**Creating a financial crisis**

Michael Lewis has suggested that the financial crisis can be tied back to a single event—when Salomon Brothers went public in the mid-1980s. By going public, the partners transferred risk from themselves to their shareholders. Consequently, management accepted too much leverage and risk and became too focused on short-term results. More and more finance companies eventually went public, increasing their tolerance for risk and shifting their risk to shareholders.

This argument for the cause of the financial crisis makes sense. However, many additional factors came together to create an environment in which the financial world became overleveraged and then collapsed:

Stock options and short-term focus. For many years, companies could give executives stock options that were not expensed. This overstated earnings and created an incentive for management to pump up short-term earnings and hype the stock to increase stock prices in the short term.

Gain-on-sale accounting. By selling loan assets so they are not held on the balance sheet, lenders record the gain before it has been earned over the life of the loan. These gains exaggerated earnings in the year of sale but were based on assumptions about future interest rates, basis risk, default rates, and other variables that turned out in many cases to be incorrect, creating massive losses for banks and finance companies.

Mark-to-market accounting. Losses from gain-on-sale accounting were magnified by mark-to-market accounting, which requires financial institutions to value assets based on what someone will pay for those assets today—right now—without regard to the net present value of the expected future cash flows from the assets. When the market is irrational, the mark-to-market provisions only magnify the mania and panic.

I recently visited a small town where the number of houses for sale increased from 20 to 60 in less than a year. If you required all of the homeowners to mark the value of their houses based on what someone would pay for them today, in cash, they would be lucky to get 10 percent of the real value. This illustrates how the mark-to-market provisions are magnifying the problem. Irrationally marking performing assets below their discounted cash flow is depleting the stated capital in financial institutions and is now having a broad effect on the economy because banks are lending much less. This is true even with the support of the Troubled Asset Relief Program (TARP) money and other government support programs. Fortunately, the accounting industry and federal regulators have studied mark-to-market accounting and have offered recommendations, which may help address some of these issues.

**Improving liquidity proactively**

Nelnet has not issued stock options and does not use gain-on-sale accounting, which is consistent with our conservative approach and long-term focus. This conservative approach helped us through the financial crisis that broadly impacted the student loan industry as the ability to finance student loans in the asset-backed securitization market became difficult and eventually went away.

This had a significant effect on us as we began 2008 with over $7 billion of student loans in our federal student loan warehouse facility. Through securitizations early in the year and asset sales, we significantly reduced this amount to $1.6 billion by the end of the year. In addition, approximately $1.1 billion of the loans still in the warehouse facility are eligible for federal programs being developed as I write this letter. These actions have improved our liquidity and helped to substantially increase the amount of unrestricted cash and assets being held by the company. Nelnet has also been one of a very few finance companies to consistently be profitable through this financial crisis.
Transforming our company

Nelnet is making a transformation from a vertically integrated financing company to a horizontally structured company focused on providing education-related processing services. Several years ago, we initiated the transformation with a diversification strategy into fee-based education services to reduce our reliance on the net interest margin on student loans. Our strategy has been very successful. In 2008, almost 50 percent of our total revenue and close to 40 percent of our adjusted base net income came from fee-based businesses, which is up from only 22 percent and 20 percent, respectively, in 2004.

Nelnet Business Solutions (NBS). Tim Tewes, David King, and their teams at NBS had an outstanding year. They set up tuition payment plans for more than 600 new K-12 schools. In total, they now serve approximately 4,200 K-12 private and faith-based institutions. In addition, NBS campus commerce services, including tuition payment plans and automated billing and payment processing, are used by more than 600 higher education institutions.

Nelnet Enrollment Solutions (NES). John Kline, Todd Eicher, and their teams at NES showed a 26 percent increase in content management and lead generation revenue as they transformed their business from a traditional paper-based subscription and printing company to an electronic and online business model. This allows our customers to pay for the results they want to achieve and generates recurring revenue for NES.

Nelnet Loan Services. The Loan Services teams did an outstanding job collaborating to streamline our student loan businesses. There are very few student loan financing and servicing companies that were as proactive and aggressive as Nelnet in reducing their cost structure to function in the new student loan world. In a little over a year, on a run rate basis, we have decreased our year-over-year expenses by approximately $75 million while maintaining effective customer service levels.

