

NELNET INC
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 001-31924

NELNET, INC.

(Exact name of registrant as specified in its charter)

NEBRASKA

(State or other jurisdiction of incorporation or
organization)

84-0748903

(I.R.S. Employer Identification No.)

**121 SOUTH 13TH STREET, SUITE 201
LINCOLN, NEBRASKA**

(Address of principal executive offices)

68508

(Zip Code)

(402) 458-2370

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed 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 Regulation 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ Smaller reporting company ☐

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

As of April 30, 2009, there were 38,281,812 and 11,495,377 shares of Class A Common Stock and Class B Common Stock, par value \$0.01 per share, outstanding, respectively (excluding 11,317,364 shares of Class A Common Stock held by a wholly owned subsidiary).

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**NELNET, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except share data)**

	As of March 31, 2009 (unaudited)	As of December 31, 2008
Assets:		
Student loans receivable (net of allowance for loan losses of \$48,497 and \$50,922, respectively)	\$ 25,624,337	25,413,008
Cash and cash equivalents:		
Cash and cash equivalents not held at a related party	15,070	13,129
Cash and cash equivalents held at a related party	228,635	176,718
Total cash and cash equivalents	243,705	189,847
Restricted cash and investments	1,218,512	997,272
Restricted cash due to customers	55,610	160,985
Accrued interest receivable	388,315	471,878
Accounts receivable (net of allowance for doubtful accounts of \$1,180 and \$1,005, respectively)	42,575	42,088
Goodwill	175,178	175,178
Intangible assets, net	70,900	77,054
Property and equipment, net	34,890	38,747
Other assets	106,105	113,666
Fair value of derivative instruments	133,010	175,174
 Total assets	 \$ 28,093,137	 27,854,897
Liabilities:		
Bonds and notes payable	\$ 27,130,406	26,787,959
Accrued interest payable	48,076	81,576
Other liabilities	187,379	179,336
Due to customers	55,610	160,985
Fair value of derivative instruments	64	1,815
 Total liabilities	 27,421,535	 27,211,671
Shareholders' equity:		
Preferred stock, \$0.01 par value. Authorized 50,000,000 shares; no shares issued or outstanding		
Common stock:		
Class A, \$0.01 par value. Authorized 600,000,000 shares; issued and outstanding 38,276,870 shares as of March 31, 2009 and 37,794,067	383	378

shares as of December 31, 2008

Class B, convertible, \$0.01 par value. Authorized 60,000,000 shares;

issued and outstanding 11,495,377 shares as of March 31, 2009 and

December 31, 2008

	115	115
Additional paid-in capital	106,678	103,762
Retained earnings	565,976	540,521
Employee notes receivable	(1,550)	(1,550)
Total shareholders' equity	671,602	643,226

Commitments and contingencies

Total liabilities and shareholders' equity	\$ 28,093,137	27,854,897
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See accompanying notes to consolidated financial statements.

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NELNET, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in thousands, except share data)
(unaudited)

	Three months ended March 31,	
	2009	2008
Interest income:		
Loan interest	\$ 170,919	329,986
Investment interest	4,091	11,680
Total interest income	175,010	341,666
Interest expense:		
Interest on bonds and notes payable	146,502	325,141
Net interest income	28,508	16,525
Less provision for loan losses	7,500	5,000
Net interest income after provision for loan losses	21,008	11,525
Other income (expense):		
Loan and guaranty servicing revenue	26,471	24,661
Tuition payment processing and campus commerce revenue	15,538	13,847
Enrollment services revenue	28,771	27,222
Software services revenue	5,705	8,204
Other income	16,862	6,254
Loss on sale of loans	(206)	(47,474)
Derivative market value, foreign currency, and put option adjustments and derivative settlements, net	19,478	(16,598)
Total other income	112,619	16,116
Operating expenses:		
Salaries and benefits	38,226	53,843
Other operating expenses:		
Cost to provide enrollment services	17,793	15,403
Depreciation and amortization	10,083	10,834
Professional and other services	6,077	7,195
Occupancy and communications	5,354	5,841
Postage and distribution	2,868	3,581
Trustee and other debt related fees	2,656	2,390
Advertising and marketing	1,710	1,948
Impairment expense		18,834
Other	7,804	8,968
Total other operating expenses	54,345	74,994

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Total operating expenses	92,571	128,837
Income (loss) before income taxes	41,056	(101,196)
Income tax (expense) benefit	(15,601)	31,371
Net income (loss)	\$ 25,455	(69,825)
Earnings (loss) per share, basic and diluted	\$ 0.52	(1.42)

See accompanying notes to consolidated financial statements.

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NELNET, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME
(LOSS)
(Dollars in thousands, except share data)
(unaudited)

	Preferred stock shares	Common stock Class A	Common stock Class B	Preferred stock	Class A Common stock	Class B Common stock	Additional paid-in capital	Retained earnings	Employee notes receivable	Total shareholders' equity
Balance as of December 31, 2007		37,980,617	11,495,377	\$	380	115	96,185	515,317	(3,118)	608,879
Comprehensive income:										
Net loss								(69,825)		(69,825)
Total comprehensive income (loss)										(69,825)
Cash dividend on Class A and Class B common stock \$0.07 per share								(3,458)		(3,458)
Forfeitures of common stock, net of issuances		(19,780)			(1)		763			762
Compensation expense for stock-based awards							1,415			1,415
Repurchase of common stock		(48,064)					(488)			(488)
Reduction of employee notes receivable									822	822
Balance as of March 31, 2008		37,912,773	11,495,377	\$	379	115	97,875	442,034	(2,296)	538,107
Balance as of December 31, 2008		37,794,067	11,495,377	\$	378	115	103,762	540,521	(1,550)	643,226

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Comprehensive income:									
Net income							25,455		25,455
Total comprehensive income									25,455
Issuance of common stock, net of forfeitures	486,583		5		2,345				2,350
Compensation expense for stock based awards					607				607
Repurchase of common stock	(3,780)				(36)				(36)
Balance as of March 31, 2009	38,276,870	11,495,377	\$	383	115	106,678	565,976	(1,550)	671,602

See accompanying notes to consolidated financial statements.

