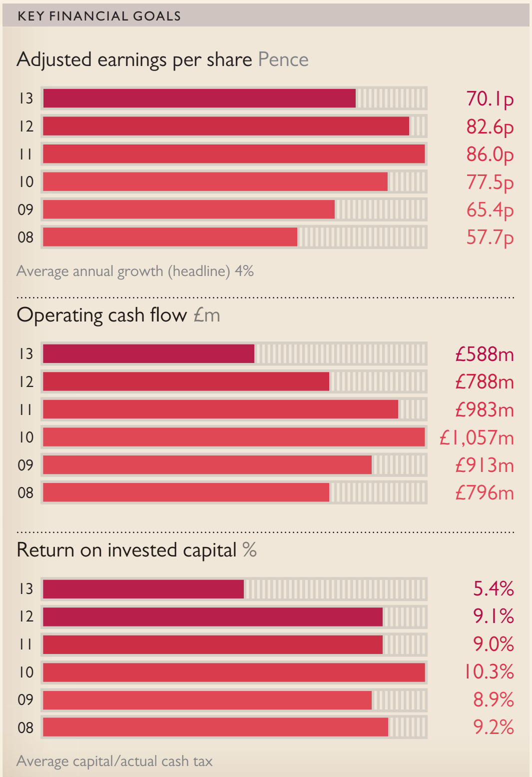
Our performance: 2013 financial overview

Robin Freestone, Chief financial officer of Pearson

In 2013, Pearson increased sales by 2% in headline terms to £5.2bn generating adjusted operating profit of £736m after net restructuring charges.



Penguin Random House was reported post-tax following completion of the transaction on 1 July 2013 and resulted in a £23m reduction in the contribution to operating income with an equal benefit to our tax charge. We expensed £135m of net restructuring charges during the year. Adjusted operating profit including the negative impact of Penguin Random House associate accounting but excluding the restructuring charges was £871m.

The headline growth rates were helped by both currency movements and acquisitions. Currency movements increased sales by £19m (with a £50m benefit primarily from a stronger dollar partly offset by a £31m reduction from non-dollar currency depreciation relative to sterling, primarily in emerging markets) but reduced operating profits by £4m (with an £8m benefit from a stronger dollar more than offset by a £12m reduction from non-dollar currency depreciation). At constant exchange rates (i.e. stripping out the impact of those currency movements), our sales and adjusted operating profit grew 2% and declined 21%, respectively.

Acquisitions contributed £119m to sales and £50m to operating profits. This includes integration costs and investments related to our newly-acquired companies, which we expense. Disposals and our exit from Pearson in Practice reduced revenues by £49m but boosted operating income by £23m. Associate accounting arising from the Penguin Random House transaction reduced operating income by £23m.

Stripping out the impact of portfolio changes, the Penguin Random House transaction, net restructuring costs and benefit and currency movements, revenues grew by 1% underlying while adjusted operating profit declined by 9%.

Our tax rate in 2013 was 14.6% compared to 23.1% in 2012 reflecting the associate accounting impact from Penguin Random House and movements in tax settlements in each year.

Adjusted earnings per share before the impact of net restructuring charges were 83.4p (2012: 82.6p). Total adjusted earnings per share after net restructuring charges were 70.1p.

Our performance: 2013 financial overview continued

Cash generation

Headline operating cash flow declined by £200m reflecting restructuring and increased investment in new education programmes. Free cash flow declined by £388m to £269m, additionally reflecting higher tax payments. Our average working capital to sales ratio improved by a further 0.4 percentage points to 13.4%, helped by lower inventory levels and the absence of Penguin in the second half of the year.

Return on invested capital

Our return on average invested capital was 5.4% (2012: 9.1%). ROIC was affected by lower underlying profit, restructuring costs and higher cash taxes.

Statutory results

Our statutory results show a decrease of £29m in operating profit to £458m, from £487m in 2012, reflecting the absence in 2013 of the £113m closure-related costs for Pearson in Practice in 2012, lower underlying profits and restructuring costs. Basic earnings per share increased to 66.6p in 2013, up from 38.7p in 2012, mainly due to the Penguin Random House transaction.

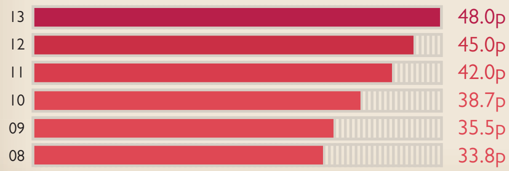
Balance sheet

Our net debt increased to £1,379m (£918m in 2012) reflecting higher cash tax payments from settlements and deferred payments from 2012 due to Hurricane Sandy, lower cash conversion, costs associated with disposals, restructuring costs and increased pre-publication investment. Since 2000, Pearson's net debt/EBITDA ratio has fallen from 3.9x to 1.6x and our interest cover has increased from 3.1x to 10.2x.

Dividend

The board is proposing a dividend increase of 7% to 48.0p, subject to shareholder approval. 2013 will be Pearson's 22nd straight year of increasing our dividend above the rate of inflation. Over the past 10 years we have increased our dividend at a compound annual rate of 7%, returning more than £2.9bn to shareholders. We have a progressive dividend policy: we intend to build our dividend cover to around 2.0x over the long term, increasing our dividend more in line with earnings growth from then.

Dividend per share paid in fiscal year Pence



Outlook 2014

In 2014, we will continue the major restructuring and product investment programme, initiated in 2013, designed to accelerate Pearson's shift towards significant growth opportunities in digital, services and fast-growing economies. We believe this will provide Pearson with a significantly larger market opportunity, a sharper focus on the fastest-growing markets and stronger financial returns.

This restructuring coincides with continued structural, cyclical and policy-related pressures in some of our largest markets. At this early stage in the year, we expect to report adjusted earnings per share of between 62p and 67p in 2014. This guidance incorporates our expected trading environment, restructuring activity and product investment. This guidance also assumes current sterling exchange rates against the dollar and key emerging market currencies.

The major factors behind our guidance are as follows:

Portfolio changes

The sale of Mergermarket to BC Partners was completed on 4 February 2014 and will reduce 2014 adjusted operating profit before central costs by £28m. This will be partly offset by a part-year contribution from Grupo Multi, which will be diluted by integration costs and the weakness of the Real against sterling.

We expect the contribution to adjusted operating profit from Penguin Random House to be approximately £20m lower in 2014 compared to the £78m contribution in 2013. That reflects currency movements, integration charges (which will be concentrated in the first half of 2014) and an additional half-year of associate accounting.

