries today.

The Slowly Amortizing Ice Cube

We were first introduced to Nelnet by one of the lead advisors for Motley Fool Canada, Jim Gillies. When Jim initially presented the company in December of 2020, he referred to Nelnet's remaining student loan portfolio as a "slowly amortizing ice cube" and we think that's an apt description.

In Nelnet's SEC filings, this segment of the business is referred to as Asset Generation and Management (AGM). AGM today consists of $19.7 billion in asset-backed loans receivable. For loans disbursed after 1993, the federal government insures 98% of both the principal and interest. For loans disbursed after 2006, that guarantee is reduced to 97%. Here's how that future cash flow shakes out.



Source: Nelnet 2020 Annual Report

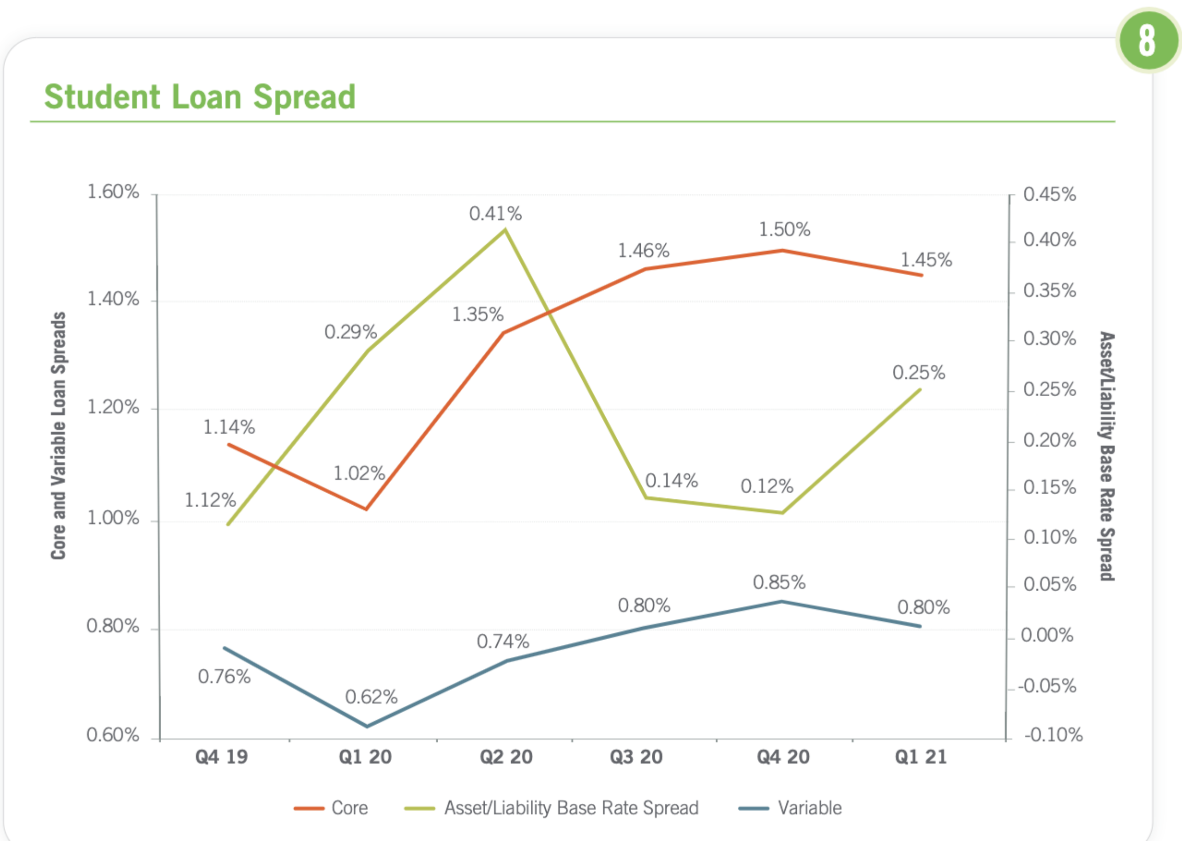
Since this is an interest-rate-sensitive operation and we're in a volatile interest rate environment, we'll dive a little deeper.