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NELNET, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)
(unaudited)

	Three months ended March 31,	
	2009	2008
Net income (loss)	\$ 25,455	(69,825)
Adjustments to reconcile income (loss) from continuing operations to net cash provided by operating activities:		
Depreciation and amortization, including loan premiums and deferred origination costs	30,134	38,952
Provision for loan losses	7,500	5,000
Impairment expense		18,834
Derivative market value adjustment	52,122	(36,003)
Foreign currency transaction adjustment	(47,242)	92,937
Proceeds to terminate and/or amend derivative instruments	50	7,547
Payments to terminate and/or amend derivative instruments	(11,760)	
Gain from purchase of unsecured debt	(8,075)	
Loss on sale of loans	206	47,474
Deferred income tax expense (benefit)	1,323	(27,389)
Other non-cash items	1,024	3,437
Decrease in accrued interest receivable	83,563	66,778
(Increase) decrease in accounts receivable	(487)	1,332
Decrease (increase) in other assets	7,236	(11,678)
Decrease in accrued interest payable	(33,500)	(36,706)
Increase (decrease) in other liabilities	2,817	(26,027)
Net cash provided by operating activities	110,366	74,663
Cash flows from investing activities:		
Originations, purchases, and consolidations of student loans, including loan premiums and deferred origination costs	(972,450)	(1,174,366)
Purchases of student loans, including loan premiums, from a related party	(13,803)	(177,788)
Net proceeds from student loan repayments, claims, capitalized interest, participations, and other	734,445	424,315
Proceeds from sale of student loans	125	841,087
Proceeds from sale of student loans to a related party	20,016	
Purchases of property and equipment, net	(62)	(1,350)
Increase in restricted cash and investments, net	(221,240)	(868,391)
Purchases of equity method investments		(1,718)
Business acquisition contingent consideration		(18,000)
Net cash used in investing activities	(452,969)	(976,211)
Cash flows from financing activities:		

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Payments on bonds and notes payable	(620,595)	(550,318)
Proceeds from issuance of bonds and notes payable	1,039,942	1,459,422
(Payments) proceeds from issuance of notes payable due to a related party, net	(21,520)	11,321
Payments of debt issuance costs	(1,448)	(3,184)
Dividends paid		(3,458)
Proceeds from issuance of common stock	118	280
Repurchases of common stock	(36)	(488)
Payments received on employee stock notes receivable		398
Net cash provided by financing activities	396,461	913,973
Net increase in cash and cash equivalents	53,858	12,425
Cash and cash equivalents, beginning of period	189,847	111,746
Cash and cash equivalents, end of period	\$ 243,705	124,171
Supplemental disclosures of cash flow information:		
Interest paid	\$ 177,210	354,904
Income taxes paid, net of refunds	\$ 8,096	5,343

See accompanying notes to consolidated financial statements.

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NELNET, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Information as of March 31, 2009 and for the three months ended
March 31, 2009 and 2008 is unaudited)

(Dollars in thousands, except per share amounts, unless otherwise noted)

1. Basis of Financial Reporting

The accompanying unaudited consolidated financial statements of Nelnet, Inc. and subsidiaries (the Company) as of March 31, 2009 and for the three months ended March 31, 2009 and 2008 have been prepared on the same basis as the audited consolidated financial statements for the year ended December 31, 2008 and, in the opinion of the Company's management, the unaudited consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of results of operations for the interim periods presented. The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Operating results for the three months ended March 31, 2009 are not necessarily indicative of the results for the year ending December 31, 2009. The unaudited consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2008. Certain amounts from 2008 have been reclassified to conform to the current period presentation.

2. Student Loans Receivable and Allowance for Loan Losses

Student loans receivable consisted of the following:

	As of March 31, 2009	As of December 31, 2008
Federally insured loans	\$ 25,055,798	24,787,941
Non-federally insured loans	218,375	273,108
	25,274,173	25,061,049
Unamortized loan premiums and deferred origination costs	398,661	402,881
Allowance for loan losses - federally insured loans	(27,310)	(25,577)
Allowance for loan losses - non-federally insured loans	(21,187)	(25,345)
	\$ 25,624,337	25,413,008

Federally insured allowance as a percentage of ending balance of federally insured loans	0.11%	0.10%
Non-federally insured allowance as a percentage of ending balance of non-federally insured loans	9.70%	9.28%
Total allowance as a percentage of ending balance of total loans	0.19%	0.20%

The Company has provided for an allowance for loan losses related to its student loan portfolio. Activity in the allowance for loan losses is shown below:

	Three months ended March 31, 2009	2008
Beginning balance	\$ 50,922	45,592

Provision for loan losses	7,500	5,000
Loans charged off, net of recoveries	(3,905)	(3,705)
Sale of loans	(6,020)	(750)
Ending balance	\$ 48,497	46,137

Loan Sales

During 2008 and the three months ended March 31, 2009, the Company sold federally insured student loans to third parties in order to reduce the amount of student loans remaining under the Company's multi-year committed financing facility for Federal Family Education Loan Program (FFELP) loans, which reduced the Company's exposure related to certain equity support provisions included in this facility (see note 3 for additional information related to these equity support provisions).