Currency movements

Pearson generates approximately 60% of its sales in the US. A five cent move in the average £:$ exchange rate for the full year (which in 2013 was £1:$1.57) has an impact of approximately 1.2p on adjusted earnings per share. The move from an average £/$ exchange rate of 1.57 in 2013 to the rate at the end of February of 1.67 will reduce operating income by approximately £30m if it continues for the full year. Similarly, when compared to 2013 average exchange rates, Sterling has significantly appreciated against a range of non-dollar currencies, primarily in emerging markets. If current exchange rates for those markets persist throughout 2014, that would reduce operating income on our 2013 base business by a further £20m.

Restructuring and investment programme

We will benefit from the absence of £176m of gross restructuring charges expensed in 2013, which we expect to generate £60m of incremental cost savings in 2014.

These benefits will be partly offset by an additional net restructuring charge of approximately £50m in 2014, primarily in North America and weighted towards the first half of the year. Our goal is to complete our restructuring programme by the end of 2014, returning to more normal annual levels of restructuring expenditure from 2015.

As previously announced, we expect additional product investment of approximately £50m in 2014 in digital, services and emerging markets to accelerate growth.

Trading conditions

We expect trading conditions to remain challenging in 2014, reflecting:

In North America, our largest market, we expect college enrolments to decline again and some states to defer assessment programmes as they transition to the Common Core State Standards. Though we expect the School publishing market to show some improvement, we expect the benefits to be largely offset by higher revenue deferrals and pre-publication amortisation. We expect margins to be lower in 2014 when compared to 2013, reflecting the above organic outlook, revenue mix, launch costs for major multi-year service-based contracts, higher amortisation and new product development expenditure.

In our Core markets (which include the UK and Australia), we see tough trading conditions in the UK as curriculum change affects school, vocational publishing and assessments, market stabilisation in Australia, and a new adoption year in Italy.

In our Growth markets (which include Brazil, China, India and South Africa), we expect continued growth in China with Brazil benefitting from a better year in public sistemas and a part-year contribution from Grupo Multi. We expect a slower year in South Africa after strong gains in 2013.

Looking at our global Lines of Business, we expect School and Higher Education to remain challenging, especially in our two largest markets, North America and the UK. In Professional, we expect continued good growth in Pearson VUE and English with the *Financial Times* continuing to benefit from its digital transition.

Interest and tax

We expect our interest charge to be similar to 2013 reflecting higher floating rates broadly offset by a weaker dollar against sterling. We expect a tax rate of between 19% and 21% on our total profit before tax (which includes the post-tax contribution from Penguin Random House).

As Pearson's structure has changed to better suit our marketplace and aspirations, so must our financial reporting change. In this year's annual report, we discuss the progress made through the lens of our existing financial reporting segments (North American Education, International Education, Professional and the Financial Times Group). We will report our 2014 revenues and operating profit against new segments that better reflect the shape of our business; these will be by Geography (North America, Core and Growth) and by Line of Business (School, Higher Education and Professional).

We will make available historical 2013 half-year and full-year revenues and operating profit by Line of Business and Geography in the second quarter of 2014.

Creating personalised products and services that meet learners' needs and deliver measurable results

North American Education

KEY PERFORMANCE INDICATORS

North American Education is Pearson's largest business, with 2013 sales of £2.8bn and operating profit of £406m.

Sales	
2013	£2,779m
2012	£2,658m
Headline growth	5%
CER growth	3%
Underlying growth	0%

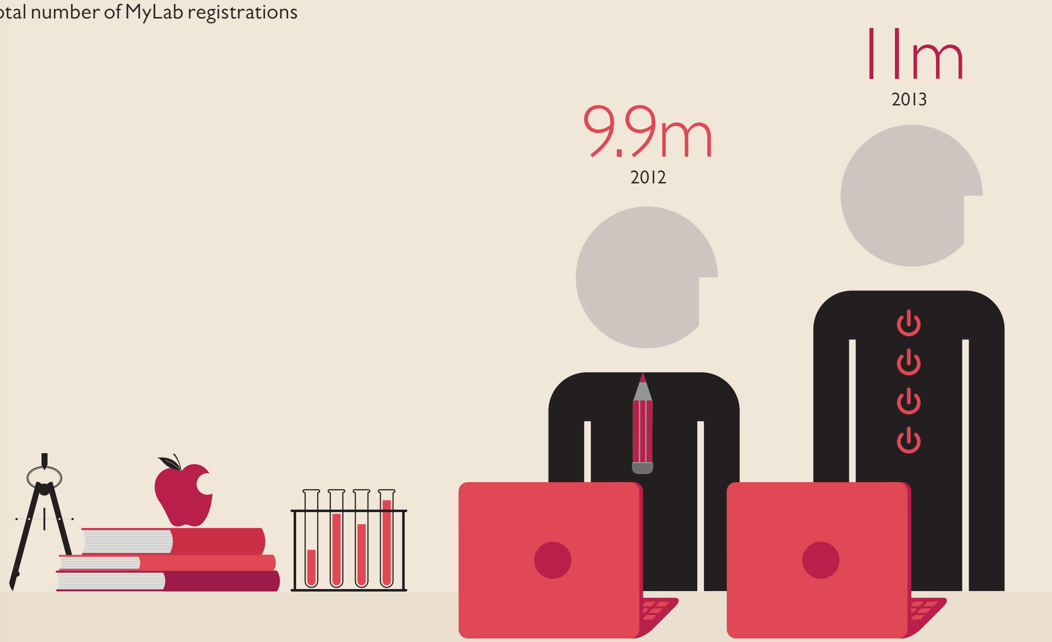
Adjusted operating profit	
2013	£406m
2012	£536m
Headline growth	(24)%
CER growth	(25)%
Underlying growth	(30)%

CASE STUDY

Online learning

We introduced adaptive learning capabilities in over 200 MyLab and Mastering products across 11 subjects. Student registrations in North America grew 9% to almost 11 million. Usage continues to grow strongly with graded submissions up 15% to almost 370 million across the globe. Evaluation studies show that the use of MyLab programmes, as part of a broader course redesign, can significantly improve student test scores and institutional efficiency (http://bit.ly/1derVjm). We acquired Learning Catalytics, which allows faculty to obtain real-time responses to open-ended or critical thinking questions, to determine which areas require further explanation, and enables earlier intervention to help improve retention and outcomes.

