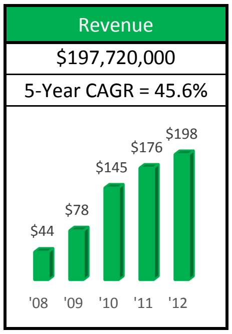
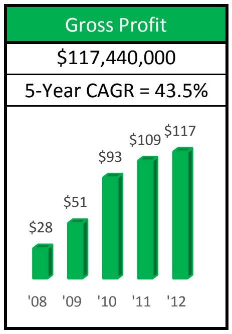
SELECTIVE
WEALTH MANAGEMENT

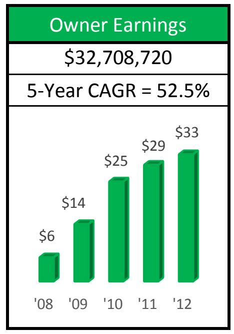
Higher One
August 27, 2013

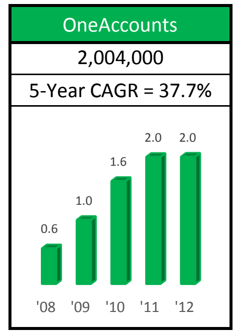
General Overview

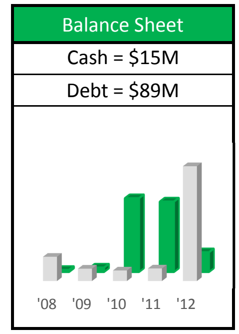
Higher One is a leading provider of technology-based refund disbursement, payment processing and data analytics services to higher education facilities across the United States. The company processes student loan refunds very efficiently and generates the majority of all revenue from interchange fees on student debit cards – much like a bank. In the last 5 years the business has seen sensational growth which validates the strong value proposition offered to higher education facilities and students.











Purchase Logic

Higher One provides loan disbursement services to higher education institutions. When reimbursements occur they offer the student the option to have their funds deposited in the student's bank account or a OneAccount. If a student opens a OneAccount every transaction that occurs using their Higher One Debit card creates revenue for Higher One. This is the primary way they generate income. Our favorite element of this business model is that the party responsible for selecting the service is different from the party responsible for paying for the service. This removes all pricing pressure. Here is how this situation occurs:

Higher education institutions are responsible for selecting how to process student loans. This is a very easy sell for Higher One because they can remove all administrative costs associated with processing student loans at almost no cost to the institution. Once the institution selects Higher One as their loan processor students can elect to have a OneAccount or use their current banking account; with about 50% of all students selecting the OneAccount. Higher One then gets paid from the students for various fees charged to the OneAccount and from interchange fees that occur using the debit card, which means the students and merchants are paying for the service Higher One provides, whereas the higher education institutions are the ones selecting the service.

Now, we weren't the only ones that noticed this disconnect. Regulators also took noticed and stepped in and changed how much Higher One could charge for various fees on their OneAccounts. After this change in regulation there were two things that needed to be evaluated prior to investing: 1) Are students being treated fairly when they open a OneAccount? and 2) How much money will Higher One make under the new rules?

We calculated that the fees charged to students would total roughly $4 per month based on ATM transactions, overdrafts, etc. and would actually be significantly less for students that were responsible with their Higher One debit card. It was very comparable, if not superior, to having a debit card with a bank. We also calculated that after the fee adjustments Higher One would be earning at least $30 million per year. After all the revisions to their business model we were delighted to buy Higher One at roughly 11 times.

Problem & Solution

Problem

Colleges receive student loan money from lenders and the government and excess funds must be refunded or distributed to students. Students use the refunded money to pay for school and living expenses. There is a lot of regulatory and administrative work that goes into identifying every student's loan disbursement preference.

Solution

Higher One handles all administrative and regulatory aspects of the loan disbursement process, including customer service. The college gathers the refund information and sends it to Higher One, the College or University wires the total disbursement amount to Higher One, Higher One then disburses the refunds based on preference and handles all exceptions and customer service.

Products & Services

They offer refund disbursement, payment processing, and data analytics services to higher education institutions and students.

OneDisburse

They help disburse reimbursement loans to save institutions money. The OneDisburse can be combined with the campus ID for an ATM debit card combined into the campus ID. They also offer payroll for schools.

CashNet Payment Suite

This is a software-as-a-service product that can be purchased separately or as a bundle. E-payment allows higher education facilities to accept online payments for tuition, charges and fees from student via credit card, pinless debit or via ACH. This transfers the cost from the institution to the payers. E-bill allows higher education institutions to automate payer billing and processing functions. It expedites the processing, authorization, and receipt of student payments. eMarket allows higher education institutions to provide their academic, athletic, and other departments with Internet e-commerce storefronts.