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On March 31, 2008, the Company sold \$857.8 million (par value) of federally insured student loans resulting in the recognition of a loss of \$30.4 million. In addition, on April 8, 2008, the Company sold \$428.6 million (par value) of federally insured student loans. The portfolio of student loans sold on April 8, 2008 was presented as held for sale on the March 31, 2008 consolidated balance sheet and was valued at the lower of cost or fair value. The Company recognized a loss of \$17.1 million during the three month period ended March 31, 2008 as a result of marking these loans to fair value.

On January 29, 2009, the Company sold \$20.0 million (par value) of federally insured student loans to Union Bank & Trust Company (Union Bank), an entity under common control with the Company, resulting in the recognition of a loss of \$0.2 million.

In addition, during the three month period ended March 31, 2009, the Company participated \$50.5 million of non-federally insured loans to third parties. Loans participated under these agreements qualify as sales pursuant to the provisions of Statement of Financial Accounting Standards (SFAS) No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS No. 140). Accordingly, the participation interests sold are not included on the Company's consolidated balance sheet. The loss on the sale of these loans was not material. Per the terms of the servicing agreements, the Company's servicing operations are obligated to repurchase loans subject to the participation interests when such loans become 60 or 90 days delinquent. As of March 31, 2009, the Company has \$5.5 million accrued related to this obligation which is included in other liabilities in the accompanying consolidated balance sheet.

3. Bonds and Notes Payable

The following tables summarize outstanding bonds and notes payable by type of instrument:

	Carrying amount	As of March 31, 2009 Interest rate range		Final maturity	
Variable-rate bonds and notes (a):					
Bonds and notes based on indices	\$ 20,387,802	0.95%	6.90%	09/25/13	06/25/41
Bonds and notes based on auction or remarketing	2,667,635	0.92%	3.75%	11/01/09	07/01/43
Total variable-rate bonds and notes	23,055,437				
Commercial paper FFELP facility (b)	1,369,485	0.41%	1.37%	05/09/10	
Fixed-rate bonds and notes (a)	193,362	5.30%	6.50%	11/01/09	05/01/29
Unsecured fixed rate debt	440,134	5.125% and 7.40%		06/01/10 and 09/15/61	
Unsecured line of credit	691,500	1.04%	1.10%	05/08/12	
Department of Education Participation	1,360,159	3.08%		09/30/09	
Other borrowings	20,329	0.50%	5.10%	01/01/10	11/01/15
	\$ 27,130,406				

	Carrying amount	As of December 31, 2008 Interest rate range		Final maturity	
Variable-rate bonds and notes (a):					
Bonds and notes based on indices	\$ 20,509,073	0.75%	5.02%	09/25/13	06/25/41

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Bonds and notes based on auction or remarketing	2,713,285	0.00%	6.00%	11/01/09	07/01/43
Total variable-rate bonds and notes	23,222,358				
Commercial paper FFELP facility (b)	1,445,327	1.32%	2.94%	05/09/10	
Commercial paper private loan facility (b)	95,020	2.49%		03/14/09	
Fixed-rate bonds and notes (a)	202,096	5.30%	6.68%	11/01/09	05/01/29
Unsecured fixed rate debt	475,000	5.125% and 7.40%		06/01/10 and 09/15/61	
Unsecured line of credit	691,500	0.98%	2.41%	05/08/12	
Department of Education Participation	622,170	3.37%		09/30/09	
Other borrowings	34,488	1.25%	5.47%	05/22/09	11/01/15

\$ 26,787,959

- (a) Issued in
asset-backed
securitizations.
- (b) Loan warehouse
facilities.

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Secured Financing Transactions

The Company has historically relied upon secured financing vehicles as its most significant source of funding for student loans. The net cash flow the Company receives from the securitized student loans generally represents the excess amounts, if any, generated by the underlying student loans over the amounts required to be paid to the bondholders, after deducting servicing fees and any other expenses relating to the securitizations. The Company's rights to cash flow from securitized student loans are subordinate to bondholder interests and may fail to generate any cash flow beyond what is due to bondholders. The Company's secured financing vehicles are loan warehouse facilities, asset-backed securitizations, and the government's Participation Program (as described below).

Most of the bonds and notes payable are primarily secured by the student loans receivable, related accrued interest, and by the amounts on deposit in the accounts established under the respective bond resolutions or financing agreements. The student loan interest margin notes, included in fixed rate bonds and notes in the above tables, are secured by the rights to residual cash flows from certain variable rate bonds and notes and fixed rate notes. Certain variable rate bonds and notes and fixed rate bonds are secured by financial guaranty insurance policies or a letter of credit and reimbursement agreement issued by Municipal Bond Investors Assurance Corporation, Ambac Assurance Corporation, and State Street.

On July 31, 2008, the Company did not renew its liquidity provisions on its FFELP loan warehouse facility. Accordingly, the facility became a term facility and no new loan originations could be funded with this facility. In August 2008, the Company began to fund FFELP student loan originations for the 2008-2009 academic year pursuant to the U.S. Department of Education's Loan Participation Program (Participation Program) and an existing participation agreement with Union Bank.