AGM's portfolio consists of millions of independent student loans all with their own respective interest rate. Each borrower in this case has a pricing and payback term unique to them. Some of the borrowers pay back their loans at a fixed rate and others on a floating rate which is reassessed on the 1st of July each year. As of the end of 2020, the split between these two was roughly 50/50.

But in order to finance these loans, Nelnet borrows money at a *variable rate*. The bulk of this financing comes from 1-month and 3-month securities indexed to the London Interbank Offered Rate (LIBOR).

Since some of Nelnet's borrowers pay back their loans at a fixed rate, Nelnet would theoretically risk losing future cash flows to rising interest rates. To mitigate this risk, Nelnet uses basis swaps as a hedge to effectively set a ceiling on the rate it borrows at. In other words, Nelnet earns a spread.

Even though these basis swaps often carve into the company's earnings, it's a small price to pay for a sense of surety. As interest rates decline, that spread widens and Nelnet's Net Interest Income rises. And in 2020 that's exactly what happened. Here's what that spread looks like.



Source: Nelnet Investor Relations Featured Presentation

However, this ice cube will eventually fully melt and that cash needs to be put to use elsewhere.

Operating Subsidiaries

Nelnet Diversified Services (NDS):

- 2020 Revenue: $497.5 million
- 2020 Net Income: $40.6 million

NDS comprises most of Nelnet's loan servicing operations and is one of its largest businesses by revenue and operating income. By the end of 2020 NDS was servicing roughly $490 billion worth of loans on behalf of more than 15 million borrowers. Since NDS receives compensation in the form of monthly fees depending on the number of borrowers and dollar volume of loans processed, the pandemic has had a negative impact on its operations as many student loans were put into a forbearance period.

Unsurprisingly, NDS's largest customer is the US Department of Education which accounts for 66% of its revenue. While we recognize that this presents some customer concentration risk, management continuously provides detailed commentary on their relationship.

This contract was just extended for another six months to the end of 2021 and contains an optional follow-on extension for an additional two years. Given that one of the three loan servicers in contention for the program just dropped out and Nelnet has a nearly 50-year history servicing loans on behalf of the federal government, we find the likelihood of a renewal to fall in Nelnet's favor.

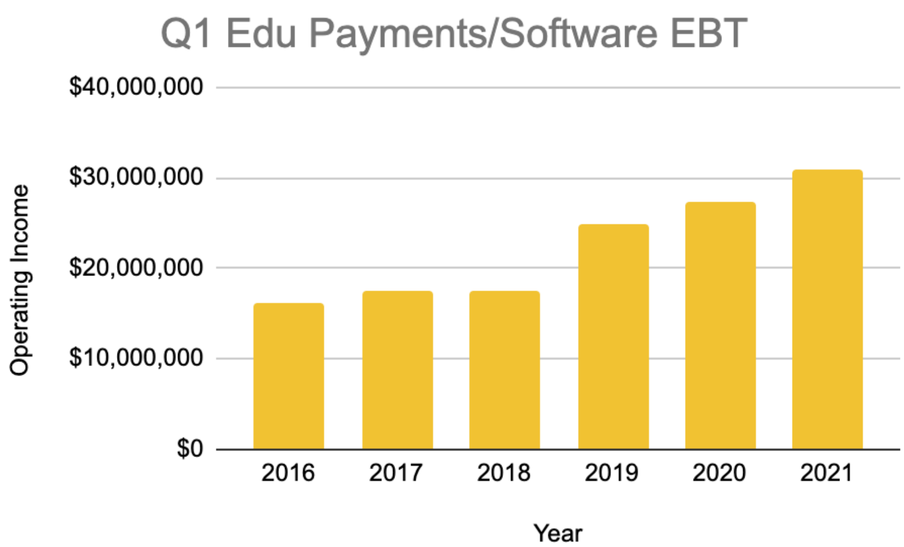
Nelnet Business Services (NBS):

- 2020 Revenue: $282.2 million
- 2020 Net Income: $50.3 million

NBS is perhaps the most intriguing business under Nelnet's umbrella. Its operations focus on providing software solutions across the education sector. Ranging from services like tuition and payments processing to administrative workflow tools and instructional services, Nelnet has dozens of solutions for schools around the globe.