Campus Labs Data Analytics Suite

The Campus Labs includes compliance assist that is a fully integrated and comprehensive solution for managing institutional research, planning and accreditation needs. Baseline is used to collect and coordinate assessment data for the purposes of improving the student experience. It allows campuses to measure learning, document student involvement, and inform strategic directions. CollegiateLink provides tools for managing student organizations. Beacon helps institutions utilize student data in supporting student success. Beacon can help identify resources for at-risk students through a series of campus wide surveys. Course Evaluation platform helps faculty and administrators with advance evaluation tools for reporting capabilities.

The OneAccount

Provides students, faculty, staff, and alumni with FDIC-insured online checking accounts. For students, there is no monthly fee and no minimum balance requirement. In 2012 they issued a $3.95 monthly fee, which can be waived by having a minimum monthly direct deposit of $100, for non-student accountholders. As of December 31, 2012 there were 2.0 million OneAccounts.

Customers

Their customers are higher education institutions and students. For Higher Education Institutions they offer OneDisburse Refund Management that handles the loan disbursement process for students. As of December 31, 2012 there were more than 600 campuses serving more than 4.6 million students using the OneDisburse service.

Distribution

The Higher Education Institutions are solicited over pro-longed periods through phone conversations, in-person presentations and formal proposals to various levels of administrators. It's a long process to get in, but once you're in - you're in.

They distribute to students once a relationship is established with the Higher Education Institution.

Revenue Creation

They generate revenue directly or indirectly based on academic financial aid received by students. The second quarter, which is from April to June, represents the smallest portion of revenues.

A substantial portion of their revenue is generated from interchange fees, ATM fees, non-sufficient funds fees, and other banking service fees. Convenience fees are charged to students, paretners, or other payers who make online payments to higher education clients through SmartPay. These convenience fees made up substantially all of the payment transaction revenue.

The OneDisburse income is generated by the number of financial aid disbursements that are made to students. The more students the higher the revenue.

The primary source of revenue is generated from the use of OneAccounts. The primary factor that impacts revenue is the number of active OneAccounts, which is significantly affected by the total number of students enrolled at the higher education institutional clients that utilize the OneDisburse service. The revenue comes from fees that are charged for the transactions that they facilitate for the higher education clients and their banking customers. The fees are charged on a per transaction basis and transaction volumes significantly affect their revenue growth.

Account Revenue – They generate 76% of their revenue from OneAccounts. They earn revenue based on the interchange fees and account service fees, which include things such as foreign ATM fees and non-sufficient fund fees. The interchange fees are paid by the merchants and not the students or institutions. They have been under a lot of scrutiny lately. They earn wire transfers, replacing lost debit cards, processing international transactions, processing stop payment requests, over-the-counter cash withdrawals, or issuing official checks and electronic bill pay features. The revenue per OneAccount was historically stable, but some changes to the fee schedule began to reduce it.

Payment Transaction Revenue – They generate 12% of their revenue from convenience fees charged to students, parents or other payers who established payment plans to make tuition payments.

Higher Education Institution Revenue – They generate 11% of their revenue from fees charged for products and services purchased from Higher One. They charge annual subscription fees based on the size of the student population, a per-transaction fee, a combination of both.

Other Revenue – They generate 1% of their revenue from a marketing incentive fee paid by MasterCard for new debit card issuances and processing fees paid by the bank partners based on total amount of deposits held in the OneAccounts and prevailing interest rates.

Expenses

Employee compensation and related expenses are the largest single expense. Other costs include outsource managed hosting, data processing, ATM-related expenses, professional services, office lease payments, travel and amortization. They pay data processing expenses, interchange expenses, customer service expenses. General and administrative expenses include finance, legal, compliance, facility, administration costs, data center costs for the information technology. Product development is a large cost and is related to employee compensation. Sales and marketing.

Real Income

Stock options are certainly real expenses and should not be added back in. They are pretty dilutive in their compensation practices, but the very large recent buyback has muted the pain (at the expense of a lot of new debt).

Their reported income is in line with their cumulative total spend and debt. If you look at the cap ex vs. depreciation expenses the cap ex has outpaced the depreciation and amortization considerably. I am going to make no adjustments to their net income, upwards or downwards, to more closely model economic reality.

Growth

They intend to grow by expanding the number of contracted higher education institutions, increasing OneAccount usage, cross-selling existing products, and extending their product and services. With 2700 4-year colleges and 1,721 2-year colleges there is significant room to add additional schools. I believe the cross-selling of products is also a legitimate means of growth. In the near term there is pressure from the ballooning student population that came from the financial crisis, but in the long-term growth for high education should remain flat or slightly positive. Going to college, I believe, is a good thing and will continue.

