Nelnet: The Quiet Technology Compounder

Nelnet (NNI)	
NNI	**$46.38**
Shares	39.2
Market Cap	**$1,817**
Net Debt	(162)
EV	**$1,655**

Nelnet has quietly built a phenomenal technology company and simultaneously compounded its book value by over 17% for almost 15 years. Despite this performance, Nelnet trades not only well below book value, but less than half of its fair value. There may be no better performing technology company with such a low valuation that is publicly traded and has over a $1 billion market cap.

At a time of such high technology company valuations, how is it possible that Nelnet's valuation is so low? Nelnet's enormous legacy student loan portfolio disguises just how fantastic its technology payments division, fiber optic network and venture investments are.

With its stock stuck in the mud, virtually no analyst coverage and a quiet management team, few have heard of Nelnet and even fewer understand that Nelnet's run-off student loan portfolio is winding down and is poised to deliver over $10 per share in cash over the next seven quarters, or close to a quarter of the current market cap and will enable Nelnet's true technology colors to emerge.

Very quietly, the company has been wasting no time and has been aggressively buying back its shares as the cash flow tsunami starts. Typical of its non-promotional style, Nelnet has reported in SEC filings and not press releases that it bought back over 2% of the company's shares in just six weeks in April and early May, and I believe by the time the quarter is finished it's possible the company will have bought back 4% of its stock in one quarter alone.

How long until growth and technology investors recognize that Nelnet is not a complex financial services company but a technology payments company, that investors can buy for free, excluding its government-guaranteed student loan portfolio? With the company buying back plenty of shares, and the cash flow spigot about to be turned on, Nelnet's shares are set to re-rate substantially higher.

Education Tech Software Business is a Phenomenal Hidden Asset

Nelnet Business Services (NBS) could not have a more boring name, but underneath that boring name is a fast growing, highly profitable payment technology company that currently has very limited competition. NBS offers tuition payment plans, online payment processing and information systems for school administrative functions (e.g. grade book management, attendance and financial needs assessments). It serves more than 11,500 private k-12 schools and over 1,300 colleges and universities.

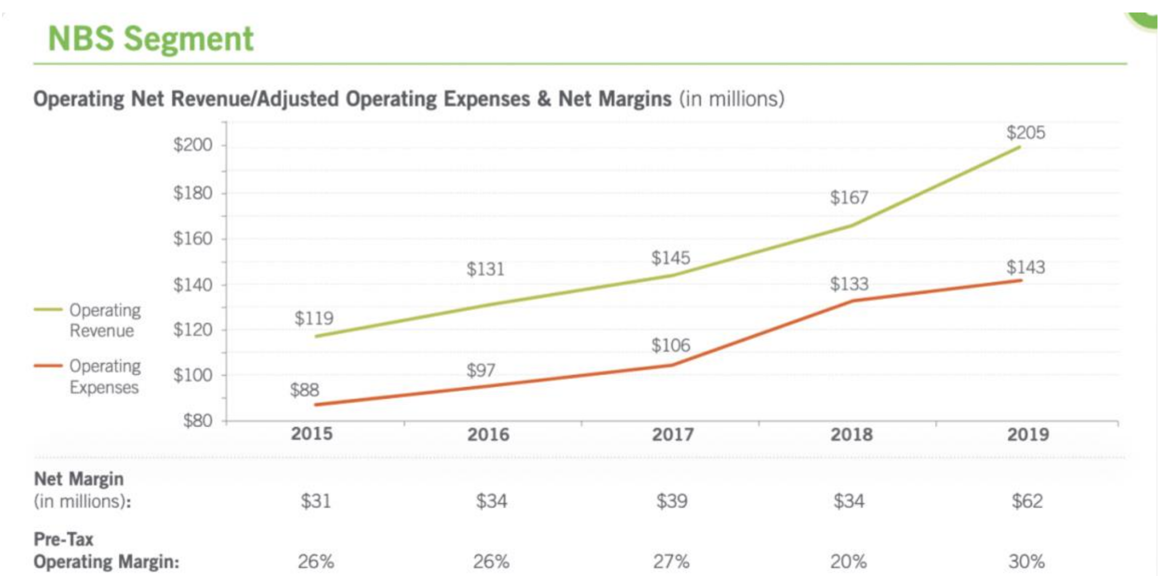
The nature of the products makes it incredibly sticky, as pulling out the technology that controls the entire backend of the tuition payments system or admin software in these monolithic institutions is a serious and complicated endeavor. This stickiness becomes even more pronounced given the underlying school's reliance on NBS' customer service portals and the deep integrations with the school partners. Additionally, the private K-12 space is dominated by regional Catholic dioceses, so NBS' positive reputation has spread throughout that community, such that the costs of new school acquisition have decreased for them over time.