Loan warehouse facilities

Student loan warehousing has historically allowed the Company to buy and manage student loans prior to transferring them into more permanent financing arrangements. To support its funding needs on a short-term basis, the Company historically relied upon a multi-year committed facility for FFELP loans and a \$250.0 million private loan warehouse for non-federally insured student loans.

FFELP Warehouse Facility

The Company's multi-year committed facility for FFELP loans terminates in May 2010 and was supported by 364-day liquidity which was up for renewal on May 9, 2008. The Company obtained an extension on this renewal until July 31, 2008. On July 31, 2008, the Company did not renew the liquidity provisions of this facility. Accordingly, as of July 31, 2008, the facility became a term facility with a final maturity date of May 9, 2010. Pursuant to the terms of the agreement, since liquidity was not renewed, the Company's cost of financing under this facility increased 10 basis points. The agreement also includes provisions which allow the banks to charge a rate equal to LIBOR plus 128.5 basis points if they choose to finance their portion of the facility with sources of funds other than their commercial paper conduit. As of March 31, 2009, the Company had \$1.2 billion of student loans in the facility and \$1.4 billion borrowed under the facility.

The terms and conditions of the Company's warehouse facility for FFELP loans provides for formula based advance rates based on market conditions. While the Company does not believe that the loan valuation formula is reflective of the actual fair value of its loans, it is subject to compliance with such mark-to-formula provisions of the warehouse facility agreement. As of March 31, 2009, the Company had a cumulative amount of \$206.7 million posted as equity funding support for this facility.

On March 26, 2009, the Company completed a privately placed asset-backed securitization of \$294.6 million. Subsequent to March 31, 2009, the Company used the proceeds from the sale of these notes and additional funds of approximately \$10 million to purchase approximately \$305 million of principal and interest on student loans, which were previously financed under the Company's FFELP warehouse facility, which allowed the Company to withdraw cash posted as equity funding support for the facility. As of May 8, 2009, the Company had \$1.2 billion of student loans in the FFELP warehouse facility, \$1.1 billion borrowed under the facility, and \$96.6 million posted as equity funding support for the facility.

The Company continues to look at various alternatives to remove loans from the warehouse facility including other financing arrangements, using unrestricted operating cash, and/or selling loans to third parties. In addition, in

January 2009, the U.S. Department of Education (the Department) published summary terms under which it will finance eligible FFELP Stafford and PLUS loans in a conduit vehicle established to provide funding for student lenders (the Conduit Program). Loans eligible for the Conduit Program must be first disbursed on or after October 1, 2003, but not later than June 30, 2009, and fully disbursed before September 30, 2009, and meet certain other requirements. Funding for the Conduit Program will be provided by the capital markets at a cost based on market rates. The Conduit Program will have a term of five years. As of May 8, 2009, the Company had approximately \$845 million of loans included in its FFELP warehouse facility that would be eligible for the Conduit Program.

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Private Loan Warehouse Facility

On February 25, 2009, the Company paid \$91.5 million on the outstanding debt of its private loan warehouse facility with operating cash and terminated the facility. Beginning in January 2008, the Company suspended private student loan originations.

Asset-backed securitizations

As part of the Company's issuance of asset-backed securities in March 2008 and May 2008, due to credit market conditions when these notes were issued, the Company purchased the Class B subordinated notes of \$36 million (par value) and \$41 million (par value), respectively. These notes are not included on the Company's consolidated balance sheet. If the credit market conditions improve, the Company anticipates selling these notes to third parties. Upon a sale to third parties, the Company would obtain cash proceeds equal to the market value of the notes on the date of such sale. Upon sale, these notes would be shown as bonds and notes payable on the Company's consolidated balance sheet. Unless there is a significant market improvement, the Company believes the market value of such notes will be less than par value. The difference between the par value and market value would be recognized by the Company as interest expense over the life of the bonds.

Department of Education's Loan Participation and Purchase Commitment Programs

In August 2008, the Department implemented the Loan Purchase Commitment Program (the "Purchase Program") and the Loan Participation Program pursuant to the Ensuring Continued Access to Student Loans Act of 2008 ("ECASLA"). Under the Department's Purchase Program, the Department will purchase loans at a price equal to the sum of (i) par value, (ii) accrued interest, (iii) the one percent origination fee paid to the Department, and (iv) a fixed amount of \$75 per loan. Under the Participation Program, the Department provides interim short term liquidity to FFELP lenders by purchasing participation interests in pools of FFELP loans. FFELP lenders are charged a rate of commercial paper plus 50 basis points on the principal amount of participation interests outstanding. Loans funded under the Participation Program must be either refinanced by the lender or sold to the Department pursuant to the Purchase Program prior to its expiration on September 30, 2009. To be eligible for purchase or participation under the Department's programs, loans were originally limited to FFELP Stafford or PLUS loans made for the academic year 2008-2009, first disbursed between May 1, 2008 and July 1, 2009, with eligible borrower benefits.

On October 7, 2008, legislation was enacted to extend the Department's authority to address FFELP student loans made for the 2009-2010 academic year and allowing for the extension of the Participation Program and Purchase Program from September 30, 2009 to September 30, 2010. The Department indicated that loans for the 2008-2009 academic year which are funded under the Department's Participation Program will need to be refinanced or sold to the Department prior to September 30, 2009. On November 8, 2008, the Department announced the replication of the terms of the Participation and Purchase Program, in accordance with the October 7, 2008 legislation, which will include FFELP student loans made for the 2009-2010 academic year.