Making federal student loans

Many people and areas within the federal government need to be commended for their foresight to make certain that American families have access to federal student loans. The Departments of Education and Treasury, the White House, Chairman Kennedy, Chairman Miller, and all of their teams worked tirelessly to pass legislation and develop effective and efficient programs that prevented a disaster in education finance. The result has been a remarkable success—lenders like Nelnet have now been able to commit to making federal student loans to all eligible students with the support of the Department of Education’s programs through the 2009-2010 academic year.

Now more than ever, however, we believe a public-private partnership, in some form, is necessary to efficiently deliver federal student loans. If all federal student loans are funded with government debt instead of private capital, it would add more than $1 trillion to our nation’s debt in less than a decade. Given the stimulus funding that is going to be needed in our economy, it is not logical to also add all student loans to the national debt.

I have confidence that by working together with all stakeholders and by thinking outside the box on how to leverage the strengths of the public-private partnership, we will be able to find a way to serve families well while minimizing the impact on our national debt and taxpayers.

*Adjusted base net income is GAAP net income excluding derivative market value, foreign currency, and put option adjustments, amortization of intangible assets, compensation related to business combinations, variable-rate floor income, discontinued operations, the special allowance yield adjustment on certain loans that earned a minimum yield of 9.5% and derivative settlements used to hedge this portfolio, and certain legislative, restructuring, and liquidity related charges. A description of base net income and a reconciliation of GAAP net income to adjusted base net income can be found in supplemental financial information online at www.nelnetinvestors.com.

*Operating expenses exclude certain legislative, restructuring, and liquidity related charges.
Focusing on 2009

In 2009, our transformation to a fee-based processing company will continue. We are excited about the progress we have made toward this goal and want you to know that it will not change our vision and core values: focus on customers, create an environment in which associates can do what they do best, build a diversified education services company, give back to our communities, and maintain open, honest communication.

To push the transition in 2009, we will focus on meeting the following objectives:

- Growing and diversifying our fee-based businesses
- Repositioning our asset generation business
- Continuing to reduce operating costs, specifically IT infrastructure
- Maximizing the value of our existing student loan portfolio
- Reducing our liquidity exposure
- Reducing our unfunded debt burden

Believing in fundamental value

I have included my perspective on fundamental value in all of our annual reports as a public company. As I hope you know, I feel strongly about this concept and reiterate it below:

We believe in conservative and transparent accounting policies. We do not use gain-on-sale accounting. Rather, we record all assets and liabilities on our balance sheet. This is both transparent and conservative because it does not result in the frontloading of revenues. We recognize income as it is generated, and thus, there is no residual risk associated with the figures reported on our income statement or residuals included in our equity on our balance sheet.

It is our goal for each Nelnet shareholder to record a gain or loss in market value proportional to the gain or loss in per-share fundamental value recorded by the company. To achieve this goal, we will strive to maintain a one-to-one relationship between the company’s fundamental value and the market price.

As that implies, we would rather see Nelnet’s stock price at a fair level than at an inflated level. Our fair value approach may not be preferred by all investors, but we believe it aligns with our long-term approach to both our business model and market value.

We will communicate our value measurements in several ways, including through the annual report, quarterly filings, and our annual shareholders’ meeting. We will also issue press releases or other forms of communication regarding business developments as appropriate throughout the year.

We will not lose sight of our fundamental value. Fundamental value is the concept by which we encourage our shareholders to evaluate their investment in Nelnet over the long term. It is the estimated value of cash that can be taken out of a business during its remaining life. Due to the subjective nature of deriving fundamental value, we will not force our estimates on investors through quarterly guidance but will supply, as noted above, the information we believe is critical to our value calculation.

Thanking our associates

When everything goes well, it is easy to thank people; when things don’t go so right, it is easy to point fingers. Although 2008 was probably the toughest year of my career, it was also one of the most rewarding because I saw our teams collaborate to transform Nelnet into one of the finest and financially strong education processing companies in the country. I want to thank all of our associates across all of our business lines—their hard work and dedication to our customers was absolutely amazing.

Sincerely,

Mike Dunlap
Chairman and Chief Executive Officer