The combination of high-quality product and excellent customer service has propelled NBS to capture over 40% of all US private K-12 schools and roughly 30% of all US higher education institutions.

Going forward, the company continues to grow through both customer expansion by replacing school-built legacy information systems and within the underlying school by upselling their vast suite of products and services. There is a big opportunity internationally as the company has expanded operations to New Zealand and Australia, where they service over 70% of the private higher education institutions in Australia!

And all of these growth drivers pale in comparison to the true "red ocean" opportunity for NBS – US K-12 public schools! NBS is actively working on developing and deploying their technology solutions (other than of course traditional tuition payments) for the US public school systems through this country, a customer set that is obviously multiples larger than the private K-12 systems.

Now imagine if this division renamed itself some cool Fintech name, or was spun out and traded on the NASDAQ. What would it trade at with 22% annual revenue growth and 32% pre-tax operating margins, and the below historical chart:



Well, I can take a pretty good guess as there are publicly traded comps out there. Let's start with publicly traded comp Blackbaud (NASDAQ: BLKB), which is the largest competitor to NBS in both K-12 and higher education space, and currently trades at 19 times 2019 EBITDA, despite only growing revenue by 6% in 2019.

There are also general payment-based technology companies, such as Fiserv or Global Payments, who both trade at 16-20 times 2020 EBITDA. Fiserv, through its acquisition of First Data, has been involved with education technology and servicing products, and Global Payments has been an active buyer in the space, purchasing Heartland Payments at 22 times EBITDA, which has been operating a direct competitor product to NBS since 2014.

As a standalone company, NBS could be worth anywhere from $39 per share to $58 per share. Imagine what this company could IPO for in today's market. Investors currently get it for free.

Allo's Fiber Network is Built Out and About to Take Off

Allo is an end-to-end fiber optic network for businesses and residences in Nebraska and expanding into Colorado with a specific focus on under-served markets. Allo has been a money loser for the past few years as Nelnet built out its network, but in Q1 it turned a corner after finishing its capex build. Allo has grown by word of mouth with little advertising simply because the competition is weak, and now they are about to turn on the marketing spend so it is poised to soar.

The below financial table tells the story well. Capex plunging, revenue soaring and now EBITDA positive. Allo is on the cusp of years of cash flow growth at a time when demand for big fat Internet pipes are more than they have ever been.

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ALLO Financial and Operating Data

	2016	2017	2018	2019
Residential revenue	$11,088	$17,696	$33,434	$48,344
Business revenue	$6,235	$7,744	$10,976	$15,689
Other revenue	$336	$260	$243	$236
Total revenue	$17,659	$25,700	$44,653	$64,269
Net income (loss)	($5,899)	($16,511)	($28,740)	($23,519)
EBITDA	($2,184)	($9,372)	($4,455)	$6,224
Capital expenditures	$38,817	$115,102	$87,466	$44,988
Revenue contribution:				
Internet	39.8%	46.6%	53.9%	59.5%
Television	32.7%	31.2%	29.0%	25.2%
Telephone	27.0%	21.8%	16.9%	15.1%
Other	0.5%	0.4%	0.2%	0.2%
	100%	100%	100%	100%
Residential customer information:				
Households served	9,814	20,428	37,351	44,744
Households passed	30,962	71,426	122,396	140,986
Total households in current markets and in new markets announced	137,500	137,500	152,840	160,884

*Dollars in thousands

While Allo did $6 million in EBITDA in 2019, it is on track for $15 to $20 million in EBITDA for 2020, and given the enormous incremental margins from increasing penetration, it is not hard to model $50+ million in two to three years.