Total number of MyLab registrations



North American Education
continued

In 2013, we generated good growth in our digital and services businesses, where we continue to invest to build scale and volume and solid growth in our school curriculum business, which benefited from Common Core curriculum purchasing. Market conditions remained tough, with ongoing state budget pressures and the transition to the Common Core affecting our School assessment business. Lower enrolments affected Higher Education with the career college enrolments, where we have a strong market position, being particularly weak. In addition to these market pressures, our North American margins were further affected by £49m of net restructuring charges, reduced demand in our assessment business as states prepared for new Common Core testing and curriculum related investment and amortisation, the launch costs related to major multi-year service-based contracts in higher education, and increased returns provisions.

Higher Education highlights in 2013 include:

› In Higher Education, total enrolments fell 1.9%, with career enrolments in two-year public (community) and four-year for-profit declining 4.4%, affected by rising employment rates, state budget pressures and regulatory change affecting the for-profit and developmental learning sectors. The publishing market was broadly level with 2012 on a gross basis, according to the Association of American Publishers, while our higher education revenues grew 5% with an underlying decline more than offset by the contribution from Embanet.

› We partnered with West Virginia University Parkersburg Online to redesign its Developmental Education curriculum using Competency-Based Education (CBE) modules. Our CourseConnect CBE products will enhance up to 220 existing courses and will be delivered through OpenClass where we will also provide access to eTextbooks, tutoring and media resources. Other CBE partnerships include Texas A&M University-Commerce, South Texas College, Kentucky Community & Technical College System and Northern Arizona University.

School highlights in 2013 include:

› For our School businesses, state funding pressures, the Federal sequester and the transition to Common Core assessments continued to make market conditions tough. Revenues grew modestly in 2013 with declines in state assessment contracts and learning assessments more than offset by gains in national assessment contracts for the PARCC consortium and the federal government's NAEP programme, as well as demand for Connections Education's virtual charter schools and Common Core reading/language arts and math programmes.

› Actionable data is critical to personalising learning and boosting achievement. Our Schoolnet business aligns assessment, curriculum and other services to help individualise instruction and improve teacher effectiveness. PowerSchool helps teachers automate and manage student attendance records, gradebooks and timetables.

› Schoolnet won significant contracts including two new Race to the Top State Instructional Improvement System contracts in New York and New Jersey, which takes the total number of state system contracts to seven; and new district contracts for Schoolnet assessment, educator development and learning management solutions in Dallas, Texas; Palm Beach, Florida; Philadelphia, Pennsylvania; and New York City. PowerSchool won new contracts in Charlotte-Mecklenberg, North Carolina; Grand Erie DSB, Ontario; and San Diego, California. Its mobile app connecting teachers, students and parents was downloaded by almost 3.4 million users. PowerSchool now supports almost 13 million students (in 70 countries), up more than 5% on 2012 while Schoolnet supports more than nine million students, up 7% on 2012.

CASE STUDY

Online learning programmes

Enterprise-wide partnerships with Arizona State University Online, Ocean Community College, Indiana Wesleyan University and Rutgers, where we run fully online learning programmes and earn revenues based on the success of the students and the institution, gained more than 64,000 student registrations, up 45% on 2012. In January 2014, we extended our partnership with the University of Florida to include both its graduate and under graduate programmes providing technology, e-Textbooks, recruitment marketing, enrolment management, student support and retention services.

Pearson Embanet increased new student enrolments by 8% to almost 12,000 and total student enrolment by 6.5% to more than 27,000; adding 16 new programmes, launching three new key academic partners with Adelphi University, Villanova University and University of Maryland; and expanding partnerships with existing customers such as Maryville and Northeastern. More than 200 colleges are working with Pearson to build online learning programmes that improve access to high quality undergraduate and graduate degree programmes.

North American Education
continued

- The Partnership for Assessment of Readiness for College and Careers (PARCC), a consortium of 18 states, awarded Pearson several contracts to deliver test item tryouts, develop field tests and to provide the online delivery platform using our cloud-based, mobile-ready TestNav 8 system for new English and mathematics assessments. The assessments will be based on what students need to be ready for college and careers, and will measure and track their progress along the way. We helped Kentucky and New York deliver the first Common Core aligned state assessments, and we won new online assessment programmes in Colorado, Minnesota and Mississippi. We continued to produce strong growth in secure online testing. We delivered almost 12 million secure online tests, up 33% on 2012. Legislative changes in Texas and California reduced the scope of assessments ahead of Common Core implementation.
- We renewed our contract with the US Department of Education to administer the National Assessment of Educational Progress (NAEP) for the 2013–2017 assessment cycles and won a number of state contract extensions in Georgia, Puerto Rico, Tennessee, Maryland, Arizona, South Dakota and Oklahoma. We were selected by the National Board of Professional Teaching Standards (NBPTS) as their partner to develop their next-generation programmes, and deliver and support NBPTS through 2025.
- ACT Aspire, a college and career readiness assessment aligned to the Common Core State Standards, successfully launched its first field test on the new TestNav 8 assessment system. ACT Aspire is a joint venture between Pearson and ACT, Inc. Alabama is the first state to adopt the ACT Aspire system for measuring the Common Core State Standards.
- Connections Education, which operates K-12 managed virtual public schools, managed blended public schools, and a private school, served almost 51,000 students in December 2013, up more than 20% from 2012, and now operates 33 managed public schools in 23 states and an international private virtual school. Connections Education also provides virtual and blended services to school districts and other schools seeking to incorporate virtual learning into their programmes. Connections Academy Schools have consistently high performance ratings, particularly in states focused on measuring growth in student learning.

CASE STUDY

Mental health administration

Pearson Clinical Assessment launched Q-interactive, a portable digital tool that enables mental health professionals to automatically manage the administration of clinical assessments, digital stimuli, response recording through stylus notes and audio. It serves 1,500 users within hospitals, private practice, and schools in five countries (US, UK, Australia, Canada and Netherlands). Paid test administrations have increased ten-fold since launch.

CASE STUDY

Learning Services

In Learning Services, we performed well in new adoptions, taking a market leading 33% of the total new adoption market ($390m), with #1 positions in maths, science and social studies and a #2 position in Reading/Language Arts. We were selected by the two largest school districts in the US, Los Angeles Unified School District and New York City, to implement Common Core instructional programmes. New York City adopted our new K-5 Common Core English Language Arts programme, Ready Gen, and our middle school math offering, Connected Math. In Los Angeles Unified School District, we partnered with Apple to deliver our innovative next generation digital learning Common Core System of Courses across K-12 Mathematics and English Language Arts, initially to 30,000 students. In both districts, we are providing professional development to thousands of teachers. Learners using our OnRamp to Algebra supplemental programme, which targets struggling maths students, significantly out-gained peers using other supplemental maths programmes, achieving 20% increase in their percentile rank while their peers increased by only 3%. In addition, students of all ability levels using OnRamp to Algebra exceeded the gains of their peers.