NBS is currently an amalgamation of 9 separate brands that Nelnet has acquired or developed over the years, and its software suite serves more than 11,000 K-12 schools, as well as 1,200 colleges and universities worldwide.

In Nelnet's most recent quarter, NBS generated $95 million in revenue (a 14% increase year-over-year) with a 32.5% EBT margin and has compounded those earnings before taxes at a 13.7% rate over the last five years -- even amidst covid-induced school shutdowns.



Source: https://docs.google.com/spreadsheets/d/1KZQycGLRqhq_roApE7UKgpbCUBhDZAxcZhEkoY8Jk-c/edit?usp=sharing

Other Assets

Allo Communications:

Allo Communications is a fiber internet and cable provider for the state of Nebraska and eastern parts of Colorado. Nelnet acquired a 92.5% stake in the company in 2015 for $47 million.

As with any cable internet business, Allo requires significant upfront investment in order to expand into new markets. In fact, in the subsequent 5 year period following the acquisition, Nelnet invested an additional $334 million into Allo's operations.

Though management's commentary indicates that these capital expenditures should provide positive returns in the future, owning Allo thus far has negatively impacted Nelnet's operating income. However, this should change.

Last year, management sold 48% of Allo Communications to an infrastructure investing firm called SDC Capital Partners for $197 million. This gives Allo Communications a price tag of roughly $410 million while simultaneously offloading much of the expansion costs to SDC.

This cash infusion was accounted for as income in 2020, which helped propel Nelnet to a likely one-time earnings yield of 13%, barring any unexpected boosts in net income this year. Nelnet still owns just over 45% of Allo Communications.

Nelnet Bank:

In March of 2020, the FDIC granted Nelnet an industrial bank charter -- the first charter granted since 2008. Following this approval, the company opened Nelnet Bank as a virtual-first operation with a single location in Salt Lake City, Utah.

As initial funding, Nelnet provided the bank $100 million in capital, with 56% of that as cash and the other 44% as asset-backed securities. Currently, the bank is writing refinance loans but has plans to start offering private student loans in late 2021.

While it should be fun to watch this bank grow, we'll avoid belaboring this topic as its current income is trivial in the grand scheme of things.

Hudl:

Hudl is a performance analysis platform used by sports organizations to review film, build highlight tapes, scout competitors, and much more. Founded in 2006, Hudl paved its way into the realm of athletics through high school football. Today, thanks to the expansion of its core Hudl platform and the acquisitions of Wyscout and Krossover, Hudl has its hands in various sports markets across the globe. From small-town high school sports to world-famous professional organizations, teams are willing to spend hundreds, and in some cases, thousands of dollars a year to get a leg up on the competition.

Like Nelnet, Hudl's roots are based in Lincoln, Nebraska which has helped contribute to an extensive history between the two companies. Nelnet's Chairman Michael Dunlap has served as a director for Hudl since 2011, and Nelnet has been involved in several funding rounds for the company since. But Nelnet isn't alone. Bain Capital and Accel Ventures are two other notable venture capital firms that have been involved in helping Hudl raise money over the years.

Though the fair value of Nelnet's stake in Hudl is hard to determine given the secrecy included in being a private company, Nelnet recorded a $50 million gain on the remeasurement of its Hudl investment during the second quarter of 2020. Management has stated that it plans to continue investing in upcoming funding rounds for the company and we view the chance of a public offering as a very real possibility and a call option for value realization by the public markets.

Other Investments:

In addition to all the operations mentioned above, Nelnet has invested $725 million into private investments over the last 8 years. This includes already partially funding a $149 million initiative to develop and operate 86 different solar sites across the country.

Since these assets are so thinly disclosed on Nelnet's balance sheet, we've assumed no return on invested capital and decided to leave the value of their renewable business at the amount of capital committed.