A publicly traded small cap comp to Allo would be Tucows (NYSE: TCX), which is only growing at about 6% a year, but trades at 14 times EBITDA. Cable One (NASDAQ: CABO) is another rural-cable play and trades at 20 times EBITDA! Even using a conservative traditional cable multiple of 8-10 times off the drastically higher EBITDA in 2-3 years, it's very easy to see how much more valuable this business will be in the future.

Again, investors are getting this fast-growing fiber network business for free at the current valuation.

HUDL Is About to Be a Unicorn

Nelnet owns approximately 19% of a high-flying venture company (worth over $1 billion) called Hudl, that is on the verge of becoming a unicorn. The company provides digital tools to coaches and athletes to review play, scout talent and analyze competition across professional, college and youth sports. A fellow, Lincoln, Nebraska company, the CEO of Hudl is on Nelnet's board.

Nelnet started Hudl a few years ago with a $100K investment. Along the way they only brought in three external investors, Accel Partners, Bain Capital, and Jeff Raikes (one of Bill Gates closest business lieutenants).

Hudl currently has 2,300 employees in twenty countries, is making several acquisitions, especially internationally, and is growing very fast.

And for proof of how successful the company has been, despite the global pandemic in April, the company closed a capital raise from highly regarded Bain Capital Ventures (prnewswire.com) that led Nelnet to disclose in an SEC filing that they need to raise its carrying value by $50 to $60 million in Q2, due to the increased valuation.

And Nelnet also has money in other venture bets. Approximately 35 companies, any one of which could become the next Hudl.

Messy and Complicated, But Extremely Low Risk Student Loan Portfolio Masks Everything

To many investors, Nelnet is viewed as a financial services company focused on student loans and is poorly understood, which masks how the company has transformed itself into a technology powerhouse.

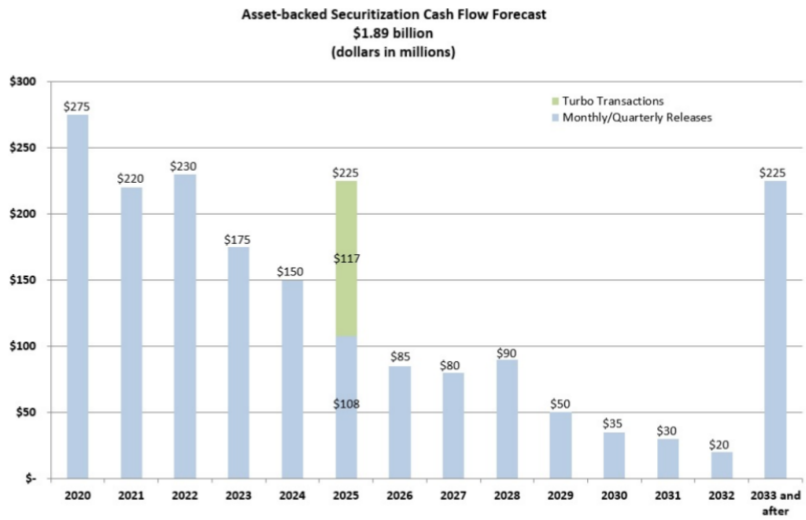
First, Nelnet appears to be highly levered because of the $20 billion in debt it holds on the over $21 billion of student loans it has securitized. The most important feature of the student loans is that they are backed by a repayment guarantee of 97 to 100% by the government in the event of a default and have little potential for impairment.