International Education

KEY PERFORMANCE INDICATORS

Our International Education business achieved another strong underlying performance in emerging markets, particularly in South Africa and China.

Sales

2013	£1,539m
2012	£1,568m
Headline growth	(2)%
CER growth	0%
Underlying growth	1%

Adjusted operating profit

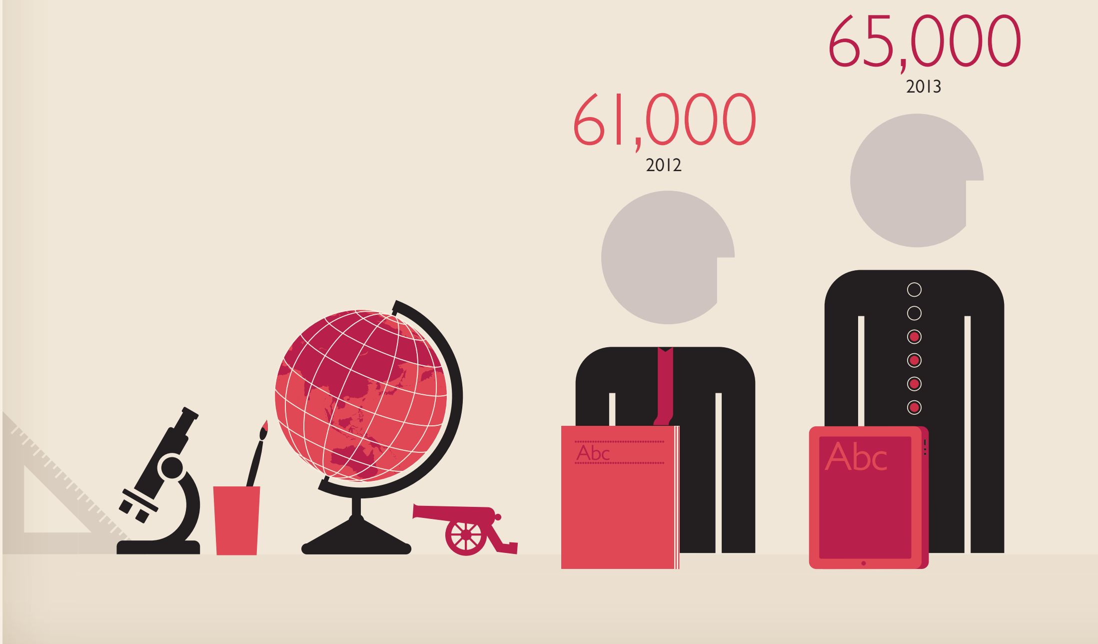
2013	£140m
2012	£214m
Headline growth	(35)%
CER growth	(29)%
Underlying growth	(30)%

CASE STUDY

China

In China, student enrolments at Wall Street English increased 7% to 65,000, boosted by good underlying demand. Our students rapidly acquire high-level English skills with average grade levels achieved rising by 14% during 2013. Enrolments at Global Education, our test preparation services for English language and vocational qualifications, increased 24% to more than 1.3 million, through 82 owned and 426 franchised learning centres with investment in learning centres and digital learning platforms enabling us to better meet learner demands and be a premier brand in test preparation. Around 70% of the high-end course students achieve IELTS 7.0 which demonstrates a high level of proficiency in English and a key grade when studying abroad.

Wall Street English student enrolments in China



Our International education business achieved another strong underlying performance in emerging markets, particularly in South Africa and China. This growth was offset by weak textbook sales in developed markets; currency weakness against sterling; the exit from certain publishing businesses primarily in Australia, Japan, Germany, France and the UK; increased customisation resulting from the Kirtsaeng ruling in the US; and policy changes affecting qualifications and textbook publishing in the UK. Although margins before restructuring charges were similar to 2012, reported margins fell due to £69m of net restructuring charges expensed during the year. More than 1.3 million students registered for our MyLab digital learning, homework and assessment programmes, an increase of 17%, with good growth in school, ELT and institutional selling in higher education.

Key highlights in 2013 include:

- Our Growth market revenues expanded strongly, boosted by curriculum change in South Africa, strong enrolment growth at CTI/MGI, and continued good growth in China; partly offset by weaker currencies against sterling, particularly in South Africa and enrolment declines in our public sistemas in Brazil.
- In Mexico, our fully accredited online university partnership, UTEL, reached 6,000 active students in 20 undergraduate and two graduate programmes and through its services arm, Scala, signed its first three agreements to help campus-based universities make the transition to online. 5,400 students have completed short duration courses in programmes developed to address corporate and government workforce training needs.
- In the Middle East, we won a five-year contract with the UAE's Ministry of Education to provide leadership training and professional development for 700 current and future Emirati school principals, in partnership with the UK's National College for Teaching and Leadership. We partnered with: Taibah University in Saudi Arabia to implement Foundation Level MyLabsPlus across four subjects for 16,000 students; Riyadh's Princess Noura University in Saudi Arabia, the world's largest female university, to provide 12,000 new students with IT course content (through our MyLabs e-learning technology) for tablets; and Qatar University to implement MyLabsPlus for 5,000 students.

CASE STUDY

In South Africa our market leading school publishing brands, Maskew Miller Longman and Heinemann, performed strongly in a year of significant curriculum reform. Student enrolments grew strongly at CTI/MGI, our universities, up 15% to 11,700 across 13 campuses.

- Our Core market revenues declined significantly, affected by curriculum change in the UK and the exit from publishing operations in Australia, Japan and Continental Europe.
- In the UK, revenues declined due to a softer school curriculum and vocational qualifications (BTEC) market anticipating curriculum change. This was partly offset by a strong performance in the GCSE and A/AS level qualifications market. In higher education, we partnered with Leeds Metropolitan University to develop a suite of online learning business education courses. In assessment, we marked almost six million GCSE, A/AS Level and other examinations with more than 93% using onscreen technology. We marked 2.7 million test scripts for over half a million pupils taking National Curriculum Tests at Key Stage Two in 2013 and were selected to administer the test until 2016. 2013 also saw the first delivery of the Next generation BTEC qualifications to over 100,000 students, with a further 365,000 students to date enrolled for 2014/15 delivery.