As of March 31, 2009, the Company had \$1.4 billion of FFELP loans funded using the Participation Program. The Company plans to continue to use the Participation Program to fund loans originated for the 2008-2009 and 2009-2010 academic years. The Company has not yet determined if it will sell its 2008-2009 academic year loans to the Department under the Purchase Program.

Union Bank Participation Agreement

The Company maintains an agreement with Union Bank, as trustee for various grantor trusts, under which Union Bank has agreed to purchase from the Company participation interests in student loans (the "FFELP Participation Agreement"). The Company has the option to purchase the participation interests from the grantor trusts at the end of a 364-day term upon termination of the participation certificate. As of March 31, 2009 and December 31, 2008, \$784.3 million and \$548.4 million, respectively, of loans were subject to outstanding participation interests held by Union Bank, as trustee, under this agreement. The agreement automatically renews annually and is terminable by either party upon five business days notice. This agreement provides beneficiaries of Union Bank's grantor trusts with access to investments in interests in student loans, while providing liquidity to the Company on a short-term basis. The Company can participate loans to Union Bank to the extent of availability under the grantor trusts, up to \$750 million or an amount in excess of \$750 million if mutually agreed to by both parties. Loans participated under this agreement qualify as a sale pursuant to the provisions of SFAS No. 140. Accordingly, the participation interests

sold are not included on the Company's consolidated balance sheet.

Unsecured Line of Credit

The Company has a \$750.0 million unsecured line of credit that terminates in May 2012. As of March 31, 2009, there was \$691.5 million outstanding on this line. The weighted average interest rate on this line of credit was 1.04% as of March 31, 2009. Upon termination in 2012, there can be no assurance that the Company will be able to maintain this line of credit, find alternative funding, or increase the amount outstanding under the line, if necessary. The lending commitment under the Company's unsecured line of credit is provided by a total of thirteen banks, with no individual bank representing more than 11% of the total lending commitment. The bank lending group includes Lehman Brothers Bank (Lehman), a subsidiary of Lehman Brothers Holdings Inc., which represents approximately 7% of the lending commitment under the line of credit. On September 15, 2008, Lehman Brothers Holdings Inc. filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code. Since the bankruptcy filing, the Company has experienced funding delays from Lehman for its portion of the lending commitment under the line of credit and the Company does not expect Lehman to fund future borrowing requests. As of March 31, 2009, excluding Lehman Bank's lending commitment, the Company has \$51.2 million available for future use under its unsecured line of credit.

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The line of credit agreement contains certain financial covenants that, if not met, lead to an event of default under the agreement. The covenants include maintaining:

A minimum consolidated net worth

A minimum adjusted EBITDA to corporate debt interest (over the last four rolling quarters)

A limitation on subsidiary indebtedness

A limitation on the percentage of non-guaranteed loans in the Company's portfolio

As of March 31, 2009, the Company was in compliance with all of these requirements. Many of these covenants are duplicated in the Company's other lending facilities, including its FFELP warehouse facility.

The Company's operating line of credit does not have any covenants related to unsecured debt ratings. However, changes in the Company's ratings (as well as the amounts the Company borrows) have modest implications on the pricing level at which the Company obtains funding.

Unsecured Fixed Rate Debt

During the first quarter of 2009, the Company purchased \$34.9 million of its 5.125% unsecured fixed rate debt with a maturity date of June 1, 2010 for \$26.8 million. These transactions resulted in a gain of \$8.1 million, which is included in other income on the Company's consolidated statements of operations. (See note 11 for additional unsecured fixed rate debt purchases made by the Company subsequent to March 31, 2009).

4. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are interest rate risk and foreign currency exchange risk.

Interest Rate Risk

The Company's primary market risk exposure arises from fluctuations in its borrowing and lending rates, the spread between which could impact the Company due to shifts in market interest rates. Because the Company generates a significant portion of its earnings from its student loan spread, the interest rate sensitivity of the balance sheet is a key profitability driver. The Company has adopted a policy of periodically reviewing the mismatch related to the interest rate characteristics of its assets and liabilities together with the Company's outlook as to current and future market conditions. Based on those factors, the Company uses derivative instruments as part of its overall risk management strategy.

The Company issues asset-backed securities, the vast majority being variable rate, to fund its student loan assets. The variable rate debt is generally indexed to 3-month LIBOR, set by auction, or through a remarketing process. The income generated by the Company's student loan assets is generally driven by short term indices (treasury bills, commercial paper, and certain fixed rates) that are different from those which affect the Company's liabilities (generally LIBOR), which creates basis risk. Moreover, the Company also faces repricing risk due to the timing of the interest rate resets on its liabilities, which may occur as infrequently as every quarter, and the timing of the interest rate resets on its assets, which generally occurs daily. In a declining interest rate environment, this may cause the Company's student loan spread to compress, while in a rising rate environment, it may cause the spread to increase.

In using different index types and different index reset frequencies to fund assets, the Company is exposed to interest rate risk in the form of basis risk and repricing risk, which, as noted above, is the risk that the different indices may reset at different frequencies, or will not move in the same direction or with the same magnitude. While these indices are short term with rate movements that are highly correlated over a longer period of time, they have recently become less correlated. There can be no assurance the indices will regain their high level of correlation in the future due to capital market dislocations or other factors not within the Company's control.