One primary concern for growth is if the Federal Government no longer uses higher education institutions as the intermediaries – in which case having a third party process loan disbursements wouldn't be required.

Consolidated Balance Sheet

They have $112 million in borrowings under their credit facility at 2.2%. This represents interest of $2.4 million. They can borrow up to $200 million with a $100 million increase upon request for a total of $300 million. They must maintain an EBITDA of at least $50 million, funded debt to EBITDA of at least 2.5 to 1.00 or less and 2.00 to 1.00 or less after December 31, 2014. They also have $9.3 million in Notes and Loans. The interest rate is equal to LIBOR + 1.75% to 2.25%.

The accounts receivable are payments due from Bank Partners for fees that need to be remitted and Higher Education Institutions. The accrued expenses are related to compensation, bank and payment processing expenses, data processing, and other. The larger accrued expenses from 2011 was related to the construction of their new facility.

The deferred or unearned revenue is from pre-paid subscription fees and implementation fees assessed for the various products. The implementation fee is realized over the life of the customer relationship, which is estimated to be 5 years. This seems obviously a short time frame given the 98% retention rate for client services.

Accounting Quality

The accounting quality is not as clean as a lot of firms due to the required judgments necessary in recognizing revenue (It's not a Point of Sale business). They need to set aside a provision for operational losses because they pay for items when clients have insufficient funds in their account and then charge and overdraft fee on those accounts. The stock compensation expenses are granted with an expiration ten years out. Much of the stock compensation bonuses were paid to employees that joined the company and then could be periodically rewarded.

Legal

They are the defendant in several putative class action lawsuits. The lawsuits allege violations of state consumer protection statutes predicated on alleged violations of Department of Education rules and violations of the federal Electronic Funds Transfer Act.

There is a lot of regulation in the industry, which includes:

- Title IV of the Higher Education Act of 1965, or Title IV;
- The Family Educational Rights and Privacy Act of 1975, or FERPA;
- The Electronic Fund Transfer Act and Regulation E;
- The USA Patriot Act and related anti-money laundering requirements; and
- Certain federal rules regarding safeguarding personal information, including rules implementing the privacy provisions of Gramm-Leach-Bliley Act of 1999, or GLBA.

They charged delinquent accounts too frequently and illegally. In 2011 they started to provide credits to current and former customers. I believe this has been resolved and the fee structure modified appropriately for continuing operations.

Market

They currently serve 1,600 higher education schools in the United States. There are 1,721 2-year colleges and 2,774 4-year colleges in the US. They have room to grow base on the assumptions used in our spreadsheet – without cross selling of new products.

I assumed 5% growth over the next decade, which is achievable through cross-selling and continue contract wins in the higher education space.

Allocation of Capital

They have allocated a significant portion to share repurchases and acquisitions in the last two years. The acquisitions were Campus Solutions from Sallie Mae for $47 million and Campus Labs, LLC for an unknown amount. Campus Labs generated $4.0 million in revenue and Campus Solutions generated $6.2 million in revenue during the six months ended June 30, 2013.

Conclusion

Higher One Holdings makes the majority of their money servicing OneAccounts. They receive fees for all types of activity, in particular interchange fees, when their students use their cards. The number of OneAccounts continues to rise at a healthy rate. The revenue per account took a major hit when they eliminated a few of the fees, but apart from this restructuring, the revenue per account per year is historically flat. I believe the number of OneAccounts will continue to rise, this is an excellent service for Higher Education Institutions. They also have a great cross-selling opportunity going forward. We are estimating an increase in revenue and income of 6% per year based on the cross-selling opportunity and the continued increasing OneAccounts.

They seem to be solid at repurchasing shares. One danger, however, is the large debt level. They currently have $112 million in debt on a variable rate. The current rate is 2.2%, when rates rise they will need to pay this down or it will take a serious bite out of income. Every 100 bps will reduce income by nearly 3%. Additional borrowing would be a potential signal for us to sell.

With 1,600 higher education institutions that disburse student loans through the Higher One platform I believe their income will be very stable for many years to come.

Disclaimer

No part of this document is to be reproduced without our written permission. This document has been prepared and issued by Selective Wealth Management ("SWM") on the basis of publicly available information, internally developed data and other sources believed to be reliable. The information contained herein is not guaranteed, does not claim to be comprehensive and is strictly for informational purposes only. SWM does not assume any liability for any direct, indirect or consequential loss that may result from the reliance by any person upon any such information or opinions. Any expressions of opinions are subject to change without notice. This document does not constitute an offer or an invitation to trade or invest. No party should treat any of the contents herein as advice. Investing contains risks.