International Education
continued

- In Italy, revenues declined, with market conditions tough due to a one-year government mandated pause in new adoptions.
- In Japan, GlobalEnglish and the FT partnered with Nikkei Inc on a 'GlobalEnglish Nikkei edition', an English language learning service to serve English students in the Japanese business community. We sold our school textbook publishing business, Kirihara Shoten, to management.
- In Australia, market conditions were very tough, particularly in higher education where we exited the vocational publishing market. We continue to make good progress developing our digital and services business including significant sales of Secondary School Australian Curriculum ebooks. In higher education, we partnered with Monash University with an enterprise implementation of the MyLab suite of products for 6,500 students including faculty training, and to provide learning services and solutions for online graduate programmes including course development, marketing, student recruitment and retention, and faculty training.
- In English Language Learning, Wall Street English (WSE), Pearson's worldwide chain of English language centres for professionals, opened a new centre in Ho Chi Minh City in Vietnam (and is now present in 28 countries), and has 107 owned and 338 franchised centres. Our students rapidly acquire high-level English skills with average grade levels achieved rising by 8% during 2013. Student numbers grew slightly to 192,000. Registered users for ELL digital products grew 45% to 610,000 with MyEnglishLabs registrations up 51% to 400,000 and Our Discovery Island registrations, an online adventure aimed at Primary education, up almost 77% to 104,000.

CASE STUDY

Brazil

In Brazil, we ended 2013 with 497,000 students (533,000 in 2012) in our public and private sistemas (or learning systems). In 2013, we added 24,000 net students in our three private sistemas, COC, Dom Bosco and Pueri Domus, up 7% on 2012. Tough market conditions for public sistemas resulted in lower enrolments in this post-election year but our NAME sistema includes the #1 performing lower secondary school in Brazil based on the 2011 IDEB (national public test) scores of 3,067 municipalities. 90% of our municipal customers tested 20% above the national standard and 70% of the municipalities that adopted NAME showed improvement in their IDEB scores. On 11 February 2014 we completed the acquisition of Grupo Multi, the largest provider of private language schools in Brazil serving over 800,000 students across more than 2,600 franchised schools.

Professional Education

KEY PERFORMANCE INDICATORS

Our Professional Education business is focused on publishing, training, testing and certification for professionals.

Sales

2013	£410m
2012	£390m
Headline growth	5%
CER growth	4%
Underlying growth	8%

Adjusted operating profit

2013	£57m
2012	£37m
Headline growth	54%
CER growth	51%
Underlying growth	(7)%

Our Professional Education business is focused on publishing, training, testing and certification for professionals. The Professional division performed well, with good revenue and profit growth in testing and training partly offset by declines in publishing.

Key highlights in 2013 include:

- Professional publishing revenues and profits declined, with good profit growth in the US, underpinned by a strong performance in our direct ecommerce sales and at Safari Books Online, our joint-venture with O'Reilly Media, offset by exiting some of our professional publishing businesses in Continental Europe.
- Professional testing continued to see good revenue and profit growth test volumes at Pearson VUE up 25% on 2012 to almost 12 million. Key contract renewals included tests for the American Board of Internal Medicine, the Association of Social Work Boards and the Pharmacy Technician Certification Board. We will continue to deliver our UK contract to administer the Driving Theory test for the DVSA until September 2016. We won a number of new contracts for computer-based testing including the Charter of Financial Analysts, Saudi Commission of Health Specialties and the Korean Productivity Centre.

CASE STUDY

Vocational training in Saudi Arabia

In Professional training, TQ grew strongly and was awarded a five-year contract by Saudi Arabia's Colleges of Excellence to develop and operate three vocational colleges in Saudi Arabia, providing high quality vocational skills and qualifications. The three colleges opened in the second half of 2013 with an expected initial intake of 1,100 students, rising to 8,000 students over time.

Financial Times Group

KEY PERFORMANCE INDICATORS

The Financial Times Group achieved profits of £55m, an underlying increase of 17% year-on-year.

Sales

2013	£449m
2012	£443m
Headline growth	1%
CER growth	0%
Underlying growth	0%

Adjusted operating profit

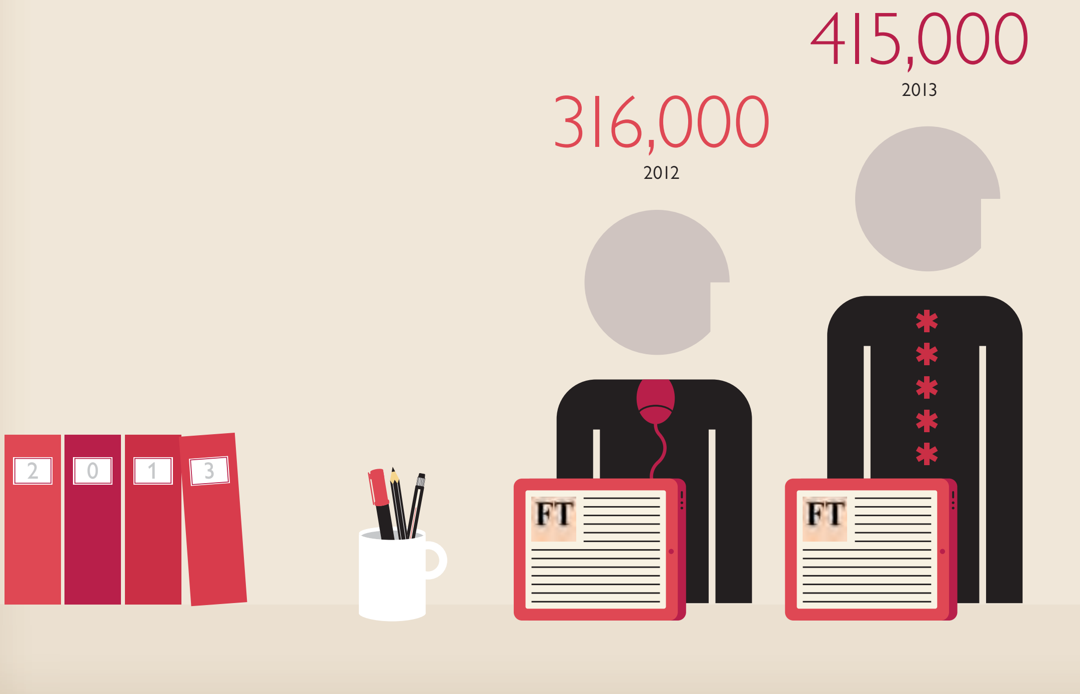
2013	£55m
2012	£47m
Headline growth	17%
CER growth	17%
Underlying growth	17%

CASE STUDY

Growth in digital readership

The FT's total circulation grew 8% year-on-year to 652,000 across print and online, the highest paying readership in its 125-year history. FT.com digital subscriptions grew 31% to 415,000, more than offsetting planned reductions in print circulation. Digital subscribers now represent almost two-thirds of the FT's total paying audience and corporate users grew nearly 60% to more than 260,000. We continue to invest to shift resources from analogue to digital and have further reduced leased printing capacity globally since 31 December 2012 from 20 to 16 sites.