The Company has used derivative instruments to hedge the repricing risk due to the timing of the interest rate resets on its assets and liabilities. The Company has entered into basis swaps in which the Company (i) receives three-month LIBOR set discretely in advance and pays a daily weighted average three-month LIBOR less a spread as defined in the individual agreements (the "Average/Discrete Basis Swaps"); and (ii) receives three-month LIBOR and pays one-month LIBOR less a spread as defined in the agreements (the "1/3 Basis Swaps").

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However, the Company does not generally hedge the basis risk due to the different interest rate indices associated with its assets and liabilities since the derivatives needed to hedge this risk are generally illiquid or non-existent and the relationship between the indices for most of the Company's assets and liabilities has been highly correlated over a long period of time. Recently, the spread has widened and may widen further, which has and may continue to have a significant impact on the net spread of the Company's student loan portfolio.

As of March 31, 2009, the Company had approximately \$23.9 billion of FFELP loans indexed to three-month financial commercial paper rate and \$20.4 billion of debt indexed to LIBOR. Due to the unintended consequences of government intervention in the commercial paper markets and limited issuances of qualifying financial commercial paper, the relationship between the three-month financial CP and LIBOR rates has been distorted and volatile. To address this issue, the Department announced that for purposes of calculating the FFELP loan index from October 27, 2008 to December 31, 2008, the Federal Reserve's Commercial Paper Funding Facility rate was used for those days in which no three-month financial commercial paper rate was available. This action partially mitigated the volatility between CP and LIBOR during the fourth quarter of 2008. However, the Department did not implement a similar methodology for the first quarter of 2009, which negatively impacted the Company's interest income earned on its student loan portfolio.

The following table summarizes the Company's basis swaps outstanding as of March 31, 2009 and December 31, 2008 used by the Company to hedge the repricing risk due to the timing of the interest rate resets on its assets and liabilities.

Maturity	As of March 31, 2009	
	Average/Discrete	Notional Amount
	Basis Swaps	1/3 Basis Swaps
2009	\$ 1,350,000	
2011 (a)	6,000,000	
2018		1,300,000
2019		500,000
2021		250,000
2023		1,250,000
2024		250,000
2028		100,000
	\$ 7,350,000	3,650,000

(a) Certain of these derivatives have forward effective start dates of January 2010 (\$1.5 billion), February 2010 (\$1.5 billion), and March 2010 (\$1.5 billion).

Maturity	As of December 31, 2008	
	Average/Discrete	1/3 Basis Swaps
	Basis Swaps	
2010	\$ 4,500,000	
2011	2,700,000	
2012	2,400,000	
2018		1,300,000
2023		1,250,000
2028		100,000
	\$ 9,600,000	2,650,000

During the three months ended March 31, 2009, the Company terminated and/or amended certain basis swap agreements for net payments of \$11.7 million.

Table of Contents***Foreign Currency Exchange Risk***

During 2006, the Company completed separate debt offerings of student loan asset-backed securities that included 420.5 million and 352.7 million Euro-denominated notes (the Euro Notes) with interest rates based on a spread to the EURIBOR index. As a result of this transaction, the Company is exposed to market risk related to fluctuations in foreign currency exchange rates between the U.S. dollar and Euro. The principal and accrued interest on these notes is re-measured at each reporting period and recorded on the Company's balance sheet in U.S. dollars based on the foreign currency exchange rate on that date. Changes in the principal and accrued interest amounts as a result of foreign currency exchange rate fluctuations are included in the derivative market value, foreign currency, and put option adjustments and derivative settlements, net in the Company's consolidated statements of operations.

The Company entered into cross-currency interest rate swaps in connection with the issuance of the Euro Notes. Under the terms of these derivative instrument agreements, the Company receives from a counterparty a spread to the EURIBOR index based on notional amounts of 420.5 million and 352.7 million and pays a spread to the LIBOR index based on notional amounts of \$500.0 million and \$450.0 million, respectively. In addition, under the terms of these agreements, all principal payments on the Euro Notes will effectively be paid at the exchange rate in effect as of the issuance of the notes.

For the three months ended March 31, 2009, the Company recorded income of \$47.2 million as a result of re-measurement of the Euro Notes and a loss of \$57.1 million for the change in the fair value of the related derivative instruments. For the three months ended March 31, 2008, the Company recorded a loss of \$92.9 million as a result of the re-measurement of the Euro Notes and income of \$94.1 million for the change in the fair value of the related derivative instruments.

The re-measurement of the Euro-denominated bonds correlates with the change in fair value of the cross-currency interest rate swaps. However, the Company will experience unrealized gains or losses related to the cross-currency interest rate swaps if the two underlying indices (and related forward curve) do not move in parallel. Management intends to hold the cross-currency interest rate swaps through the maturity of the Euro-denominated bonds.

Accounting for Derivative Financial Instruments

The Company accounts for derivative instruments under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133), which requires that every derivative instrument be recorded on the balance sheet as either an asset or liability measured at its fair value. Management has structured all of the Company's derivative transactions with the intent that each is economically effective; however, the Company's derivative instruments do not qualify for hedge accounting under SFAS No. 133. As a result, the change in fair value of derivative instruments is recorded in the consolidated statements of operations at each reporting date. Changes or shifts in the forward yield curve and fluctuations in currency rates can significantly impact the valuation of the Company's derivatives. Accordingly, changes or shifts to the forward yield curve and fluctuations in currency rates will impact the financial position and results of operations of the Company. The change in fair value of the Company's derivatives are included in derivative market value, foreign currency, and put option adjustments and derivative settlements, net in the Company's consolidated statements of operations and resulted in an expense of \$52.1 million for the three months ended March 31, 2009 and income of \$36.0 million for the three months ended March 31, 2008.