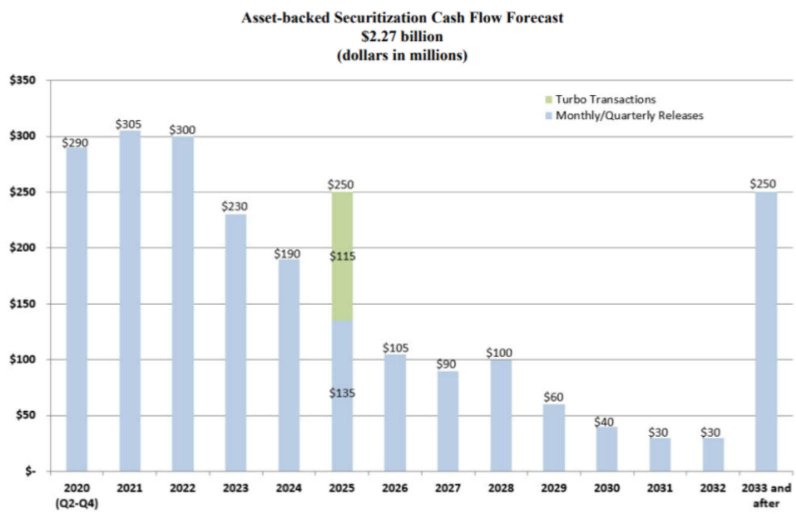
Second, the student loans are securitized, and Nelnet earns a spread that can move up and down based upon short term interest rates. The Company uses interest rate hedges to manage the spread between the loans they own and the borrowing rate that resets based upon LIBOR and can cause some short-term volatility in some quarters.

Third, due to the long-term nature of the securitized structures, cash has been trapped within the securitizations and that cash will only now begin to be released back to Nelnet.

Student Loan Cash Flows About to Explode Higher Due to 0% Interest Rates

Nelnet is a prime beneficiary of the Federal Reserve holding interest rates at zero until 2022, as the underlying students continue to pay fixed rates while Nelnet pays the interest on their securitizations based on LIBOR. See the two charts below. The first chart is from a SEC filing at the end of 2019 and the second one was part the financial update after they reported Q1.





You can see that now instead of expecting $275 million of pre-tax cash flow in all of 2020, they now expect $290 million in just three quarters. And 2021's cash flow forecast increased from $220 million to $305 million. Nelnet's loans have a floor pricing feature which makes cash flow explode when rates drop as dramatically as they have. That is over a $100 million positive swing in cash flow thanks to lower interest rates. And 2022-2023 went up by another $135 million as well. In total the company is expecting almost $600 million in cash flow to flow from their securitizations on to their balance sheet in just the next seven quarters. On average that is $85 million of cash flow a quarter, or $2.18 per share pre-tax. That is EVERY quarter for the next seven quarters.

The pre-tax cash flows expected from Nelnet's student loan portfolio over time is $58 per share, with the vast majority expected to be received in the next seven years. This is literally a cash flow tsunami that is coming.

Loss of Two Student Loan Servicing Contracts

Another reason Nelnet has been so beaten down is that investors have placed an undue emphasis on its student loan servicing business, which has historically driven earnings and short-term results. And Nelnet, which is the largest student loan servicer just inexplicably lost two key contracts for the long-term servicing of millions of student loans. Nelnet has a strong reputation in this space but there appears to be some funny business around the award of the contracts, and Nelnet and First Data have protested the award after a small, less well-regarded company appears to have won the award. (journalstar.com)

Given the history of this loan servicing RFP, I believe Nelnet still has a good chance to participate. But as I will highlight below, Nelnet is so significantly undervalued that one can value this business at zero and it doesn't matter, as the company still sells for less than half of fair value and well below book value.

Nelnet is Deeply Undervalued

Book value is estimated at approximately $62 per share in Q2, given the gain on Hudl and the company's earnings. Book value should grow to over $70 per share by end-2021

As the below valuation chart shows, assuming a base valuation of the sum of the company's parts, Nelnet is worth somewhere around $90 per share and possibly $114 on the high end. And this values their loan servicing business at zero, an extremely conservative stance.

Division	Valuation Method	TTM	Base	High
Asset Generation & Management	DCF - Discount Rate		4.0%	3.0%
Ed Tech and Payment Processing	EBITDA	76.4	20.0 x	30.0 x
Communications - ALLO	Invested Capital	333.0	1.2 x	1.5 x
Hudl	Book Value	51.8	2.6 x	2.6 x
Loan Servicing and Systems	EBITDA	103.8	0.0 x	0.0 x
Corporate & Other	EBITDA	(34.6)	8.0 x	8.0 x
Net Corp. Cash (Debt)	Book Value	161.9	1.0 x	1.0 x