Financial Times digital subscriptions



The Financial Times Group achieved profits of £55m, an underlying increase of 17% year-on-year. This was driven by strong growth in digital and content businesses and improved print circulation margins which more than offset weak advertising. Digital and services revenues accounted for 55% of FT Group revenues (31% in 2008). Content revenues comprised 63% of revenues (48% in 2008), while advertising accounted for 37% of FT Group revenues (52% in 2008).

Key highlights in 2013 include:

- Advertising continued to be short term and generally weak, but the FT increased its market share with luxury and financial sectors showing good growth in digital.
- Mobile is an increasingly important channel for the FT, driving 62% of subscriber consumption, 45% of total traffic and almost a quarter of new digital subscriptions. The FT's flagship web app now has more than 5 million users and new FT apps on Google Newsstand and Flipboard have strengthened our mobile offering. Other innovations, including launching 24-hour news service fastFT, redesigns to mobile apps and improvements to FT.com, have helped significantly increase overall digital engagement.
- The Economist Group, in which Pearson owns a 50% stake, had a record operating profit after tax, up 3% on 2012. Content revenues accounted for 60% of total revenues (44% in 2008) and digital and services revenues comprised 39% of total revenues (29% in 2010). Global print and digital circulation at *The Economist* reached a record high of 1.6 million.
- On 4 February 2014, we completed the disposal of Mergermarket to BC Partners for £382m, payable in cash. In 2013, Mergermarket contributed £108m of revenue and £28m of adjusted operating profit before central costs.

CASE STUDY

Executive education

The FT continues to expand its executive education business. FT in Education products, including annotation tool FT Newslines, are now used by almost 300 education institutions, including 37 of the world's top 50 business schools. The FT launched its Non-Executive Director (NED) Diploma in Hong Kong. More than a third of NED enrolments are now outside the UK.

Penguin Random House

The merger of Penguin and Random House was completed on 1 July 2013. Bertelsmann owns 53% and Pearson owns 47% of Penguin Random House, the first truly global consumer publishing company.

PENGUIN RANDOM HOUSE

Penguin Random House traded well in the second half of the year, with a strong bestseller performance in all major territories. Penguin Random House was reported post-tax following completion of the merger on 1 July 2013 and resulted in a £23m reduction in the contribution to our operating income with an equal benefit to our tax charge. Market share normalised, following the unprecedented success of E L James' *50 Shades of Grey* trilogy for Random House in 2012.

The integration of the two companies has commenced in each of its territories. Divisional structures are being combined, systems integration is underway, and the US business has announced a plan to consolidate distribution operations.

Key highlights in 2013 include:

› In Australia, where market conditions remain challenging, we had four out of the top five bestsellers for the year: Jeff Kinney's *Hard Luck: Diary of a Wimpy Kid;* Jamie Oliver's *Jamie's 15 Minute Meals* and *Save with Jamie;* and Dan Brown's *Inferno.*

› In Brazil, Companhia das Letras (45% stake) posted strong revenue growth driven by an expanded publishing program. In a challenging market, Penguin Random House India had more than 40 titles pro forma on the 2013 Hindustan Times Nielsen top ten in combined categories. In China, our local-publishing programme continued to grow, with notable bestsellers, including *My Life* by Li Na. DK achieved significant growth through its co-edition model with Chinese publishers. In South Africa, Penguin Random House completed the purchase of the Times Media Group's majority stake in Random House Struik, cementing our market leading position, but lost a significant agency contract during the year.

› DK performed well, boosted by the exceptional performance of Brady Games® GTA V Strategy Guide™, which sold over 800,000 copies, and the ongoing success of the DK LEGO® properties, which sold almost 10 million units in 2013.

› The pro forma ebook share of Penguin Random House global revenue is 20%. Ebook growth for Penguin continued but at a slower rate, while Random House ebook sales declined significantly year-on-year due to much lower sales for the Fifty Shades trilogy. Digital innovations included the launch of Bookscout, a dedicated app created for and with Facebook which enables sharing personalised reading recommendations among friends and online communities.

› Penguin Random House's authors won numerous major literary prizes around the world, including the 2013 Nobel Prize for Literature (Alice Munro); The National Book Award for Fiction in the US (James McBride's *The Good Lord Bird*); and an unprecedented four US Pulitzer Prizes.

› In self-publishing, Author Solutions performed well, growing significantly over 2012, and continuing to launch and plan for self-publishing imprints in conjunction with Penguin in such territories as India and South Africa.

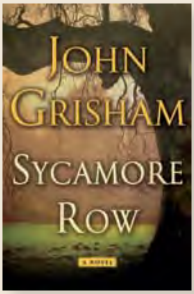
› For 2014, Penguin Random House has a strong publishing list with major new books from authors such as: Isabel Allende, Martin Amis, Lee Child, John Cleese, Harlan Coben, Steve Coogan, Lena Dunham, Janet Evanovich, Ken Follett, Stephen Fry, Robert Gates, Ina Garten, John Grisham, Deborah Harkness, Carl Hiaasen, Jan Karon, Sue Monk Kidd, Jeff Kinney, Michael Lewis, David Mitchell, Haruki Murakami, Jamie Oliver, James Patterson, Jodi Picoult, Nora Roberts, Danielle Steel, Colm Toibin, Jacqueline Wilson; and movie tie-in paperbacks of John Green's *The Fault in Our Stars;* Gillian Flynn's *Gone Girl;* and Laura Hillenbrand's *Unbroken.*

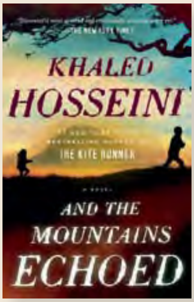
CASE STUDY

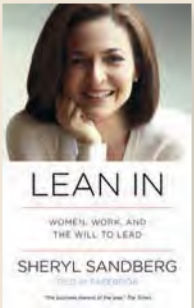
Bestsellers in 2013

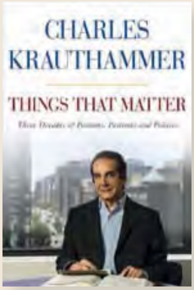
In the US, on a pro forma basis, Penguin and Random House published 480 *New York Times* bestsellers, including three out of the top five Bookscan adult fiction bestsellers for the year: Dan Brown's *Inferno,* John Grisham's *Sycamore Row* and Khaled Hosseini's *And The Mountains Echoed.* Other *New York Times* bestsellers included, in adult nonfiction: Sheryl Sandberg's *Lean in;* Charles Krauthammer's *Things That Matter;* and in children's fiction: John Green's #1 bestselling *The Fault in Our Stars.*