Capital Deployment By Year (in millions)

	2013	2014	2015	2016	2017	2018	2019	2020	8-Year Total
FFELP loan/residual acquisitions, net of financing	$38	$127	$140	-	-	$105	$71	$141	$622
Private and consumer loan/residual acquisitions, net of financing	$68	$17	$173	$61	$75	$188	$61	$71	$714
Business acquisitions	-	$47	-	-	-	$153	-	$30	$230
Nelnet Bank	-	-	-	-	-	-	-	$100	$100
ALLO acquisition and capital expenditures	-	-	$47	$39	$115	$87	$45	$48	$381
Other capital expenditures (non-ALLO)	$17	$26	$17	$29	$41	$38	$48	$65	$281
Hudl investment	-	$1	$41	-	$10	-	-	$26	$78
Other investments (venture capital/real estate/solar)	$20	$45	$53	$22	$19	$67	$103	$396	$725
Debt repurchases	$79	$47	$42	$77	$181	$13	-	$26	$465
Stock repurchases	$13	$16	$96	$69	$69	$45	$40	$73	$421
Dividends	$19	$19	$19	$21	$24	$27	$29	$32	$190
	$254	**$345**	**$628**	**$318**	**$534**	**$723**	**$397**	**$1,008**	**$4,207**

*A table of Nelnet's Capital Deployment since 2013. Source: Nelnet 2020 Letter to Shareholders

Sum of the parts

Below is our valuation estimate for each Nelnet asset. We then conclude with our "sum of the parts" analysis.

Asset Generation and Management (AGM): **$1.75B**

- Nelnet expects to generate $1.5 billion in cash from AGM's loan portfolio over the next 5 years and nearly $2 billion over the next 10. This is our rough discount of what all the future cash flow in total is worth.

Loan Servicing and Systems (NDS): **$203M**

- In 2020, NDS generated $40.6 million in net income. Due to the customer concentration risk, we've applied a 5x earnings multiple. (This is hopefully far too conservative)

Education, Technology, Services, and Payment Processing (NBS): **$1.41B**

- NBS has generated $70 million in income before taxes over the last 12 months and has compounded its EBIT at ~13% per year for the last 5 years. Since it's a growing, high-margin software business, we're applying our most aggressive valuation to NBS at 20x trailing EBIT.

Nelnet Bank: **$100M**

- Nelnet funded its bank with $100 million in initial capital. Operations have only just begun, so we carry this at cost.

Allo Communications: **$185M**

- SDC Capital Partners paid $197 million for a 48% stake in the business valuing Allo at roughly $410 million. This values Nelnet's remaining 45% stake at $185 million.

Hudl Investment: **$78M**

- Nelnet began by investing $1 million in Hudl in 2014 and has deployed an additional $77 million in follow-on funding rounds since then. While we're optimistic about Hudl's business we're sticking with the invested capital number for the sake of being conservative.

Renewable Energy: **$148.6M**

- Once again the financials from this investment aren't broken out, so we're taking the capital deployed/committed to deploy at face value.

Cash: **$121.2M**

(Nelnet also possesses a venture and real estate portfolio, but it's too difficult to value so we've excluded it from our estimates.)

Sum of the Parts = **$3.997B**
Current Market Cap = **$2.85B**
Equity Upside = **40.2%**

For my full analysis, here's a link to our spreadsheet:
https://docs.google.com/spreadsheets/d/1KZQycGLRqhq_roApE7UKgpbCUBhDZAxcZhEkoY8Jk-c/edit?usp=sharing

Thesis Summary

Our thesis for Nelnet is simple. The parts together are worth more than where it currently trades. While spinning off any one of Nelnet's subsidiaries would likely create short-term shareholder value, we don't expect management to do so, nor would we care for it.

Michael Dunlap has been Chairman for almost 30 years and owns 43.1% of the company's shares outstanding -- more than anyone else. Dunlap doesn't care about what happens tomorrow, he cares about Nelnet's durability.

Here's a passage highlighting his thought process in the company's latest annual letter:

"Our goal at Nelnet is to be here decades into the future and for our stock to trade for a fair value. When we make investments and buy businesses, we look at the discounted cash we will create over time and then look for ways to reinvest that cash into the future."

He continues:

"if you are looking for the quick pop in value you may get from Bitcoin, or the newest hyped entrant to the market, then Nelnet is the wrong investment. If you want us to invest your money for the long term, we will try and maximize the long term cash flow and long term sustainable value to the best of our abilities."

Our goals are aligned with Dunlap's and we believe this strategy will yield exceptional returns over the long term.