Valuation	Base	High
Asset Generation & Management	1,573.3	1,648.3
Ed Tech and Payment Processing	1,528.5	2,292.7
Communications - ALLO	399.6	499.5
Hudl	134.4	134.4
Loan Servicing and Systems	0.0	0.0
Corporate & Other	(276.5)	(276.5)
Net Corp. Cash (Debt)	161.9	161.9
Total	3,521.2	4,460.3
Shares	*39.2*	*39.2*
Value Per Share	**$90**	**$114**
Upside %	**94%**	**145%**

Nelnet's New Bank Charter Offers More Upside

In March of this year, Nelnet received an ILC Bank Charter, which offers another source of upside that is not recognized in the stock. New ILC bank charters are extremely rare, as there hasn't been a single one issued in over a decade, until Nelnet and Square both received one.

Nelnet has a strong balance sheet, skills and expertise to be a successful online bank, especially in the areas of private student loan origination and refinance loans, which have typically earned impressive returns on equity. When you think about the cash flow tsunami that is coming this is a wonderful place to put the company's assets to earn outsized returns and continue to increase book value.

And while a company like Square adds billions in market cap for getting a bank charter, Nelnet has received no credit.

Another comp to Nelnet's bank opportunity is the private company Sofi, which like Nelnet offers student loan refinancing and is now valued at approximately $5 billion.

Disconnect Between Book Value growth and Share Price Leads to Buybacks

Management went public in 2004 at a valuation of seven times book value. See the below chart to see how the stock has lagged the great performance of its book value growth.

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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%
CAGR	**17.4%**	**7.5%**	**9.1%**

This has led the company to be aggressive in buying back its shares, especially recently. In 2014, the company had 46 million shares outstanding and now the company has only 39 million shares outstanding. The company's shares are simply disappearing.

Oracle of Lincoln

A few large holders of Nelnet have come to call the Executive Chairman, Michael Dunlap, the Oracle of Lincoln for his long-term vision and impressive book value growth that seems awfully similar to a smaller and more agile Berkshire back in the day. And it is obvious that intrinsic value has grown much faster than book value. Remember that Berkshire loved insurance as a source of cash flow to grow the company, similar to how Nelnet has viewed student loans. It helps that Lincoln, Nebraska the headquarters are quite close to Omaha.

The CEO Jeff Noordhoek is equally impressive in how he has grown the Company's technology divisions and investments. The management team and board of directors own 44% of the company. Those percentages are likely increasing with such aggressive share buybacks.

Risks

The company is non-promotional, doesn't hold quarterly calls so don't expect them to tout or promote the stock even when there is good news. A great example is the company not mentioning that it bought back 2% of the company's shares in their Q1 press release so one had to search deep in the 10Q filing, released afterwards to no fanfare.

There could be more noise and turmoil surrounding their student loan servicing, which could affect short term results although I believe any negative news around their student loan servicing is more than priced into the stock price. Again, Nelnet is so cheap that I'm valuing this profitable business at zero.

Finally, there is a chance that if the government truly offers to "cancel" student loan debt that investors could be confused and think Nelnet's student loan book would be impacted. But the reality is that this would involve the federal government writing Nelnet a $21+ billion check and other holders of student loans an $150+ billion check, an unlikely occurrence! Even so, this would pull forward almost all of its cash flows and be an enormous home run, leaving Nelnet with over $1 billion in cash to either redeploy or return to shareholders along with two fast growing education technology and telecom businesses. A more likely scenario is the Federal Government taking over the role of paying for some student loans, which just makes the payment stream more regular and guaranteed.

Summary

Nelnet is not only undervalued; it owns a wonderful low-risk, run-off student loan portfolio that is about to rain cash flow while the company continues to grow its technology divisions and compound intrinsic value. With an aligned long-term management team aggressively buying shares, the stock is unlikely to remain at depressed levels for long. Finally, I am not sure how many if any technology or growth investors know about or are invested in Nelnet and that is sure to change.

Catalysts

Positive Q2 results with strong cash flows and jump in book value due to Hudl. Q3 and Q4 results will also be very strong.
Continued buybacks
Allo performance accelerating
Tech/Growth investors discovering Nelnet and the hidden tuition payments business