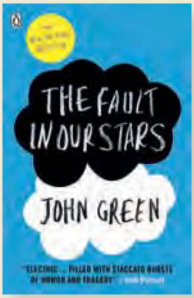
In the UK, on a pro forma basis, Penguin and Random House published 102 Bookscan bestsellers including: Dan Brown's *Inferno;* David Jason's *My Life;* Jamie Oliver's *Save with Jamie;* Rachel Joyce's *The Unlikely Pilgrimage of Harold Fry;* Helen Fielding's *Bridget Jones: Mad About the Boy;* and a strong ongoing overall performance from Jeff Kinney's *Diary of a Wimpy Kid* series, and from its newest volume *Hard Luck.*

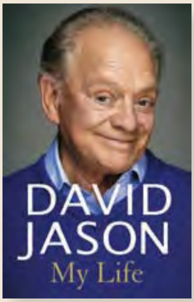


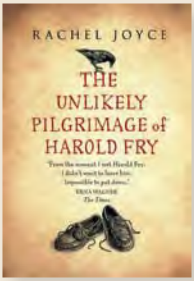


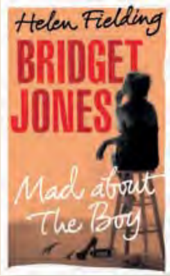


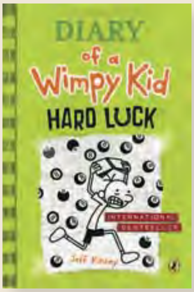


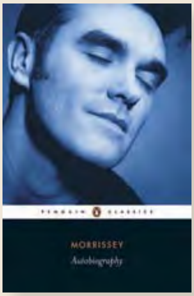












More and more people want a better education and new ways of learning

Other financial information

	2013 £m	2012 £m
Net finance costs		
Net interest payable	(72)	(65)
Finance income in respect of employee benefit plans	(3)	(2)
Other net finance costs	(1)	(29)
Total net finance costs	(76)	(96)

Net interest payable in 2013 was £72m, up from £65m in 2012. Although our fixed rate policy reduces the impact of changes in market interest rates, we were still able to benefit from low average US dollar and sterling interest rates during the year. Year-on-year, average three month LIBOR (weighted for the Group's net borrowings in US dollars and sterling at each year end) fell by 0.2% to 0.3%. This decrease in floating market interest rates was offset by an increase in the Group's average net debt which was the main driver behind the Group's higher interest charge. These factors combined with lower levels of cash and deposits and the impact of new notes issued in 2013 created a decrease in the Group's average net interest payable from 7.0% to 4.8%. The Group's average net debt rose by £561m, largely reflecting acquisition activity, cash costs relating to the formation of Penguin Random House (PRH) and cash paid in respect of the closure of Pearson in Practice in 2012 together with an increase in tax and dividend payments which more than offset cash generated from operations. Cash generated from operations was lower in 2013 partly as a result of restructuring activity in the year.

Net finance costs relating to post-retirement plans have been restated to reflect the adoption of IAS 19 (revised) and under the new standard was £3m in 2013 compared to £2m in 2012. Finance costs relating to retirement benefits have been excluded from our adjusted earnings as we believe the new presentation does not reflect the economic substance of the underlying assets and liabilities.

Also included in the statutory definition of net finance costs are finance costs on put options and deferred consideration associated with acquisitions, foreign exchange and other gains and losses. Finance costs for put options and deferred consideration are excluded from adjusted earnings as they relate to future earn outs and similar payments on acquisitions and therefore do not reflect cash expended. Foreign exchange and other gains and losses are excluded from adjusted earnings as they represent short-term fluctuations in market value and are subject to significant volatility. These other gains and losses may not be realised in due course as it is normally the intention to hold the related instruments to maturity. In 2013, the total of these items excluded from adjusted earnings was a loss of £1m compared to a loss of £29m in 2012. The majority of the loss in 2012 relates to movements in the valuation of put options associated with acquisitions. In 2013 losses relating to put options were largely offset by foreign exchange gains on a proportion of unhedged US dollar assets.

Funding position and liquid resources

The Group finances its operations by a mixture of cash flows from operations, short-term borrowings from banks and commercial paper markets, and longer-term loans from banks and capital markets. Our objective is to secure continuity of funding at a reasonable cost from diverse sources and with varying maturities. The Group does not use off-balance sheet special purpose entities as a source of liquidity or for any other financing purposes. The net debt position of the Group is set out below.

	2013 £m	2012 £m
Cash and cash equivalents	729	1,062
Marketable securities	6	6
Net derivative assets	76	178
Bonds	(2,168)	(2,200)
Bank loans and overdrafts	(47)	(55)
Finance leases	(11)	(17)
Net debt – continuing	(1,415)	(1,026)
Net cash classified as held for sale	36	108
Total net debt	(1,379)	(918)

Acquisition activity, cash costs relating to the formation of PRH and cash paid in respect of the closure of Pearson in Practice in 2012 together with an increase in tax and dividend payments and lower than expected cash generation in 2013 are the largest contributors to the increase in the Group's net debt. Reflecting the geographical and currency split of our business, a large proportion of our debt is denominated in US dollars (see note 19 for our policy). The strengthening of sterling against the US dollar during 2013 (from $1.63 to $1.66:£1) decreases the sterling equivalent value of our reported net debt.

Other financial information
continued

The Group's credit ratings remained unchanged during the year. The long-term ratings are Baa1 from Moody's and BBB+ from Standard & Poor's, and the short-term ratings are P2 and A2 respectively. In January 2014, Moody's changed the outlook on their short-term and long-term ratings from 'Stable' to 'Negative'. In May 2013, the Group accessed the capital markets, raising $500m through the sale of notes maturing in May 2023 and bearing interest at 3.25%. The notes were swapped to floating rate to conform with the policy described in note 19. The Group has a $1,750m committed revolving credit facility which matures in November 2015. At 31 December 2013 this facility was undrawn. The facility is used for short-term drawings and providing refinancing capabilities, including acting as a back-up for our US commercial paper programme. This programme is primarily used to finance our US working capital requirements, in particular our US educational businesses which have a peak borrowing requirement in June. At 31 December 2013, no commercial paper was outstanding. The Group also maintains other committed and uncommitted facilities to finance short-term working capital requirements in the ordinary course of business. Further details of the Group's approach to the management of financial risks are set out in note 19 to the financial statements.