Upon termination of a derivative instrument, any proceeds received or payments made by the Company are included in derivative market value, foreign currency, and put option adjustments and derivative settlements, net on the consolidated statements of operations and are accounted for as a change in fair value on such derivative.

The following table summarizes the fair value of the Company's derivatives not designated as hedging instruments under SFAS No. 133:

Asset derivatives		Liability derivatives	
Fair value	Fair value as of	Fair value as of	Fair value as of
as of	December 31,	March	December 31,
March 31,	2008	31, 2009	2008
2009			

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Average/discrete basis swaps	\$ 761	2,817	(31)	(1,800)
1/3 basis swaps	22,039	5,037	(33)	(15)
Cross-currency interest rate swaps	110,210	167,320		
 Total	 \$ 133,010	 175,174	 (64)	 (1,815)

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The following table summarizes the effect of derivative instruments in the consolidated statements of operations. All gains and losses recognized in income related to the Company's derivative activity are included in Derivative market value, foreign currency, and put option adjustments and derivative settlements, net, on the consolidated statements of operations.

Derivatives not designated as hedging under SFAS No. 133	Amount of gain (or loss) recognized in income on derivatives	
	Three months ended March 31	
	2009	2008
Settlements:		
Interest rate swaps	\$	(3,177)
Average/discrete basis swaps	10,022	39,573
1/3 basis swaps	10,744	884
Cross-currency interest rate swaps	3,592	3,483
Total settlements	24,358	40,763
Change in fair value:		
Interest rate swaps		(34,871)
Average/discrete basis swaps	(286)	(26,289)
1/3 basis swaps	5,274	2,568
Cross-currency interest rate swaps	(57,110)	94,129
Other		466
Total change in fair value	(52,122)	36,003
Total impact to statements of operations	\$ (27,764)	76,766

Derivative Instruments Credit and Market Risk

By using derivative instruments, the Company is exposed to credit and market risk.

When the fair value of a derivative instrument is negative, the Company would owe the counterparty if the derivative was settled and, therefore, has no immediate credit risk. Additionally, if the negative fair value of derivatives with a counterparty exceeds a specified threshold, the Company may have to make a collateral deposit with the counterparty. The threshold at which the Company posts collateral may depend on the Company's unsecured credit rating. If interest and foreign currency exchange rates move materially, the Company could be required to deposit a significant amount of collateral with its derivative instrument counterparties. The collateral deposits, if significant, could negatively impact the Company's capital resources.

When the fair value of a derivative contract is positive, this generally indicates that the counterparty would owe the Company if the derivative was settled. If the counterparty fails to perform, credit risk with such counterparty is equal to the extent of the fair value gain in the derivative less any collateral held by the Company.

The Company attempts to manage market and credit risks associated with interest and foreign currency exchange rates by establishing and monitoring limits as to the types and degree of risk that may be undertaken, and by entering into transactions with high-quality counterparties that are reviewed periodically by the Company's risk committee. The Company also has a policy of requiring that all derivative contracts be governed by an International Swaps and Derivatives Association, Inc. Master Agreement.

5. Segment Reporting

The Company has five operating segments as defined in SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS No. 131), as follows: Student Loan and Guaranty Servicing, Tuition Payment Processing and Campus Commerce, Enrollment Services, Software and Technical Services, and Asset Generation and Management. The Company's operating segments are defined by the products and services they offer or the types of customers they serve, and they reflect the manner in which financial information is currently evaluated by management. The accounting policies of the Company's operating segments are the same as those described in the summary of significant accounting policies. Intersegment revenues are charged by a segment to another segment that provides the product or service. Intersegment revenues and expenses are included within each segment consistent with the income statement presentation provided to management. Changes in management structure or allocation methodologies and procedures may result in changes in reported segment financial information.

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The management reporting process measures the performance of the Company's operating segments based on the management structure of the Company as well as the methodology used by management to evaluate performance and allocate resources. Management, including the Company's chief operating decision maker, evaluates the performance of the Company's operating segments based on their profitability. As discussed further below, management measures the profitability of the Company's operating segments based on base net income. Accordingly, information regarding the Company's operating segments is provided based on base net income. The Company's base net income is not a defined term within generally accepted accounting principles (GAAP) and may not be comparable to similarly titled measures reported by other companies. Unlike financial accounting, there is no comprehensive, authoritative guidance for management reporting.

Historically, the Company generated the majority of its revenue from net interest income earned in its Asset Generation and Management operating segment. In recent years, the Company has made several acquisitions that have expanded the Company's products and services and has diversified its revenue primarily from fee-based businesses. The Company currently offers a broad range of pre-college, in-college, and post-college products and services to students, families, schools, and financial institutions. These products and services help students and families plan and pay for their education and students plan their careers. The Company's products and services are designed to simplify the education planning and financing process and are focused on providing value to students, families, and schools throughout the education life cycle. The Company continues to diversify its sources of revenue, including those generated from businesses that are not dependent upon government programs, thereby reducing legislative and political risk.