Taxation

The effective tax rate on adjusted earnings in 2013 was 14.6% as compared to an effective rate of 23.1% in 2012. The reduction in the rate is partly explained by the associate accounting treatment of our investment in PRH – tax on the profits of PRH are netted against profits in the presentation of the associate interest and is not included in the tax line. Our overseas profits, which arise mainly in the US, are largely subject to tax at higher rates than that in the UK (which had an effective statutory rate of 23.25% in 2013 and 24.5% in 2012). These higher tax rates were largely offset by amortisation-related tax deductions and by adjustments arising from settlements with tax authorities. The reported tax charge on a statutory basis was £87m (22.8%) compared to a charge of £138m (35.3%) in 2012. The decrease in the statutory rate is due to the factors affecting the adjusted rate as described above but is also exacerbated by the lack of tax relief in 2012 on the loss on closure of Pearson in Practice. Tax paid in 2013 was £246m compared to £65m in 2012. Tax paid in 2012 was unusually low as a result of the permitted deferral of US tax payments following Hurricane Sandy. These payments were subsequently made in 2013 and were accompanied by additional payments arising from settlements with tax authorities including £55m relating to prior year disposals.

Discontinued operations

In October 2012, Pearson and Bertelsmann announced an agreement to create a new consumer publishing business by combining Penguin and Random House. The transaction completed on 1 July 2013 and resulted in a gain on the disposal of the Penguin assets of £202m. The gain arises as Pearson no longer has control of the Penguin Group of companies. The 47% interest in the new Penguin Random House (PRH) venture has been accounted for as an equity investment from 1 July 2013.

The loss of control resulted in the Penguin business being classified as held for sale on the Pearson balance sheet at 31 December 2012 and the results for both 2012 and the first six months of 2013 have been included in discontinued operations. The share of profit from associate interest in the PRH venture arising in the second half of the year has been included in operating profit in continuing operations net of tax of £23m.

Additionally on 29 November 2013 we announced the sale on the Mergermarket Group to BC Partners. The sale was completed on 4 February 2014 and the Mergermarket business has been classified as held for sale on the balance sheet at 31 December 2013. The results for both 2012 and 2013 have been included in discontinued operations.

Non-controlling interest

There are non-controlling interests in the Group's businesses in the US, South Africa and China although none of these are material to the Group numbers. Some of the minorities in South Africa and the minorities in India were bought out in the year.

Other comprehensive income

Included in other comprehensive income are the net exchange differences on translation of foreign operations. The net loss on translation of £217m in 2013 compares to a loss in 2012 of £238m and is principally due to movements in the US dollar. A significant proportion of the Group's operations is based in the US and the US dollar weakened slightly in 2013 from an opening rate of £1:$1.63 to a closing rate at the end of 2013 of £1:$1.66. At the end of 2012 the US dollar had also weakened in comparison to the opening rate moving from £1:$1.55 to £1:$1.63.

Also included in other comprehensive income in 2013 is an actuarial gain of £79m in relation to post retirement plans. This gain arises from changes in the assumptions used to value the liabilities and from returns on plan assets that are in excess of the discount rate. The gain compares to an actuarial loss for 2012 of £103m.

Dividends

The dividend accounted for in our 2013 financial statements totalling £372m represents the final dividend in respect of 2012 (30.0p) and the interim dividend for 2013 (16.0p). We are proposing a final dividend for 2013 of 32.0p, bringing the total paid and payable in respect of 2013 to 48.0p, a 7% increase on 2012. This final 2013 dividend which was approved by the board in February 2014, is subject to approval at the forthcoming AGM and will be charged against 2014 profits. For 2013, the dividend is covered 1.5 times by adjusted earnings.

We seek to maintain a balance between the requirements of our shareholders for a rising stream of dividend income and the reinvestment opportunities which we identify around the Group and through acquisitions. The board expects to raise the dividend above inflation, more in line with earnings growth, thereby maintaining dividend cover at around two times earnings in the long term.

Pensions

Pearson operates a variety of pension plans. Our UK group plan has by far the largest defined benefit section. We have some smaller defined benefit sections in the US and Canada but, outside the UK, most of our companies operate defined contribution plans.

The charge to profit in respect of worldwide pensions and retirement benefits after restating 2012 figures for IAS 19 (revised) and including discontinued operations amounted to £104m in 2013 (2012: £114m) of which a charge of £101m (2012: £112m) was reported in adjusted operating profit and £3m (2012: £2m) was reported against other net finance costs.

The overall deficit on the UK group plan of £19m at the end of 2012 has become a surplus of £86m at the end of 2013. The movement has arisen principally due to favourable asset returns and deficit funding. In total, our worldwide deficit in respect of pensions and other post retirement benefits fell from a deficit of £172m at the end of 2012 to a net deficit of £56m at the end of 2013.

Acquisitions and disposals

During the year the Group purchased a 5% interest in NOOK Media for $89.5m. The Nook investment was made as part of the strategy to accelerate our move into digital content and personalised learning and was made at the same time as entering into a commercial arrangement to work together on device-agnostic platforms.

Also in the year we have completed the purchase of remaining minorities interests in some of our South African and Indian businesses.

The acquisition of Grupo Multi for £492m, announced in December 2013, completed in February 2014 and has not been reflected in the financial statements at 31 December 2013.

In the first half of the year the FT Group disposed of its associate interest in BDFM, the South African Business Media Group realising a small loss and in July 2013 the International business disposed of its Japanese school and local publishing assets via a management buy-out for a nominal sum. The sale of Mergermarket will be accounted for in 2014.

Net cash consideration for all acquisitions made in the year ended 31 December 2013 was £198m including the investment in NOOK and provisional goodwill recognised was £19m. In total, acquisitions completed in the year contributed an additional £15m of sales but did not contribute a material amount to operating profit.

Return on invested capital (ROIC)

Our ROIC is calculated as total adjusted operating profit less cash tax, expressed as a percentage of average gross invested capital. ROIC fell in 2013 to 5.4% from 9.1% in 2012. Reduced profit and increased tax payments are the main reasons for the movement.

Related party transactions

Transactions with related parties are shown in note 37 of the financial statements.

Post-balance sheet events

On 4 February 2014 the Group completed the sale of Mergermarket for £382m. On 11 February 2014, we acquired 100% of Grupo Multi, the leading adult English language training company in Brazil for approximately £435m in cash plus the assumption of £57m of debt.