Fee-Based Operating Segments**Student Loan and Guaranty Servicing**

The Student Loan and Guaranty Servicing segment provides for the servicing of the Company's student loan portfolios and the portfolios of third parties and servicing provided to guaranty agencies. The servicing and business process outsourcing activities include loan origination activities, application processing, borrower updates, payment processing, due diligence procedures, and claim processing. These activities are performed internally for the Company's portfolio in addition to generating fee revenue when performed for third-party clients. The guaranty servicing, servicing support, and business process outsourcing activities include providing software and data center services, borrower and loan updates, default aversion tracking services, claim processing services, and post-default collection services to guaranty agencies. The following are the primary product and service offerings the Company offers as part of its Student Loan and Guaranty Servicing segment:

- Origination and servicing of FFELP loans

- Origination and servicing of non-federally insured student loans

- Servicing and support outsourcing for guaranty agencies

Tuition Payment Processing and Campus Commerce

The Tuition Payment Processing and Campus Commerce segment provides products and services to help institutions and education-seeking families manage the payment of education costs during the pre-college and college stages of the education life cycle. The Company provides actively managed tuition payment solutions, online payment processing, detailed information reporting, financial needs analysis, and data integration services to K-12 and higher educational institutions, families, and students. In addition, the Company provides customer-focused electronic transactions, information sharing, and account and bill presentment to colleges and universities.

Enrollment Services

The Enrollment Services segment offers products and services that are focused on helping (i) students plan and prepare for life after high school (content management and publishing and editing services) and (ii) colleges recruit and retain students (lead generation and recruitment services). Content management products and services include online courses, admissions consulting, licensing of scholarship data, and call center services. Publishing and editing services include test preparation study guides and essay and resume editing services. Lead generation products and services include vendor lead management services and admissions lead generation. Recruitment services include pay per click marketing management, email marketing, and list marketing services.

Software and Technical Services

The Software and Technical Services segment provides information technology products and full-service technical consulting, with core areas of business in educational loan software solutions, business intelligence, technical consulting services, and Enterprise Content Management solutions.

Asset Generation and Management Operating Segment

The Asset Generation and Management segment includes the acquisition, management, and ownership of the Company's student loan assets. Revenues are primarily generated from the Company's earnings from the spread, referred to as the Company's student loan spread, between the yield received on the student loan portfolio and the costs associated with originating, acquiring, and financing its student loan portfolio. The Company generates student loan assets through direct origination or through acquisitions. The student loan assets are held in a series of education lending subsidiaries designed specifically for this purpose. In addition to the student loan portfolio, all costs and activity associated with the generation of assets, funding of those assets, and maintenance of the debt transactions are included in this segment. This includes derivative activity and the related derivative market value and foreign currency adjustments. The Company is also able to leverage its capital market expertise by providing investment advisory services and other related services to third parties through a licensed broker dealer subsidiary. Revenues and expenses for those functions are also included in the Asset Generation and Management segment.

Table of Contents***Segment Operating Results Base Net Income***

The tables below include the operating results of each of the Company's operating segments. Management, including the chief operating decision maker, evaluates the Company on certain non-GAAP performance measures that the Company refers to as "base net income" for each operating segment. While "base net income" is not a substitute for reported results under GAAP, the Company relies on "base net income" to manage each operating segment because it believes this measure provides additional information regarding the operational and performance indicators that are most closely assessed by management.

"Base net income" is the primary financial performance measure used by management to develop the Company's financial plans, track results, and establish corporate performance targets and incentive compensation. Management believes this information provides additional insight into the financial performance of the core business activities of the Company's operating segments. Accordingly, the tables presented below reflect "base net income," which is the operating measure reviewed and utilized by management to manage the business. Reconciliation of the segment totals to the Company's operating results in accordance with GAAP are also included in the tables below.

Segment Results and Reconciliations to GAAP

Three months ended March 31, 2009									
	Fee-Based							Base net income	
	Student Loan and Guaranty Servicing	Tuition Payment Processing and Campus Commerce	Software and Technical Services	Total Fee-Based	Asset Generation and Management	Corporate Activity and Overhead	Eliminations and Reclassifications	Adjustments to GAAP Results	GAAP Results of Operations
Total interest income	\$ 66	30		96	172,587	1,427	(560)	1,460	175,010
Interest expense					138,594	8,468	(560)		146,502
Net interest income (loss)	66	30		96	33,993	(7,041)		1,460	28,508
Less provision for loan losses					7,500				7,500
Net interest income (loss) after provision for loan losses	66	30		96	26,493	(7,041)		1,460	21,008
Other income (expense):									
Loan and guaranty	26,853			26,853		(382)			26,471

servicing										
revenue										
Tuition										
payment										
processing										
and campus										
commerce										
revenue		15,538			15,538					15,538
Enrollment										
services										
revenue			28,771		28,771					28,771
Software										
services										
revenue	875			4,830	5,705					5,705
Other										
income	112				112	4,651	12,099			16,862
Loss on sale										
of loans						(206)				(206)
Intersegment										
revenue	19,878	57		3,124	23,059		8,921	(31,980)		
Derivative										
market value,										
foreign										
currency, and										
put option										
adjustments									(4,880)	(4,880)
Derivative										
settlements,										
net						24,358				24,358
Total other										
income										
(expense)	47,718	15,595	28,771	7,954	100,038	28,803	20,638	(31,980)	(4,880)	112,619

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